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Do Lessons from Argentina Apply to Greece?

Latin American economies often serve as a guide to understand crisis & recessions and resolving the same. Within Latin American economies, Argentina has a notorious track record of an economy which keeps surprising markets by its inherent crisis-oriented policies. Economists joke that if there is a crisis in any part of the world watch out Argentina as it could be impacted as well!

Economists have been suggesting that Greece and other European economies can take some lessons from Argentina. Argentina had a fixed exchange rate prior to its 2001 crisis and was seen as a major stumbling block in the 2001 crisis. As Argentina could not devalue immediately following the crisis, it prolonged the crisis. The situation only eased after the board was abandoned and Argentina allowed Peso to float and depreciate. The same is suggested for Greece (and other EU troubled economies) to abandon Euro and go back to their own currency.

This paper reviews the evidence and compares the Argentine economy to Greece. It looks at lessons from Argentina's crisis and whether they can be applied to Greece and other troubled EMU economies as well.

I. Background on Argentina Crisis 2001

Argentina had a crisis in late 1980s with growth declining by 7% in 1989. The crisis was mainly because of very high inflation averaging nearly 570% in the 1980s decade. Inflation touch 3079% in 1989. To counter high inflation and loose monetary policies, Argentina established a currency board. In a currency board, the local currency is pegged to the targeted currency (in Argentina case US Dollar) in a predetermined ratio. The Board promises to exchange the local currency with the foreign currency in the ratio at all times and to honor this maintains a forex reserve fund. In Argentina's case the exchange rate was fixed at 1 peso equal to 1 US Dollar. Hence, at any given point of time the citizens could exchange the local pesos for US Dollars.

This arrangement helps keep inflation in check as money supply in the economy is equal to forex reserves. The reserves are also invested strictly in safe assets of targeted currency. One major reason for continuous high inflation in Argentina was its central bank pursuing highly loose policies with money supply being much higher than nominal growth. The central bank was also seen as under continuous pressure from the government to keep printing money and buying government debt. This was all inflationary in nature. A currency board was seen as a credible solution to the incessant inflationary policies of Argentina.

The board functioned well for initial years as inflation came down to touch 4% by 1994 and averaged a low of around 1.5% in the period 1994-2001. Given this initial success, the currency board started to compromise the principles after a few years. The government could not cut down on expenditures and deficits started to rise. What is worse is that the currency board started buying debt of the government as it did earlier leading to compromise of basic principles of the currency board. Economists later said it was not really a currency board at all. Apart from financing government debt, the board also acted as lender of last resort and regulated commercial banks, both of which are not to be done by the board as it again leads to excessive money supply.

The higher deficits & debt levels along with rampant corruption sowed the seeds for the huge crisis in 2001. Most of the deficit financing was via issuing bonds in foreign currency as domestic private

savings were low. This took place despite large inflows of income from the privatization of formerly state-owned companies indicating the largeness of the deficits.

Apart from this Latin American economies like Brazil and Mexico faced economic crisis in 1999 leading to concerns over Argentine economy. As Argentina was a leading tarde partner with both these economies and faced crisis in the past, investors feared Argentina would follow suit as well. The pegging of currency to USD did not help either as currencies of Brazil and Mexico depreciated but Argentina's could not because of the board arrangement. Hence, Peso became overvalued relative to other currencies leading to further widening of current account deficit.

A poor macroeconomic outlook along with crisis in other Latin American economies finally led to a severe crisis in Argentina as well. There were attempts to maintain the currency peg but was finally broken under huge pressure in Jan 2002. The crisis was far severe than anyone imagined leading to huge distress in the country. The devalued currency and credible policies finally helped restore the economy. The higher growth in global economy during the period also helped as it led to demand for Argentina's natural resources.

II. Argentina vs. Greece

In this report we will not discuss the causes of the Greece crisis as our previous reports have discussed the same (Greece Crisis – What are the Options? Jun-11). We instead focus on similarities and differences between the structure and policies of two economies. Let us see the similarities first:

- **Limited role for Central Bank and loss of monetary policy:** As Argentina adopted currency board, the role of central bank was to defend the peg and resulted in loss of monetary policy. Strictly speaking, Argentina did not follow the principles of currency board and did some central banking activities like lender of last resort etc. This led to erosion of credibility of the currency board institution.

  In Greece there was no such loss of credibility as it was part of European Monetary Union and gave up its central banking and monetary policy activities to European Central Bank. In a crisis, a central bank usually starts easing its policies and provides liquidity but this option was not available to both the economies. In Argentina's case, the board had to be abandoned but in Greece's case even this option is not available as joining Euro is a one way street. Neither can a country be asked to leave Euro nor can a country opt out of Euro itself.

- **Depreciation of currency:** In a crisis, currency usually depreciates serving as kind of automatic stabilizer. As currency depreciates, it leads to lower prices of exports and helps boost growth and employment. Another benefit of currency depreciation is that it boosts competiveness of an economy by lowering the relative prices to rest of the world. In a crisis, a country boosts its competitiveness by either lowering internal prices i.e. reducing wages, cutting costs, etc. or via external prices which is depreciation of the currency. Both Argentina and Greece did not have this currency advantage as Argentina had pegged its currency to US Dollar and Greece shared the common currency Euro as a member of the monetary union. As currency could not depreciate, the initial phases of the crisis forced both economies to reduce wages and cut costs, leading to wide discontent and unrest in the population. Argentina finally escaped from the situation by abandoning the currency board but similar option is not available for Greece.

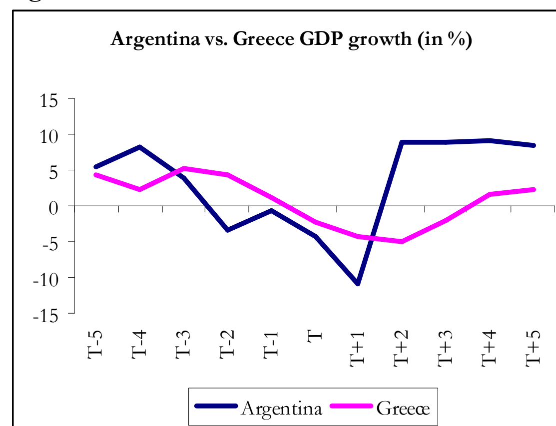
- **Twin Deficits:** Both countries had high fiscal and current account deficits also called as twin deficits in economic literature (read our report India in Twin Deficit Club – Implications and

Issues, Feb-11). In case of twin deficits, an economy needs both domestic savings and foreign savings to manage its deficits. In normal times both can be managed but in case of a shock, both the deficits exacerbate the crisis. During a crisis, the fiscal deficit widens as tax revenues decline and expenditures rise. There is also a case of outflows from the capital account widening the current account deficit further. In case of other countries, current account deficit position is managed relatively via the currency depreciation route but this option was not available either to Greece or Argentina.

- **Crisis struck post good years of growth:** In both Argentina and Greece, the crisis struck after a relatively good period of high growth. The phase of high growth made the policymakers complacent which ignored some obvious building risks in the system. Argentina reformed its economy after recession in late 1980s. Average growth between 1991 and 1998 was a healthy 5.9% inspite of growth declining to 2.8% in 1995 Mexican crisis. Growth rates started to slip in 1999 tracking crisis in Brazil and Mexico and then slumped sharply following the recession in 2001. In 2002 growth slipped sharply to -10.9% before recovering to 8.9% in 2003. Argentina clocked an average growth of 8.5% in 2003-08 when most thought it would again slip into a recession. Hence Argentina is often used as a reference to suggest that Greece can also grow after abandoning Euro.

  In Greece the decline in growth is much lower compared to Argentina which is surprising as Greece's indicators are far worse than Argentina at the eve of the crisis (discussed later in the report).

Figure 1



T indicates start of recession. In Argentina it is 2001 and in Greece it is 2009
Source: IMF

- **Non-adherence to policy rules:** Ultimately, both Greece and Argentina faced severe crisis as they did not stick to the policy rules. Argentina did not follow the rules of a currency board and Greece did not follow the rules specified under Stability and Growth Pact of the EMU. Both currency board and the common currency can only work if there is strict discipline in fiscal policy and in both these countries fiscal policy was highly irresponsible which sowed the seeds of the crisis.

- **Political logjam:** There was political logjam in Argentine crisis leading to multiple change of governments and multiple policies. This worsened the economic chaos. The situation is no better in Greece with continuous threats of resignations and formation new governments. The plight of Greece is even more as apart from its own government it has to deal with sixteen governments

of the monetary union. It is forced to take up fiscal austerity policies imposed by the union members but rejected by its electorate leading to a tough ropewalk for the government. Balancing these two interests has been a nightmare for both Greek and member country politicians.

The differences between the two economies are:

- **Greece economic indicators far worse than Argentina's:** Table 1 compares the key economic indicators in the two countries in their year of crisis. Greece has nearly double debt as % of GDP compared to Argentina and budget deficit is nearly two and a half times of Argentina average. Even current account deficit of Greece is nearly eleven times of Argentina.

Table 1: Argentina vs. Greece		
	Argentina – 2001	Greece - 2009
(% of GDP)		
Budget Deficit	-6.0	-15.0
Debt	53.69	127.1
Current Account Deficit	-1.41	-11.0
(in %)		
CPI Inflation	-1.06	1.35
Unemployment	19.2	9.38

  In terms of inflation both countries have low inflation with Argentina actually having slight deflation as even before its own recession in 2001, its growth rates had slipped on account of recession in Brazil and Mexico.

  Only in terms of unemployment Argentina fares worse than Greece. High unemployment was one puzzling aspect of Argentina as it grew smartly during 1991-98 but the unemployment remained very high averaging around 15% for the 1991-98 period and rising further to 22.5% in 2002 after the crisis.

- **EMU the savior of Greece:** From the first difference follows a question that how is it that despite such poor indicators for most of 2000s, Greece faced a crisis only so late in 2009? The situation gets even more absurd as even after the crisis, Greece has faced a much lower decline compared to Argentina. The reason is Greece is part of EMU which has strong economies like Germany and France as members and as a result Greece's dismal economic performance was ignored by markets. It was as if Greece had become like the German economy and as a result no alarms were raised till 2009 when Greece's fiscal deficit numbers were continually revised upwards.

  Greece continues to benefit from this membership with strong North European economies as markets believe it will be bailed out by the latter. Hence, for Greece the association with Euro cuts both ways. It is negative as it cannot make desired policy adjustments like depreciation of the currency and central bank's lender of last resort policies. It is positive as Greece has managed to avoid a crisis despite having much worse economic indicators. In a way, membership with EMU encouraged Greece to postpone much needed reforms.

Overall, there are both interesting similarities and differences between Argentina and Greece. The main similarity is the irresponsible policies were followed by both the countries. There were policy

rules in both the economies but were violated. The violation is more troublesome in the case of Greece as it was under a monetary union and the members should have exerted pressure on Greece to comply with the rules else penalize it. However, this pressure tactic was weakened as countries like Germany and France were the first violators of Stability and Growth pact (SGP) and threatened other countries if an action was taken against them. As a result the whole idea of SGP and keeping lower deficits and debt levels was abused by the most important members of the union.

III. Any Argentine lessons for Greece?

Economists are divided over whether Greece can exit from Euro and reinstate its original currency Drachma and restore competitiveness. There are undoubtedly economic advantages of having your own currency during a crisis but there are some key differences here.

First, Argentina always had pesos in circulation and abandoning the currency board and letting the currency depreciate was easier compared to Greece's situation. In Greece's case the situation is much more complicated as it gave up Drachma in 2001. There is no history with Drachma usage and an introduction of Drachma will lead to further chaos as firstly its value is likely to be unknown. It will lead to redoing the entire pricing structure in Greece which at such crisis times will only lead to more complexity. It will also mean rewriting various banking contracts with respect to retail deposits, wholesale deposits and above all liabilities to other European banks. The operational costs of switching to Drachma are huge to say the least.

Second, all Greek debt is in Euros and with Drachma likely to be hugely depreciated (after all that is the main purpose), it will only lead to much higher liabilities and indebtedness. Greece is already under severe debt and cannot afford upward pricing of its debt. Infact, it is looking at banks to take haircuts on the debt which is also the latest proposal floated by European Commission.

Third, as pointed above Greece has benefitted greatly from its membership with EMU. Its macroeconomic parameters are so weak that any exit from the union will only lead to further pain for the economy. The credibility will be lost and international investors will stay away from Greece for a long time.

Fourth, actually it is in the interests of EMU to ask Greece to exit from the union. But this is also unlikely to happen as first there is no such legal provision in the union. Second, Germany and French banks have taken large exposures to Greek sovereign debt making this whole crisis hugely interconnected at European level.

IV. Final Thoughts

The above analysis shows despite many similarities in Argentina and Greece there are some crucial differences as well. The economics of a country in a monetary union versus a standalone country with a pegged currency is very different. There are many interconnections and linkages in a monetary union making any exit a near impossible thing to do like it happened in Argentina. Hence, it is not really right to draw Argentine lessons for Greece. Infact, Greece clearly replaces Argentina from the position of a crisis reference country. The way Greece crisis has unfolded it will act as the reference for future crisis. It not just has all the ingredients of a perfect crisis recipe but has spiced up the ingredients many times over.

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