# Austerity Measures without Growth? Greece, Ireland and Latin America

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For several years before the global financial crisis, many advanced economies let government expenditures run well ahead of revenues. Moreover, after the crisis, fiscal policy provided major support in response to the deep downturn. Yet, countercyclical policies were not without a cost. The combination of a slump in economic activity and stimulus measures pushed fiscal deficits in advanced economies to about 10 percent of GDP. And debt-to-GDP ratios in some of these economies are expected to exceed 100 percent in 2011, some 40 percentage points of GDP higher than before the crisis.[2]

While the outlook for economic activity remains uncertain and the room for monetary policy maneuvers in many advanced economies has either been exhausted or has become much more limited, developed countries must return to a sustainable path in their fiscal stance. In Europe, the situation is more complex than in the U.S. because many sovereign governments are involved and policymakers have to deal with more immediate concerns: Greece and contagion to other economies.

However, even if fiscal consolidation is necessary, austerity without structural reforms is likely to slow growth further and will not suffice to bring down debt-to-GDP ratios. Although monetary and exchange rate policies are clearly beyond the control of individual European governments, the latter could focus on removing bottlenecks to growth, enhancing competitiveness and increasing efficiency. It is evident that authorities have reached the limits of macroeconomic policy tools and that in order to increase growth and return to sustainable fiscal paths they have to concentrate now on implementing structural policies.

Lessons from other countries strengthen this statement. Structural reforms were a crucial component of the Latin American strategy to exit the debt crisis of the 1980s. Furthermore, Ireland's reforms to improve productivity and restore growth are starting to deliver tangible benefits as it returned to positive growth in the first half of 2011.

The European fiscal crisis has been a serious source of concern for almost two years now. The initial causes of the fiscal crisis were narrowly focused on the issue of funding pressures for some countries, particularly Greece. However, contagion to other countries in the periphery spread swiftly and began to contaminate even core countries due to links between the sovereign debt crisis and the region's banking sector.

Three things are clear from this process:

1. In the case of Greece, the problem was initially characterized as one of liquidity rather than solvency both by the International Monetary Fund and the European authorities. This made sense in order to buy time, ring-fence other countries (especially Spain) and avoid widespread contagion.

2. The strategy failed mostly due to the perception that the authorities have consistently been "behind the curve." Policy implementation has been reactive to market stress and the dynamics between the political and economic dimensions of the problem seems to have further deteriorated. Recession fears in Europe have risen, exacerbated by widespread austerity

measures and the perception of an increasingly complex political decision-making process. It is becoming clear that the final problem is one of loss absorption—i.e., who pays for the losses accumulated so far and the losses that will be added until the problem is finally restored. The longer it takes to restore market confidence, the larger the losses and spillover effects to the rest of the world.

3. Additionally, growth-enhancing reforms that are so badly needed are virtually absent. Although the European leadership has rhetorically emphasized the issues of growth and competitiveness, in practice the programs put together so far have mostly focused on austerity measures and fiscal consolidation. Achieving competitiveness and growth in the context of a fixed exchange rate system requires more drastic structural measures and in most cases a painful "internal devaluation" process. The flip side to this is that austerity with no foreign exchange devaluation is almost always doomed to fail.

This last point is particularly important and can be illustrated with the two examples previously mentioned: the Latin American debt crises of the 1980s and Ireland.

Like developed countries today, Latin America also had to face public sector over-indebtedness. In the late 1970s, Latin American economies, like peripheral Europe in the 2000s, let government expenditures run well ahead of revenues. This situation, along with a rigid exchange rate regime, resulted in large fiscal and current account deficits. At that time, financial markets were buoyed by excess liquidity due to an influx of petro-dollars.

Initially in the late 1970s, while the global economy expanded and interest rates were relatively low, debt dynamics seemed to be sustainable. Latin America's growth rates exceeded interest rates. But much was explained by cyclical factors. Latin America's growth was mainly driven by public spending and debt resources were not being used for productive activities. While both private and public sector spending were rising, productivity was not. Once excess liquidity dried up, interest rates rose as anti-inflationary policies were put in place and the global economy decelerated. As a consequence, the unsustainability of Latin America's debt became evident. Growth stalled and Latin American countries had to endure a sudden reversal of capital flows.

In 1982, falling international oil prices, rising world interest rates, and massive capital outflows pushed external creditors to refuse to roll over Mexico's short-term debt, leading to the subsequent suspension of Mexican interest payments. Explosive inflationary and balance-of-payment difficulties ensued.[3]

In light of the current European debt problems, it is revealing to analyze how Latin American authorities faced the debt crises of the 1980s. They basically took three steps:

1. They engaged in fiscal adjustment through IMF Stand-by Programs;
2. They stimulated growth through structural reforms; and
3. They sought debt relief through the Brady Plan.

## Fiscal Adjustment

In the 1980s, the first response to the debt crisis was the implementation of IMF-sponsored stabilization programs—the so-called IMF Stand-By Programs. These conditioned additional access to international finance—loans from official institutions and refinancing of existing international bank lending—on a significant level of fiscal adjustment, tighter monetary policy and slimmer public sectors, including the privatization of state-owned enterprises. In my view, there was a clear understanding between the IMF, the U.S. Treasury and commercial banks that Latin America had to adjust without new money or debt restructuring.

The claim was that banks were in no position to recognize losses on sovereign lending.

The adjustment resulted in higher primary surpluses. But this response was not enough. Debt-to-GDP ratios continued to rise and creditworthiness deteriorated even further. Deep recessions were triggered by fiscal adjustments, while lower creditworthiness led to higher interest rates. Lasting primary surpluses were not sufficient to offset the negative effects on economic growth of continued capital outflows, deteriorating terms of trade and the upward pressure of higher default risks on interest rates. Large current account surpluses were needed to service debt. This led to exchange rate policies geared to promote exports, undermining the recovery of domestic markets and boosting inflation even with fiscal adjustment taking place. Indeed, it was through the devaluation-inflation policies that external transfers were realized. This is obviously not an option in the European case.

In order to contain the effects of its debt crisis, Greece is following today the same path Latin American countries did in the 1980s. The first step was fiscal adjustment. However, although Greece has already put in place a program for fiscal adjustment, it seems that it may not be able to accomplish such consolidation. The draft budget plan approved for 2012 shows that because, the Greek economy is expected to contract by 5.5 percent this year, the deficit is now seen at 8.5 percent of GDP (compared to a target of 7.6 percent in the EU/FMI program). Achieving a successful domestic adjustment without devaluating and going through a recession in the middle of a negative global environment is definitely a challenging task. Still, further adjustment is required.

## Growth Stimulus

Another important ingredient for solving the Latin American debt crisis was growth stimulus. Apart from fiscal and monetary adjustments, several countries initiated a far-reaching process of structural reforms that would eventually enhance growth. Throughout this period of macroeconomic turmoil, 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. Clearly, the real exchange rate depreciation helped, which is not an avenue open today to European countries. In addition, external demand conditions were favorable for export growth; this is also not the case today. Concentrating on the fundamental issues of economic policy underpinning a sustainable development process was as important as solving the debt overhang itself.

In the case of Europe, although policymakers are generally aware that debt sustainability is not achievable in the absence of economic growth, only timid steps in the direction of growth-enhancing policies have been taken so far. It is true that implementing structural reforms and austerity measures simultaneously may have been politically easier in the Latin America of the 1980s, where mostly authoritarian regimes were in place.[4]

## Debt Relief

The third step taken in Latin America was debt relief. Even with fiscal adjustment and reforms, by the mid-1980s it was apparent for several countries that their strategies had failed. Growth was absent and debt-to-GDP ratios were still increasing. In addition, international capital markets were not providing the resources needed to mitigate running reform program costs, despite the expected future benefits. Growth was barely enough to cover the transfer of resources to creditors, which itself was becoming a drag on growth.

In the late 1980s, U.S. Treasury Secretary Nicholas Brady sponsored a concerted debt reduction program—the Brady Plan. Countries that agreed to a new stabilization program sponsored by the IMF would become eligible for voluntary reduction of international bank debt. The U.S. Treasury allowed banks to offset future tax liabilities with loan

write-offs. Countries could then exchange existing loans for so-called Brady Bonds and negotiate the menu that best suited their needs—a reduction in the principal of the loan, a lower interest rate or an extension of the average loan maturity.

In 1988, Mexico was the first country to negotiate. In net-present-value terms, it obtained a 35 percent reduction on its external public sector bank debt.[5] At the time Mexico announced its Brady Plan, the secondary market yield on its external debt plunged and the exchange rate stabilized thanks to lower default risk. The combination of fiscal adjustment and debt reduction allowed the country to regain creditworthiness. In addition, these policies enabled the government to anchor inflation, which had been running above 100 percent, and to resume economic growth.

Debt relief in a context where fiscal adjustment was already undertaken was what provided the possibility of success to the disinflation program that was put in place at the time and what, in combination with a credible structural reform program, set the stage for higher growth in the ensuing years.

The so-called "Brady Plan" for Greece is, in my view, premature and misplaced. As explained, the Brady Plan worked in Latin America because fiscal adjustment and structural reforms had already been put in place, which is certainly not the case in Greece. Substantial debt write-offs may be needed, (which is not the case in the current version of the so called "Brady Plan") but they will not by themselves restore growth and competitiveness.[6]

In this respect, it is worth analyzing the Irish case. In Ireland, reforms to improve efficiency and enhance growth are starting to deliver tangible benefits. Even if there are downside risks to growth due to the stress in European sovereign debt markets, recent data are consistent with a return to positive growth in 2011.[7] Actually, while strong implementation of the IMF program has continued with fiscal consolidation on track to meet the 2011 target, the economy is growing at an annualized pace of 7 percent in the first half of the year. The main stimulus comes from exports; however there are also encouraging developments on the domestic side: fixed investment spending and consumption are both growing.[8]

There are two underlying advantages that the Irish economy has compared to the other periphery countries. The first one is strong productivity growth, which the economy's growth ultimately depends on. From 1990 to 2010, Ireland has managed to maintain an average annual growth rate of 3.2 percent on its labor productivity; much higher than the 1.6 percent observed in Greece, the 0.7 percent of Italy, the 2.3 percent of Portugal or the 1.3 percent of Spain. As a result of this, GDP per hour worked in Ireland was almost twice (1.8x) the GDP per hour worked in Greece in 2010.

Also, competitiveness in Ireland is improving. Since 2000, rising labor costs eroded competitiveness. However, unit labor costs have fallen (reflecting efficiency gains) by around 8 percent since the peak observed in 2007 and by 11 percent relative to the euro area average in that time.[9]

The second advantage for Ireland is its rapid foreign direct investment (FDI) growth. From 1990 to 2010, FDI inflows to Ireland registered an average annual growth rate of 20.6 percent, more than three times the average annual growth rate of the European Union[10] (5.6 percent), and more than 10 times the growth rate of the GIPS (Greece, 1.3 percent; Italy, 2.0 percent; Portugal, -2.2 percent and Spain, 2.1 percent). In addition, as a percentage of GDP, in 2010, FDI inflows in Ireland were 12.9 percent compared to 0.7 percent in Greece, 0.5 percent in Italy, 0.6 percent in Portugal and 1.5 percent in Spain.[11]

Ireland's success in attracting FDI has required an increasing focus on research and development support, and on improving workers skills. Furthermore, Ireland became more attractive for investors within the EU by establishing a low corporate tax rate. This encouraged multinational companies to establish their European offices in Ireland and thus book their profits there.

What is missing in the European periphery? Apart from the fundamental issue of policy coordination on the fiscal front and persistent fiscal consolidation, the Latin American and Irish cases prove that growth enhancing reforms are crucial for solving the European debt crisis.

Fiscal adjustment is a clear necessity, but just as important is setting the stage for renewed economic growth. Today like in the 1980s, reforms to reduce uncertainties and stimulate growth are of the essence. The package approved on July 21 has bought Greece some time, but the key problem remains unsolved: how will Greece reduce its debt burden without being able to engage in faster economic growth?[12]

There is an urgent need to transform the Greek economy into a more productive and competitive one, especially by reducing the high tax burden on labor which discourages hiring, making the judicial system more efficient and removing barriers to growth in specific sectors.[13]

In the short term, Europe has to deal with a host of issues that include: the Greek program; the issue of contagion, particularly in Italy—a country that is clearly too big to deal with if it loses market access; and the problems of the banking system, which range from signs of systemic funding strains in the interbank market to questions about the capitalization needs if inter-European claims are valued at market prices. Then again, there are also medium-term fundamental issues to solve, like reshaping the institutional framework to foster further integration with a coordinated fiscal approach and a push for structural measures that could enhance Greece and Europe's growth potential. Room for policy maneuvers has either been exhausted or is much more limited than before the crisis and fiscal sustainability cannot be achieved in the absence of renewed economic growth. Macroeconomic policy tools have their limits. It is now the time to focus on implementing structural policies.

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## Endnotes

[1] This paper is based on the material prepared for the conference "What Can the Developed World Learn from the Latin American Debt and Mexican Peso Crisis?" presented in the 53rd annual meeting of the National Association for Business Economics on September 12, 2011. I am grateful to Dolores Palacios for her expert assistance.

[2] According to Cecchetti, Mohanty and Zampolini (2010), if governments do not make substantial fiscal policy changes, debts worldwide will soar by 2020, going above 300 percent in Japan, 200 percent in the U.K. and 150 percent in Belgium, France, Ireland, Greece, Italy and the U.S.

[3] See Wijnbergen, King and Portes (1991).

[4] Even so, not all growth policies were implemented in a timely manner or with enough depth.

[5] See Wijnbergen, King and Portes (1991).

[6] The PSI initiative was clearly a political mistake, the NVP obtained by Greece (nominally 21%) was clearly insufficient, to the point that just a few months later it is being reopened. Debt relief may

be essential, but it should be conditioned to the undertaken of structural measures.

[7] See IMF (2011b).

[8] See Global Data Watch, September 23rd 2011.

[9] See IMF (2011a).

[10] EU15 until end 2003, EU25 in 2004-2006, EU27 as from 2007. European Union includes data reported to Eurostat. Source: Most recent FDI Statistics for OECD and G20 countries, updated on 13 July 2011.

[11] Most recent FDI Statistics for OECD and G20 countries, updated on 13 July 2011.

[12] The last Troika report on Greek debt revised down growth prospects; a longer and more severe recession is now assumed for 2011 and 2012, with positive growth returning until 2013.

[13] See IMF (2011c).