# Addressing the Eurozone Crisis: Lessons from Latin America

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The countries in the periphery of Europe are facing what looks like a traditional Latin American macroeconomic crisis. All the ingredients are there: recessions that in some cases have turned into economic depressions; large fiscal deficits which are leading to increases in the debt levels and are starting to pose a threat to sovereign solvency; large current account deficits which usually reflects a loss of external competitiveness and overvalued currencies; and problems in the banking systems due to the rise in funding costs and in the stock of nonperforming loans.

What are the policy alternatives to get out of the current crisis in Europe? The focus so far has been on reducing the debt burden and the approach has emphasized efforts to improve the fiscal accounts either through cuts in expenditures and/or increases in taxes. Never mind that these adjustments have been taking place in the midst of one of the worse economic recessions that the region has experienced, and that countries such as Greece, Portugal and Spain are facing the risk of an economic depression.

These countries face a combination of lack of external competitiveness which is associated with large current account deficits, low rates of growth, and very high and increasing rates of unemployment, which in Spain and Greece exceed 20 percent, and very high long-term interest rates that are a reflection of the concerns about their inability to continue to service the debt and a possible debt restructuring.

Latin America provides what is perhaps the richest laboratory of macroeconomic crises as they have come in all variety and sizes. Examples include the debt crises of the early 1980s in which the three largest economies of the region—Mexico, Brazil and Argentina—restructured their sovereign debts, which at that time were mainly with commercial banks. In the 1990s, the Mexican devaluation of 1994—the so-called Tequila effect—started a series of attacks on the currencies that quickly expanded to East Asia (1997) and Russia (1998) before returning to the region to Brazil (1999) and then to Argentina and Uruguay (2002).

The Argentine experience of 2001 is perhaps the one that resembles most closely the current policy dilemmas faced by the peripheral countries of Europe. Argentina had a fixed exchange rate set by the so-called convertibility law, which had removed the possibility of using devaluation as a policy instrument to address domestic or external imbalances. It was experiencing twin deficits in the fiscal and the current accounts, public debt was rising and most of it was denominated in dollars, the currency became clearly overvalued once commodity prices collapsed (especially soybean which is the main export), the dollar strengthened in the word markets and international interest rates rose as the U.S. tightened monetary policy.

Argentina for almost two years tried the austerity approach in its efforts to restore a deteriorating fiscal situation that was threatening the perceived government's solvency and leading to skyrocketing levels of sovereign credit spreads. Argentina attempted to introduce further structural reforms, especially in the labor markets, to reduce labor costs and to restore external competitiveness.

In the end, the austerity-adjustment approach failed in the context of high rates of unemployment and a fixed exchange rate system. There were two problems. First, the efforts to restore fiscal solvency

that were effected through cuts in expenditures or increases in taxes failed because they ultimately made the recession worse and led to a vicious cycle in which tax revenues fell further, implying that the policies were ineffective in achieving improvement in the fiscal accounts. These policies finally backfired in Argentina as they did not restore solvency while unemployment increased. The second problem was that deflation and structural reforms were ineffective in achieving the much needed depreciation of the currency. They were not a substitute for devaluation. As a result, Argentina was forced to allow the currency to depreciate, and when it did it the exchange rate overshot quite dramatically from one to more than three pesos per U.S. dollar. This sharp move in the exchange rate was very traumatic for an economy that was highly dollarized, mainly because it had negative balance sheet effects and it led to widespread bankruptcies.

The trigger of the Argentine crisis was the run on the banks, as the bulk of the deposits were in dollars in a system where there was no lender of last resort. The central bank did not have sufficient dollars to cover deposits and there were not external lines to provide enough liquidity in an emergency.

The final effects are well known. The attempts to restore competitiveness through domestic deflation failed as they generated large costs in terms of unemployment. In the end, Argentina had its largest macroeconomic crisis ever which included default on public debt, maxi-devaluation of the currency, and a banking crisis in which all foreign currency deposits and loans were forcefully converted into pesos.

One important difference between Argentina and the countries in the periphery of Europe is that the latter have not experienced a run on the banks, mainly because they have a lender of last resort that has been providing liquidity. This support largely reduces the risk of a banking crisis, but the challenges for restoring growth, competitiveness and solvency are still an issue.

Is there an alternative to the austerity approach to correct macroeconomic imbalances? When one looks at the Latin American experience there are many cases in which countries in the region managed to improve their fiscal and current accounts simultaneously; however, in all those cases devaluation was an important part component of the policy response. In what follows, we look at three episodes that can help to illustrate the point: Mexico in 1994, Brazil in 1999 and Uruguay in 2002.

At the end of 1994, Mexico was forced to make a maxi-devaluation of its currency in order to correct a severe current account deficit of almost 6 percent of GDP and to try to stop a spiraling of domestic interest rates. Once it became apparent that the current account deficit was unsustainable, there were large capital outflows and the government faced significant difficulties to rollover the domestic debt, which was to a large extent held by foreign investors. There was a run on the currency and by December reserves had dropped to around $6 billion.

In Mexico, the devaluation was a central part of the adjustment package. On the one hand, it definitely helped to stop the capital outflows, perhaps with some degree of overshooting as the exchange rate moved from 3.4 to 7.6 pesos per U.S. dollar between December 1994 and December 1995. By the end of 1995, international reserves had recovered to more than $15 billion, a remarkable turnaround. In addition, the current account improved dramatically as the deficit in 1995 dropped to just 0.5 percent of GDP.

The devaluation was also instrumental in correcting some of the domestic imbalances. In particular, it helped to improve the fiscal accounts; in fact, the primary surplus increased from 1.7 in 1994 to 4 percent of GDP the following year. The devaluation helped by increasing tax revenues through two mechanisms: first, there was a direct effect that raised the value in domestic currency in terms of those revenues linked to exports (namely oil taxes). Second, there was also an indirect effect that took place through an induced increase in the price level that had a positive effect on indirect tax revenues. This was supported by a stricter control on domestic government expenditures in pesos

and in wage increases that helped to reduced primary expenditures as a share of GDP.

The devaluation in Mexico had the typical expenditure reduction and expenditure switching effects. The real depreciation of the currency was reflected in a reduction in real wages, which dropped by almost 20 percent between 1994 and 1996. The figures indicate that the increase in inflation in the aftermath of the devaluation to 52 percent in 1995 and 27 percent in 1996, but it was mainly temporary. It then continued to drop and relatively quickly returned to the historical levels (which were obviously high by international standards). The interpretation of these events is that it was in effect an increase in the price level that was helpful to correct some of the macroeconomic imbalance (namely it eroded the peso denominated debt as well as real wages).

Although the economy suffered a severe recession in 1995 (when GDP drop by 6.2 percent), the economy recovered quite rapidly as it grew by 5 and 7 percent respectively in 1996 and 1997. This new growth was much more balanced, as the fiscal accounts had improved significantly, the current account deficit had dropped to manageable levels (1.6 percent of GDP) while international reserves were again on the rise. The government was able to avoid a restructuring of the domestic debt (which was under severe pressure in 1994) to a large extent thanks to the external assistance that the country received from the International Monetary Fund and U.S. Treasury, which at the time was quite controversial as there were concerns about moral hazard.

The 1999 devaluation in Brazil took place to address a run on the currency in an environment where there was a large current account deficit. The country had been facing pressures on the currency that were leading to persistent losses in international reserves. The rise in domestic interest rates were leading to perverse debt dynamics in which high short-term interest rates and high costs of debt caused larger fiscal deficits and further increases in domestic debt. While the current account was showing a deficit of 3.9 percent of GDP, the main problem was the spiraling growth of domestic debt.

The devaluation in Brazil took place in January 1999, as the real-dollar exchange rate moved from 1.2 to 2.07. In contrast to the Mexican case, inflation did almost did not rise, though it still helped to improve the fiscal primary balance (from 0.3 to 2.4 percent of GDP) and to reduce real wages and to improve competitiveness.

This devaluation did not help the current account, which only showed clear signs of improvement in response to additional depreciations of the currency that took place in 2001 and 2002. This second round of depreciations was more effective in reducing real wages but they still had a relatively small effect on inflation.

In the case of Uruguay, the country in 2002 was facing severe pressures on the currency and losses in international reserves, which were partly due to a contagion effect from the Argentine crisis. In addition to capital outflows, Uruguay had large current account and fiscal deficits, and the country was on the verge of a full-blown macroeconomic crisis.

Uruguay, in contrast to Argentina, received significant financial support from the multilateral organizations and the U.S. Treasury, perhaps because these institutions wanted to avoid another mega crisis. The bottom line, however, is that the combination of external support and depreciation of the currency were critical for the macroeconomic adjustment.

The adjustment in Uruguay was successful by almost any standard. By 2004, two years after the devaluation, the country was growing at 4.6 percent (GDP was contracting before), the current account had improved by more than two percentage points of GDP, and the country managed to generate a primary fiscal surplus of 3.8 percent of GDP compared with a deficit of 1 percent of GDP in 2001. The maxi-devaluation in Uruguay had a very small impact on inflation, which after rising to 26 percent in 2002

(when the currency depreciated by 96 percent), it moved back very quickly to the 5-7 percent range.

What are the lessons from the Latin American experiences? The most important lesson is that macroeconomic adjustment required a real depreciation of the currency, which in the end had to be achieved through devaluation as opposed to a fall in domestic prices and wages. The so-called internal adjustment failed and the devaluation worked in several ways. First, it facilitated the fiscal adjustment mainly because there was a path through to domestic prices that helped to increase tax revenues. These effects were larger in countries in which there was a high elasticity of tax revenues to the exchange rate (e.g. in Mexico where taxes on oil exports were important).

A second effect of the devaluation-inflation package was that it helped to erode the real value of the domestic currency debt (it fell as a share of GDP) as well as to improve the competitiveness of the tradable sector by reducing real wages. Workers that were unwilling to accept reductions in nominal wages ended up tolerating a dropped in real wages as they were not able to be obtain nominal wage increases to compensate the rise in domestic prices. The exchange rate and its pass through effect on inflation appear to be still today the best option to deal with the downward rigidities of nominal wages and some prices.

What are the implications for the periphery of Europe? Those countries do not have the option of relying on a devaluation to improve the fiscal and current account balances, to reduce real wages or to erode the real value of their debts, as none of them have their own currency. The so-called internal adjustment approach has made very little progress and is likely to lead to adjustment fatigue and political unrest before it achieves any meaningful changes in relative prices.

Experience indicates that the current approach based only on austerity is bound to fail, and hence Europe will need to look for alternative options. One alternative would be to allow the common currency, the euro, to depreciate in order to induce a rise in domestic prices, but at the moment this approach does not seem to be an option either. The main problem is that the European Central Bank continues to be concerned about inflation although many countries in the periphery are facing the risk of entering an economic depression.

A second and related possibility is a more expansionary monetary policy, along the lines of quantitative easing in the U.S. It would entail a further reduction in interest rates and a more aggressive increase in the monetary base that should include direct purchases of debt of the peripheral countries that can be considered solvent (Greece and perhaps Portugal would be the exceptions). With much lower long-term interest rates, the countries could get out of the perverse debt dynamics and gradually regain voluntary access to the markets. Equally important, it would allow most countries to maintain an expansionary fiscal bias as a countercyclical policy, removing some market pressures.

The European countries have an important advantage over the Latin American ones, namely that they use one of the world's reserve currencies and the region as a whole remains solvent. One obvious way to improve the situation would be to achieve more fiscal integration and transfer resources to the countries in the periphery. This requires some political consensus, which today does not seem to exist. Alternatively, the region could start pooling the credit worthiness of the strongest with the weakest countries and issue Eurobonds to help reduce the costs of financing to the weaker ones.

One needs to keep in mind though that restoring solvency is addressing only one part of the problem. Most European countries still face a lack of competitiveness due to high domestic prices and wages. Too much emphasis on fiscal adjustment and on the debt dynamics could be myopic and could mean a protracted period of low growth. The Latin American experience suggests that expenditure switching is just as important as expenditure reducing policies to restore balanced growth.

# TABLES

## Brazil

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| Devaluation (YoY) | 7.4% | 8.2% | 49.3% | 8.0% | 18.5% | 53.0% |
| Inflation (Dec/Dec) | 5.2% | 1.7% | 8.9% | 6.0% | 7.7% | 12.5% |
| Real GDP (YoY) | 3.4% | 0.0% | 0.3% | 4.3% | 1.3% | 2.7% |
| Primary Balance (% GDP) | n.a | 0.3% | 2.4% | 2.7% | 2.5% | 2.3% |
| Primary Expenditure (% GDP) | n.a | 31.1% | 29.2% | 29.9% | 31.3% | 32.4% |
| Domestic Public Debt (% GDP) | n.a | n.a | n.a | 49.9% | 54.1% | 57.4% |
| Reference Interest Rate | 40.9% | 29.0% | 19.0% | 15.8% | 19.0% | 25.0% |
| Real Wages (2001=100) | 135.0 | 141.4 | 134.1 | 131.4 | 100.0 | 94.7 |
| Current Account (% GDP) | -3.5% | -3.9% | -4.3% | -3.8% | -4.2% | -1.5% |
| International Reserves (USD Bn.) | 52.17 | 44.56 | 36.34 | 33.01 | 35.87 | 37.82 |

## Mexico

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|
| Devaluation (YoY) | 1.6% | -0.3% | 57.6% | 56.7% | 2.6% | 2.3% |
| Inflation (Dec/Dec) | 11.9% | 8.0% | 7.1% | 52.0% | 27.7% | 15.7% |
| Real GDP (YoY) | 3.6% | 2.5% | 4.8% | -6.2% | 5.5% | 7.2% |
| Primary Balance (% GDP) | 4.3% | 2.8% | 1.7% | 4.0% | 3.7% | 3.0% |
| Primary Expenditure (% GDP) | 15.6% | 16.3% | 17.0% | 15.7% | 16.1% | 16.8% |
| Domestic Public Debt (% GDP) | 11.6% | 11.0% | 7.3% | 7.1% | 7.1% | 8.1% |
| Reference Interest Rate | 24.5% | 12.5% | 26.4% | 51.4% | 28.6% | 20.1% |
| Real Wages (2001=100) | 99.4 | 103.8 | 108.2 | 94.5 | 85.2 | 84.7 |
| Current Account (% GDP) | -6.1% | -4.8% | -5.8% | -0.5% | -0.6% | -1.6% |
| International Reserves (USD Bn.) | 18.43 | 24.41 | 6.60 | 15.59 | 17.51 | 28.00 |

## Uruguay

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| Devaluation (YoY) | 7.7% | 11.2% | 93.5% | 6.7% | -8.1% | -8.6% |
| Inflation (Dec/Dec) | 5.0% | 3.6% | 26.0% | 10.2% | 7.6% | 4.9% |
| Real GDP (YoY) | -1.8% | -3.5% | -7.1% | 2.3% | 4.6% | 6.8% |
| Primary Balance (% GDP) | -1.1% | -1.0% | 0.2% | 3.1% | 3.8% | 3.7% |
| Primary Expenditure (% GDP) | 26.9% | 27.9% | 26.2% | 24.6% | 24.0% | 24.2% |
| Domestic Public Debt (% GDP) | 13.3% | 20.3% | 22.7% | 21.6% | 22.8% | 21.7% |
| Reference Interest Rate | 16.5% | 40.0% | 63.1% | 2.2% | 0.0% | 0.7% |
| Real Wages (2001=100) | 100.3 | 100.0 | 89.3 | 78.1 | 78.1 | 81.7 |
| Current Account (% GDP) | -2.5% | -2.4% | 2.9% | -0.7% | 0.0% | 0.2% |
| International Reserves (USD Bn.) | 2.82 | 3.10 | 0.77 | 2.09 | 2.51 | 3.08 |