Krugman's wrong analogy does help his point

By Domingo Cavallo

Paul Krugman's analysis about the euro and the European situation in his article in the New York Times "Can Europe be saved?" is spot on. Moreover, the scenarios he spells out are an excellent depiction of not only the options in front of policy makers, but most likely the realities we will live through over the next few years. Unfortunately, the analogy with Argentina 2001/2002 is wrong in terms of size, prospects and the world response. Not to mention the costs of pursuing a "Full Argentina". The fact that such analogy is wrong could in some sense help Krugman's argument and that of those that believe restructuring is the only option, given that the world thought so in the case of a much milder problem.

There are at least two very important differences in terms of the size of the problem. Argentina's debt/GDP ratio at the time of default was 44%, while that of Greece today is 128%, Ireland's since guaranteeing banks is 99%, Portugal's is 76%, etc. Argentina's primary fiscal deficit at the time of default was 0.5% and overall deficit less than 5%, while most EU countries are close or higher than 10% (Greece's deficit was 15.5% in 2009 and 9.4% in 2010; Ireland last year had a deficit of 12% of GDP plus the bank guarantees was 32.2%; while Portugal last year brought it down to 7.8% from 9.3%).

The international financial help picture is also drastically different. The total pledge by the IMF to Argentina in the run-up to default was about 8% of GDP (which did not get disbursed), while Greece received a package of about 67% of its GDP, and that of Ireland is almost 50% of GDP. The 3-year financing needs arithmetic for Portugal would produce a package of about 40% of its GDP. Private estimates of the potential need for Spain are about 40%. I can only dream of what could have happened if the international community would have just hinted at a package of those sizes in the case of Argentina 2001, or, less ambitiously, if the IMF had not decided to unplug Argentina in early December 2001 and continue disbursing the funds that had been committed in August.

Another difference, which can be touted as 'monday-morning-quarterbacking' is that of the growth prospects. A chart of the CRB Thomson-Jefferies commodities index shows its absolute bottom in October 2001, and a drastic and sustained recovery ever since (24% in the first 12 months of its recovery). The terms of trade improvement (well beyond anything the FX depreciation can achieve in real terms) explains a very significant percentage of Argentina's performance since defaulting and devaluing. Again, I can only dream about the alternative outcome had Argentina be given the chance to endure 6-9 more months under its previous institutional setup.

Finally, and more dangerously, Krugman fails to look at the cost of the strategy when he suggest that a “Full Argentina” outcome may be better than simply a “Restructuring” one. The example of Argentina shows that the strategy of default and devaluation implies tremendous economic and welfare costs for the population that endures them. Moreover, the institutional devastation that it produces ends up depressing confidence and productive investments for years.

An additional aspect to think about, which was not there for Argentina, is the impact on other EU countries. If, let’s say, Greece, Ireland and Portugal were pushed to restructure and devalue, what would Spanish depositors or debt holders do? Performing a “Full Argentina” in a set of EU countries would most likely produce a serious bank run in the countries perceived to be next in the domino.

Thus, the case of Argentina 2001 was milder and easier to fix, but we failed to do so. It is only natural to expect the same outcome for a much bigger problem. But still Europeans should fight hard to avoid the “Full Argentina” outcome.