The Financial Crisis in Europe: Lessons from Latin America

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The current Financial Crisis in Europe has the same origin as the Financial Crisis in the US: *excessive* leverage. In some countries it was excessive leverage of families and businesses. In other countries it was excessive leverage of governments. In most places, it was excessive leverage of the financial intermediaries. The US and Europe are economies of the same size. Taking Europe as an aggregate, Fiscal and Current Account deficits were, and still are, much bigger in the US than in Europe. In principle, if the US was able to find a solution, Europe should also be.

United States' Solution

In the US the Financial Crisis was alleviated with a huge increase in the balance sheet of the FED and a very large increase in budget deficits to recapitalize the banks and stimulate aggregate demand. This strategy worked because the demand for US treasuries and bonds did not collapse. On the contrary, in the worst moment of the crisis, when worries tuned into panic, the US treasuries and bonds rallied as a consequence of a phenomena that has been named "flight to quality".

The US is the provider of the reserve currency to the world and at the same time its financial obligations are a reservoir of financial trust, even at times when it's previous economic mismanagement and mistakes gave origin to a global crisis. It is precisely this privilege of the US economy that allows many American macroeconomist to argue that even when the origin of the crisis was excessive liquidity and fiscal expansion, the response to persisting unemployment and a weak recovery should be more liquidity and more fiscal stimulus.

In my opinion, even unlimited supply of liquidity and very large fiscal stimulus may not generate sustainable development in the US unless "animal spirits" revive and there are new technological breakthroughs. The Financial Crisis in the US could be solved just as it was solved in Japan after the burst of its real state bubble at the end of the eighties even if the economy stagnates for more than a decade. Latin America offers no relevant experience in regards to this kind of Financial Crisis, simply because no Latin American country has ever have a reserve currency and Latin

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American debt instruments have never been seen as reservoirs of trust. For the US' financial crisis and its possible solutions, the Japanese experience is much more relevant.

Solving the European Financial crisis

When Europe introduced the Euro in 1999, most of the political leaders, economists and bankers thought that the Euro would become a competitor to the Dollar as a reserve currency and that financial obligations denominated in Euros would be trusted as much as those of the US. What all of them overlooked is that those financial obligations, even if issued in Euros, were not European but national.

European bankers and economists overlooked the fact that individual country debts were not European debts. If bankers and economists, who should be better equipped than politicians to see the difference, had realized that each country was responsible for its own debt, then the interest rates applied to the debt of each individual country would not have converged as fast as they did. Consequently the availability of credit for the periphery of Europe would not have been as abundant as it was.

But the reality is that the countries in the periphery became excessively indebted to the point of not being able to repay. Just as in the United States the subprime mortgages became toxic assets of the banks, in Europe the debt of Greece and some other countries of the periphery have also become toxic assets.

Could Europe then apply some of the policies that are helping the US to cope with its crisis?

Europe could apply similar policies if the national debts were transformed into debts guaranteed by Europe as a whole and not by each individual country. In that case the ECB would be able to expand liquidity without limits and Europe could apply fiscal stimulus to recapitalize its banks and fuel aggregate demand, exactly as the US has done and seems to be prepared to continue doing.

European bankers, and lenders to Europe all over the world, would love this solution. But of course, political leaders and taxpayers of the European countries that are still solvent are not willing to absorb the losses generated by banker's misappraisal of risk.

If at the time of introducing the Euro, political leaders had created a political Union in Europe today Europe would be in the same situation than the US or, maybe not as bad because after all, the size of the toxic assets of their banks is smaller than those of the US.

Bankers and economist blame the politicians for not having created this political union prior to the monetary union. But12 years ago European Nations were not ready to resign fiscal sovereignty. Neither are they ready for that nowadays. The fact is that political union does not exist but still the crisis has to be coped with.

But if the “US approach” for Europe is not available, what is the solution for the European Financial Crisis? Traditional Euro-skeptics and many American mainstream macro-economists suggest a disintegration of the Euro and a recovery, at least for the countries of the periphery, of their national monetary sovereignty.

It is here were the Latin American Experience becomes relevant. In particular it is relevant the experience of Argentina in 2001 and that of Latin America as a whole in 1982.

The Argentinean experience of 2001 is the one that more closely resembles the problems that Greece is facing nowadays, although I must recognize from the very beginning that the current situation in Greece is much worse than that of Argentina in 2001.

The Latin American experience of 1982, that became to be known as the “Latin American Debt Crisis”, is the one that most likely would resemble the situation of many countries of Europe if they decided to replace the euro with national currencies.

Let’s start with the Argentinean experience and the advice Nouriel Roubini and others are giving to Greece these days.

Nouriel Roubini’s advice

Nouriel Roubini suggests Greece do exactly what Argentina did the last week of 2001 and the first week of 2002 in the middle of a political crisis that forced the resignation of the government that had won the election of 1999 and after several interim presidents, turn power to the candidate that had lost that election.

Greece, in his opinion, should default on its public debt, abandon the Euro and reintroduce the Drachma at par. Then it should let the Drachma be devalued as much as necessary to restore competitiveness and growth.

Of course he recognizes that such a decision would create terrible balance sheet problems to Greek banks and indebted Greek households and Corporations.

Therefore he suggests that Greece should transform its financial assets and liabilities, at least those created under Greek Law, from Euros into Drachmas. That way, the devaluation of the Drachma would also devalue debt obligations of both, the public and the private sectors.

He argues that that would benefit Greece, because it would immediately restore competitiveness and the economy would start growing immediately after. He uses the Argentinean experience to back his arguments.

I have just written a paper explaining that Nouriel Roubini's interpretation of facts in Argentina is completely wrong and that the consequences for Greece of adopting those decisions would be extremely costly, from every point of view.

Moreover, if Greece were follow that path, the markets would predict that Portugal, Ireland and even Italy and Spain will be forced to do the same, and Europe would find itself in a situation like that of Latin America in 1982, when the default of Mexican debt provoked large devaluations and defaults on several other Latin American Countries.

What followed in Latin America is well known: stagflation, hyperinflations and all the associated miseries of what was called the "lost decade".

The situation was reversed only after deep pro-growth market reforms, extensive fiscal consolidation and finally, the "Brady Plan" for the debt, starting in 1989. But in most of the countries it took almost 20 years of big and persistent efforts to leave all the vestiges of the financial crisis behind. And in those countries like Venezuela and Argentina that did not persist with the reforms, inflation is still a chronic problem.

What is the alternative?

Europeans should be alarmed but not despaired. There is a solution. And the solution is to move gradually toward fiscal integration.

The Institution the European have created to deal with the Financial crisis, the EFSF (European Financial Stability Fund), should allow for as much debt restructuring as necessary to put the indebted countries in a sustainable path.

Additionally, the EFSF should issue European Debt to finance the remaining fiscal deficits of those countries while they implement their respective fiscal consolidation and pro-growth plans. The first trench of the newly issued European debt should be lent to the countries that need to capture the debt discount that the markets are already revealing in order to bring their debt to a sustainable path. In the case of Greece, the new European debt to be issued would amount to half the outstanding Greek debt that would be retired.

The second trench of newly issued European Debt should be lent to the same countries to finance their remaining fiscal deficits, but conditioned to the timely execution of fiscal consolidation and pro-growth plans previously approved by a European Finance Minister. This means that only those countries would be resigning fiscal sovereignty.

The argument that is insistently made in Germany and other solvent nations that their people are not prepared to resign fiscal sovereignty would not stand in the way of this solution, because those countries would not be required to resign any of their sovereign powers.

The other argument that is made to oppose issuing of European debt is that such solution would put a heavy burden on the taxpayers of the well behaved countries. The counter argument is that the burden will be much higher if all these countries exit the Euro and disorderly default on their debts. The efforts that solvent Europe will have to make to recapitalize European banks and maintain the trust on their own economies would be much larger.