Greece, November 2011, in light of Argentinean Experience exactly ten years ago.

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Let me be very sincere upfront. Greece has been overspending during many years and excessive increases in labor costs have significantly reduced competiveness. As a Consequence two costly adjustments are inevitable, whatever the circumstances and whatever the government:

Greece needs to adjust down its domestic consumption, both, public and private.

Labor costs in productivity units should decline to increase profitability in the production of tradable goods.

To implement only one of the adjustments will not be enough

If you just do the first part of the adjustment, it may happen that as consumption goes down, employment and production also go down. If that happens, eliminating the current account deficit may take a very long time. That is why, some economists, particularly Americans, propose Greece to abandon the Euro, reintroduce the Drachma and let the New Drachma suffer a large devaluation.

They argue that the devaluation of the New Drachma will make the cut in spending unnecessary and a subsequent boost of exports will immediately reinitiate growth. They have been using Argentina after 2001 as an example of the supposedly beneficial effects of a large devaluation.

The experience of Argentina 2001 is relevant

I have heard some people arguing that comparing Greece today with Argentina in 2001 is inappropriate because Argentina, after 10 years of a Peso –Dollar pegging still conserved the Peso and, therefore, it was possible to devalue the local currency without having to change the outstanding financial contracts. That opinion overlooks the fact that in Argentina more than 90 % of financial transactions and contracts were denominated not in Pesos but in US dollars.

In practice Argentina in 2001 had the Dollar as its main currency the same way as Greece has the Euro. For Argentina to devalue the Peso as a solution to the crisis it was necessary first to transform all contracts written under Argentinean law from Dollars into Pesos and, simultaneously, to default all debt contracts written under foreign law. What happened in Argentina in the New Year Eve of 2002 was exactly what the proposers of a New Drachma are suggesting Greece should do. So the comparison between Greece 2011 and Argentina 2001 is, in this sense, correct.

But it is absolute incorrect to argue that the Argentinean “Pesofication” demonstrates that a “Drachmization” of the Greek economy would solve the crisis with less suffering off the people and better prospects for future growth than staying in the Euro Zone.

The impact effect of exiting the Dollar peg was extremely costly

In Argentina, the Devaluation of the Peso following the “Pesofication” was 66 %: that is, 1 Peso devalued from 1 Dollar to 33 cents of a Dollar, or to put it the other way around, the price of the Dollar jump up from 1Peso to 3 Pesos.

The impact of this devaluation was terrible: GDP declined an additional 5%, adding up to a 17 % decline for the four recession years, unemployment increased from 18 % in October 2001 to 24 % in May 2002, Exports declined in 2002 in comparison with 2001 and the inflation rate went up from 0 to 40 % the year of the devaluation. Real Wages and pensions declined 30 %.

Of course, the devaluation produced a very large fiscal adjustment, much larger than the one that would have been necessary if Argentina had preserved its monetary regime. That adjustment did not follow any priority setting or equity consideration but was simply the imposition of the jump in the prices of tradable goods that provoked a drastic reduction in the real value of the salaries of public employees and retirees. The reduction in the fiscal deficits, on a cash bases, came from the suspension of interest payments on the debt, but the interest arrears added up to the debt that would have to be renegotiated in the future.

But, how is that starting in 2003 Argentina enjoyed rapid growth?

If the devaluation had these very negative impact effects, how it is that since 2003 Argentina’s GDP has grown more than 60 % and unemployment has declined to 7 % in 2011?

The explanation is simple:

Argentina, in 2001, had a very large unutilized capacity in well capitalized energy, transport, agricultural and industrial sectors. During the years of the convertibility (1991-2001) after defeating hyperinflation the Argentinean government used the popular support it gained from its initial success to introduce pro-growth market reforms. The economy was opened up to foreign trade and investment, many professions that had been heavily protected by regulations were liberalized, the state owned companies were privatized after the organization of competitive markets and there was a complete elimination of taxes that had prevented investment and technological advance in the most productive sectors of the Argentine Economy: Agriculture and Agribusiness.

The recession that had started in 1999 was the result of external shocks that affected Argentine competitiveness in spite of the significant productivity increase her economy displayed in the previous years.

By 2001 the Dollar had became extremely strong and commodity prices were down to their lowest levels in a century. The interest rate set by the Fed was very high (it had reached 6 % in 2000), The Brazilian Real had suffered a large devaluation in early 1999 and the Euro had depreciated during 1999 to 2001 in relation to the Dollar. From 1.17 Dollars per Euro in January 1999, a Euro could be purchased with just 82 cents of a Dollar in the mid of 2001. As Brazil and Europe had been the main export markets for Argentina, all this events generated a recession that lasted four consecutive years.

There had been some fiscal excesses, particular those of the provinces that had financed their deficits borrowing from the local banks at floating rates. But, in general, Argentina had had a relatively low fiscal deficit (2 % on average but never higher than 5 % of GDP in a single year) and Public Debt was around 50% of GDP. Even though Argentina had had current account deficits as high as 5 % of GDP during the years of significant increase in foreign direct investment and large capital inflows, by 2001 recession had produced already a complete adjustment in the current account and the current account deficit was less than 1 % of GDP.

The fast growth of Argentina since 2003 was the result of drastic changes in the external situation: by mid 2002 the Dollar started to weaken, the interest rate set by the Fed was rapidly adjusted down and commodity prices boomed. Just to give an example, the price of soy, the main agriculture export of Argentina, jumped up from 120 dollars per ton to 600 dollars per ton.

As the economy had a well capitalized and very efficient agriculture sector, she could take advantage very rapidly of this improvement in the terms of trade, and in spite of the high taxes on agricultural exports imposed by the government, agriculture and agribusiness flourished in an impressive way. The additional income generated in the most efficient activities of the Argentine Economy spilled over the rest of the economy and most sectors could expand production using their unutilized capacity.

If Argentina had continued using the Dollar there would have been growth without inflation

The same would have happened if Argentina had not devalued the Peso in 2002, with the big advantage, in that case, that Inflation would have not been reintroduced in the economy and the government would not have created the big distortions that have plagued the Argentine economy since 2002.

Just to give some examples:

Argentina is now suffering 25 % annual inflation, The Price of the Dollar in the official market is 4.2 Pesos and everybody expects a new large devaluation. During the last four years capital flight has amounted to 80 billion dollars and during the current month it has been already 5 billion dollars.

Price controls on public utility rates (particularly energy and transportation) discouraged investment and obliged the government to grant very high subsidies. The subsidies have recreated a fiscal deficit in spite of the high increase in tax revenues that came from the improved terms of trade. Immediately after the recent election, the government announced very large public utility rate increases to reduce the subsidies, and, in the short run, these increases are feeding higher inflationary expectations.

Many other price controls, like those applied to domestic sales of beef, accompanied by bans to export of beef, have produced a boomerang effect. Production went down and the market price of beef in Argentina is nowadays much higher than in the rest of the world.

If Greece abandoned the Eurozone would only aggravate the social and economic costs

If Greece were to abandon the Eurozone, her economy will suffer all the problems that are clearly seen in the Argentine economy since 2002 and will not get the growth that Argentina enjoyed since 2003. For the simple reasons that Greece does not have significant unutilized capacity in her economy, the introduction of the Euro was not accompanied by the king of pro growth market reforms that generated a significant increase in productivity in Argentina, and there is no reason to expect a significant increase in the foreign terms of trade will benefit her economy.

Actually, the relevant currency depreciation that would bring benefits to Greece in terms of increased foreign demand for her exports is that of the Euro in relation to the Dollar but not that of the Drachma in relation to the Euro. With the recessionary policies that are being applied in Europe, including Germany, the increased demand for Greek exports will not come from the Eurozone, but from the Rest of the World.

Actually what Greece and the other Countries of the periphery of the Eurozone should demand is a more realistic monetary policy of the ECB and more fiscal expansion in Germany. That would bring the valuation of the Euro closer to that of the Dollar. In my opinion Europe is underestimating the negative consequences for her economy of the extremely Strong Euro policies of the second part of the 2000's, not very different from the Strong Dollar policies of the last part of the 90's in the US.

Greece should…

Having devoted so many minutes to say what Greece should not do, I want to devote the last minutes of my speech to explain what, in my opinion, Greece should do:

It is very important that Greece does produce a significant fiscal adjustment and eliminates the fiscal deficit in a period not longer than two to three years. But this fiscal adjustment should be implemented in an orderly way, with enough discussion in Parliament and civil society, as to reassure that the Greek People realizes that the needed adjustment follows reasonable priorities and pursue social justice.

Expenditure should be cut whenever it generates incentives to continue feeding inefficiencies and corruption, but not when they are required to provide high quality public good and services.

Tax Revenues should be increased by eliminating differential treatments and loopholes in the Value Added and Income taxes and facilitate the fight against tax evasion.

Some taxes should be drastically reduced, like the social security contributions that increase the cost of labor in the formal economy without increasing the take home income of the workers. These tax reductions should be part of an integral plan of pro-growth market reforms. Of course, renewed growth will greatly increase the possibility of rising tax revenues in spite of these tax rate reductions.

Deregulation of heavily protected sectors and privatization of state owned companies should be decided as ingredients of the pro-growth market reforms and not simply as a way to repay debts. The Argentine experience demonstrates that the privatizations that contribute to increase efficient investment are those that are implemented after markets have been opened to competition or, if technology does not allow competition, clear regulations are established to put caps in monopoly pricing practices.

The risk of privatizing under the pressure of creditors is that they may prefer the privatization of monopolies, as to generate higher privatization proceeds. But that would be a big mistake if then the customers and users of the services provided by the privatized companies are set using monopoly power. This policy would not contribute to increase competitiveness and efficiency.

Greece should drastically reduce employers Social Security Contributions

I want to reinforce my suggestion to drastically reduce Social Security Contributions by employers.

I argued strongly, already more than a year ago, on the need to drastically reduce the social security contributions and other payroll taxes paid by employers of the formal economy. Look at the proportion that social security contributions represent of total fiscal revenues in various economies:

	Total general government revenue, percentage of GDP	Social Security Contributions, percentage of GDP	Percentage that Social Security Contributions represent of total revenues
Australia	33.0	0.0	*0.0*
Canada	39.8	4.5	*11.3*
Denmark	55.3	1.8	*3.3*
Greece	39.8	13.5	*34.0*
Iceland	44.2	2.8	*6.4*
Ireland	35.4	7.0	*19.8*
Israel	42.3	6.8	*16.0*
Korea	33.4	6.1	*18.3*
Mexico	23.1	1.5	*6.6*
New Zealand	42.3	1.2	*2.8*
Norway	59.9	9.0	*15.1*
Portugal	40.7	11.7	*28.7*
Spain	37.1	13.2	*35.4*
Sweden	53.7	9.0	*16.7*
Switzerland	34.5	6.8	*19.7*
United Kingdom	42.5	8.4	*19.8*
United States	32.7	6.9	*21.2*

You can see that while in Greece Social Security contributions represent 34% of total fiscal revenues (very similar to the figures of Portugal and Spain) in most countries shown in the table, that proportion ranks from 0% (in Australia) to 21.2 % in the US. In countries of the EU like Iceland, Denmark and Ireland, the proportion of Social Security Contributions to total Tax Revenues are below 20 %. In Denmark that proportion is as low as 3.3%.

Greece could get the same effect on unit labor costs in relation to the price of tradable goods that would arise from devaluation, by reducing the rate of social security contributions and increasing the effective VAT in compensation. If Greece introduces this tax reform she will be shifting the incidence of taxes from the payroll to consumption and, therefore, would be producing the same effect of currency devaluation, without abandoning the Euro.

The substitution of VAT for social security contributions could be of varied dimension. In a soft movement it could try to jump to the rates of the UK, which are similar to those that prevail in the US. Or it could go to the extreme of completely eliminating the Social Security Contributions, as it is the case in Australia.

But for all these measures to produce results the Greece has to get sufficient debt relief

None of these recommendations will have a chance to be useful unless the debt and banking crisis is not solved in a very short period of time. Fortunately the long due debt relief and bank recapitalization measures have been included in the October 27 program. In this sense it is urgent that the debt relief is implemented and New Greek bonds are exchanged for the outstanding bonds. It is also urgent that Greek banks are recapitalized as to remove any risk of insolvency.

Two recommendations seem to me crucial in relation to these two urgencies:

The New bonds, in addition to produce a 50 % haircut in the principal, should convey initial coupons for interest not higher than 2 % per anon during a five years period, and the interest rate should be adjustable up for 50 % of annual GDP growth whenever the rate of GDP growth increases above 2 % per anon during a period of 5 years, or something equivalent in terms of a GDP extra coupon for the bonds. Similar interest rates should be applied by the ECB and the EFSF for their loans to Greece.

In order to avoid a significant Net Present value devaluation of the New Bonds, the ECB should make it clear that the New Greek Bonds will be eligible for rediscount in the same condition as the triple A bonds of other Eurozone countries. If the renegotiation of the debt does not satisfy these conditions, the markets will probably consider that the debt problem has not been solved in a sustainable way, and the sense of crisis will continue impeding growth.

In recapitalizing the Greek Banks, the EFSF should purchase preferred stocks as to assure that the recapitalization will not transform the banks into state owned and managed companies. If the government will be actively involved in reorganizing the public finances, it would be dangerous to make it also responsible for managing the banks that will be crucial in recreating trust in efficient financial management.

Do not give to the EU, the IMF and the ECB any formal excuse to unplug Greece from the system…

One last word on the comparison between Greece 2011 and Argentina 2001: Argentina in 2001 attempted to use the strategy I am now suggesting to Greece but she could not avoid exiting the Dollar Zone and suffering a large devaluation. You may legitimately ask why did Argentina fail and what is the key for Greece to succeed.

Argentina failed because the IMF, that had granted some support (although infinitely smaller than the one the Troika is providing to Greece), decided to withdraw the support in the middle of the complex process of implementing debt restructuring. The IMF decided that it was better to push Argentina into formal default and de-dollarization, what the markets had been predicting since the mid of 2001. And the very indebted industrialists and governors were happy to have a way to inflate away their debts, even though most of the middle class people would lose their life savings.

The key for Greece to succeed is to reassure the support of Europe and the IMF. If that support were withdrawn Greece will face no alternative but to do what Argentina did in the New Year Eve of 2002. And that would be a truly Greek Tragedy. Do not give Europe and the IMF any excuse to behave in relation to Greece as the IMF did in December 2001 in relation to Argentina.

Many thanks.