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The Greek Crisis: Argentina Revisited?

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Greece's enormous fiscal deficit and high debt level culminated earlier this year in the euro zone's first sovereign debt crisis. High yields on Greece's debt indicate that markets have priced in the possibility of default. Compared with Argentina, which defaulted on its debt in 2001, Greece's fiscal position is much worse. However, unlike Argentina, Greece is supported by other euro zone countries and is not vulnerable to speculative currency attacks, advantages that offer it some protection from default.

Greece's revision of its fiscal deficit numbers in November 2009 was the first of a sequence of events that culminated six months later in the European debt crisis. After numerous rating agency sovereign debt downgrades and rising debt financing costs, the Greek government announced a series of austerity measures to reduce its public deficit and the buildup of its public debt. In addition, the International Monetary Fund and the European Commission implemented their first fiscal stabilization and financial assistance program for a euro zone country. Despite these steps, yields on Greek bonds stabilized above pre-crisis levels, signaling that markets still question the sustainability of Greek public debt.

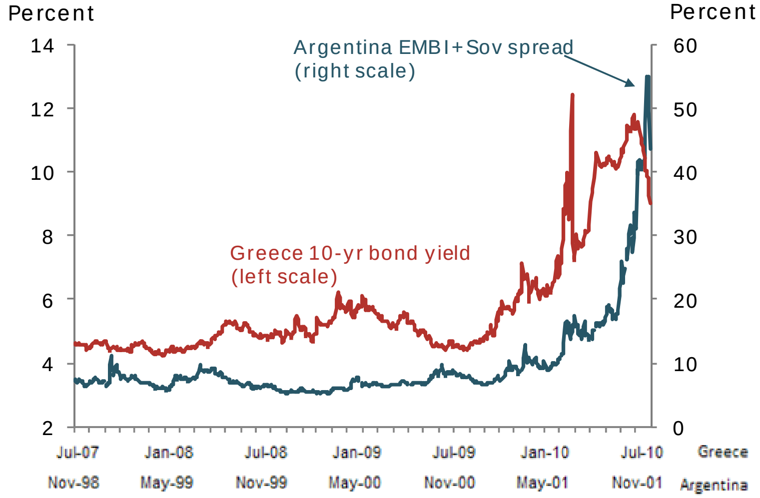
This *Economic Letter* compares Greece's recent experience with developments in Argentina in 2001, which culminated in a public debt default. In 2001, Argentina was in the midst of a crisis characterized by high indebtedness, a fixed exchange rate regime, and an economy in the throes of a recession. IMF financial assistance, which was conditioned on a program of fiscal austerity, was not enough to prevent a government debt default and abandonment of the Argentine peso's peg to the dollar. The Argentine example has many parallels with the current experience of Greece, which is characterized by high debt levels, a stagnant economy, and utilization of the euro, the equivalent of a hard currency peg. Moreover, Greece, like Argentina, is carrying out an IMF program with a focus on fiscal adjustment and reform.

Background

Greece joined the European Monetary Union and adopted the euro in 2001. The agreements that institutionalize the Union, in particular the Maastricht Treaty, set as guidelines that each member country limit its fiscal deficit to 3% and its public debt to 60% of GDP. In November 2009, Greece reported revised fiscal data that showed a fiscal deficit for that year of 13% of GDP, well above the previously reported figure of 8%, and a projected public debt level of 115% of GDP. This sharp deterioration in Greece's fiscal picture raised concerns about the country's ability to service its debt, worries that intensified as the cost of financing government debt rose. Yields on Greece's 10-year bonds more than doubled between January and May 2010.

In response, Greece, the IMF, and the European Commission agreed in May 2010 on a three-year €110 billion rescue package, including €30 billion from the IMF and €80 billion from other euro zone countries. This assistance was conditioned on implementation of austerity measures, with the goal of reducing the fiscal deficit-GDP ratio to 7.6% in 2011, 6.5% in 2012, and below 3% by 2014. The program, which includes €10 billion in assistance for Greece's banking system, effectively covers the country's sovereign borrowing needs for the next two and a half years as long as it sticks to its schedule of planned austerity measures and reforms. Recent fiscal data show that Greece is implementing those measures on schedule, permitting disbursement of the first two tranches of assistance. Nonetheless, yields on Greek 10-year sovereign bonds stabilized around 10%, only two percentage points below their May 7 peak, as Figure 1 shows.

Figure 1
Sovereign yields for Argentina and Greece



For its part, Argentina in the early 1990s carried out several IMF-supported economic reform programs, and it moved from hyperinflation in the 1980s to single-digit inflation in the 1990s. A major reason for the sharp drop in inflation was the adoption of a currency board arrangement which by law fixed the value of the Argentine peso at US$1 and limited monetary policy autonomy. The country greatly benefited from the loss of monetary policy independence, since the currency board regime prevented Argentine authorities from boosting the monetary base to finance fiscal deficits or for other purposes. However, labor and fiscal reforms were not put in place. As a result, several problems emerged in the mid-1990s, including a buildup of public debt, an inefficient and convoluted budgetary process, and low labor market competitiveness. Ultimately, contagion from the Russian and the Brazilian crises in 1997 and 1998 caused increasing capital outflows, higher domestic prices, and real currency appreciation. These further lowered Argentina's competitiveness, pushing the country into a deep three-year recession. The constraints of its IMF and currency board arrangements deprived the country of the fiscal and monetary tools to fight a downturn. A new IMF $5 billion fiscal program was unable to prevent Argentina's default on $132 billion in government debt in December 2001. The following month, it abandoned the currency board regime.

A closer look at the two episodes

Table 1 shows that Greece's current fiscal imbalance is much worse than Argentina's at the time of its default. Even excluding interest payments, Greece's primary deficit as a share of GDP in 2009 was almost eight times larger than Argentina's in 2001. In both countries, the buildup of government deficits resulted mostly from large government spending increases. Sharp declines in economic growth and tax revenue were also factors. Argentina's real GDP shrank by an average of 3% annually from 1999 to 2001. The Greek economy, after several years of growth averaging 4%, slowed in 2008 and fell into recession in 2009, with real GDP decreasing 2%. In addition, the relatively low labor competitiveness and high nominal wage rigidity of both countries pushed up unemployment.

In both Argentina and Greece, the lack of monetary policy autonomy initially enhanced confidence and contributed to lower inflation and interest rates. However, loss of independence eventually became problematic. Argentina's currency board regime deprived the country of monetary tools to fight recession. At the same time, it was unable to adopt expansionary fiscal policy because of its already high fiscal debt levels. In addition, the capital outflows that followed the Russian and Brazilian crises combined with Argentina's limited ability to expand exports left it without the foreign reserves to sustain the currency peg. Finally, Brazil's 1999 devaluation led to a sizable appreciation of the Argentinean peso relative to the currency of one of its main trading partners.

Table 1
Comparing Greece (2009) to Argentina (2001)

	Greece (%)	Argentina (%)
Deficit/GDP	12.9	6.3
Debt/GDP	115.1	62.2
Primary deficit/GDP	8.5	1.4
Current account deficit/GDP	11.2	2.0
Exports/GDP	10.0	8.0
Debt/GDP held abroad	75.0	60.0

Greece's labor costs are high and its competitiveness is low compared with its European partners. In addition, its fiscal imbalance is more severe than Argentina's was. However, in several ways Greece is less exposed. First, the currency board was more vulnerable to speculative attack because the arrangement was perceived as a softer form of peg than Greece's euro adoption and did not require 100% foreign reserve backing. Argentina's currency board fueled speculation against the peso, intensifying capital outflows and foreign reserve losses. In addition, Argentina's banking system was more exposed to exchange rate risk. The large cost difference between borrowing in pesos versus dollars left banks with large currency mismatches, either directly or through the exposure of their household customers, because both households and banks held most of their assets in pesos, while their liabilities were denominated in dollars. Argentina's banks were also more exposed to sovereign default risk because government bonds represented more than 20% of their assets. Finally, roughly 90% of Argentina's sovereign debt was denominated in dollars.

By contrast, Greece's banking system shows much less sovereign exposure. Public debt represents only around 11% of Greek bank assets. And banks have nearly no currency mismatches, since some 90% of both their assets and liabilities are denominated in euros. And only 1.5% of Greece's debt was denominated in foreign currency as of December 2009.

The onset and aftermath of Argentina's default

A bank run was the final event that precipitated Argentina's debt default. Businesses and households converted peso deposits into dollars and withdrew them from banks in increasing amounts, reducing the domestic deposit base by more than 6% in two days at the height of the crisis in November 2001. To stop the run, the government set weekly $250 withdrawal limits, prohibited peso loans, restricted foreign exchange for travel, and blocked foreign funds transfers that weren't related to trade. A moratorium on foreign public debt was announced on December 23, followed a little more than a week later by the formal ending of the currency board. The government also established an asymmetric "pesoization," with dollar debts converted into pesos at 1-to-1, and dollar deposits converted at 1-to-1.4, compared with the previous official rate of 1-to-1.8. This transferred the burden of depreciation to domestic banks and later forced the government to issue compensation bonds to help them. The depreciation and new borrowing to help the banking system more than doubled public debt as a share of GDP by the end of 2002.

The economic effects of the Argentine crisis were severe. In 2002, real GDP fell by 11%, unemployment rose above 20%, and inflation climbed to 40%. In addition, the peso depreciated 55%, which sharply increased the burden of financing dollar-denominated sovereign and private debt. On the other hand, the depreciation also increased Argentina's competitiveness, which helped reverse the current account and trade deficits. However, nearly a decade after the default, the country is still essentially shut out of global financial markets, with discounts on its debt still under negotiation.

Default and exit from the euro?

The high yields on Greek sovereign debt indicate that markets are pricing in the possibility of a debt restructuring despite the IMF program and recent fiscal improvement. In fact, even if Greece follows precisely the IMF forecast benchmark scenario, its debt will continue to increase to a level of 140% of GDP in 2014. A Greek debt restructuring would raise the question of whether the country might also exit the euro zone to gain monetary independence and exchange rate flexibility. While the benefits of monetary independence are evident, the Greek economy grew rapidly and the country acquired important credibility after it adopted the euro. It is far from clear that the benefits of exchange rate flexibility would outweigh the loss of credibility that would come from forsaking the euro umbrella. On the other hand, the Greek banking system's lack of currency mismatches would make it easier to adjust to withdrawal from the euro than Argentina's experience ending its dollar peg. But the costs of establishing a new currency and exchange rate policy would be sizable. Moreover, the relevant treaties have no provision for withdrawal from the European Monetary Union, which would make such a move a venture into unknown territory (see Athanassiou 2009).

Conclusion

Argentina's experience vividly illustrates the economic damage stemming from default and departure from a hard-peg currency regime. In hindsight, the IMF has recognized that it was too optimistic about Argentina's prospects. The lesson is that postponing an unavoidable debt restructuring increases the ultimate costs, and that orderly restructuring is far preferable to the chaos of unilateral default under extreme duress (see IMF 2003).

While the Greek and Argentine episodes have in common some fiscal and monetary features, they differ importantly in their exchange rate regimes. Argentina's currency board exposed the country to balance sheet mismatches and made it vulnerable to speculative attack. More importantly, both its decision to establish a currency board in the first place and later to abandon it were unilateral. Greece's use of the euro protects it from speculative attack. Moreover, its currency regime is a result of a multilateral agreement involving continental Europe's dominant economic powers. As a member of the euro area, Greece is part of an important and influential "family." It gains a measure of protection by being under the monetary authority of the European Central Bank, one of whose primary objectives is the maintenance of stability in the euro area. As recent developments show, disorder in one country can undermine the financial stability of the whole euro area, giving member countries strong incentive to back each other up. As part of the European Monetary Union, Greece gains powerful supporters that it would lose if it were to go it alone. The magnitude of Greece's debt problem is very great and is not likely to normalize quickly. So these relationships may be tested in a few years when Greece's financial assistance package is depleted.

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