

Free exchange

Latin lessons

In a guest article, Mario Blejer (pictured left) and Guillermo Ortiz, former central-bank governors of Argentina and Mexico respectively, explain why Greece should not leave the euro

Feb 18th 2012 | from the print edition



EUROPE'S handling of its sovereign-debt crisis has been disastrous. Euro-zone leaders succeeded in turning a manageable economic problem in Greece into a political conundrum that jeopardises the single currency. A premature insistence that private-sector creditors take a hit on Greece has fostered contagion. Massive write-offs are necessary but nobody yet knows what constitutes sustainable debt or what Greece's "real" GDP is. In Latin America in the 1990s debt relief was granted only when fiscal adjustment and structural reforms were very advanced. This is certainly not the case in Greece. Although

the European Central Bank's three-year liquidity operations and the probable provision of more bail-out money for Athens provide a breathing space for a more comprehensive solution, Greece will remain a source of uncertainty. The country is in a deep recession: its GDP has fallen and unemployment has risen for three consecutive years. More austerity will only increase economic and social pressures within the country.

Given this grim outlook many analysts suggest that it would be better for Greece to exit the euro zone. They often cite Argentina's exit from its currency board in 2002 as evidence of the benefits that would accrue to Greece if it reintroduced its own currency. It is true that following the peso devaluation, and after a painful (but short) adjustment period, Argentina enjoyed six years of rapid growth. But Argentina's experience was singular. Strong export prices resulted in sustainable external surpluses, and prudent fiscal management ensured internal balance. Greece, on the other hand, cannot rely on favourable external conditions and is already in a deep, fiscally induced recession.

In practice, moreover, Argentina had no choice after defaulting but to ditch its peg since the currency board was a unilateral arrangement that did not envisage counterparty support or institutional safety nets. Unlike Argentina, Greece belongs to a formal multilateral arrangement that could provide the intensive care and official finance needed to smooth the adjustment. Indeed, we argue that an analysis of the costs incurred by Argentina strengthens the case for Greece to remain within the euro zone.

Corralito chaos

What were those costs? First, a bank run. As soon as devaluation was considered possible, a persistent bank run took place in Argentina. It lasted for over a year and

consumed two-thirds of the country's foreign-exchange reserves. To avoid total meltdown in the financial sector the only choice was to impose limits on bank withdrawals. Argentina had a disastrous experience in this regard. When cash withdrawals were severely restricted (the infamous set of measures known as the *corralito*) output collapsed because of a credit and liquidity crunch. The *corralito* led to unrest, bewilderment, chaos and, eventually, to the fall of the government. The anticipation of Greece abandoning the euro would also cause a generalised bank run, but it would be much more destructive and widespread than Argentina's, given European financial integration.

Exiting the euro would require the compulsory redenomination of banks' assets and liabilities, and of practically all contracts, prices and wages. In Argentina, where dollars were widely used as a unit of account, redenomination took the form of "pesification". It had vast redistributive consequences. If Greece abandons the euro the "drachmatisation" of loans and deposits—and the exchange-rate movements that would follow—would benefit bank debtors and harm depositors, leading to further social turmoil.

Argentina's experience also shows that exiting a long-term peg tends to sink large private corporations with access to international financial markets, because their foreign-currency liabilities cannot be redenominated. Indeed, Argentina's companies devoted years to negotiations with their foreign creditors and many had no choice but to default. The position of Greek companies in this regard may be even worse. Many Argentinian contracts had continued to be denominated in pesos, since the currency board did not eliminate the local currency. These contracts, at least, could be honoured. But Greece would have to deal with the complete universe of covenants since every contract would need redenomination. A sea of bankruptcies would follow.

For richer, for poorer

The end of Argentina's currency board was harrowing. It led to endless violations of contracts that left an enduring stain on the investment environment. But reintroducing an abandoned currency is even more difficult. Argentina never stopped using the peso, but Greece discarded the drachma. To generate confidence in the drachma in the midst of a crisis would be very challenging. Convincing potential investors to commit to projects denominated in a reintroduced currency is an almost unachievable task.

The proponents of a euro-zone exit for Greece grossly underestimate its devastating consequences. Argentina's experience should deter rather than promote the thought of exit. Nevertheless, a real problem remains: how does Greece regain competitiveness? Doing so without devaluation is difficult. All successful adjustments in Latin America involved huge initial devaluations and immediate reductions in real wages, thus cutting unit labour costs. In normal circumstances, in order to cut real wages, devaluing the currency is more palatable than reducing nominal wages. But when devaluation requires exiting a monetary union, the resulting financial implosion has to be factored in.

What is required is not an abandonment of the euro but a framework adapted to the specific context of the euro zone and of Greece itself. Such a framework should recognise that the process of adjustment and reform will extend over a long time horizon (about ten years). Competitiveness will arise as a result of adjustment and structural reform, not as a precondition of support. The programme should acknowledge that markets are likely to remain shut to Greece and that lots of long-term official finance will be needed. Equal emphasis should be put on public-sector

adjustment and nominal-wage reduction in the private sector.

This type of programme is best designed and implemented within the euro framework. The IMF is analytically ill-equipped for long-term engagements. Greece is in for a long and difficult journey, but the voyage will be less traumatic and more successful if it is undertaken within the euro zone, not outside it.

NB. Guillermo Ortiz is also chairman of Grupo Financiero Banorte Ixe