What Can the Developed World Learn from the Latin American Debt and Mexican Peso Crisis?

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The global financial crisis of 2007–08 resulted from massive institutional failure and proved that a robust regulatory and supervisory frameworks are necessary. Such frameworks are not yet in place. This paper recounts the legacy of the financial crisis in the sovereign debt crisis in Greece as of September 2011. It then turns to comparing the current situation to those of Latin America, and especially Mexico, in the 1980s. It describes what was done to recover in Latin America and what lessons can and cannot be learned from those experiences in acting to assist the countries of the European Union threatened with sovereign debt default.

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The financial crisis of 2007–08 resulted from massive institutional failure at a global level. It involved all kinds of entities—financial intermediaries, regulators, rating agencies, and international organizations. It also proved the regulatory and supervisory framework for the financial system in core developed economies to be clearly deficient.

The conceptual and intellectual underpinnings (such as the efficient market hypothesis and other rationales for minimal governmental intervention in financial markets) of the “light regulation” approach led to the widespread belief that market discipline was sufficient to sustain financial stability.

The crisis is a clear example that price stability does not bring about financial stability. On the contrary, it is precisely during periods of price stability and easy financial conditions that the seeds for asset bubbles and their subsequent bursts germinate at rapid and sometimes uncontrollable rates [White 2006]. Lightly regulated financial markets have proven to be insufficient to allocate resources efficiently and manage risk.

The recognition of this reality has led to efforts at strengthening and capitalizing the financial system. But for all the efforts that have taken place over the past three years, the fundamental intellectual structure and paradigm shift that is needed to achieve a stable financial system is yet to be developed.

Several additional factors, of course, contributed to the formation of the crisis. These include, among others, external imbalances, excessively lax global monetary policy, distortions in risk-adjusted prices for credit and other financial instruments, the unfounded belief that home prices in the United States would continue to rise indefinitely, and the opaque exposure of financial institutions to high-risk products.

1. The Legacy of the Financial Crisis

To offset the effects of the crisis, authorities in the epicenter implemented both monetary and fiscal countercyclical policies. Without these measures, the real and financial consequences would probably have been much worse. Despite such efforts, the stimulus adopted in advanced economies has not proved as effective as in previous recoveries. In fact, Figure 1 shows that GDP in the six largest industrialized countries is still below precrisis

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Figure 1. Gross Domestic Product (Index 1Q08 = 100).

Source: U.S. Bureau of Economic Analysis and Eurostat.

peaks. This illustrates both the severity of the recession and the slow recovery process in the developed world. Also, labor markets have not responded as expected.

The reasons for this lie mostly in the very rapid growth of household and financial sector leverage in the major developed economies prior to the crisis, the unprecedented large credit and/or property bubbles, and the subsequent adjustment and de-leveraging process in which we are still immersed.

Countercyclical policies implemented were not without a cost. In supporting stressed economies, government finances deteriorated at an alarmingly fast pace in developed countries. Policymakers had to sustain banking systems and compensate for private-sector de-leveraging. As a consequence, public debt and fiscal deficits as a percentage of GDP dramatically increased. For instance, in 2007 Ireland's public debt was 25.0 percent of GDP and is expected to surpass 110.0 percent of GDP in 2011. For the United Kingdom, debt in 2011 is projected to practically double the 43.9 percent of GDP reached in 2007. For the United States and Spain, debt-to-GDP ratios are expected to increase by about 30 percentage points from 2007 to 2011.¹

¹The deterioration of government finances in developed markets and fiscal deficits was partly a reflection of the revenue loss due the magnitude of the recession [International Monetary Fund 2010].

According to the BIS, if governments do not make substantial fiscal policy changes, deficits worldwide will soar by 2020. Ireland's deficit could reach 13 percent of GDP; that of Japan, Spain, the United Kingdom, and the United States, 8 percent; and that of Australia, Germany, Greece, the Netherlands, and Portugal, between 3 and 7 percent. But even more worrisome is the impact on indebtedness. Without significant policy changes, the debt-to-GDP ratio would go above 300 percent in Japan, 200 percent in the United Kingdom, and 150 percent in Belgium, France, Ireland, Greece, Italy, and the United States [Cecchetti, Mohanty, and Zampolli 2010]. This is clearly an unsustainable path.

As alarming as these numbers appear, the need for fiscal consolidation does not hold the same level of urgency across the developed world. For instance, the United States is not facing an immediate fiscal crisis. The U.S. downgrade by Standard and Poor's led to a flight *into* treasuries rather than away from them. The United States is facing an employment and growth crisis and a problem of debt sustainability over the medium term. In truth, at least conceptually, it is much easier to visualize fiscal consolidation in the United States than in most other developed economies that need to set government debt on a sustainable course. This is not least because U.S. government spending (measured by total spending as a percent of GDP) is smaller than in the rest of the G10 countries.² The real challenge for the United States is to stimulate economic growth and job creation in the short term while at the same time credibly addressing the issue of fiscal sustainability in the medium term.

Let's turn to the situation in Europe. In the weeks prior to presenting this paper (September 11, 2011), capital markets plummeted while uncertainty continued to grow, as shown in Figure 2. Yet the European fiscal crisis has been a serious source of concern for almost two years now. The initial causes of the fiscal crisis were narrowly focused on the issue of funding pressures for some countries, particularly Greece. However, contagion to other countries in the periphery spread swiftly, and more recently began to contaminate even core countries due to links between the sovereign debt

²U.S. average government expense between 2006 and 2008 was less than 22 percent of GDP, while in countries like Belgium, France, Italy, and the United Kingdom it represented more than 40 percent of GDP [World Bank 2011].

Figure 2. Capital Markets¹ (Index 01-Jul-2011 = 100)/ MSCI Indexes.

Source: Bloomberg.

crisis and the banking sector of the region. Actions taken by European politicians and the European Central Bank (ECB) seem to belong more to the realm of political economy than the crisis-solving manual. In other words, the European political system has turned a manageable economic situation into a nearly unmanageable political problem.

A little bit of history is useful to understand how these countries have found themselves in such a dilemma. In 1992, the Maastricht Treaty set the rules for all member-countries to achieve Economic and Monetary Union (EMU): low inflation, low interest rates, and *controlled public spending*. The Stability and Growth Pact (SGP) agreed on in 1997 specified that the same rules should apply once the euro was launched.

However, in 2003 some countries, even among the largest economies in the Eurozone such as France and Germany, broke the rules. Instead of taking strong action against them, in 2005, the European Council agreed to give the SGP more flexibility. Furthermore, even these new rules were challenged in 2007. So the loosening of the fiscal anchor was already taking place before the global financial crisis occurred.

It is worth keeping in mind that the architecture of the Exchange Rate Mechanism (ERM) did not include the framework for the proper functioning of the monetary union. Those missing pieces are crucial for answering key questions in the

current context. For instance, apart from no fiscal coordination, there is no defined mechanism for banks' recapitalization, no debt restructuring procedure, or clear debt reduction mechanism. Nor is there even an exit route from the euro for countries that cannot or will not adjust.

A comprehensive set of rules defining how to deal with overly indebted countries without risking the overall health of the system is vital for the European monetary union. In order to preserve the union, European leaders need to establish an effective political mechanism for policy coordination and fiscal decision-making. In the absence of these rules, the introduction of the euro merely substituted foreign exchange risk for credit risk for some of its weakest members.

This imperative has been borne out in each and every step of the crisis. The timeline of events of the European crisis can be split into three distinct phases: first, denial; second, recognition; and finally, implementation and action.

- *Denial:* During the early stages of the crisis, policymakers were divided over whether Greece needed IMF support. Many believed that Greece was a European problem that had to be handled within the existing European framework, and that default or even debt restructuring in the euro area was not an option. Apparently, authorities were trying to avoid any possibility of restructuring, as its potential consequences for the euro system were (and probably still are) unknown. They also aimed to ring-fence other countries in the periphery. This, in the end, proved impossible.
- *Recognition:* It was a long and arduous process for European leaders to pass from anger and disbelief to finally recognize the seriousness of the problem. Gradually, they have realized that weak public finances in several countries undermined the stability of the Union and that the sovereign debt crisis threatened to spread to the banking system. However, the political dynamics in different blocs of countries are still far from converging. Taxpayers in Germany and other northern countries are reluctant to finance potential resource transfers to the periphery, while citizens in southern countries are increasingly unhappy with austerity measures.
- *Implementation:* Today, European authorities are finally facing the reality of the crisis, including

the institutional need for a much more coordinated fiscal policy. Proposals have ranged from the strengthening of the existing mechanism with stricter sanctions for deviations (Maastricht and the SGP), to the establishment of a European finance ministry, to the issuance of a Eurobond. The basic notion that the preservation of the Eurozone requires much closer fiscal integration and a substantial surrendering of sovereignty is slowly sinking in. This may be the ultimate solution, but it will certainly take time, and meanwhile the debt crisis must be dealt with.

Three things, in my view, are clear from this process:

1. In the case of Greece, the problem was initially characterized as one of liquidity rather than solvency both by the IMF and the European authorities. This made sense in order to buy time, ring-fence other countries (especially Spain), and avoid widespread contagion.
2. The strategy failed mostly due to the widespread perception that the authorities have consistently been “behind the curve.” Policy implementation has been reactive to market stress, and the dynamics between the political and economic dimensions of the problem seems to have further deteriorated. Recession fears in Europe have risen, exacerbated by widespread austerity measures and the perception of an increasingly complex political decision-making process. It is becoming clear that the final problem is one of loss absorption—who pays for the losses accumulated so far and those that will be added until the problem is finally restored. The longer it takes to restore market confidence that a solution is in place, the larger the losses and the spillover effects to the rest of the world.
3. Although the European leadership has rhetorically emphasized the issues of growth and competitiveness, in practice the programs put together so far have mostly focused on austerity measures and fiscal consolidation. Achieving competitiveness and growth in the context of a fixed exchange rate system requires more drastic structural measures and, in most cases, a painful “internal devaluation” process. The flip side to this is that austerity with no foreign exchange devaluation is almost always doomed to fail.

This last point is particularly important and can be illustrated with the Latin American debt crises of the 1980s.

2. Dealing with the Crisis and Parallels with Latin American Debt Crises

Like developed countries today, Latin America also had to face public sector over-indebtedness. In the late 1970s, Latin American economies, like peripheral Europe in the 2000s, let government expenditures run well ahead of revenues. This situation, along with a rigid exchange rate regime, resulted in large fiscal and current account deficits. At that time, financial markets were buoyed by excess liquidity due to an influx of petrodollars. Latin American countries were able to finance large deficits with external debt which reached levels similar to those of Greece, Ireland, Spain, and Portugal before the current crisis. Figure 3 shows a comparison of the Latin American and European countries prior to their crises, and Figure 4 shows a comparison during the crises.

Initially in the late 1970s, while the global economy expanded and interest rates were relatively low, debt dynamics seemed to be sustainable. Latin America’s growth rates exceeded interest rates. But much was explained by cyclical factors. Latin America’s growth was mainly driven by public spending, and debt resources were not being used for productive activities. While private and public spending was rising, productivity was not. Once excess liquidity dried up, interest rates rose as anti-inflationary policies were put in place

Figure 3. Government Debt (% of GDP). 1/Average for 1981–86 for Argentina, 1981–85 for Brazil, 1980–85 for Chile, and 1982–85 for Mexico.

Source: Reinhart, Rogoff, and Savastano [2003], and International Monetary Fund [2011a].

Figure 4. Government Debt (% of GDP). 2/Estimate for 2010.

Source: International Monetary Fund [2011a and 2011b].

Figure 5. External Debt of Latin America 1973–82 (billions of U.S. dollars).

Source: Devlin and French-Davis [1995].

and the global economy decelerated, the unsustainability of Latin America's debt became evident, as shown in Figures 5 and 6. Growth stalled, and Latin American countries had to endure a sudden reversal of capital flows.

In 1982, falling international oil prices, rising world interest rates, and massive capital outflows pushed external creditors to refuse to roll over Mexico's short-term debt, leading to subsequent suspension of Mexican interest payments. Explosive inflationary and balance-of-payment difficulties ensued.

In light of current European debt problems, it is revealing to analyze how Latin American authorities faced the debt crises of the 1980s. They basically took three steps:

1. They engaged in fiscal adjustment through IMF Stand-by Programs;
2. They stimulated growth through structural reforms;
3. And, finally, they sought debt relief through the Brady Plan (described below).

Fiscal adjustment

In the 1980s, the first response to the debt crisis was the implementation of IMF-sponsored stabilization programs—the so-called IMF Stand-By Programs. These conditioned additional access to international finance—loans from official

Figure 6. External Debt Service for Latin America (interest as a % of GDP).

Source: International Monetary Fund [2011a].

institutions and refinancing of existing international bank lending—on a significant level of fiscal adjustment, tighter monetary policy, and slimmer public sectors (including the privatization of state-owned enterprises). In my view, there was a clear understanding between the IMF, the U.S. Treasury, and commercial banks that Latin America had to adjust without new money or debt restructuring. The claim was that banks were in

no position to recognize losses on sovereign lending.

The adjustment resulted in higher primary surpluses. But this response was not enough. Debt-to-GDP ratios continued to rise, and creditworthiness deteriorated even further. Deep recessions were triggered by fiscal adjustments, while lower creditworthiness led to higher interest rates. There was indeed a contradiction in the IMF programs that sought to attain debt sustainability: High primary surpluses were unable to solve debt problems. Lasting primary surpluses were not sufficient to offset the negative effects on economic growth of continued capital outflows, deteriorating terms of trade, and the upward pressure of higher default risks on interest rates. Large current account surpluses were needed to service debt. This led to exchange rate policies geared to promote exports, undermining the recovery of domestic markets and boosting inflation even with fiscal adjustment taking place. Indeed, it was through the devaluation and inflation policies that external transfers were realized. This is obviously not an option in the European case.

Also, in countries like Mexico, the initial retrenchment and consolidation efforts were also undermined by external shocks such as the international oil price collapse of 1986. As shown in Figure 7 and Table 1.

Figure 7. Mexico's Primary Balance and Debt (% of GDP).

Source: Instituto Nacional de Estadística y Geografía de México (INEGI), Banco de México, International Monetary Fund [2011b] and Banorte.

Table 1. Mexico's Fiscal Adjustment
(Average primary balance and debt as a % of GDP)

	Primary Balance	Debt
1983–86	4.3	60.4
1987–90	5.4	66.0
1991–94	4.9	35.2
1995–98	2.5	52.6
1983–1998	4.1	53.6

Source: INEGI, Banxico, GFS, HPDD and Banorte.

In order to contain the effects of its debt crisis, Greece is following today the same path Latin American countries did in the 1980s. The first step was fiscal adjustment. In May 2010, the Greek government presented a package that sought a reduction in the public deficit by 5.6 percent of GDP over the next five years (from -8.1 percent in 2010 to -2.6 percent in 2014), contemplated a reduction in debt-to-GDP ratios from 146.1 to 142.7 percent in the same period, and assumed that it could eventually go back to the markets in 2011.

Unfortunately, this proved unrealistic. In July this year, the Greek government obtained a vote of confidence in Parliament and the approval of a new package with similar objectives, albeit with a more active private sector participation through privatizations and the rollover of maturing debt. It is still to be seen whether this new plan is feasible; market developments since the announcement indicate that, to say the least, skepticism on the success of the program is widespread.³

Growth stimulus

Another important ingredient for solving the Latin American debt crisis was growth stimulus. Apart from fiscal and monetary adjustments, several countries initiated a far-reaching process of structural reforms that would eventually enhance growth. Throughout this period of macro-economic turmoil, Mexico, for instance, transformed itself into a much more open economy through extensive trade reforms, the privatization of most public sector enterprises, and financial

³Editor's note: As of November 13, 2011 the Greek government had fallen, and there was no resolution of whom or what would solve/mitigate the Greek financial crisis. Also, Italy had fallen into a sovereign debt crisis and was forming a new government.

market liberalization. In a few years, Mexico went from being mainly an oil exporter to a country focused primarily on manufacturing exports. Clearly, the real exchange rate depreciation helped, which is not an avenue open today to European countries. This was a vital step for eventually achieving medium- and long-term debt sustainability. In addition, external demand conditions were favorable for export growth; this is not the case today. Concentrating on the fundamental issues of economic policy that would underpin a sustainable development process was as important as solving the debt overhang itself.

In the case of Europe, although policymakers are generally aware that debt sustainability is not achievable in the absence of economic growth, only timid steps in the direction of growth-enhancing policies have been taken so far. It is true that implementing structural reforms and austerity measures simultaneously may have been politically easier in the Latin America of the 1980s, where mostly authoritarian regimes were in place.⁴ Table 2 illustrates the Latin American “Lost decade,” and the declines in per-capita GDP that took place.

Debt relief

The third step taken in Latin America was debt relief. Even with fiscal adjustment and reforms, by the mid-1980s it was apparent for several countries that their strategies had failed. Growth was absent, and debt-to-GDP ratios were still increasing. In addition, international capital markets were not providing the resources needed to mitigate running reform program costs, despite the expected future benefits. Growth was barely enough to cover the transfer of resources to creditors, which itself was becoming a drag on growth.

Latin America gradually put sufficient structural policies and domestic fiscal measures in place for sustainable growth to take off. What was missing, however, was the required patience of external creditors to allow for the results. The only way to get a credible commitment was debt relief [Wijnbergen, King, and Portes 1991]. Three elements were essential to the success of the new strategy:

- An adequate burden-sharing mechanism, with appropriate incentives for the countries to service the new debt;

⁴Even so, not all growth policies were implemented in a timely manner or with enough depth.

Table 2. Growth and Investment in Latin America

Country	Change in Per Capita GDP (%)	Investment Share of Per Capita GDP (%)	
	1980–87	1980	1987
Argentina	–10.0	26.6	18.7
Brazil	–2.6	28.6	22.7
Chile	–6.4	22.7	16.6
Mexico	–10.8	25.9	15.7
Venezuela	–14.1	24.3	20.5

Source: Penn World Table 7.0; Heston, Summers and Aten [2011].

- A new disbursement guarantee;
- And a reduction in default risk (and thus a reduction in interest rates).

In the late 1980s, U.S. Treasury Secretary Nicholas Brady sponsored a concerted debt reduction program—the Brady Plan. Countries that agreed to a new stabilization program sponsored by the IMF would become eligible for voluntary reduction of international bank debt. The U.S. Treasury allowed banks to offset future tax liabilities with loan write-offs. Countries could then exchange existing loans for so-called Brady Bonds and negotiate the menu that best suited their needs—a reduction in the principal of the loan, a lower interest rate, or an extension of the average loan maturity.

In 1988, Mexico was the first country to negotiate. In net-present-value terms, it obtained a 35 percent reduction on its external public sector bank debt. Official domestic debt was not eligible for reduction. At the time Mexico announced its Brady Plan, the secondary market yield on its external debt plunged, and the exchange rate stabilized thanks to lower default risk. The combination of fiscal adjustment and debt reduction allowed the country to regain creditworthiness. In addition, these policies enabled the government to anchor inflation, which had been running above 100 percent, and to resume economic growth.

Debt relief, in a context where fiscal adjustment was already undertaken, was what provided the possibility of success to the disinflation program that was put in place at the time and what, in combination with a credible structural reform

program, set the stage for higher growth in the ensuing years.

In the Mexican case, the Brady Plan was a game changer. Its effects were psychological as much as real—a seal of approval by the world economic establishment of the Mexican stabilization strategy [Wijnbergen, King, and Portes 1991]. The Brady Plan worked.

A so-called Brady Plan for Greece is, in my view, premature and misplaced. As explained, the Brady Plan worked in Latin America because fiscal adjustment and structural reforms had already been put in place, which is certainly not the case in Greece. Substantial debt write-offs may be needed (which is not the case in the current version of the so-called Brady Plan for Greece), but they will not by themselves restore growth and competitiveness.

What's missing in Europe? Apart from the fundamental issue of policy coordination on the fiscal front, I can think of three key components needed for a solution to the crisis, given the Latin American lessons from the 1980s.

- *Growth-enhancing reforms:* Fiscal adjustment is a clear necessity, but just as important is setting the stage for renewed economic growth. Today, like in the 1980s, reforms to reduce uncertainty and stimulate growth are of the essence. The package approved on July 21 bought Greece some time, but the key problem remains unsolved: how will this country reduce its debt burden without being able to engage in faster economic growth? Figure 8 shows the gravity of this problem.

There is an urgent need to transform the Greek economy into a more productive and competitive one, specially by reducing the high tax burden on labor, which discourages hiring, making the judicial system more efficient, and removing barriers to growth in specific sectors [IMF Survey Online 2011].

In Ireland, reforms to improve efficiency and restore growth are starting to deliver tangible benefits. Even if there are downside risks to growth due to the stress in European sovereign debt markets, recent data are consistent with a return to positive growth in 2011.

- *Persistent fiscal adjustment:* Even after the Brady Plan, Latin American countries had to

Figure 8. Greece's Real GDP (annual % change).

Source: Eurostat.

continue pursuing a fiscal adjustment strategy in order to stabilize debt-to-GDP ratios, as indicated by Table 3. In fact, in some cases fiscal adjustment overshooting was needed to sustain the disinflation programs and to give strong fundamental support to the Brady Plan. European countries still have a long way to go on that front. In order to bring debt-to-GDP ratios back to precrisis levels within five years, for example, Table 4 shows that Greece, Ireland, Portugal, and Spain would have to generate an average annual primary surplus of 5-12 percent of GDP. A less aggressive adjustment path of 20 years would require an annual primary surplus of around 2 percent of GDP for the countries mentioned but would leave governments exposed to high debt ratios in the short and medium terms [Cecchetti, Mohanty, and Zampolli 2010]. In current market conditions, frontloading fiscal adjustment is probably needed, as was the case in Latin America.

- *Recovering market credibility:* In the 1980s and 1990s, the Brady Plan was the closure that market participants needed. More than the haircut, it was the change of regime that allowed Latin American countries to restore creditworthiness and debt sustainability. The main point here is that the consequent change in market perception successfully put an end to the debt crisis. Europe has a long way to go

Table 3. The Brady Plan and Latin America's Fiscal Adjustment
(Average primary balance and debt as a % of GDP)

	Average Debt 1986–89	Brady Deal Announcement	Primary Balance			
			The year of the announcement	Next 5 years	Next 10 years	Average up to 2009
Panamá	95.32	1995	4.50	2.36	1.89	2.53
Costa Rica	86.17	1989	0.39	2.46	2.03	2.13
Uruguay	82.60	1990	1.56	1.10	0.41	1.29
México	72.20	1989	5.89	5.77	3.49	2.56
Brasil	69.86	1992	1.44	1.68	1.87	2.55
Argentina	61.46	1992	1.69	0.15	0.12	1.35
Venezuela	51.09	1990	1.28	0.69	2.16	1.84
Perú	41.35	1995	0.32	0.86	0.57	1.21

Source: ECLACSTAT, Government Fiscal Statistics IMF and Banorte-Ixe.

Table 4. Average Primary Balance Required to Stabilize the Public debt/GDP Ratio at the 2007 Level
(% of GDP)

	Average Debt 2008–2010	Primary Balance			Primary Balance Required		
		2010 ¹	2011 ²	2012 ²	Over 5 years	Over 10 years	Over 20 years
Greece	126.4	–3.2	–0.9	0.9	5.4	2.8	1.5
Portugal	74.9	–4.6	–1.6	–0.8	5.7	3.1	1.8
Ireland	68.7	–29.7	–7.5	–5.3	11.8	5.4	2.2
U.K.	65.9	–7.8	–5.5	–3.9	10.6	5.8	3.5
Spain	51.0	–7.8	–4.6	–3.7	6.1	2.9	1.3

Source: Stephen G. Cecchetti, M.S. Mohanty and Fabrizio Zampoli, “The Future of Public Debt: Prospects and Implications”, BIS, Working Paper 300 (March 2010), WEO Database April 2011 and Banorte-Ixe.

¹Estimate.

²Forecast.

in the process of regaining credibility. European authorities have to deal with an extremely complex crisis that has both an economic and a political dimension.

On the economic sphere, there are a number of immediate problems to tackle, especially:

- The Greek program, including the uncertainty of the continued support of the IMF after repeated failures to meet targets, the question of private sector participation, and whether the agreed net-present-value discounts are meaningful, and other factors.
- The issue of contagion, particularly in Italy, a country that is clearly too big to deal with if it loses access to financial markets.

- The problems of the banking system, which range from signs of systemic funding strains in the interbank market to questions about the capitalization needs if inter-European claims are valued at market prices.

There are also medium-term fundamental issues to solve: reshaping the institutional framework to foster further integration with a coordinated fiscal approach, and a push for structural measures that could enhance Europe's growth potential. Of course, both the immediate and medium-term issues feed on each other.

The European saga has now been going on for almost two years, while the Latin America sovereign crisis lasted almost a decade. The end-game in the case of Europe will probably come much sooner than in the case of Latin America.

3. Market Jitters and Package Design: Enhancing Credibility

In addition to the Latin American experience of the 1980s, Mexico's 1994 peso crisis is also helpful to analyze today's fiscal dilemmas, particularly on the recovery of market credibility and stopping contagion. In the years leading up to the crisis of 1994–95, Mexico received huge capital inflows. To a large extent, this capital was drawn by a favorable economic outlook that followed several years of stabilization and intensive structural reforms. In 1993 inflation fell to single-digit levels for the first time in over 20 years. The beginning of a comprehensive effort to implement financial-sector liberalization in 1988 gave an additional boost to foreign capital inflows.

It is also worth noting that, at the time, investors from industrial countries were seeking better returns abroad in the face of low domestic interest rates. The early 1990s saw a sharp increase in net capital inflows, which reached a record high of U.S.\$29.4 billion in 1993 [Leiderman and Thorne 1996]. Naturally, these developments had a major impact on the Mexican economy; financial depth rose substantially; bank financing to the private sector posted impressive growth; and domestic demand grew due to widely available resources, fueling massive current account deficits. In sum, financial institutions, firms, and households all incurred in a leveraging process.

Unfortunately, a number of vulnerabilities began to emerge. The current account deficit was very large and mostly financed by short-term flows in the context of an inflexible exchange rate regime. Also, the large increase in credit to the private sector occurred at a time of inadequate financial supervision and regulation by the monetary authorities. In addition, as a result of the banking sector nationalization in 1982, the banks had lost trained and experienced personnel, and incentives were misplaced. The new bankers wanted to recover their investments quickly with little regard to risks taken.

In the end, the crisis was triggered by rising international interest rates, political events, and criminal acts that caused a considerable amount of political and economic uncertainty. Investors abruptly changed their risk perceptions, leading to bouts of panic and massive capital outflows. The sudden interruption of capital flows unleashed a profound crisis in the domestic financial system.

Why was Mexico hit so hard? Apart from the vulnerabilities mentioned, the crisis was so acute

because of a massive loss of confidence in the country and its institutions. Financing to Mexican banks was cut, and trade financing became scarce. The new administration obtained a financial package from the U.S. government, the IMF and other international organizations that helped avoid a liquidity problem that would have resulted in a systemic financial debacle.

President Clinton offered a loan from the Exchange Stabilization Fund of U.S.\$20 billion that required no congressional approval. The IMF then agreed to lend another U.S.\$17 billion, an unprecedented amount at that time. Together with other funds from international organizations, the loans to Mexico added up to close to U.S.\$50 billion.

At the same time, parallel negotiations with the political forces in Mexico (including the congress and the unions) were taking place. Mexican authorities implemented a harsh austerity program that included higher taxes, increases in energy prices, and expenditure cuts. It was clear that substantial changes had to take place in order for Mexico to come out on the other side. And, as is always the case, big changes imply enormous risks.

The negotiations were fraught with tension, conflict, and challenges. However, by March, a final package and adjustment program were agreed upon. The truth is that, at the time, it was impossible to say whether the measures taken would work. Turning market sentiment around is by no means an easy task, but it is of the essence in resolving a crisis of such proportions.

Fortunately, the program did work in the end, and by mid-1995, less than a year later, Mexico was in a position to enter the capital markets for financing once again, and was able to repay both the U.S. government and the IMF years ahead of schedule. The results of the efforts set in motion in Mexico as a response to the crisis of the early 1990s are testament to the success of this strategy. However, we must keep in mind that the costs were also high. GDP declined by 6.2 percent in 1995, and the fiscal cost of the associated banking and financial crisis is estimated at around 15 percent of GDP. Yet, recovery was V shaped. By the end of 1997, output was substantially higher than precrisis levels, helped by very rapid export growth associated with NAFTA and, in general, a favorable international context.

In my view, the most important lesson from this episode is that recovering market credibility is

crucial in the resolution of a crisis. Decisive action was what determined the positive outcome of the Mexican peso crisis. The program was designed to overshoot both in financing and adjustment, and to stay ahead of the curve. This is what allowed the authorities to enhance credibility; and this is what the actions undertaken to deal with the euro crisis is missing. The 1995 financial package for Mexico and the stabilization program that was implemented had a similar effect as the Brady Plan. They set the stage for the restoration of stability and growth.

Going back to Greece, in spite of July's Eurozone Summit, which delivered an additional 109 billion of official lending and improved liquidity by removing its need to access the market until 2014, debt sustainability remains highly unlikely at the moment. Greece will have to run a primary surplus of about 3–4 percent of GDP until the end of this decade just to bring its debt-to-GDP ratio to 120 percent by 2020.

But what if the program is fully implemented but yet insufficient to allow Greece to return to the markets? To push its debt ratio further down, to 80 percent of GDP for instance, in order to be able to return to the markets, the country would need to run a primary surplus of 10 percent until the end of this decade. This assumes that nominal growth and interest rates average 3.5 and 4.5 percent, respectively. This is more than twice the adjustment achieved in the most ambitious fiscal consolidations on record [Deutsche Bank 2011]. On top of that, social resistance to wage and expenditure cuts is escalating, making fiscal retrenchment more complicated.

4. Concluding Remarks

The funding concerns of the Eurozone have broadened to more basic questions regarding the effectiveness of Euro area policymaking and the sustainability of the euro.

The European fiscal crisis has turned into a political crisis, and it is the linkage between the two wherein the problem lies. There is an eroded confidence in the political process, as European leaders have consistently fallen short by giving mixed signals to both debtors and creditors. Although the proposals agreed to on July 21 did show some progress, they were still perceived to be part of a pattern of "too little, too late."

One of the main problems for Europe is that institutions, with the exception of the ECB, are not

designed to make decisions, but to deal with processes. Thus, they are ill-equipped to deal with a financial crisis. Only the ECB has the power and ability to make decisions, but the mandate and scope of the bank is in the sphere of monetary policy and financial stability.

However, the escalating crisis and the problems described regarding the institutional framework have forced a reluctant ECB to go well beyond its traditional responsibilities. The last example is the ECB taking the role of the IMF and imposing fiscal conditionality in Spain and Italy in exchange for activating the Securities Market Programme⁵ to purchase Spanish and Italian debt.

The question regarding the effectiveness of policymaking—or lack of it—in the Euro area has to do with the absence of political mechanisms (and perhaps political leadership) designed to tackle problems which, in the view of market participants, are essential to the viability of the Eurozone.

Furthermore as the fiscal crisis remains unresolved, the concern that policymaking is ineffective has morphed into the question of the very existence of the euro. This is the most difficult and worrisome aspect of the fiscal crisis. The rescue of Greece and the other countries within the IMF-EU programs is a necessary first step, but it will not end the debacle.

When Greece's debt problems emerged last year, some believed they were trivial given that the country's weight in the Euro area's GDP is only 2.5 percent. However, the failure to end this crisis in its early stages triggered a domino effect, putting the sustainability of the ERM at risk.

Basically, two ways out of the Euro debt crisis exist: (1) a fiscal union, or (2) an ERM breakdown. As I mentioned, the establishment of an effective political mechanism of coordination and decision making on the fiscal front seems to be the next step needed to preserve the Monetary Union (accompanied by: (i) debt relief and (ii) a credible and deep structural reform). Regarding the alternative, a breakdown policymakers should keep in mind that currently there is no exit strategy and that the costs such disintegration would entail are probably enormous, both for the Eurozone and the entire

⁵The Securities Market Programme is defined by the European Central Bank as: "Interventions by the Eurosystem in public and private debt securities markets in the euro area to ensure depth and liquidity in those market segments that are dysfunctional." <http://www.ecb.int/home/glossary/html/act4s.en.html>.

global economy. There is no way that an ERM rupture could occur in a simple and orderly manner. The consequences are unknown, but in my view the costs of the Lehman Brothers collapse would be dwarfed by comparison.

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