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Jeromin Zettelmeyer¹

Lessons from the 2000–2002 Crisis in Argentina for the Sustainability of the Euro

In December of 2001, after two years of recession and increasingly desperate attempts to forestall a debt crisis through IMF financial support, fiscal adjustment and debt management operations, Argentina defaulted on its external debt. A few days later, on 2 January 2002, it discontinued its “convertibility regime” – a legal commitment, backed by hard currency, to exchange the Argentina peso for US dollars at 1:1. The peso subsequently devalued by about 200 percent, and GDP fell by about 11 percent, before beginning a sustained recovery from 2003 onwards.

There are important parallels between the Argentine 2000–2002 crisis and the euro crisis ten years later, particularly as it played out in Greece. Both occurred in the context of hard pegs. Both were triggered by large external shocks. Both involved IMF-supported programmes that failed to restore solvency. Both resulted in historically large sovereign debt restructurings (Cruces and Trebesch 2013, Zettelmeyer et al. 2013). Both involved large output losses – cumulative negative growth of almost 20 percent in Argentina between 1999 and 2002, and almost 30 percent in Greece between 2009 and 2013. They differed, however, with respect to one critical outcome: the Argentine crisis resulted in the abandonment of Argentina’s hard peg, while the euro survived the crisis – even although Greece came close to exiting.

This article aims to examine both the commonalities and differences of the Argentina and euro crises, with a particular focus on Greece, with a view to answering two questions.

- Firstly, what were the causes of the abandonment of the Argentine convertibility regime in early 2002, and what does this allow us to infer about the conditions, if any, in which the euro might in the future suffer a similar fate?

- Secondly, what does the Argentine experience teach us about the potential costs and benefits of a euro exit?

To answer these questions, the article begins by briefly recalling the origins of the two crises. The question of why there was a devaluation in Argentina, but not in Greece is examined next, followed by a review of the aftermath of default and devaluation in Argentina and its lessons for the euro area.

CRISIS ORIGINS

In both Argentina and the euro area, the dynamic that ended with default and devaluation in Argentina and with loss of market access and eventually debt restructuring in Greece was set in motion by a severe external shock. In Argentina, this was the 1998 Russian default, which led to large capital outflows from emerging markets, the devaluation of the currency of Argentina’s largest neighbour, Brazil, and a deep recession in 1999. In the euro area, it was the end of the US housing bubble in 2007 which, following the collapse of Lehman Brothers in 2008, triggered large capital outflows from Europe to the United States and a deep recession in 2009.

In both cases, vulnerabilities that had accumulated prior to the external shocks played a critical role. The nature of these vulnerabilities, however, was somewhat different.

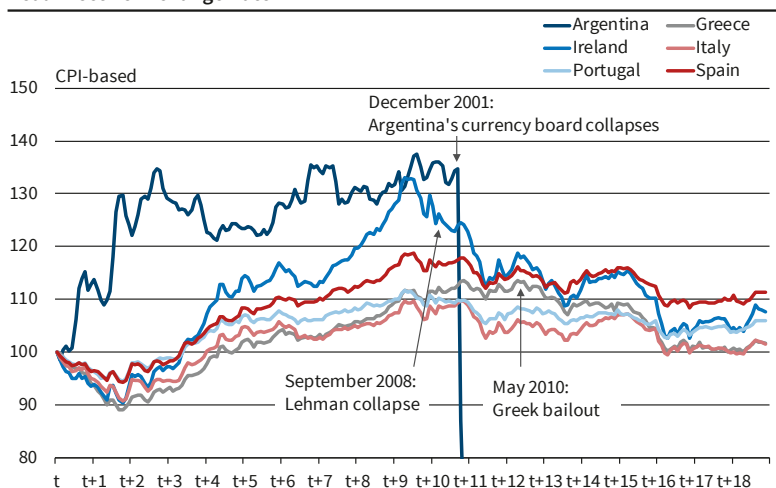
- In Argentina, the main vulnerability was a sustained loss of competitiveness after the introduction of the convertibility plan in 1991 (Figure 1). Primary fiscal deficits also played a role, but they were comparatively modest, and not a major contributor to the debt dynamics at the central government level (Figure 2). At the end of 2000, the year prior to the collapse, federal debt stood at just 45 percent of GDP. The debt ratio exploded only after the 2002 devaluation. More important than the size of fiscal imbalances was the government’s inability to reduce them, a result of



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Figure 1

Real Effective Exchange Rate



Note: The series starts at the time of the currency pegging. Argentina: series starts in April 1991 when the currency board regime was introduced, and ends in January 2002 when it was abandoned. Rest of the countries: series starts in January 1999 when the euro was introduced.
Source: IMF (2018).

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political weakness, recession, and a federal structure that made it hard to impose fiscal adjustment on local authorities (Sturzenegger and Zettelmeyer, 2007).

- Euro area crisis countries also suffered from a loss of competitiveness in the decade leading up to the crisis, albeit more gradually and (except in Ireland) to a lesser extent. Instead, the key vulnerabilities resulted from credit booms in some countries (Ireland, Spain) and public overborrowing in others, particularly Greece, where government debt stood at 130 percent of GDP at end-2009. Unlike Argentina, primary deficits were a leading contributor to the rapidly rising debt to GDP ratio between 2003 and 2009 (Figure 3). In short, in Argentina, the loss of competitiveness and external shocks led to stagnation and recession, boxing the economy into a corner that it found impossible to exit without a devaluation. Argentina's debt crisis was mostly a *consequence* of a balance-of-payments crisis. Greece's debt, by contrast, became unsustainable due

to a combination of longstanding public over-borrowing and a major recession.

WHY ARGENTINA EXITED CONVERTIBILITY, BUT GREECE DID NOT EXIT THE EURO

While the crises in Argentina and the euro area had an important trigger in common – external shocks that led to severe recessions – they differed in one critical respect, namely, the availability of external financing. This explains why Argentina exited its currency board, while Greece did not exit the euro.

From 2000 onwards, crisis management in Argentina consisted of a constant struggle to retain or regain access to external financing. A rising deficit, driven mostly by higher borrowing rates following the 1998 Russian shock and its knock-on effects on Latin America, had triggered a debt run in December 2000. Over the course of the ten months that followed, Argentina attempted to continue

servicing its public debt through a combination of borrowing from the IMF, pressuring local banks to buy bonds and roll over provincial debt, a large – and expensive – voluntary debt swap in June of 2001 that reduced debt service obligations in the short run, and by drawing on a contingent credit line that it had contracted with international banks. A collapse in revenue amid a deepening recession in the second half of 2001 nonetheless forced the government to attempt an extensive restructuring of locally-held sovereign debt in November 2001, followed by the decision to suspend all debt payments on December 24. At this point, massive capital flight made a devaluation inevitable: the government simply did not have sufficient reserves to continue backing the convertibility regime and had run out of sources from which to borrow those reserves.

Greece's struggle to continue servicing its public debt during 2010–2011 initially had a similar flavour. Rapidly rising yields on public debt, together with a looming rollover deadline, forced the country to seek official help, from the IMF and the EU, in early May of 2010. Despite signifi-

cant fiscal adjustment, however, the scale of government indebtedness combined with a widening recession made a deep debt restructuring unavoidable. It finally happened between February and May of 2012.

At the same time, there were significant differences between Greece's and Argentina's crisis experiences.

First the volume of official financing was much higher in Greece, coming not just from the IMF, but also (and primarily) from the EU. While net IMF disbursements to Argentina during 2000–2001 amounted to just under USD 10 billion (3.1 percent of 1999 GDP), the EU and IMF together disbursed almost EUR 73 billion to Greece during 2010–11 (31 percent of 2009 GDP). In addition, the ECB purchased around EUR 43 billion in Greek bonds in the secondary markets (Trebesch and Zettelmeyer 2018). This massive official support had the effect of delaying the debt restructuring, which would have happened much earlier in an emerging market setting.

Most importantly, the restructuring did not trigger an exit from Greece's currency regime. The essential reason is that a currency union does not require its members to own the reserves that are required to defend it. As capital flees the country, these reserves are automatically borrowed from the central banks of other member states, through the payments system that links banks to one another – the “TARGET” system, as it is called in the euro area. On the eve of its debt restructuring, Greece's TARGET liabilities amounted to about EUR 107 billion – EUR 88 billion more (37 percent of 2009 GDP) than in May 2010, the first month for which the ECB publishes TARGET balances. In contrast, as Argentina was entering its crisis at end 1999, it had just USD 26 billion of gross international reserves at its disposal (8.5 percent of 1999 GDP).

Since any currency union member can effectively borrow unlimited amounts of reserves through the payments system, the constraint that determines whether a country is forced to exit a currency union is not the balance of payments. Rather, it is the willingness of the currency union's central bank to continue to provide liquidity to the country's banking system (the essential condition for the payments system to work). In the case of the ECB, this willingness does not seem to depend on whether the government meets the conditionality of an official support programme, nor similar standards of behaviour (as dictated by EU fiscal rules for example). But neither is it unlimited. During 2010–2015, the ECB appeared to follow a decision rule whereby it continued to provide liquidity to the Greek banking system through either regular facilities, or emergency liquidity assistance (ELA) regardless of programme performance, provided that the government was either still formally in a programme (i.e. the time window approved for disbursements had not expired), or was negotiating a new programme in good faith. Greek banks were cut off from ECB liquidity support only when neither of these conditions were met, in the first two weeks of July 2015, forcing Greece to choose between issuing its own currency and returning to the bargaining table. It chose the latter.

THE COSTS OF EXIT IN ARGENTINA

Following default, exit from convertibility and devaluation, Argentina's economy continued to shrink, by about five percentage points in the first quarter of 2002. While it is impossible to distinguish how much of this was due to the confidence effects and capital outflows triggered by the default, a contributing factor was surely the “pesification” of early February – an attempt to redistribute the losses associated with the revaluation of US dollar liabilities through the forced conversion of USD-denominated deposits and bank loans into pesos at different rates.² “Pesification” led to a banking crisis, withdrawal restrictions, and – as the central bank injected liquidity into the banking system – a further currency collapse.

It is possible that the economic costs of exit and devaluation in Argentina were aggravated by the government's choice to convert the deposits of the banking system at higher rates than its claims, while at the same time choosing a deposit conversion that was less favorable to households than the market rate. In this way, pesification both rendered banks insolvent and triggered a deposit run. However, if the government had chosen a different approach – one more favourable to the banks, for example, by converting their claims on private borrowers at a rate closer to the market rate – this would have led to massive corporate insolvencies. No matter how a devaluation is managed, the presence of large-scale foreign currency denominated claims in the financial system will hurt either creditors or debtors. Attempts by the government to control panic by forcing bank holidays or imposing withdrawal restrictions can make things worse.

In light of this, what is most surprising about Argentina's 2002 currency crisis is perhaps not that it led to an additional output collapse, but that the collapse was not bigger, and gave way to stabilisation after only two quarters, and recovery after only one year. The cumulative output decline associated with Argentina's crisis was much smaller than that of the Greek crisis. It took Argentina about three years to restore its end-1999 real output level, whereas Greece has still not returned to its 2009 real GDP after eight years, and will not reach it even by 2023, according to IMF projections.

A potentially much more serious consequence of Argentina's default and exit from convertibility was a breakdown in trust and the return of populist politics for the next decade, and beyond, with the election of Nestor Kirchner, to the presidency in 2003, succeeded by his wife, Cristina Fernandez, in 2007. Under the Kirchner/Fernandez presidencies, output initially recovered rapidly, but at the costs of repressed inflation, supply-side distortions, international isolation stemming from its aggressive handling of the dispute with external

Figure 2

Argentina Debt Dynamics Decomposition 1995–2005, central government

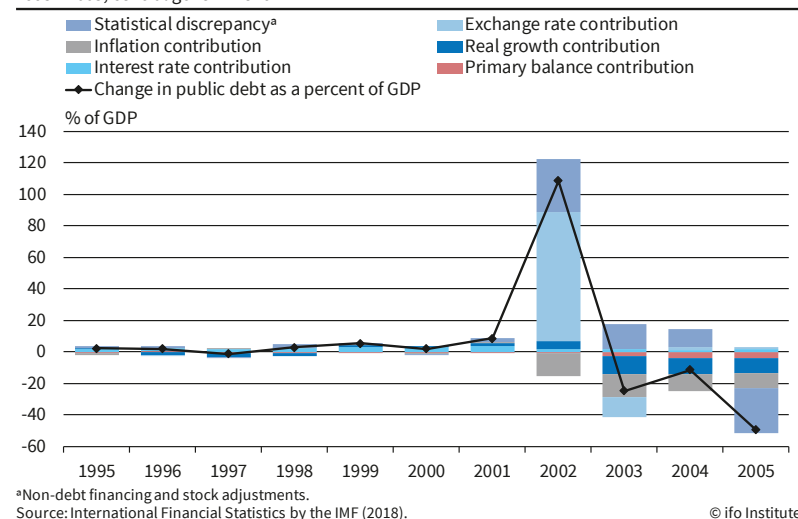
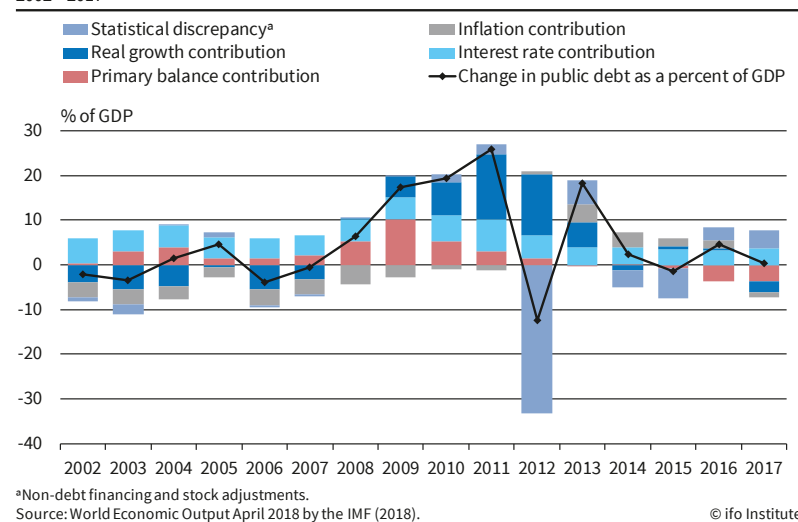


Figure 3

Greece Debt Dynamics Decomposition 2002–2017



² USD deposits were converted into pesos at a 1:1.4 rate, USD loans to the public sector at 1:1.4 and USD loans to the private sector at 1:1, at a time when the market exchange was about 2:1. For details, see Sturzenegger and Zettelmeyer (2007), pp. 182–186.

creditors and a return to growing deficits from 2009 onwards, which ultimately led to a new crisis in 2018, despite a change in government in 2015. While these problems have deep historical roots and were compounded by external shocks, the failure of Argentina's "convertibility" experiment surely contributed to them.

IMPLICATIONS FOR THE EURO

The observations made in the previous three sections have two main implications for the sustainability of the euro and the consequences of exit.

Firstly, the euro is, by construction, much more resilient as a currency regime than any of its cousins in the family of hard pegs. Sudden capital outflows from any specific member are automatically accommodated by the intra-euro payments system. This does not mean that they have no real consequences – as the euro crisis showed, they can trigger banking and sovereign debt crises. But they cannot force exit via the same mechanism through which currency crises happen, namely, that the government either runs out of resources to defend a peg or is forced to raise interest rates to prohibitive and self-defeating levels. Membership in the euro is equivalent to a hard peg with infinite reserves.

This does not imply that the euro cannot fall apart, only that exit is voluntary. Specifically, there are two scenarios that could conceivably lead to exit.

As became clear during the 2015 Greek crisis, the equivalent of running out of reserves in the euro – in the sense of a financial constraint that could force exit – is the decision by the ECB to stop emergency liquidity assistance (ELA) to a member's banking system. The trigger for this, in turn, is the non-cooperation of a member, in the sense that the member in question experiences a financial crisis in which its banking system would require ELA, but does not seek ESM support. Hence, one way that euro exit could happen is through a run on a member's debt, together with the member's decision not to engage with the ESM or the EU on an economic programme that could resolve the crisis.

Voluntary exit may also happen if euro area membership is associated with protracted stagnation which, in the eyes of the government and the general population, can only be addressed by exiting the euro. In this sense, there is a parallel between Argentina's exit from convertibility and a potential future exit from the euro. While Argentina's exit was ultimately triggered by a lack of resources to continue supporting the peg, this lack of resources was closely related to the inability of the Argentine government to restore growth within the framework of the convertibility plan, despite repeated efforts over the preceding two years.

The second – more speculative – lesson for the euro from the Argentinian crisis is that exit from the euro would be economically very costly, given the need to manage enormous balance sheet losses. Even more importantly, it would be politically extremely damaging for both the exiting country and the EU, because the

acrimony associated with creditor-debtor conflicts – within the country and across borders – would happen on a larger scale than in Argentina, given much closer financial, political and institutional linkages. With the EU becoming the arbiter of these conflicts, it is easy to see a level of populist response that could take the country out of the EU too, even if the EU tried to accommodate a euro exit. For this reason, an exit from the euro is unlikely to be followed by the quick (if ultimately unsustainable) recovery that Argentina experienced from 2003 onward.

CONCLUSION

The aftermath of Argentina's default and exit from convertibility in 2002 suggests that euro exit would threaten the political and social cohesion of the EU, perhaps with irreparable consequences. Making euro exit irreversible as a matter of economics, rather than just law, requires meeting two conditions.

Firstly, the euro area needs to develop a legal and governance framework that allows the ECB to continue providing liquidity to a member's banking system even when a government does not agree to an ESM-supported programme. This requires giving a euro area authority the power and resources to recapitalize, restructure, and temporarily run a banking system that would otherwise lose access to ELA.

Secondly, the architecture of the euro area must minimize the chances of prolonged periods of depression or stagnation. This requires, in particular, that unsustainable sovereign debts be restructured, rather than pretending that they can be gradually reduced through many years of austerity. As argued by Bénassy-Quéré et al (2018), allowing debt restructurings as a last resort means that banking systems need to be protected from sovereign risk, giving pre-qualified sovereigns easier access to ESM liquidity, and better private and public risk sharing.

Even with these reforms, it is possible that a euro member may find itself in a long period of stagnation in which a nominal devaluation begins to look like the only way out. But in the long run, economic performance is determined by institutions, not exchange rate regimes. Preventing crises and avoiding crisis responses that perpetuate recessions and pit euro area authorities against members and members against each other should hence go a long way to ensuring the sustainability of the euro.

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