Is the Euro zone on the Mend? Latin American Examples to Analyze the Euro Question

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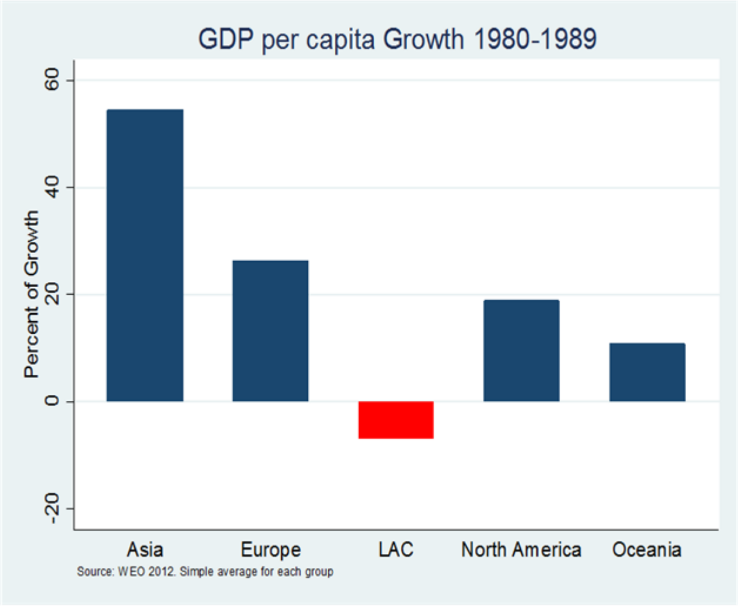
Emerging Markets Workshop 2013
Madrid, Spain
November 4 and 5, 2013

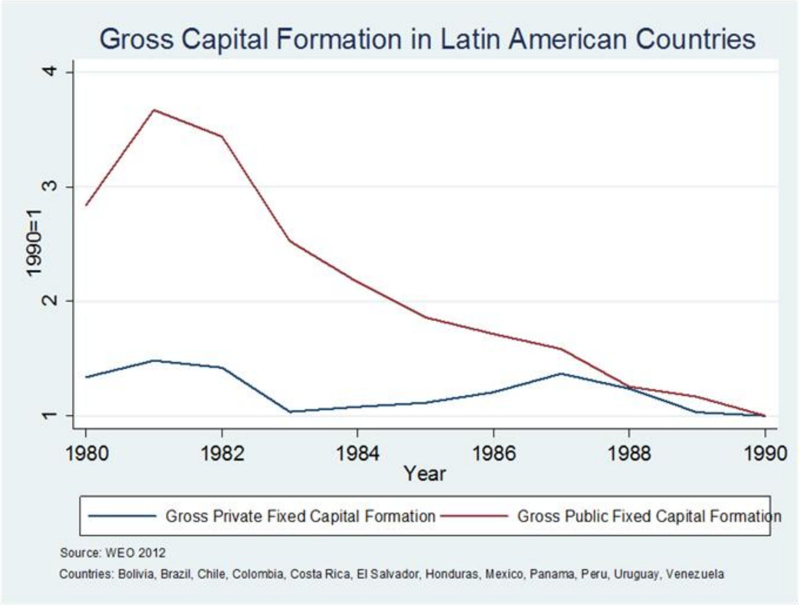
Europe is facing an old LatAm-style crisis

- **European challenges:**
  - ✓ **Debt overhang.**
  - ✓ **Sudden stops in *private* capital flows.**
  - ✓ **Growth collapse and low competitiveness.**
  - ✓ **Banking system distress.**
- **What does the LatAm experience with crisis resolution tell us about current European challenges?**

Debt Overhang is a Problem

- **<u>Baker Plan in the 1980s</u>: protracted rescheduling –to diffuse the threat of a banking crisis in the United States.**
  - Fiscal austerity proved inimical to growth.
  - The unyielding debt overhang acted as an implicit tax on investment.
  - Balance-of-payments pressures further constrained economic activity.





Debt Overhang is a Problem

- **<u>Brady Plan</u>: recognized that the debt overhang needed to be eliminated through deep debt reduction.**
  - The external official sector facilitated bilateral debt restructuring between countries and creditor banks.
  - No "debt mutualization", but multilateral institutions lent long term substantial amounts to finance discounted debt buybacks or financial enticement.
  - Countries became eligible for the Brady Plan only after meeting investment readiness requirements.
- **Countries regained market access and capital flowed back to the region.**
- **Despite the success of the Brady Plan, another type of debt problem materialized in the 1990s…**

Debt Problems are Aggravated by Sudden Stops…

- Latin American countries tended to be heavily dollarized and sovereigns and the private sector alike had significant debts denominated in nominal dollar contracts.
- Hence any negative shock that implied a required adjustment in the current account and hence that required a real devaluation had an impact on debt sustainability.
- The Calvo, Izquierdo and Talvi (2003) model combines a standard debt sustainability type methodology with the potential effects of a relative price adjustment with different assumptions regarding currency denomination of debt.

The Calvo et al. Model

- **Step 1: If a Sudden Stop hits: *what is the real exchange rate depreciation required to restore current account balance*?**
- **Step 2: Given that estimated real exchange rate depreciation, find the effect on debt to GDP ratios –given debt may be in foreign currency (i.e., tradeables).**

$$b = \frac{B + EB^*}{Y + EY^*},$$

- **Step 3: What is the effect on debt sustainability and the fiscal surplus required to maintain the (new) steady state debt level?**

Is this relevant for Europe?

- In the case of Europe, a pertinent question is the treatment of Euro debt.
- E.g.: If Spain suffers a Sudden Stop and has no other sources of financing, it would have to adjust and that implies a real depreciation in order for the balance of payments to remain in balance.
- As Spain has adopted the Euro, the value of which is not determined by Spain's particular set of circumstances, but rather that of the Euro zone as a whole, it is clear that having Euro debt is just like having debt in an external currency.
- In the context of the Calvo, Izquierdo and Talvi (2003) model, it is akin to having debt denominated in tradeables and not in (Spanish) non-tradeables.

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Calibrating a Latin American Model to Europe

Table 2: Results from a Simulation of a Sudden Stop Debt Sustainability Model

Growth and interest rates are medium term averages, debt, and other economic characteristics are as of 2012

Country	Required RER Depreciation	DEBT (% GDP)	Estimated New Debt (% GDP)	Primary Surplus (%GDP)	Required Primary Surplus to Stabilize Debt using Hist. Interest Rates (% GDP)	Required Primary Surplus to Stabilize Debt using Higher Interest Rates (% GDP)
Portugal	9.91%	122.99%	130.13%	-0.75%	5.03%	7.60%
Italy	4.57%	126.98%	130.98%	2.31%	3.60%	6.19%
Greece	25.86%	158.55%	187.27%	-1.20%	15.46%	19.16%
Spain	8.62%	84.08%	88.80%	-7.86%	0.96%	2.69%

Source: authors' calculations.

- **Except for Greece, the potential problem that RER valuation effects might cause in the Euro zone appear to be small.**
- **A key difference between Europe now and Latin America then, is the availability of intra Euro zone financing mechanisms to keep the sudden stop at bay.**

Is Europe on the Mend?

Country	Year	Required RER Depreciation (Baseline; χ=0.4)	DEBT (% GDP)	Estimated DEBT/GDP (assuming all debt is foreign)	Estimated DEBT/GDP (assuming all debt is domestic)	Primary Surplus (% GDP)
	2010	38.09%	61.32%	76.65%	55.51%	-8.25%
Spain	2011	29.92%	69.12%	82.28%	63.33%	-7.51%
	2012	8.62%	84.08%	88.80%	81.81%	-7.86%

- **If Spain does not get access to new private capital flows, and yet wishes to reduce the stock of Euro system financing and get back to somewhere close to the level of unemployment of 2010, then it will have to continue the adjustment process, engineer greater real depreciation and consequently the debt to GDP ratio will have to continue to rise.**

Europe has more and better tools to keep the sudden stop at bay….

- **The existence of EU creates possibilities that were not available in Latin America.**
- **Supranational institutions, such as the ECB, are resourceful and have the capability to avoid costly crises.**
- **The ECB and various Euro funds may keep the sudden stop at bay, and keep the interest rate low.**
- **But having more tools to address the problems does not guarantee success.**
- **This buys time…but the time has to be put to good use…**

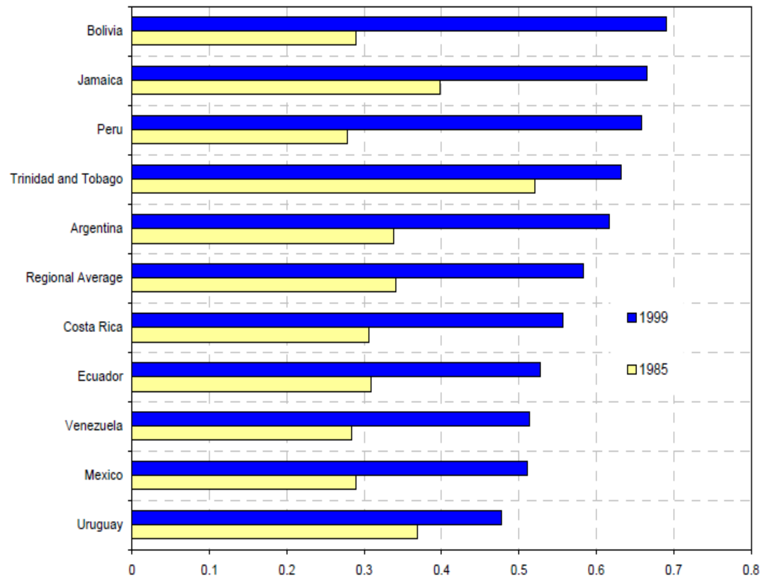
Facing Sudden Stops

- **Post-Sudden Stop adjustment: cyclical vs. structural factors.**
- **Cyclical: LatAm experience suggests that expansionary macro policies can smooth the adjustment…BUT, how do you finance it? (i.e., see Cavallo and Izquierdo, 2009)**
- **Structural: the longer it takes for private capital flows to resume, the more likely it is that solvency will be at risk and require some form of debt restructuring and/or growth-oriented policy reforms to restore it.**
- **Countercyclical policies financed with external financial assistance can allow time for economies to adjust, but they are no substitute for structural reforms aimed at reducing the underlying vulnerabilities and restoring long-term growth.**

Reigniting Growth is Essential

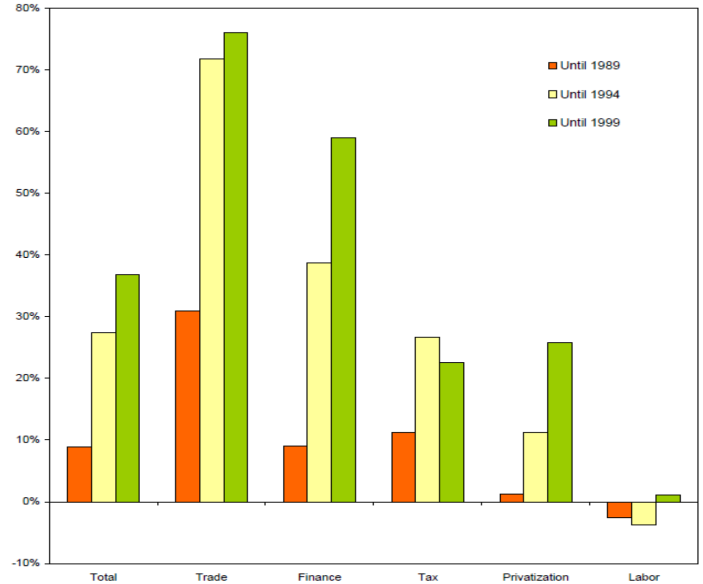
- **In LAC, the Brady Plan in the 1990s was implemented concurrently with structural reforms, giving credibility to fiscal discipline and allowing for productive use of renewed investment**

Figure 1. Structural Reform Index
(Countries with the best and worst ratings in 1999)



Source: Lora and Panizza (2002)

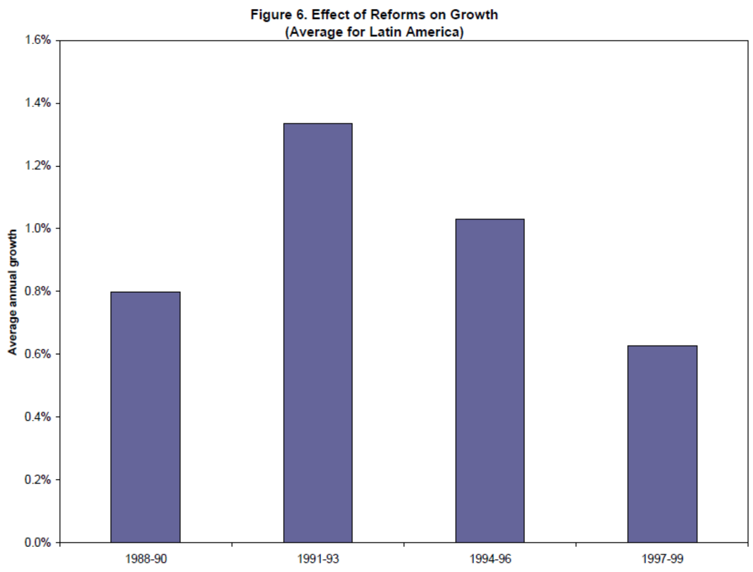
Figure 2. Progress of Reforms in Latin America
(Margin of Reform Put to Use)



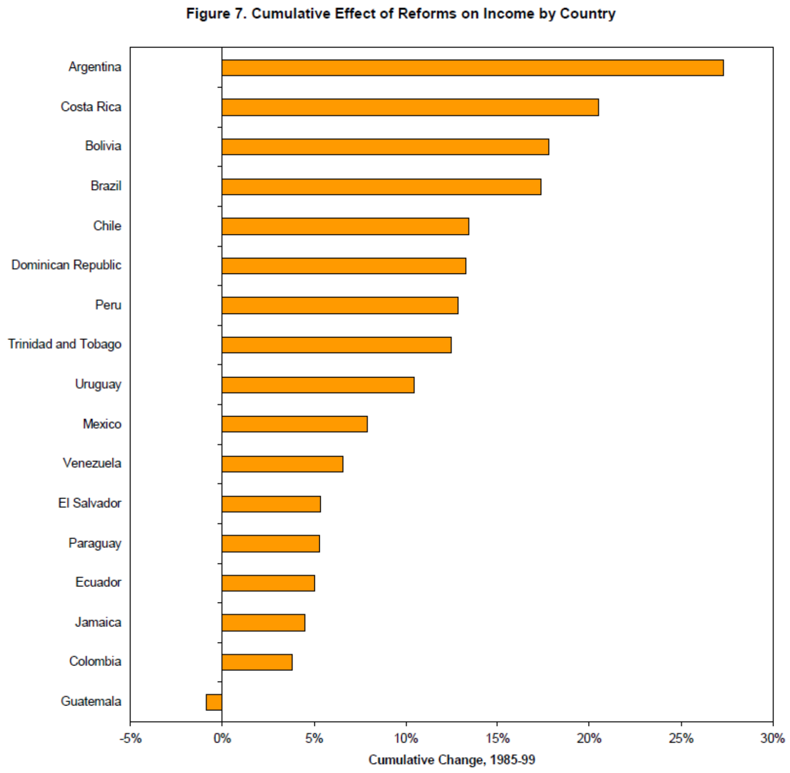
Note: Progress in reforms is measured as that part of the potential for reform as of 1985 that was actually used by the years 1989, 1994, and 1999.
Source: See Appendix 1.

Source: Lora and Panizza (2002)

Structural Reforms Payoff



Lora and Panizza (2002)



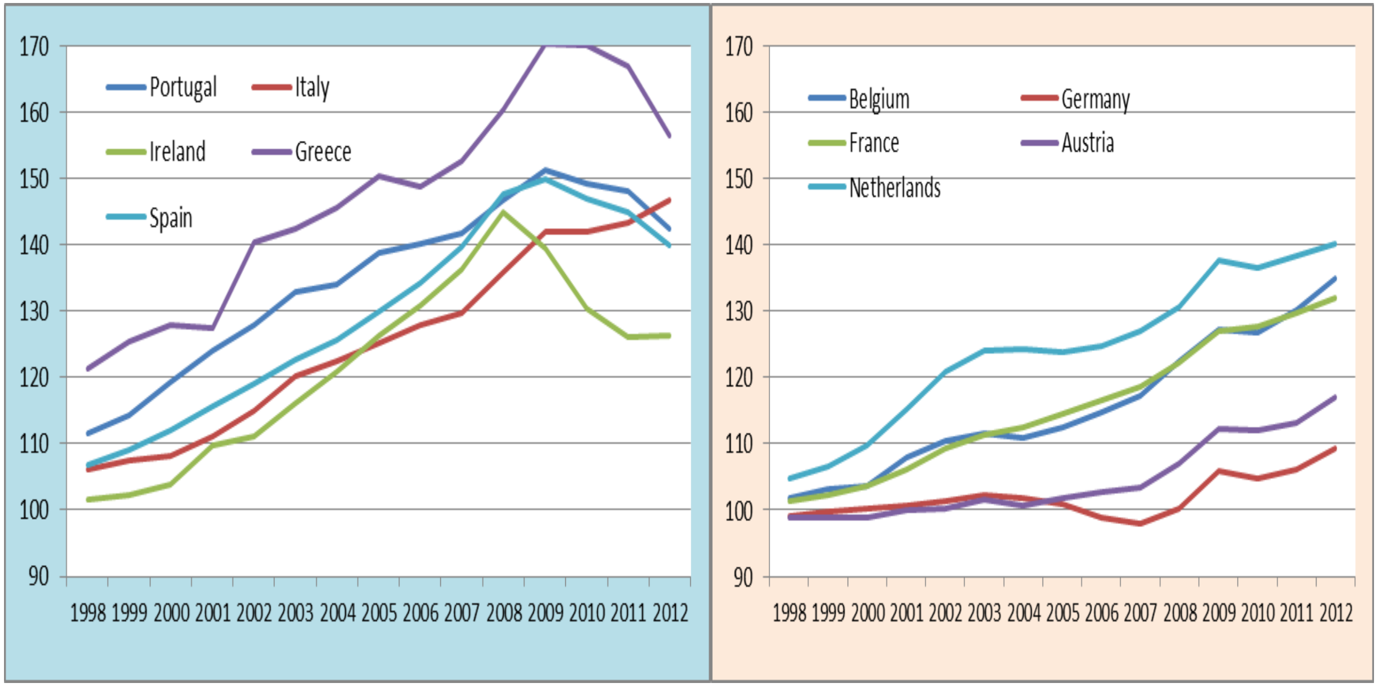
Lora and Panizza (2002)

- **To be effective, reform effort has to be sustained overtime.**
- **Crises are periods when reforms can be implemented.**

The Competitiveness Problem

Figure 3: Nominal Unit Labor Costs: Peripheral and Core Euro zone Countries

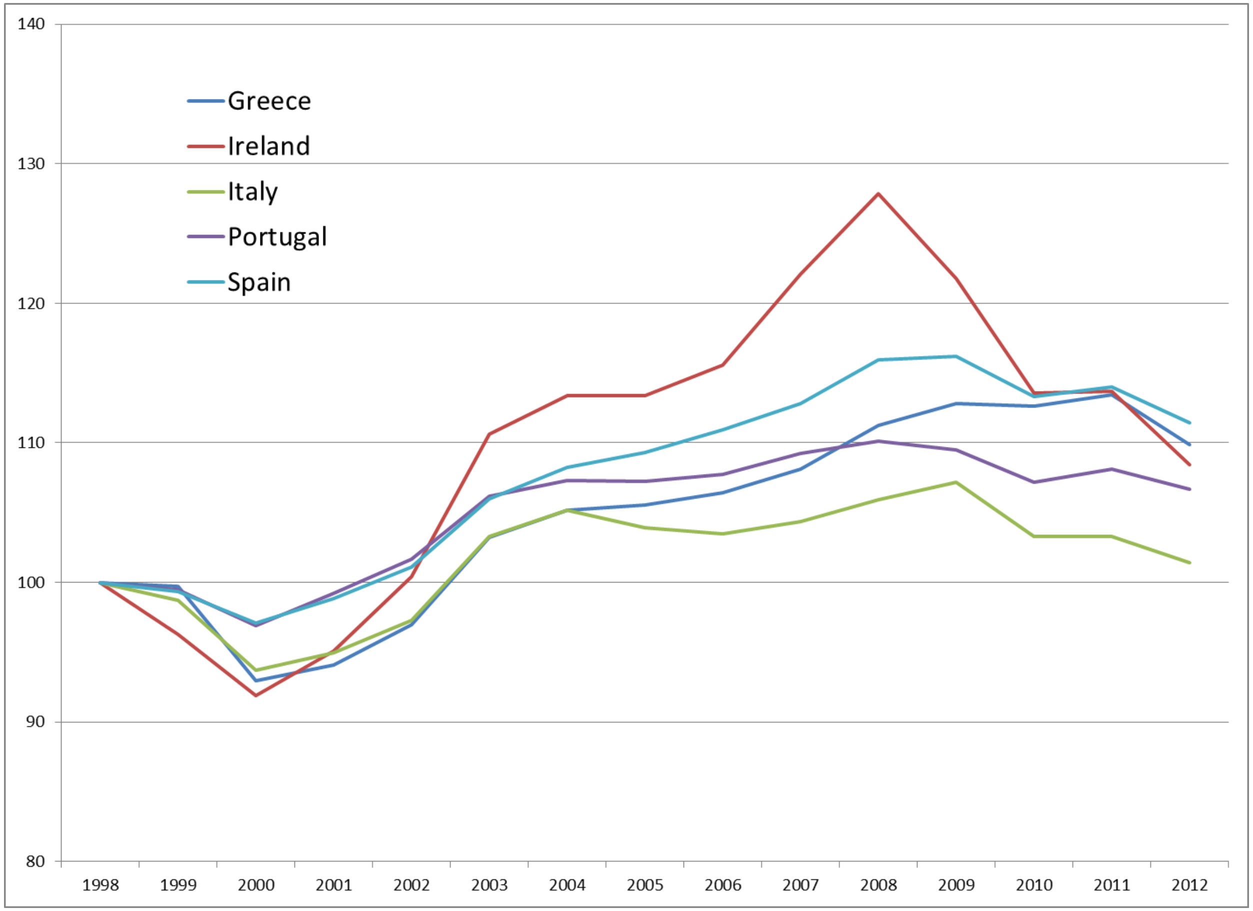
(Index 1995=100)



Source: AMECO

Real Exchange Rates have been adjusting in Europe: is it enough?

Figure 4: Real Exchange Rate for Peripheral European Countries

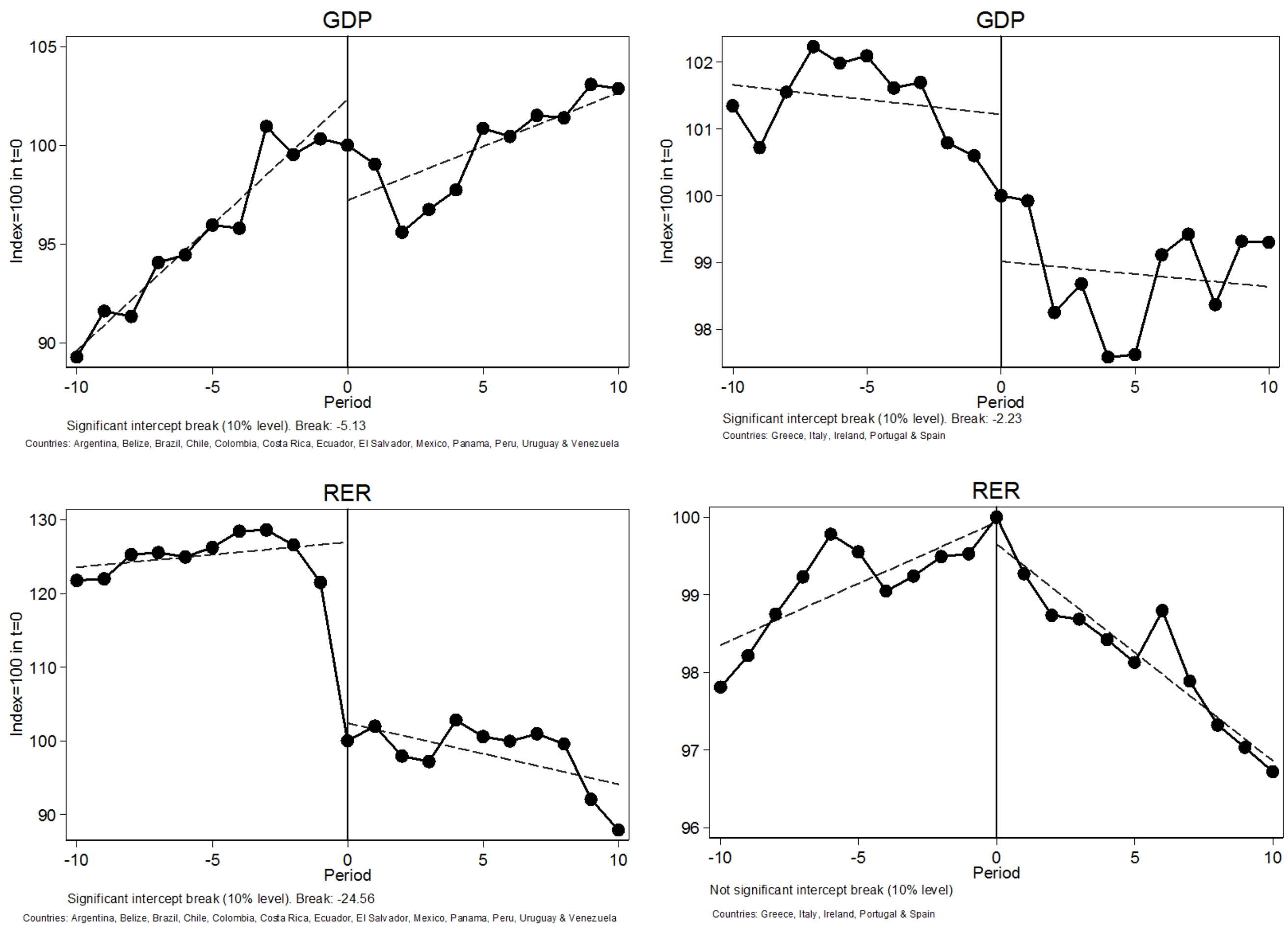


Surce: Real effective Exchange Rate (IMF-IFS).

The ability to effect RER depreciation is the Euro zone is limited

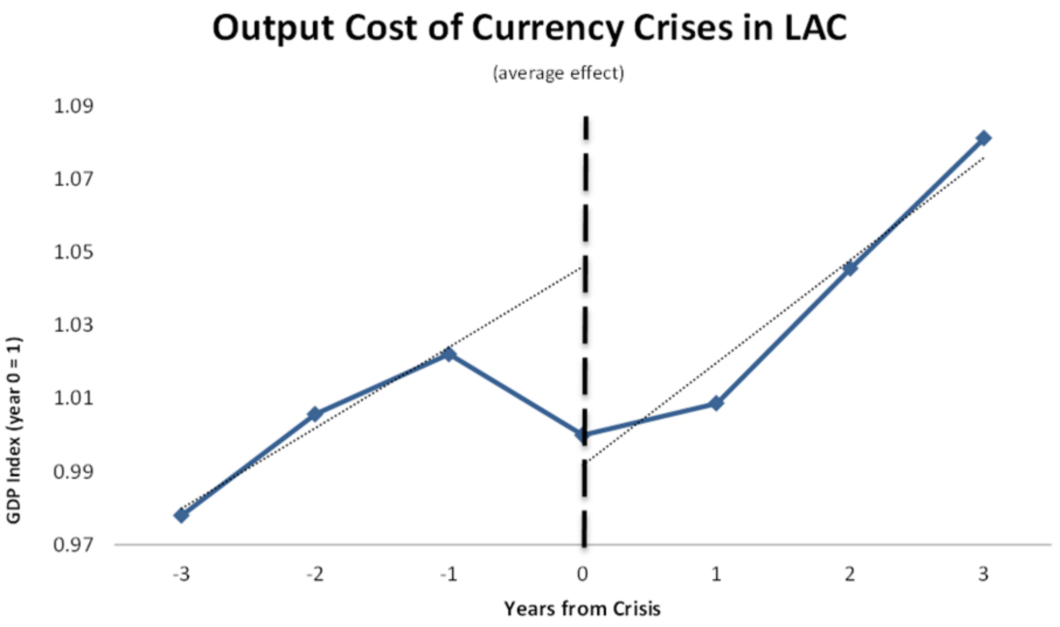
Figure 2: Capital flows in Selected Latin American and Eurozone Countries

Latin America | **Peripheral Europe**



Restoring Competitiveness Avoiding Debacles

- **Real depreciations entail either nominal ER devaluations or lower domestic price inflation, even deflation in extreme cases.**
- **For Euro zone countries, having nominal ER flexibility would be desirable now, BUT beware of currency redenomination when exit under pressure...**



Source: World Bank data. Crisis Dates:: Laeven and Valencia, 2008.
Countries (crisis year in parenthesis): Argentina(75,81,87,02), Bolivia(73,81), Brazil(76,82,87,92,99), Chile(72,82), Colombia(85), Costa Rica(81,91), Ecuador(82, 99), El Salvador(86), Guatemala(86), Honduras(90), Mexico(77,82,95), Nicaragua(79,85,90), Peru(76,81,88), Paraguay(84,89,02), Uruguay(72,83,90,02), Venezuela(84,89,94,02).

Restoring Competitiveness Avoiding Debacles

- **The costs of exiting the euro could be very high (Cavallo and Fernández-Arias, 2012).**
- **On the positive side: European cooperation may go a long way toward helping Euro zone crisis countries regain competitiveness despite not having the devaluation option….**
- **…complementing fiscal devaluation in less competitive economies with fiscal revaluation in core countries in the Euro zone, and buy time for these policies to work gradually.**
- **Or allowing higher euro inflation, which would provide more space to open a healthy inflation gap in peripheral countries.**

Banking Fragility and Crises

- **LatAm is a clear example of the "Fatal Embrace" between banking crises and public debt.**
- **To minimize the entanglement it is better to err on the side of resolution mechanisms that economize on public resources.**
- **Basic principles:**
  - If liquidity considerations due to contagion or panic are at play, it is important to swiftly provide ample liquidity even if some resources are put at risk.
  - If banking problems are more fundamental (e.g., bad real estate loans), liquidity remedies will be ineffective and decisive banking crisis resolution must be implemented, but always with an eye to minimizing emerging fiscal liabilities.
  - In LAC, some of the successful methods employed were: the privatization of troubled public banks; and a minimalist approach to only address problem banks and target assistance to preserve the payment system.

Is the Glass Half Full or Half Empty?

- **Difficulties in Europe are similar to those faced by Latin America in the past.**
- **Complicating factor: currency rigidity.**
- **Alleviating factor: more and better tools to confront the crisis.**
- **Difficult balance to strike: more RER depreciation is probably needed for competitiveness, but RER depreciation can deepen debt problems.**
- **Euro break-up would be extremely costly, so it should tried to be avoided.**
- **Limited external support was behind the depth of Latin America's great collapses.**
- **Europe can and should fare a lot better, but be aware of the risks.**

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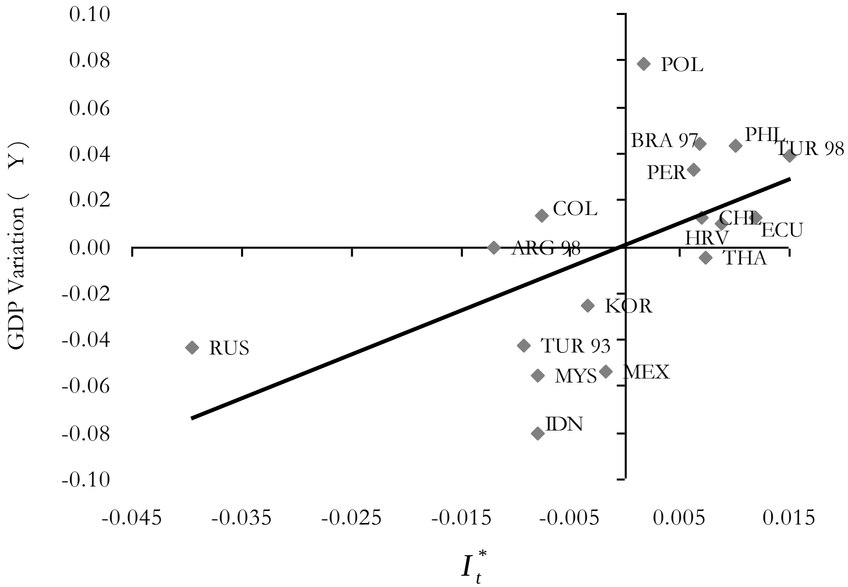
Expansionary Policies can Help

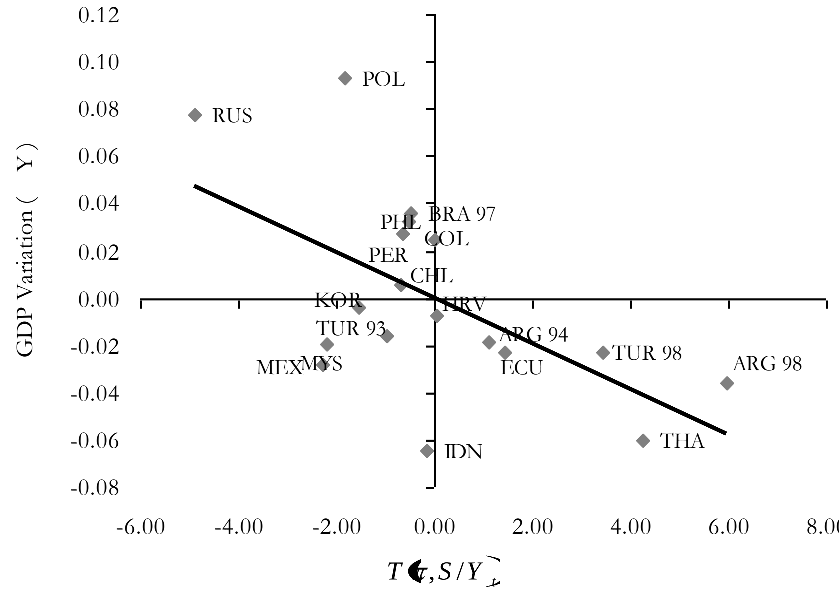
Fiscal Policy

(GDP variation and Structural Fiscal impulse partialling out the effects of monetary policy)



Monetary Policy

(GDP variation and Monetary Policy Regime index partialling out the effects of fiscal policy)



Source: [Ortiz, Ottonello, Sturzenegger and Talvi (2008, Chapter 2 in Izquierdo and Cavallo, Eds)]

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