

Latin Lessons for the Euro Zone

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Crises invite comparisons. And we have already more than a few comparisons between the Latin American crisis of the 1980s and the euro-zone crisis today. But crises also invite facile comparisons. It is important, in other words, to draw the right lessons.

A first lesson of the Latin American debt crisis for Europe today is that politics matter. To a significant extent, the crisis of the 1980s had political roots. Latin American governments ostensibly borrowed abroad to finance infrastructure projects and boost economic growth. In reality, however, much of the borrowed money was used to maintain consumption standards and, in that way, political support for sitting governments.

This was especially true after 1979, with the second OPEC oil-price increase and then the Volcker shock (the sharp increase in interest rates by Paul Volcker's Fed designed to wring inflation out of the U.S. economy). Imported oil and payments on the foreign debt both having become more expensive, Latin American governments and households should have adjusted their borrowing and spending. Instead, Latin American debt more than doubled from \$159 billion to \$327 billion between the beginning of 1979 and end of 1982. Populist politics made the alternative, austerity, effectively impossible. That 1982 was a presidential election year in Mexico, the first country to default, was no coincidence. This failure to rein in spending made the subsequent crisis inevitable.

Precisely the same was true of Southern Europe over the last decade. Supposedly the capital flowing into countries like Greece, Portugal and Ireland was for financing the investment needed for them to catch up, economically, to their wealthier EU partners. In reality the imported finance fed an enormous consumption boom. While the exact symptoms differed – while Greece saw a sharp increase in public-sector pay that spilled over to the private sector, Spain experienced a real-estate bubble, and Portugal a combination of these problems – the underlying cause was the same, namely the fall in interest rates to German levels and the ready availability of finance. Again, external shocks, this time in the form of the Great Recession of 2008-9, triggered the crisis. Again, that there were elections coming, like that in late 2009 in Greece, explains why governments didn't take steps to head it off.

But a second lesson of Latin America's crisis is that it takes two to tango, as our Argentine friends would say. That money center banks in New York engaged in the process of petro-dollar recycling were flush with funds is a large part of the explanation for why they were so willing to lend. It is not as if the banks could claim ignorance of the fact that there existed gaping budget deficits and other economic problems in Latin America. But given ample liquidity and the fact that the big U.S. banks were losing large corporations, their prize customers, to the commercial paper market made loans to Latin America an attractive alternative.

Again, we have seen precisely the same thing in Europe in recent years. The world economy was swimming in liquidity, and European financial institutions, in desperate competition with one another, were aggressively ramping up their leverage. Under these circumstances, German, French and British banks found it irresistible to lend to their Spanish and Irish counterparts, which turned around and lent to local property developers. For those German, French and British banks and the three countries' respective governments to now deny all responsibility – for them to insist that the crisis is the responsibility of Spain and Ireland alone – is disingenuous.

This observation leads to the third lesson. The reluctance of the United States and other creditor countries to contemplate debt forgiveness reflected not any deeply held belief in the sanctity of contracts but simple fears for the stability of their banks. The loan portfolios of the money center banks were more than double their aggregate capital. Thus, significant write-downs, on the order of 50 per cent, would have bankrupted them and precipitated a major financial panic.

So U.S. regulators, in their wisdom, insisted that Latin countries were able to pay. They piled more debt on the borrowers' existing debts, through official loans co-financed by the IMF and the creditor countries. They insisted on harsh austerity, or structural adjustment, programs as a condition for the extension of official credit. But spending cuts meant recessions, which produced an even larger debt overhang, discouraging investment. The result was Latin America's lost decade.

All this made debt restructuring inevitable. And the inevitable finally came starting in 1989. By which time the money-center banks had fortified their capital base, enabling them to withstand it. But much better would have been for the U.S. to have recapitalized its banks in 1982-3 in order to avoid this destructive seven-year delay.

Again this is precisely the situation in Europe today. French and German leaders are deluding themselves into thinking that debt restructuring can be avoided, since haircuts on Greek, Irish and Portuguese bonds would devastate French and German banks. In demanding that restructuring be avoided at all cost, they are consigning the Euro-zone periphery to a lost decade. A better use for their funds would be to adequately recapitalize their own banks, rather than co-financing emergency loans to the crisis countries.

A final lesson from Latin America is that, with support from the creditor countries and multilaterals, debt restructuring can be done. Starting in 1989, foreign banks were offered a menu of new bonds, some with the same nominal value as the old ones but a significantly lower interest rate, others with a shorter maturity but discounted face value. Money raised through the IMF, World Bank and U.S. government was used to add "sweeteners" or credit guarantees to the new bonds, reassuring the creditors that the new terms of payment would stick.

It took up to four years to complete the negotiations. But in the end the creditors took a 35 per cent haircut, or present-value reduction, in line with both 19th century restructurings and

debt restructurings in the 1930s. And as for fears that the borrowers would be shut out of international capital markets, by 1993 they were borrowing again, with a vengeance.

There is no reason why this experience couldn't serve as a model for Southern Europe and Ireland today. The borrowing countries could offer a menu of new bonds. IMF and EU money could provide the sweeteners. A 35 per cent write-down would be just about enough to restore them to solvency. And a lost decade would be avoided.

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