

(Re-)Evaluating the Policy Response to the Eurozone Crisis and its Implications – A Reprise

By Ranjan Chakravarty and Joseph Cherian (December 2011)

The authors wish to acknowledge extremely significant comments and contributions to this article by Bernard Yeung, Dean and Stephen Riady Distinguished Professor at the NUS Business School.

Joseph Cherian and Bernard Yeung had identified in a Straits Times [article](#) on 8 July 2010 that the immediate causes of the crisis in the Eurozone were overleveraging and overspending, and hence a period of belt tightening was to be expected in order for the European countries to emerge positively from this crisis.

Instead, in the last year, the situation has in fact deteriorated and the policy response to date has been misdirected towards managing liquidity instead of solvency. The former will stave off crisis in the short term but latter is actually the need of the hour. It is clear to us that a coordinated supra national (ECB/IMF driven) growth-oriented policy and a Brady-style debt restructuring are necessary for Europe, and on a priority basis. However, we see no indications as of today of a decisive move in this direction.

Furthermore, as the current situation stands, we see no evidence that policy coordination in Europe has been effective. Let us take a look at the centre of attention – Italy. Going by its M2 and M3 numbers, where we see a precipitous drop in growth this year, we see strong signals of economic contraction. This situation clearly is difficult, because due to credit spreads, Italian rates are high, and the only recourse open to Italy is via a broad ECB-led easing, which is not forthcoming. It is problems like this that bring back what Martin Feldstein has warned against in the effort to hold the Euro together.

In the U.S., Daron Acemoglu of MIT has recently called for the focus to be on growth and innovation. We still see no immediate evidence of such policies. Growth in the Eurozone is at 1.4%, which is close to the US's growth situation. It is symptoms like these that underscore our view that both Europe and the US are going to be in the economic doldrums for the next year and possibly out further, and the runs on their banks could continue sporadically.

Today's situation in the Eurozone is extremely similar - with the exception of the non-local currency of debt denomination - to the scene as it unfolded across Latin America, which grew robustly in the 1970s, borrowed, defaulted and resulted in the emerging market debt crisis of the 1980s, and again in the 1990s.

It is important to note that the first solution to the emerging market crisis was the Baker Plan launched in the mid-1980s, which focused on debt rescheduling, i.e., extending the

tenor of existing debt and on extending lines of credit to enable payment on rescheduled debt. The Baker Plan believed that the crisis was temporary and this bailout would create a 'growth-oriented adjustment' that would help the debtors tide over the crisis, and enable them to make payments until necessary. No restructuring of the debt was done. This did not work, the problem had exacerbated, and the Baker Plan had to be succeeded by the more prudent Brady Plan of the late 1980s.

The current bailout strategy in Europe involves using the European Financial Stability Facility (EFSF), which will offer lines of credit, with a pool of guarantor countries that would enable debtor countries to make their payments. Couple this with tenor increases, and the EFSF facility indeed looks similar to the Baker Plan, revisited. A worrisome footnote to all this is that the EFSF facility is a total of EUR 780 Billion as of the current time, of which a significant portion is contributed by Italy. The concern is whether this facility will be sustainable as Italy turns from a donor to a recipient. And what if it is joined by Spain, the next biggest contributor? This would then be possible only if the facility itself again leverages itself. Would the EFSF then be able to preserve its current AAA status? What if the European banks with exposure to Italy cause contagion in their own countries? With an EFSF facility, there is a risk that the solution may spiral into an uncontrollable problem.

In contrast, consider the Brady Plan, which consisted of negotiated restructuring of debt with a two-pronged guarantee regime. The first was that the new, reduced principal on the debt was guaranteed via the purchase of US Treasury bonds, then the global risk-free security. To this was added a series of credit-linked policy guarantees by the multilaterals, which had been agreed upon between the formerly defaulting sovereigns and the multilaterals. Finally, there was a successful face-to-face negotiated rescheduling of debt via "haircuts" or principal reductions agreed between the debtors and the creditors.

The outcome of the Brady process was that it turned formerly nonperforming sovereign fixed income assets into tradable securities that could be taken on and off the books of the creditors, and as the economies came back, would grow in value organically. Indeed many such bonds became highly profitable, and spawned not just a huge emerging market fixed income industry, but also one in related asset classes. It is worthwhile to note that even Argentina has for the most part had a great run in the Brady and post-Brady period. Other countries that have had great success are Mexico and Poland. Brazil has gone from an era of hyperinflation and economic catastrophe all the way to its current status as a successful and stable mega economy.

In the European context, the nature of the restructuring and the policy guidance could be decided upon irrespective of who remains in the euro or leaves. We see the European Central Bank taking on multiple important roles similar to the IMF, and potentially in conjunction with it - as a policy guide, a target setter as in the case of deficits, a structuring advisor across Europe, a guarantor of sorts, and as a liquidity

provider of last resort, in that it could be empowered to intervene in the bond markets before an insolvency situation hits. We feel that such a rethink is important before too much contagion spreads in the system. Indeed, the recent announcement by the IMF to ready a EUR 600 billion rescue plan for Italy, potentially with the ECB, is the right step in that direction.

Currently, a section of learned opinion, notably that of Guillermo Ortiz, the former Governor of Mexico's Central Bank, feels it is yet too early to go into a Brady style restructuring in Europe. The reasoning is that the structural adjustments, consisting of extensive privatisation and fiscal prudence guided by multilateral agencies had already been put in place in Latin America, and the Brady program followed it. The assumption is that the deficit target of 4% of GDP, the Brady trigger, is too difficult to achieve.

We instead opine that not only is the deficit target of 4% of GDP realistic in the current situation, but achievable relatively painlessly, in contrast to what could play out if one waited too long. In fact Greece has already scaled back its deficit from 16% to 11% over this year, Italy is at 4.5%, and both France and Spain are at about 7%. Hence, we recommend that an ECB-led full scale policy guidance program with Brady-type restructuring, and serious spending cuts to reign in government deficits, complemented with economic growth-boosting policy reforms, be commenced at the earliest.

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