MLC Viewpoint

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The Eurozone crisis – end game?

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A deep and ongoing economic recession, a 25% unemployment rate, political and social instability, sovereign debt default and a run on banks as depositors lose faith in the stability of the financial system.

Sound very much like Greece today? Most certainly. But in fact it describes Argentina during the crisis which engulfed that country between 1999 and 2002.

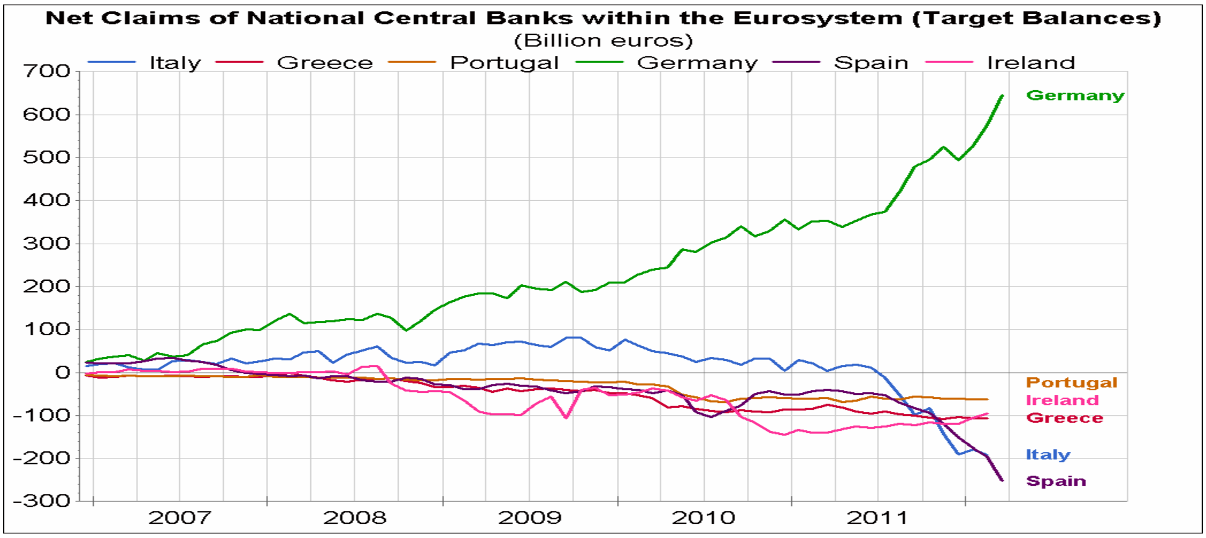
What was the setting in Argentina?
As with the current Greek crisis, the origins of the crisis in Argentina can be traced to government financial mismanagement, escalating government deficits and a deteriorating balance of payments against a backdrop of weakening economic activity.

However, a lack of policy flexibility eventually led to a catastrophic sequence of events. The hard peg of the Argentinian peso against the US dollar prevented expansionary monetary settings being introduced, while the International Monetary Fund (IMF) demanded the introduction of severe austerity measures to rein in government spending.

The inevitable outcome was a severe deflationary recession and a run on Argentina's banks by fearful depositors. Capital controls were introduced to prevent financial collapse, and widespread rioting resulted in the declaration of a state of emergency. The subsequent collapse of the federal government was followed by Argentina defaulting on its debts at the end of 2001.

Desperate times, unusual measures
Against the IMF's advice, a new government introduced unorthodox policies to deal with the crisis. These included the free float of the peso, which ultimately led to a dramatic currency depreciation of around 75%. While there was a crack-down on tax avoidance, austerity measures targeting spending on welfare were actually relaxed as the government sought to prevent widespread poverty.

A dramatic recovery
In 2002, the Argentinian economy contracted by a catastrophic 10%. However, between 2003 and 2007, economic growth rebounded by around 50%, due largely to an improvement in trade competitiveness stemming from the peso's collapse. Unemployment dropped back to 8%. Today, Argentina is one of the more successful turnaround stories in South America.



Source: Financial Times

Parallels with Greece today
While there is currently enormous uncertainty about the likely future twists and turns of the Eurozone crisis, the situation for Greece and other peripheral European countries is eerily similar to Argentina's a decade ago. Unfortunately European policy makers seem to have learned little from the experience of Argentina – nor, indeed, the Asian Financial Crisis of the late 1990s or Europe's own unfortunate experience in the early 1930s.

One clear message emerges from history. Faced with severe debt deflation, austerity is no solution - no country faced with a severe debt deflationary environment has successfully addressed it by implementing severe austerity measures.

Greece's inability to introduce policies to inflate its way out of recession through currency depreciation and monetisation condemns it to what is potentially a long period of deflation, economic depression and escalating social and political instability. If there is no rapid change of attitude in Europe, the only practical solution seems to be an early exit of Greece from the Eurozone (as opposed to exiting the European Union).

Although this step is likely to cause significant short term pain, it would concentrate the adjustment process and potentially allow Greece a return to stability and growth much sooner - as was the case with Argentina.

Contagion in the Eurozone?
If Greece were an isolated case within the Eurozone, its early exit might indeed signal the end of the crisis. However, without a major rethink of Eurozone policies, a number of critically weakened Eurozone countries, including Spain, Portugal, Ireland and Italy, could ultimately share Greece's fate.

Significantly, we are now seeing a widening of the European banking crisis, with capital flowing from banks in the periphery into safe havens as depositors fear the outlook (see chart above). This development represents a dangerous escalation of the crisis and, if left untreated, will magnify economic and financial instability.

Financial markets, having dismissed until now the likelihood of a Greek exit, have moved rapidly over recent weeks to factor this in.

Long-dated government bond yields have rallied once again, reaching historic lows in the US and 60 year lows in Australia. Equity markets have unwound the gains made in 2012.

Greece's exit may clear the air
In reality, getting a Greek Eurozone exit over and done with may go a long way to removing the heightened concern hanging over markets. Similar events in history have often proved a rallying point for equity markets. This could be the case now but **only** if Europe can convince investors that an exit from the Eurozone by Greece would be the last domino to fall in this crisis.

To do this, policy makers in Europe must move rapidly towards restoring confidence in and stabilising the European banking system. At the same time, they need to quickly introduce pro-growth fiscal and monetary policies aimed at reflating the Eurozone economy and depreciating the Euro.

The alternative is clear: persevering with the current focus on austerity could easily lead to escalating turmoil and, ultimately, a broader fragmentation of the Eurozone. The clock is ticking.

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