Can argentian model be applied to overcome greek financial crisis?

Може ли се аргентински модел применити за решавање грчке финансијске кризе?

Бојан Георгиевски*
Факултет за економски и административни науки, Меѓународен Балкански Универзитет, Македонија

Јулијана Ангеловска**
Факултет за економски и административни науки, Меѓународен Балкански Универзитет, Македонија

Abstract: The latest financial crisis that started in Greece and emerged in several European countries is a problem that concerns EU and has to be resolved within the European Union. Through analyses of the similarities and differences of the financial crises in Argentina and Greece this paper tries to give answer if Argentinean successful model can be applied in Greece. Analysts have been emphasizing the possibility of introducing the Drachma instead of the Euro as a national currency. By using the experience from the Argentinean financial crisis in 1999-2002 several different possibilities on resolving Greece financial crisis are analyzed. Argentina changed its currency as one of the steps for solving the financial crisis. The implementation of the Argentinean model will not create the desired effect due to the differences in the economic background and the reflection to other European countries can be problem.

Keywords: Greek financial crisis, Argentinean financial crisis, introducing the Drachma.

1. Introduction

The latest financial crisis uncovered the problems in the European Union. Several countries are facing severe economic crisis with Greece being the center of this financial mess. Historically observing, Greece spent half of its life defaulting its debt, starting from its independence in 1832 (Reinhart and Rogoff, 2009 p.99). Only Latin America countries have spent more time in default than Greece.
With the adoption of the Euro and the entrance into European Union, Greece gained access to cheap capital and this situation created investors’ confidence in weaker European countries. These capital inflows were not used for improving the financial and economic market but rather for government spending and offsetting lower tax revenue. This created one of the biggest budget and trade deficits. Additionally, all this money was never used for productive investment that could generate growth, increase of the economy, improve the competitiveness and create resources and funds that can be used for debt repayment. Instead, this capital was used for current consumption which did not bring any revenue.

**Figure 1. Greece Budget and current account deficit**

Source: International Monetary Fund, World Economic outlook, April 2011

**Figure 2. Current Account Deficit (of PIIGS countries)**

Source: OECD
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Figure 3. Government deficit 2007-2010 (PIIGS Countries)

Source: Eurostat

Figures 1, 2 and 3 show the results of increased capital inflows in the last several years. Comparing Greece to other European countries, which face financial trouble, shows similar pattern and large current account deficit and government deficits. Main difference is the size of these deficits, with Greece having the largest problems of all five countries.

According to Arghyrou&Tsoukalas(2010), reasons for this financial crisis in Greece are:

1. Continuous Budget deficits
2. High and rising public debt
3. No systematic control of expenditure or contain tax evasion
4. Continuous worsening of competitiveness after EMU entry

Capital inflows didn’t result in any changes of how the economy is managed in the country and in the region. These inflows caused inability to repay long-term debt and structural problems in the public sector. The government created large national companies and the government administration was overemployed (Themistocleous, 2012).

The financial capital that entered the country didn’t result in increasing the competitiveness in the country and didn’t change how the economy was managed. The government used this cheap credit money for government spending and paying expensive imports. This resulted in balloon government budgets and trade deficits, instead of channeling these funds into the productive sphere in order to generate future growth. Also, the competitiveness of Greek companies steadily worsened inside the European Union. This resulted in increasing of labor costs and prices. Wages in Greece have in-
increased at a 5% annual rate since the country adopted the euro, about double the average rate in the Eurozone as a whole. Over the same period, Greek exports to its major trading partners grew at 3.8% per year, only half the rate of those countries’ imports from other trading partners (Nelson et al., 2010).

Another issue that burdens these problems is the inability of the government to force tax payment. Not only common citizens, even government officials were avoiding tax payment. Some studies have valued the informal economy between 25%-30% of GDP (Economist Intelligence Unit, 2010; OECD, 2009; and ELIAMEP, 2010). All above mentioned things burden the financial stability of the country. Bigger public expenditure, tax evasion, big and inefficient public administration, rigid control of the economy affected the buildup of Greece debts. Greece has to address these problems in order to raise the revenues that are necessary to improve its fiscal position.

2. Crisis responses

Crisis responses included fiscal consolidation from the Greek government and international financial assistance. The purpose of this assistance is to limit the troubles to Greece and to avoid further spreading of the crisis to other European countries such as Italy and Spain. A default on their debts would create big pressure on the Euro and the European Union.

So far, several financial institutions have given financial aid to the country, and the government made two attempts of financial consolidation and economic reforms. Several political and economic institutions concluded that default on Greek debt is very risky and should be avoided at all cause. Fear of contagion and financial turmoil drove a major policy response by the Europeans, the IMF, the Greek government, and central banks in May 2010 to avoid a Greek default.

- Financial Aid from European Union and the IMF

With the initial financial Aid, EU and IMF loaned 110 billion Euros at market-based interest rates from which 80 billion were from European countries, and the additional 30 billion were given from IMF. This was done to prevent contagion of the financial crisis on other European countries, but was also conditioned with economic reforms from the Greek government. Additionally, EU created mechanism for financial aid for troubled financial countries, which consists of two temporary, three-year lending facilities that could make loans totaling €500 billion to Eurozone members facing debt crises (Nelson et al, 2010). Because these measures are temporary, the EU established the European stability mechanism that will replace the temporary facilities after 2013.

Second financial package from EU countries provided loans totaling 109 billion. This is done by much favorable terms than the initial package. This time the total amount was provided from European countries without contribution of the IMF. Additionally, the European stability mechanism will provide precautionary line of credit, to countries, that are in need of financial assistance. This financial aid can be used for
Economic reforms in Greece

These economic reforms consisted of additional fiscal measures, and were put on by European countries when they were providing financial assistance. The measures consisted of lowering the budget deficit by 11 percentage points, cutting the public spending, lowering the tax evasion that was mentioned before, and several tax increases (tax increases included raising the average VAT and increasing taxes on several commodities such as fuel, tobacco and alcohol). Biggest step for the government would be lowering the public administration, and the wage bill of public servanters and administration.

When the conditions worsened through mid-2011, the Greek parliament approved additional measures and structural reforms. This package is worth 28 billion Euros, and includes 6.5 billion Euros of spending cuts and revenue measures. Additional measures consisted of privatization of state-owned companies, selling public real estate, reducing the employment in the public sector, and improving the financial performance of government companies.

Other market measures

Other market measures included responses from the European Central Bank (ECB), and the American Federal Reserves. The ECB purchased government bonds of 78 billion Euros. This was done to increase confidence in the bond market. Half of these 78 billion were Greek bonds. Also, the ECB provided liquidity support to Greek banks (and other countries). The total financial package of the ECB climbed to 98 billion Euros.

The Federal Reserves also, contributed in Greece salvation by re-establishing temporary reciprocal currency arrangements. These, so called swap lines were previously used during the global financial crisis, with intention of increasing the liquidity in the global economy.

All these policy responses aimed at restoring the stability and to prevent further spread of this financial crisis across the Euro zone countries. The latest solution that is suggested is re-establishing the drachma as a national currency and rejecting the euro. Before analyzing this solution we will look at the Argentinean financial crisis and a similar measure that was done by the government and how this affected the financial crisis.

3. Argentinean financial crisis

The financial crisis of Argentina and Greece face a similar pattern. Main cause was their "currency". In order to increase capital inflows and to control the inflation, Argentina pegged its currency to the US dollar. Initially this created economic growth and prosperity in the country.
This activity is similar to Greece’s adoption of the euro, with which the government brought the inflation under control and created economic growth. This growth was fuelled by cheap financial capital inflow, which was the result of economic and financial integration within European Union.

On one hand this led to inflation control, but with a large cost to the economy. The adoption of both the euro (for Greece), and the peg to US dollar (for Argentina), made the economies dependent on capital inflows to stimulate domestic demand. Both economies were dependent on foreign debt because of permanent balance of payment deficits.

The Argentinean economy faced financial crisis in the period of 1999-2002. The period before the financial crisis was a period of long term economic growth. After 1990, the government of president Menem decided to liberalize the economy and to attract as much foreign capital as possible. Attracted by the sale of state-owned firms, foreign direct investment averaged $7.8 billion between 1991 and 2000 (Bustelo, 2004).

The results of the increased Foreign Direct Investment were obvious. Average increase of GDP was 10%, and Argentina witnessed a period of low inflation that reached its prime in 1994 when it was just 4% (De la Torre et al., 2002).

Figure 4. Argentinean Foreign Direct Investment

Source: World Bank
Figure 5. GDP Growth of Argentina

Figures 4 and 5 show the FDI investment and the GDP growth in Argentina. As a result of increased investment, GDP grew on average of 6.3% in the period of 1991-98. In 1999 Argentina witnessed its highest investment of almost 24 billion $.

The effects of the financial crisis were devastating to the Argentinean economy. The GDP loss was over 10% in 2002 which is the year that Argentina started its recovery.

In 2001 Argentinean economy reached its highest level of savings in history. But several political and economic downturns initiated the financial crisis. These downturns included (Cinzia, Giovannini and Gros, 2011):

- Outdoor events - such as financial crisis in Brazil (biggest Argentinean trade partner) and financial crisis in Russia that affected the world markets;
- Domestic events – in order to slow the inflation and credit expansion, the government increased the base rate from 8 to 19 % in 1998. Starting from October 1998 the economy entered a phase of recession.

The following period is a turbulent period (political and economic) when the government was trying to restore faith in the financial system. These measures included tax increases (personal taxes were brought to US level of 35 %, VAT Level at 21 %, also they inducted taxes on several financial transactions), financial assistance by the IMF, with a loan of 22 billion dollars (this was a record at the moment) (Saxton, 2003).

In 2001, the government initiated a change in monetary policy to prevent the financial crisis. Initial changes included changes in currency rates that previously were tied to the dollar. With these changes the currency was tied to a combination of dollar and euro. This was considered as a first step for devaluation of the currency that was inevitable to increase the competitiveness of the economy. In February 2001, there was a massive bank run on deposits, which was followed by increasing of the interest rates. In order to prevent further financial trouble, the government froze all banking activities in the country. Additionally, they changed the currency regime, and restated the following measures (Saxton, 2003):
They ended the convertibility system, and confiscated 14.5 billion dollars

Devaluation of the pesos to 1.4 pesos for 1 dollar (additionally they adopted a fluctuation currency rate that also depreciated the value of the currency)

Pesoification of deposits, all deposits that were in dollar currency were transferred to pesos deposits (for a rate of 1.4 pesos for dollar), and loans that were given in dollar currency were converted for 1 pesos for 1 dollar. Interest rates were frozen before devaluation. This cost the owners of deposits 23 billion dollars, while bank expense of devaluation of loans were additional 12 billion dollars

Prolongation of maturity of loans

Alteration of maturities of deposits

Changes of contracts denominated in dollars for pesos with value 1 dollar for 1 pesos

Confiscation of dollars in banks, that cost banks 1.6 billion dollars

Restrictions in buying foreign currency

Suspended bankruptcy procedures

Increased penalties for companies that are firing employees

New taxes and additional taxation

All these measures contributed for stabilizing the economy and initiating economic growth. A country that was on a verge of a financial fiasco, now again is one of the most competitive economies. Before the financial crisis, the Argentinean pesos were exchanged at rate one peso for one dollar, which impacted the exports of the country. This currency regime had a negative impact on Argentina’s exports and made them uncompetitive in the world market. With the financial measures that the government brought as a response to the financial crisis, set the cornerstone for current economic growth. Even though the measures were unpopular, and impacted the Argentinean middle class, they made the economy more competitive.

4. Evaluation of the effects of application the argentinian model in greece

Implementation of the Argentinian model of financial reforms in Greece will not be an easy task. Some of the measures will not have the same effect as they did in Argentina. Also, only changes in the currency regime alone will not help. The changes in currency regime will have to be complied with additional financial reforms. This was an expensive solution. Most of the load will be on the people, who will definitely lose vast amount of money. Changing currency has three implications on the national economy:
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1. Devaluation of the currency will cause larger debt repayments
2. International lending markets will be closed for number of years
3. The country will have to balance its budget, because it will not have the possibility to borrow money for financing its budget needs and trade deficits. The international markets will be closed for Greece.

Since all loans that are given to Greece would remain in foreign currency, this will bring additional burden to an already declining economy. This will add more trouble to a country that cannot repay its debt, and will be even harder to service these loans in the short term. Greece will not have a chance of receiving new loans to repay old debts.

Another problem is the unemployment. Any fiscal and monetary policies will have to be designed to boost the economy and reduce the unemployment. The unemployment rate reached 16.2% in March and is constantly growing. This is 40% more than the previous year (Pierre Weill, 2011).

But on the other side, the positive effects of importation of the new currency that would make the economy much more competitive will not be as effective as in Argentina. In Greece the change of currency and the devaluation of it, will lead to increase inflows from tourism which has a declining path the past few years, but Greece doesn’t have the Argentinean exports. Argentina has always been a commodity producer. Historically, Argentina is one of the world’s major agricultural producers and exporters of beef, citrus fruit, grapes, honey, maize, sorghum, soybeans, squash, sunflower seeds, wheat, and yerba mate (Faostat, 2012).

Due to excessive uncertainty, identical approach to the Greek crisis may be a radical approach, which may have large financial implications, too. Leaving the euro may need to be done gradually, due to potential negative consequences. Initially, they will need to stop the downward movement of the economy of this country and later for changing the currency for this solution as the basis for economic growth.

5. Conclusion

Unfortunately, there is no perfect solution for any financial crisis. The financial reforms that had worked to solve the Argentina default cannot easily be applied in Greece. This study analyses the possible effects of importing the Argentinean solution in Greece as an option. The difference in the economic background will not create the desired effect, from the devaluation of the currency. In Greece, the change of currency and the devaluation of it, will lead to increase inflows from tourism, but Greece doesn’t have the Argentinean commodity exports.

Additionally, this measure cannot be a solution if implemented individually. The measures that Argentina adopted also included freezing of banking activities, addition-
al loans from the IMF and other solutions.

The solution to overcome the financial crisis which has already started is not an easy task. The European Union has to find mechanism to prevent the occurrence of financial crisis. To prevent or possibly accelerate the recovery of the economy there are measures that can be set. Most appropriate solution for economic recovery is an adjustment of the production structure and to influence the savings to consumers, to liquidate all misdirected investments and make the transfer of factors of production stages to final consumption.

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Resume

There is no perfect solution for any financial crisis. Whatever Greece decides, it will have severe effects on the wealth of its population. Also, some solutions used before in other countries, might not have the desired effect. Greek economy requires structural changes, bailing the economy cannot be done without severe changes in the economic financial system.