What Can Euro Crisis Learn from Asian and Latin American Economic Crisis?

Chin-Ming Lin

Every bail-out plan for debt crisis has a basic worry: will the debtor pay its debts? Taking Greece for example, there are three reasons for the doubt.

First, politics plays a crucial role in blocking resolution of the crisis. A bail-out plan always involves an austerity package which requires government to tighten its belt in order not to waste valuable rescuing resources and also to curb current spoils in public expenditures. However, many people, especially the opposing parties, will not stand to bear the painful austerity plan and, furthermore, even the ruling government is also doubtful about it. At the same time, voters in the helping countries are aghast at the prospect of the bail-out, which they think would merely throw more money in the drain hole of a country that is incapable of repaying its debts or reforming itself.

Second the markets are also erecting barriers rather than making the plan work. Market traders know that the debtor, Greece, whose debts are equivalent to around 160% of its GDP, is insolvent. Spreads on sovereign bonds are getting wider as time goes by. These all point to imminent default and devaluation, giving the country little chance of growing. Therefore, private investors shying away from the bond market rather than delving into it to take advantage of the spreads.

Third, the fears of contagion are growing rather than receding. The situation of insolvency of Greece extended to Ireland and Portugal, who also sought help. The Euro zone regulatory mechanism comes in and has tried to draw a line around these three relatively small economies. But there seems be no way to prevent other larger economies such as Spain and Italy from being pushed into the market muddles. Big countries are not prone to attacks as some tend to believe. The prospect of Greek default might bring down many others and wreak havoc the world economy.

The above is reminiscent of the Latin American debt crisis of the 1980s when the Citibank persuaded other big banks to restructure loans to Latin American governments. Taking the most recent case for example, an offer was provided in 2003 to extend the maturity of Uruguayan bonds by five years which achieved a 93% participation rate by creditor banks. Today the International Institute of Finance (IIF) is trying something similar for Greece. IIF members – global banks, insurance funds and investment managers account for nearly all privately held Greek bonds. The IIF wants its members to extend the maturity of their Greek bonds maturing before the year 2020, while also reducing the overall amount owed by the Greek government. The question is, can the lesson taught in Latin America then be applied to Europe now? If the markets are to be convinced the plan can stabilize Greek debt, participation rate of creditors in the plan should be very high. Is this likely?

Some may want to believe it will work. However, we have to take note of differences between the 1980s and today. In the 1980s, syndicates of banks financed government directly through loans. Every bank had a strong interest in ensuring that governments avoid default. On the other hand, today's Greek bondholders include hedge funds, mutual funds and even private individuals, many of whom would have purchased bonds in the secondary market at below-par prices. The diversity of bondholders and the varying levels of their tolerance of defaults make coordination complicated.

Moreover, in the 1980s, the IMF generally made further lending to troubled governments conditional on private participation in debt-reduction schemes. That gave creditor banks significant leverage. They knew that if they refuse to restructure loans, governments would default without official-sector financing and their loans would never be repaid. The IIF members do not have the same leverage today. European governments have already committed to provide more financing to Greece[1]. Greece may have the funds to service the bonds of banks that refused to participate

[1] See Peter Spiegel et al., "EU leaders agree €109bn Greek bail-out," *Financial Times*, last update July 21, 2011 (http://www.ft.com/intl/cms/s/0/952e0326-b3af-11e0-855b-00144feabdc0.html#axzz1fFqVaJkK).

in the IIF plan.

Notwithstanding the differences in situation, there are still some similarities between then and now, especially the role played by governments. In the 1980s, the U.S. Treasury was wary of a series of Latin American defaults, so it pressed banks to participate in debt structuring. Today, while Greek banks certainly will participate in the IIF plans, French and German governments are also putting pressure on their national banks to participate.[2] IIF officials further concede that they have shaped their proposal after discussing with euro-area governments, in the hope of increasing pressure to participate.[3]

Sovereign-debt restructuring is very common in the developing world, but it was seldom heard in advanced economies since the end of the second world war. Nevertheless, this is the second similarity we want to look into. No matter how stern European leaders in general and Greek government in particular are insisting on maintaining the record of no restructuring, the Latin American dimension is surfacing. The Uruguayan experience looms larger and larger as time goes by. The 2003 swapping of its creditors' bonds for new ones reduced the effective burden of the South American country's debt by around 15% at little cost. Soon afterwards, Uruguay was borrowing again in international markets. Thus, Greece could do the same. Putting off bond repayments for a few years would mean that the official rescue fund would last longer.

However, Greece in 2011 is not that similar to Uruguay in 2003. Greece's debt stock, expected to reach 160% of GDP in 2012, is almost twice as large as Uruguay's then. Furthermore, Greece is unlikely to enjoy a strong economic growth as Uruguay has, with a growth rate of 6.1% per year thanks to the global commodity boom. Actually, a more accurate similarity is the debt crises of the 1980s. Greece is bust now, just as Mexico was in 1982. A plan named after James Baker, then the U.S. treasury

[2] See, e.g., Jennifer Thompson, "French banks back Greek bail-out," *Financial Times*, July 28 (http://www.ft.com/intl/cms/s/0/650c2e14-b942-11e0-b6bb-00144feabdc0.html#axzz1TVHL6A70).

[3] "Rescuing sovereigns: Why it was easier then," *Economist*, July 29.

secretary, offered the Latin Americans a temporary rescheduling, similar in spirit to the scheme being discussed for Greece today. It gave the U.S. more time to recover, but Latin America's economies buckled under the burden of debts that could not be repaid, still similar to Greece today. In 1989 another plan, named after another treasury secretary, Nicholas Brady, provided the necessary debt reduction. The Brady plan seems to be the right one for Greece.

Now we will switch to the Asian financial crisis in 1997-98. What is similarity between this crisis and current euro crisis? As evident afterwards, the IMF misjudged the Asian crisis then as caused by lax fiscal expenditure which seems rather a more correct prescription for Greece now. Therefore, a corporate debt restructuring was needed then rather than sovereign debt restructuring pertaining to Greece now. However, the euro zone can still draw lessons from the Asian financial crisis. That is the contagion effect.

The term "contagion" was first introduced in July 1997, when the currency crisis in Thailand quickly spread throughout East Asia and then on to Russia and Brazil. Even developed markets in North America and Europe were affected, as the relative prices of financial instruments shifted and caused a collapse of Long-Term Capital Management (LTCM), a large U.S. hedge fund. Now we have witnessed the same effect in Europe. The European debt crisis has already spread like a virus from Greece to Ireland and Portugal, and other countries are now at risk: Spain and Italy are probable candidates for financial problems.

Contagion generally has much to do with actual economic links among countries. Financial ties in particular is responsible for the "fast and furious" spread of crisis from one country to another. Trading activity between countries, however, can propagate economic sickness more slowly. When an ailing country becomes over extended and unable to handle its debt, banks and other financial firms that have lent it money could be exposed to major losses. This could destabilize the home country of the banks or even spread the trouble to a third country. That can occur, for instance, because banks may try to cover their losses in one country by calling in loans in another.

After the Asian economic crisis, economists realized the importance of financial contagion and produced a large volume of researches on it. Perhaps, this is what the Asian currency crisis contributed most to the current European crisis. As we are again staring a crisis in the face and its contagious effect taking shape in Europe, and even could have endangered outside the region, European leaders have spent two years struggling to prevent contagion from affecting the region’s largest economies such as France and Germany. Perhaps the precious lesson from the previous Asian crisis is that European authorities must move aggressively and with decisiveness to address the crisis and restore financial market stability and confidence.