Write Downs, Bank Bailouts, and Austerity Are Not Enough

Charles W. Calomiris | 11/02/2011 |

At an academic meeting recently, former Argentine Finance Minister Pablo Guidotti remarked that many Argentines see market liberalization policies of the 1990s, rather than the excessive government spending and the resulting unsustainable deficits of that period, as the source of Argentina's collapse in 2001. A decade later, that misperception contributes to the continuing popularity of the incumbent Peronists and discourages growth-oriented reform.

The Argentine experience offers vivid lessons for European leaders today. In the fall of 2000 Argentina began to lose market confidence in its ability to repay its international debts and maintain its fixed exchange rate. Capital inflows ceased, exports declined, sovereign debt prices fell, the real exchange rate became severely over-valued, and Argentina's recession deepened. The IMF prescribed austerity (arguing that a debt write down, much less a devaluation, was not needed or helpful), and offered enough dribbles of funding to postpone a sovereign debt collapse. Argentina tried to raise taxes, but that only deepened its recession. Its debt problem kept worsening, and its banks steadily lost deposits until a bank run in December 2001 forced Argentina – after more than two years of severe economic contraction – to default, devalue, and write down the values of its dollar-denominated bank deposits and loans. The costs of denial were not just a severe recession, high unemployment, and civil unrest, but a debilitating long-term political shift.

Sometimes austerity alone can fix what ails a country. In the US today, in the UK, and in many other countries, credible long-term reductions in future spending to restore fiscal sustainability would be enough to promote growth and avoid inflation. And sovereign debt write downs, like the 50% write down just agreed for Greece, can sometimes restart an ailing economy, as several Latin American episodes illustrate. But austerity and debt write downs alone don't always work.

Consider Greece today. Even if Greece managed to keep cutting spending, wrote down its debt by 50%, kept its banks solvent somehow, and managed to fund its continuing huge deficit without leaving the eurozone, Greece would still face a daunting real exchange rate over-valuation problem (currently estimated at between 40 and 50 percent relative to Germany). Without devaluation, it will take Greece many years of deflation and recession to eliminate that over-valuation. Furthermore, deep reforms in labor laws and other economic rules would also have to occur immediately to restore competitive productivity growth, or else Greece will continue to experience further slippage relative to the North.

Does anyone believe that while Greek voters experience years of politically polarizing depression they will institute productivity-enhancing reforms that will undo its decades-long history of bad economic policies? And if no one does believe that fairy tale, then what is the point of Europe's austerity prescription for Greece? Similar arguments can be made for Portugal, Italy, and Spain, each of which suffers from severe over-valuation.

If the answer for the South is not just debt write downs, bank bailouts, and austerity, then what is it? Either the departure of some countries from the eurozone to permit growth, or a gamble to preserve the currency union through higher inflation, engineered by the European Central Bank (ECB) to encourage southern reforms. In my view, the first option is the better one; I doubt that a credible deal can be agreed to trade deep reforms in the South for higher inflation, and once higher inflation becomes entrenched, it will be costly to bring it down.

Either option beats austerity for the simple reason that some or all countries in the South eventually will decide that continuing privation is not worth the benefits of eurozone membership. At the current levels of real exchange rate over-valuation in the South austerity just isn't a realistic way forward. Many European leaders insist that neither high inflation nor eurozone defections can be permitted; but that is tantamount to arguing that there are no political limits to austerity policy. If austerity is infeasible, then the two other options, however unattractive, must be taken seriously.

I recognize that exiting the eurozone is not costless to the South. Bank deposits and other debt contracts would have to be redenominated into the depreciated currencies of the departing countries to avoid massive bank and borrower insolvencies, as was done in Argentina in 2002 (as in the U.S. in 1862 for similar reasons). Those violations of contracts cannot be viewed lightly. Also, currency depreciation would remove pressure to pursue desirable long-term reforms.

Alternatively, an ECB commitment to raise its inflation target to, say, six percent for five years, with a subsequent phased-in reduction back to its two percent target, would result in an inflation tax and a growth slowdown in the north, but it would ease deflationary pressures of adjustment in the South. The mitigation of deflation could encourage credible agreements on reforms (labor reforms, removal of competition barriers, improved tax collection, and pension reductions), which could boost chances of eurozone survival.

But raising inflation entails costs – initial negative growth consequences in the North, and costs of wringing entrenched inflation out of the economy in the future. That is why purposefully increasing inflation is generally an undesirable policy. In my view, the inflationary gamble is not worth taking, hence my preference for orderly exits. But if Germany and other northern countries insist on avoiding departures, they should recognize that an inflationary gamble may be the best way forward.

The challenge in the eurozone is not just to agree on debt writedowns, bank recapitalizations, sovereign bailouts, and austerity programs. Achieving those alone may calm markets for a few months, but will not fix the deeper inconsistencies that plague the euro project. Tackling the deeper problem requires either allowing orderly departures from the eurozone or gambling on inflation to make reform achievable.

Charles W. Calomiris is Henry Kaufman Professor of Financial Institutions at Columbia Business School.