An Argentine guide to the Greek crisis

Policymakers in Europe seem to be surprised at the ongoing bank run in Greece (and the nascent run in Spain). They should not be. Anyone familiar with emerging-market meltdowns knows that a financial crisis nearly always follows a fiscal crisis.


Illustration by Margaret Scott

Argentina’s default in 2001 is but one useful example. In the Argentine crisis, the economy contracted by 18% and unemployment soared to 22% of the labor force. Greece is already close to these levels.

Argentina went through a complete and chaotic default on its public debt. In Greece, the “haircut” imposed on creditors so far has been managed by the European Union and the International Monetary Fund. But, with debt still unsustainable, the next round of Greek default could well make Argentina’s look positively Teutonic in its orderliness.

In Argentina, the banking system came close to collapse, causing the government to ban bank withdrawals – introducing the so-called corralito, or bullpen, for deposits – and establishing capital controls. That could be the stage that Greece is entering now. So, if the precedent of the Argentine and other emerging-market crises is a useful guide, what could be in store for Greece next?

crises. Banks hold government and corporate loans as assets. Fiscal crisis and default reduce the value of the former, while the ensuing recession undermines the value of the latter.

That is the link running from budget to bank problems. But there is a link going in the opposite direction as well: as banks deleverage to offset losses, they cut credit and the economy slows, causing government revenue to fall. If and when banks require a capital injection from public sources, the additional expenditure – which can be large – weakens public finances still further.

These mutually reinforcing forces can work themselves out in a lengthy process of recession and deleveraging. Or they can prompt a sudden run on the banks, causing the financial system to implode. The outcome depends on confidence.

Economists have long understood that, in the absence of a credible lender of last resort, banks are vulnerable to self-fulfilling confidence crises. That lender can be monetary or fiscal, and in Greece both types are in doubt.

If Greece’s agreement with the EU and the IMF unravels, the European Central Bank will no longer accept Greek bonds as collateral. And the Greek state does not have the wherewithal to stand behind its banks. In these circumstances, it would be more surprising if depositors were not rushing to pull their funds out of Greek banks.

The Argentine experience suggests that, after the run on bank deposits, the saga’s next installment is monetary collapse. With revenues plummeting and credit cut off, the Argentine provinces had to resort to printing scrip to pay salaries and pensions. At one point, more than a dozen quasi-currencies were in circulation.

What happens if Greece is cut off from EU and IMF credit? Optimists point out that the country is supposed to eliminate its primary deficit (the budget balance minus interest payments) by 2013, which implies that it could pay its non debt-related bills with its own resources after a default.

But that view overestimates the state's capacity to collect revenues in the midst of a panic. With the economy in free fall and uncertainty pervasive, many households and firms simply stop paying taxes. So, even if the Greek government defaults on all of its debt, it might have no option but to print pieces of paper in order to meet its obligations.

That would not constitute official abandonment of the euro, but, over time, the difference could become more formal than real. The newly issued scrip – call it the neo-drachma – would be tradable and highly liquid. Even if it traded at a deep discount, as it surely would, sooner rather than later it would likely be used for settling all kinds of transactions.

Here, the Argentine story suggests, the mechanism loops back to the banks: firms soon start complaining that their income is now denominated in neo-drachmas while their loans remain in euros. They begin to demand loudly that the loans be neo-drachmatized ("pesified" in Argentine parlance). A parliament anxious for public approval is eager to meet these demands. But this only accelerates the run on the banks, as households and firms realize that no solid assets are backing their deposits.

Paying public sector workers with depreciated neo-drachmas implies a cut in the real wages that they receive. The final step in the process comes with the neo-drachmatization of private-sector wages. Firms again demand it, claiming that otherwise they cannot export. Unions initially oppose it, but eventually give in, spooked by the specter of even greater unemployment. The promise of selective price controls sweetens the deal.

How large will the devaluation of the neo-drachma be? In Argentina, the number of pesos needed to buy one dollar rose by more than 300%. Greece posted a current-account deficit of nearly 10% of GDP in 2011, despite the domestic depression. The real devaluation necessary to restore external balance will be enormous, perhaps larger than that in Argentina.

Greece now has its third government in less than a year, and a fourth is not far off. Argentina ran through four presidents in less than two years, before the political and economic situation stabilized. Greece, too, will eventually stabilize. At this point, that is just about the only hopeful precedent that the Argentine story holds.

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