N°25 | SEPTEMBER 2014

ECONOTE

Societe Generale
Economic and sectoral studies department

EURO ZONE: IS THE CRISIS OVER?

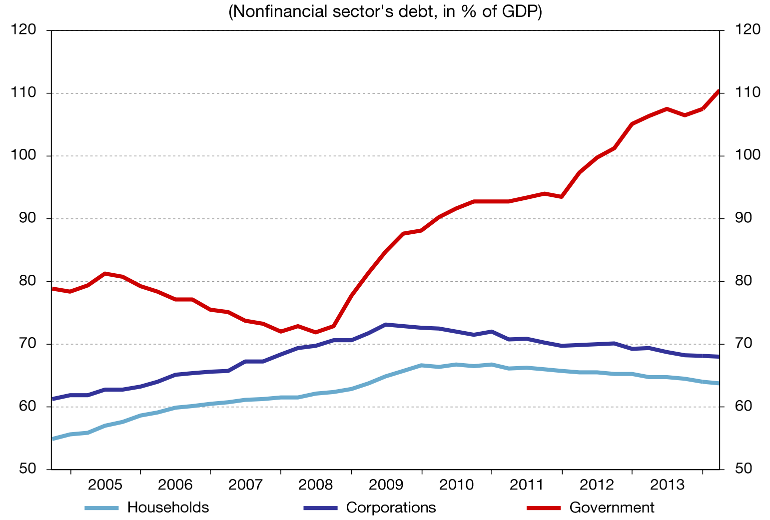
Two years after Mario Draghi, the European Central Bank president, pledged to do "whatever it takes" to save the euro, the acute phase of the euro zone crisis appears to be over. Borrowing costs for the troubled euro countries have fallen sharply. Ireland and Portugal have exited their international bailout programs and Spain has exited its bank bailout.

So is the euro zone crisis over? The answer to that question is negative, as many of the underlying weaknesses remain unresolved. While the ECB's signal that it will act as sovereign lender of last resort has been very effective in removing self-fulfilling liquidity crises, peripheral Europe remains stuck with its twin problems of debt and competitiveness.

These problems have been tackled through fiscal austerity, internal devaluation and structural reforms. The trouble, however, is that the cut in wages which is necessary to improve the periphery's competitiveness worsens its debt overhang problem, because nominal incomes are reduced while the value of the inherited debt remains intact.

The policy mix currently applied in Europe appears to be insufficient to address the debt overhang. Throughout history, other policy tools, such as debt monetization or debt restructuring, have been used to remove the debt overhang. In a monetary union, some form of debt mutualization could also offer a way for troubled countries to escape their high-debt traps. Taken as a whole, the euro zone enjoys a sustainable debt position.

EURO ZONE: DOMESTIC DEBT OUTSTANDING
(Nonfinancial sector's debt, in % of GDP)



Source: Thomson Reuters Datastream

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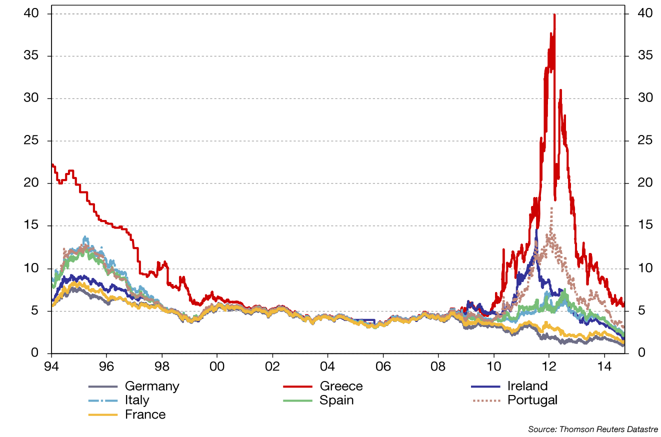
Much has changed in the euro zone over the past two years. In the summer of 2012, the monetary union was teetering on the brink of collapse, gripped by fears of a Geek exit and loss of market access for Italy and Spain. Today, the sense of crisis in the euro zone has substantially abated, as the borrowing costs for the distressed members of the euro zone periphery have fallen sharply. On December 15, 2013, Ireland exited its three-year long international bailout program, mimicked by Portugal on May 17, 2014. In addition, on January 23, 2014, Spain exited its (more limited) bank bailout.

Gr1. GOVERNMENT BOND YIELDS

(10-year yield, in %)



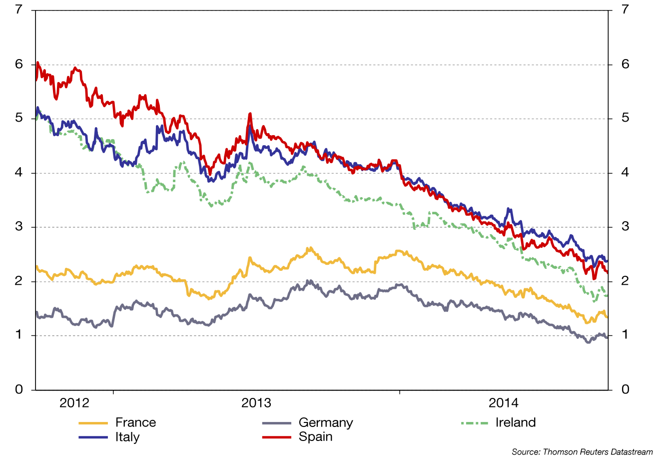
Today, the risk of the monetary union breaking up appears to be fairly low. So is the euro zone crisis over? Unfortunately, the answer to that question is negative, as the underlying causes of the crisis have thus far remained largely unaddressed. While the most acute phase of the crisis is probably behind us, peripheral Europe remains stuck with its twin problems of debt overhangs and insufficient competitiveness which caused the crisis in the first place.

THE ECB AS A LENDER OF LAST RESORT FOR SOVEREIGNS

THE OMT PROGRAM

Mario Draghi's July 2012 pledge to do "whatever it takes" to save the euro marked a key turning point in the euro crisis. In September 2012, the Outright Monetary Transactions (OMT) program was set up, under which the ECB committed to purchasing unlimited amounts of government bonds of stressed countries, provided they agreed to undertake fiscal and economic reforms[1]. The announcement of the OMT bond-buying program led to a dramatic fall in the long-term government bond rates in the peripheral countries.

Gr2. THE "DRAGHI EFFECT"



The mere announcement of the program was enough to stabilize the financial markets without the need for the ECB to actually buy any government bonds. By announcing that there would be no ex ante quantitative limits on euro zone government bond purchases, the ECB acknowledged that euro zone governments needed a lender of last resort. It is now a widely held view that in a currency union lacking a credible last resort that can buy sovereign debts, member states are particularly prone to fear and panic (see on this issue the influential work of De Grauwe (2011a, b, 2013)[2].

THE "ORIGINAL SIN" PROBLEM

When joining the euro, euro zone member states relinquished their ability to print money. By doing so, they lost control over the currency (the euro) in which their debt is issued. Now indebted in a currency that they do not control, heavily indebted euro zone members have ended up facing risks which are far more akin to those facing emerging countries than those facing advanced economies such as the United States and the United Kingdom. Emerging countries typically suffer from what is referred to as "original sin", i.e. an inability to borrow abroad in their own currency[3].

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[1] The OMT program targets one- to three-year bonds that are traded on the secondary bond markets only (i.e. no direct government financing) and issued by governments subjecting themselves to "strict and effective" conditionality, under either a full EFSF (European Financial Stability Facility) / ESM (European Stability Mechanism) macroeconomic program (as Portugal, Greece and Ireland had) or a less stringent "precautionary program".

[2] De Grauwe, Paul (2011a), "The governance of a fragile euro zone", Economic Policy, CEPS Working Documents; De Grauwe, Paul (2011b), "The European Central Bank as a lender of last resort", Vox, 18 August; De Grauwe, Paul (2013), "The European Central Bank as lender of last resort in the government bond markets", CESifo Economics Studies, 59(3), 520-535. See also Buiter, W. and Rahbari, E. (2012), "The European Central Bank as lender of last resort for sovereigns in the euro zone", Journal of Common Market Studies, 50, 6-35.

[3] This concept was first proposed by Barry Eichengreen and Ricardo Haussmann. See Eichengreen, B. and Hausmann, R.

Due to this inability, the external debt of many emerging countries is mainly denominated in foreign currency. As past and recent history has shown, the likelihood of debt crises increases if the debt is in foreign currency.

Historically, sovereign debt crises have primarily been foreign currency debt crises. Although there have been cases of sovereign restructurings of local currency debt, these have been much less frequent than foreign currency debt restructurings, because governments that have the option of printing money to service their local currency debt rarely default on it[4]. Having given up their right to resort to the printing presses, heavily indebted euro zone member states have ended up being in the same situation as an emerging country suffering from original sin. Unable to guarantee holders of public debt that the liquidity will always be available to ensure that they will be paid out, member states have become prone to self-fulfilling (or panic-based) debt crises.

SELF-FULFILLING CRISES

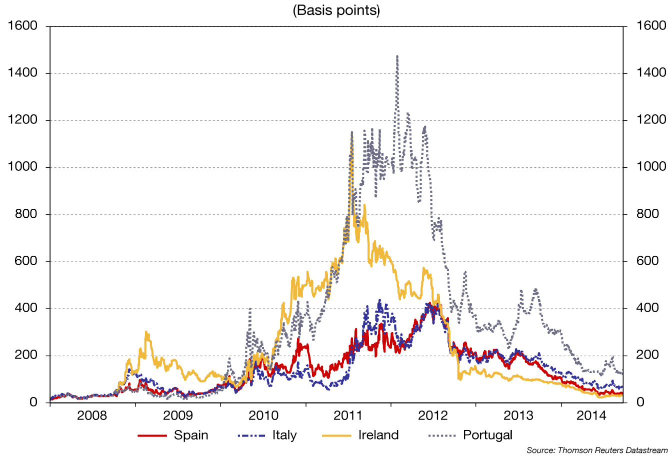
In the 2000s, prior to the global financial crisis, financial markets treated all euro zone government bonds as if they were riskless, as reflected in a long period of convergence of government bond yields in periphery countries to the low levels seen in core countries (see Graph 1). However, when the Greek crisis raised the specter of default, the spreads for all peripheral European countries rose dramatically, as the market perception of default risk shot up. Lacking a credible lender of last resort capable of backstopping member states' liabilities (as the Federal Reserve did during the global financial crisis) heavily indebted European countries fell victims of speculative attacks on their bonds. The run on government debts sent peripheral country risk premiums sky high, threatening to push peripheral countries into default.

This vicious circle — investors selling government bonds because they fear a default, the selloff prompting a rise in interest rates, the rising interest rates threatening to precipitate a default — is the vulnerability that the ECB sought to remedy by announcing its OMT program. With its pledge to print a potentially unlimited volume of euros to buy sovereign debts (conditional on a European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) program), the ECB has *de facto* taken over the role as a lender of last resort for the sovereigns of the Eurosystem.

(1999), "Exchange rates and financial fragility", NBER Working Paper N° 7418, November.

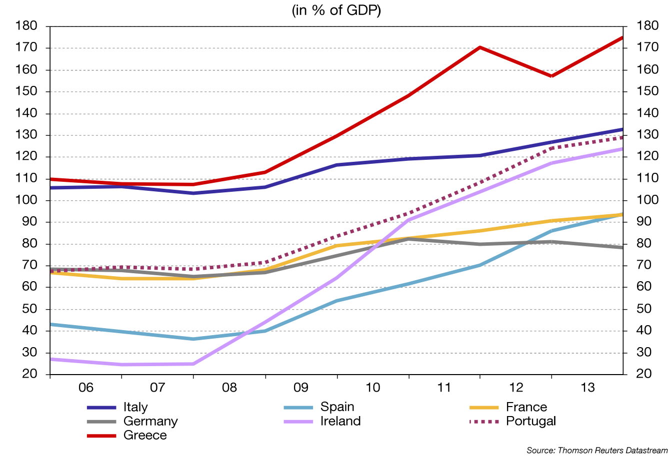
[4] Yet paying debt by printing money may sooner or later entail a risk of higher inflation or depreciated currency.

Gr3. 5-YEAR CDS SPREADS OVER GERMANY
(Basis points)



As the dramatic fall in spreads that we have observed since September 2012 cannot be related to an improvement in the underlying debt dynamics — in fact, the public debt-to-GDP ratios have continued to rise after September 2012, as can be seen in Graph 4 — there is a strong case to be made that self-fulfilling expectations played a key role in the escalation of the euro crisis in the early 2010s (see De Grauwe and Ji (2012)[5]).

Gr4. GROSS PUBLIC DEBT
(in % of GDP)



LIQUIDITY-DRIVEN CRISES VS. FUNDAMENTALS-DRIVEN CRISES

The timing of the sharp fall in sovereign bond spreads — which occurred when the path of the general government debt ratios was worsening — strongly suggests that, by assuming the responsibility of lender of last resort in the sovereign bond markets, the ECB has effectively removed vicious feedback loops in which fears that a country will default on its debt become a self-fulfilling prophecy. Yet eliminating the risk of self-fulfilling defaults does not mean that a default cannot occur. While liquidity provision can

[5] See De Grauwe, Paul, and Ji, Yuemei (2012), "Mispricing of sovereign risk and multiple equilibria in the euro zone", Vox, 23 January.

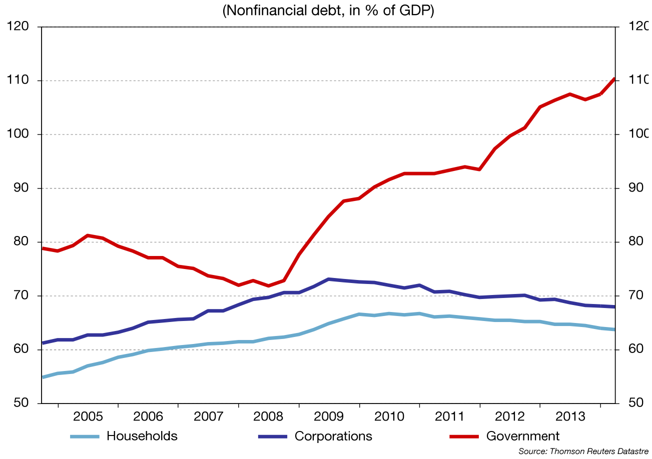
remedy financial distress caused by panic/self-fulfilling shocks, a central bank cannot take fundamentals-driven solvency crises off the table.

THE UNRESOLVED DEBT OVERHANG PROBLEM

DELEVERAGING HAS HARDLY BEGUN

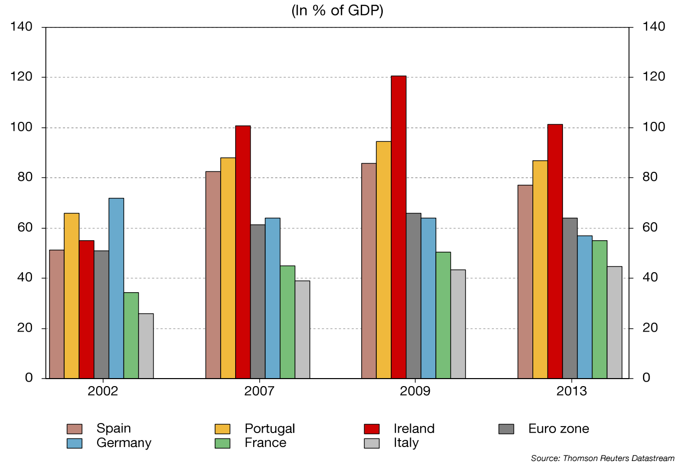
Nearly five years after the onset of the European debt crisis the issue of debt sustainability in the euro zone remains unresolved. The total gross debt of the non-financial sectors (private and public) as a share of GDP is at historically high levels, and continues to rise in many countries, due, in large part, to very weak or negative nominal and real GDP growth. The public-sector debt load is especially burdensome in Greece, Italy, Ireland and Portugal, which all have public debt well above the limit of 60% of GDP imposed by the Stability and Growth Pact.

Gr5. EURO ZONE: NON-FINANCIAL DEBT OUTSTANDING
(Nonfinancial debt, in % of GDP)



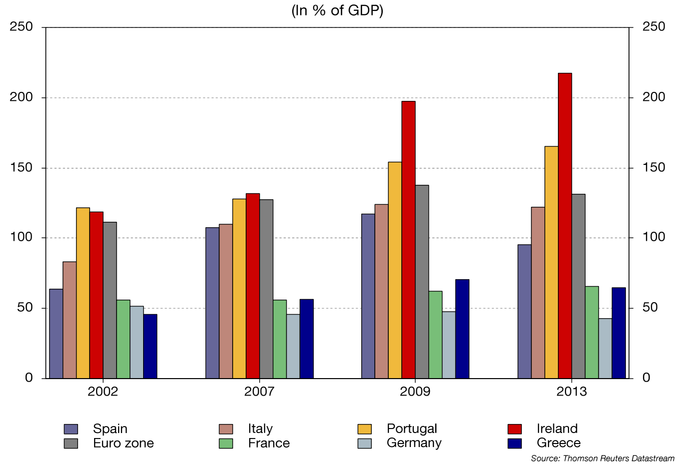
The private-sector debt burden is worst in Ireland, Portugal and Spain, which all display levels of private leverage well in excess of the "safety" threshold of 133% of GDP set by the European Commission[6]. The private sector's debt is an enduring legacy of the credit bubble that hit peripheral Europe in the 2000s. The ready availability of finance, along with the large and rapid fall in interest rates in peripheral economies, which followed the launch of the euro in 1999 (and which, with hindsight, bears testimony to the massive underpricing of sovereign risk during that period) unleashed a lasting credit-financed boom in the economies of the periphery. Debt was mostly directed to non-tradable activities, including housing and transport infrastructure.

GR6. HOUSEHOLD DEBT
(In % of GDP)



In some parts of the euro zone (Ireland, Spain) the economic boom was underpinned by a huge real-estate bubble, which left a legacy of sky-high levels of household debt, mainly mortgages. Acute debt overhang problems are also found in the non-financial corporate sector, especially in Ireland, Portugal, Italy and Spain. In Spain and Portugal, unsustainable levels of corporate debt are mainly concentrated amongst small firms. In Italy, the debt problems are widespread across the whole corporate sector.

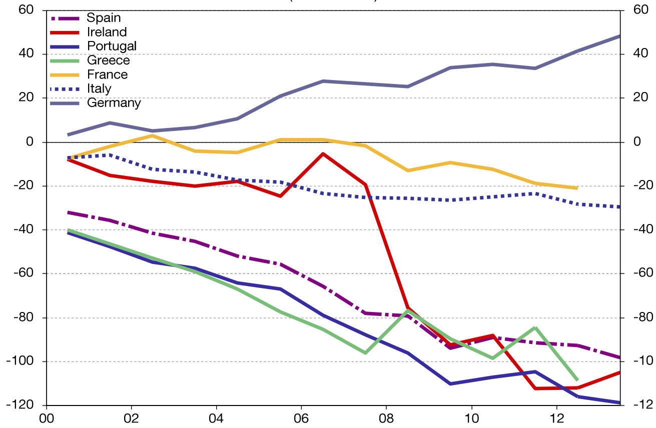
Gr7. CORPORATE DEBT
(In % of GDP)



High indebtedness of the different sectors of the economies (banks, households, corporate and government) has contributed to the piling up of large net external liabilities.

[6] *The European Commission is in charge of identifying any emerging macroeconomic imbalance in the euro zone.*

Gr8. NET INTERNATIONAL INVESTMENT POSITIONS
(In % of GDP)



Source: Thomson Reuters Datastre

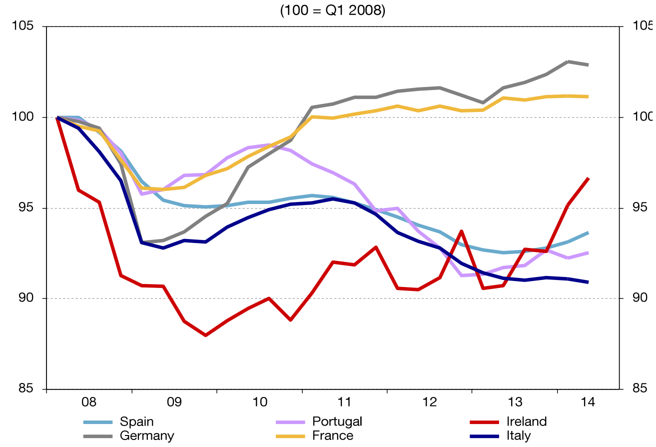
THE DEBT TRAP

Debt overhangs can be resolved in four distinct ways:

1. Higher real GDP growth rates;
2. Increased savings (including through fiscal austerity);
3. Increased inflation (which erodes the real value of the debt held by creditors and the effective debt-to-GDP ratio)[7];
4. Debt restructuring or debt mutualization.

Since the onset of the euro zone crisis, some form of debt mutualization has been implemented thanks to the European Stability Mechanism (ESM) and the ECB's OMT, which have enabled risk premia across the troubled economies to fall sharply and durably. Member states, for their part, have attempted to implement options 1 and 2, but to little avail so far. Raising the growth rate of real GDP is, of course, everyone's favorite deleveraging policy. The snag, however, is that growth is not a policy but an outcome.

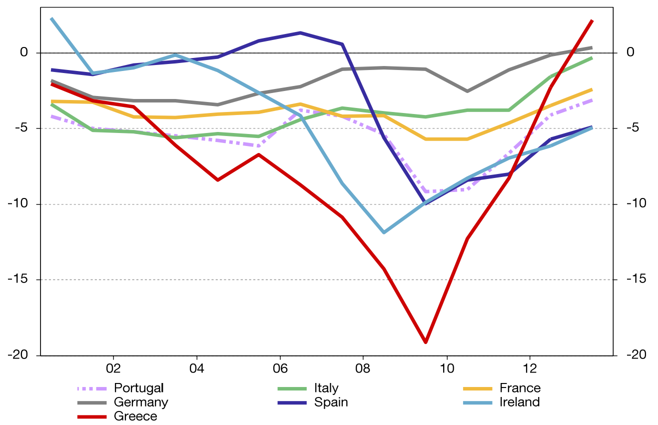
Gr9. REAL GDP LEVELS
(100 = Q1 2008)



Source: Thomson Reuters Datastre

Over the past few years, the governments in trouble have shown remarkable resolve in implementing substantial fiscal consolidation through deep cuts in public spending or tax increases. Nevertheless, public sector debt ratios have generally risen strongly, partly as a result of the migration of bad and impaired private sector assets to the public balance sheet. Massive capital injections into the banking sector had to be undertaken in Ireland, Greece and Spain. The IMF (2013) reckons that, for the public debts of the heavily indebted European countries to first stabilize, and then fall to the target limit of 60% of GDP, their governments will have to run primary budget surpluses[8] in excess of 5% of GDP, for periods as long as ten years[9]. This is an exceptionally large adjustment by historical standards, which raises the question of whether domestic agents/workers will be willing to accept many years of low growth, high unemployment, high taxes and falling welfare.

Gr10. CYCLICALLY ADJUSTED GENERAL GOVERNMENT BUDGET
(in % of GDP)



Source: Thomson Reuters Datastream

Meanwhile, private sector debt-to GDP ratios have, on average, declined since the global financial crisis of 2007-2009, but only slightly, despite the fact that the private sector has moved into a financial surplus position. While private debt ratios have eased in Spain — though they remain high relative to the pre-boom period —, they have continued to rise in Ireland and Portugal.

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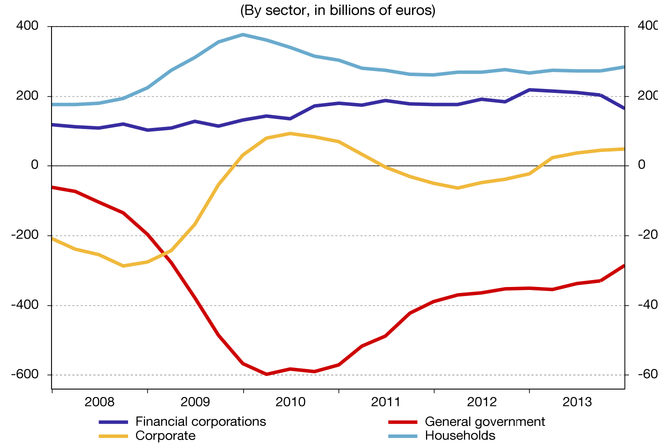
[7] *Importantly, though, the average maturity of the debt and the share that is indexed to inflation affect the ability of inflation to erode the real value of the debt. In the extreme cases of zero maturity or fully-indexed debt, inflation has no impact on reducing the debt burden.*

[8] *The primary budget balance excludes interest payments from expenditure.*

[9] *The IMF calculated that Spain, Ireland, Portugal, Italy and Greece needed to run an average primary surplus of, respectively, 4.0%, 5.6%, 5.9%, 6.6% and 7.2% of GDP in the period from 2020 to 2030. See International Monetary Fund (2013),* Fiscal Monitor, *Washington D.C: IMF, April.*

Gr11. FINANCIAL BALANCE IN THE EURO ZONE
(By sector, in billions of euros)



Source: Thomson Reuters Datastre

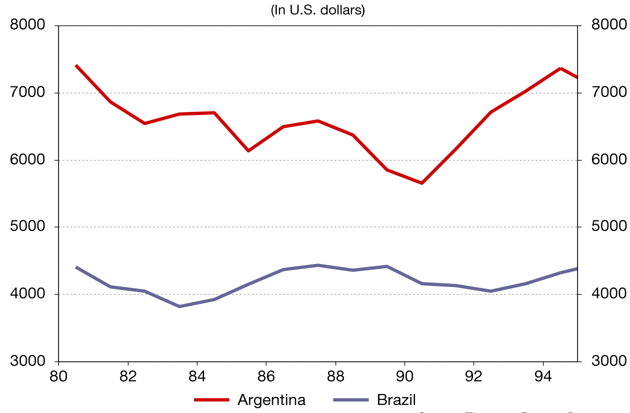
Despite substantial adjustment efforts over the past few years, reducing the euro zone's debt-to-GDP ratios has proved intractable in an environment which has been highly inimical to growth. To the extent that the excessively high levels of debt apply not only to the private sector (banks, households and corporate sectors) but also to the public sector, all the domestic sectors of the economies have been engaged in a process of deleveraging, by cutting back on their spending on goods and services. The simultaneous deleveraging by the corporate, household, financial and government sectors has exerted a severe drag on domestic demand flows, which has only served to elicit a lack of nominal growth and a rising debt burden. The debt burden (i.e. debt as a share of GDP) automatically becomes heavier when nominal GDP declines. So it is not surprising that the troubled euro zone countries, which have been hit by falling output and falling prices, have so far been unable to escape their debt traps.

A LATIN AMERICA-STYLE LOST DECADE?

The problems of the euro zone are strikingly reminiscent of the Latin American debt crises of the 1980s, known as the Lost Decade[10]. In 1982, the initial answer to the Latin American debt crisis was a combination of fiscal austerity in indebted countries and "concerted lending" by international private creditors. The latter was designed to give debtor countries the breathing space necessary to return to economic growth, which would eventually allow them to pay down their debt. The basic premise of this policy was that indebted countries were facing a liquidity crisis, not a solvency crisis[11]. Yet for 10 years, the heavily indebted Latin American countries were stuck with shrinking economies and rising debt overhangs. In 1990, the real output of Latin America was 8% smaller than it was in 1980.

Belatedly, there was recognition that the debt overhang had stifled investment and growth, that austerity just made the recession worse and that, consequently, the fiscal adjustments did not — as had been expected earlier — restore solvency. The answer therefore was debt reduction. The Brady Plan of 1989, named after US Treasury Secretary, Nicholas Brady, was the cornerstone of the debt write-down strategy which ended the debt crisis and paved the way to economic recovery.

Gr12. REAL GDP PER CAPITA
(In U.S. dollars)



Source: Thomson Reuters Datastream

There is a clear parallel between Latin America in the early 1980s and the heavily indebted euro zone countries today. Like Latin America at the time, Europe's strategy to overcome its debt crisis has been articulated around three pillars: 1) fiscal austerity to restore solvency, 2) provision of liquidity to provide breathing space for the sovereigns to enact reforms, and 3) structural reforms to boost productivity and growth. Perhaps the most important lesson that Europe can learn from Latin America's experience is that fiscal austerity can be self-defeating to the extent that, by leading to declining GDP, it makes it even harder for debtors to meet their debt obligations.

However, the full range of issues currently facing peripheral Europe cannot be addressed by the sole experience of Latin America in the 1980s, because currency devaluation, which Latin America largely resorted to in the 1980s in order to regain competitiveness, is precluded in Europe given the constraints of euro membership. This is Argentina's internal devaluation experience in the late 1990s which is the most useful in shedding light on current European policy challenges. Like peripheral Europe, Argentina could not resort to a depreciation of its currency, because it had a currency board and a strong commitment to the fixed exchange rate. Hence, like the

[10] *See Cavallo, E.A. and Fernandez-Arias, E. (2013), "Coping with financial crises: Latin American answers to European questions", International Development Policy, 5.1, p 7-28.*

[11] *For an account of the Latin American debt crisis of the 1980s, see Krugman, Paul R., Enders, Thomas and Rhodes, William R. (1994), "LDC Debt Policy", A chapter in* American Economic Policy in the 1980s, *from NBER, Inc, pp 691-740.*

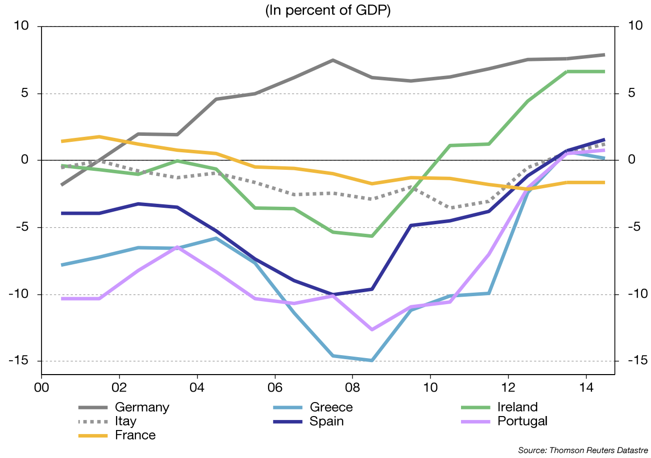
euro zone peripheral countries, Argentina tried the deflationary route to a real depreciation (see Box 1).

THE REMAINING COMPETITIVENESS PROBLEM

THE LIMITS OF THE AUSTERITY-LED INTERNAL DEVALUATION

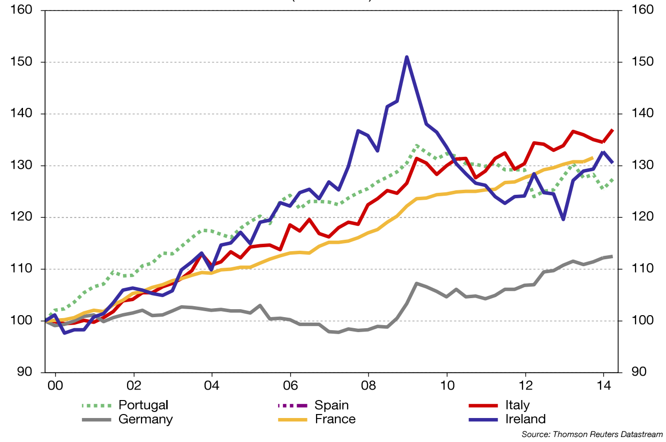
The economies of the euro zone periphery suffer not only from a debt overhang problem, but also from a competitiveness problem. In the first decade of the euro, peripheral countries lost competitiveness to core countries, most notably Germany, either because they spent more than their incomes, or due to a rise in their unit labor costs, as productivity growth lagged behind wage growth. In the 2000s, unit labor costs in peripheral Europe grew 20%-30% faster than in Germany. The loss of external competitiveness, coupled with strong domestic demand, was reflected in large external deficits in peripheral countries (see Graph 13).

Gr13. CURRENT ACCOUNT BALANCE
(In percent of GDP)



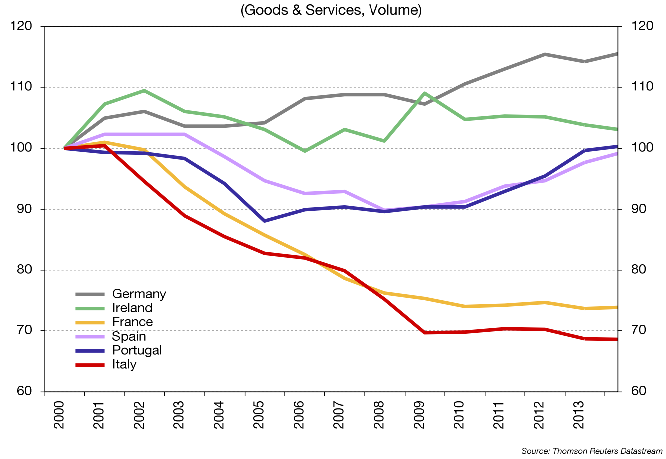
The resolution of the euro zone crisis requires that competitiveness be restored in peripheral Europe. Without large improvements in competitiveness, peripheral Europe's ability to grow will remain severely circumscribed, which will ultimately put debt sustainability at risk. To address their competitiveness problems, peripheral countries have to engineer real depreciations. This can be achieved by either nominal devaluations or lower domestic prices. Since nominal devaluation is not an option for euro zone members, peripheral countries are left with no choice but to lower domestic price inflation. So "internal devaluation", that is, cuts in wages, pensions and other costs, has been the cornerstone of the European strategy to restore competitiveness in the periphery. An important complement to internal devaluation has been structural reforms, including labor market reforms, which are intended to enhance competitiveness through an increase in productivity.

Gr14. NOMINAL UNIT LABOR COSTS
(1999 = 100)



Over the past few years, peripheral Europe has made real progress in reducing its unit labor cost gaps with the European core. Ireland and, to a lesser extent, Spain and Portugal have succeeded in cutting their relative prices to a significant degree. Yet despite years of austerity implementation, the required adjustment is still a long way from being complete, as there remains a large unit labor cost growth differential with Germany. To reduce this differential, Europe has two options: (1) implement a more substantial rise in nominal wages in Germany and/or (2) engineer productivity gains, along with moderate wage growth or even actual wage deflation in the troubled southern economies.

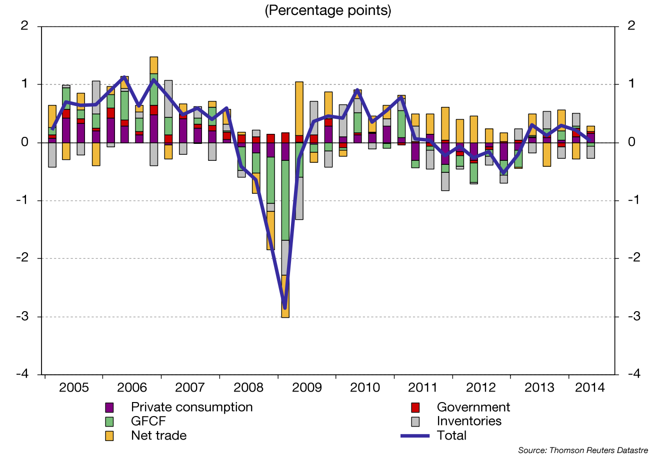
Gr15. EXPORT PERFORMANCE
(Goods & Services, Volume)



So far, the improvement in unit labor costs in the economies of the periphery has overwhelmingly been achieved through labor shedding, rather than falls in nominal wages. Wage cuts have been limited, and have mainly occurred in the public sector. There has been virtually no decline in wages in industries in the private business sector. The sharp contraction in public demand under fiscal austerity across European countries, combined with still high labor costs in troubled countries, has brought about large cumulative falls in output and employment in the periphery. The reason for the sharp improvement in the current account balances of peripheral Europe since 2008 is primarily a strong decline in imports, driven by the collapse in domestic demand, rather than gains in competitiveness.

Gr16. EURO ZONE: CONTRIBUTIONS TO GDP GROWTH

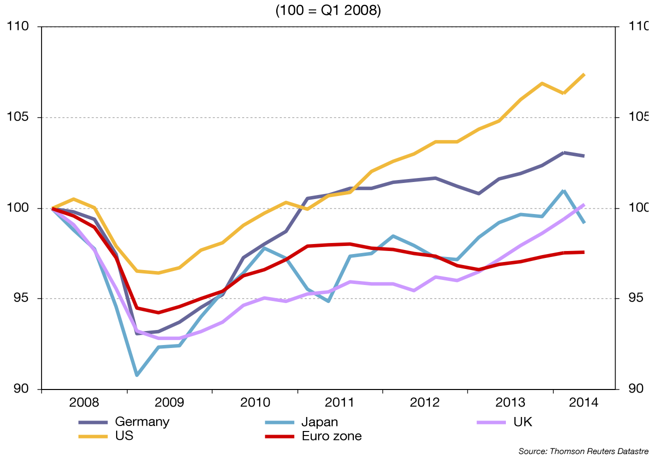
(Percentage points)



The problem for the European periphery is that a long enough recession or stagnation can lead to losses of both human and physical capital, which can erode the economy's future potential (the so-called hysteresis effects). Output shortfalls in Southern Europe's economies are threatening to turn into a permanent output gap[12] which has the potential to plunge these countries into a dangerous debt trap.

Gr17. REAL GDP LEVELS - INTERNATIONAL COMPARISONS

(100 = Q1 2008)

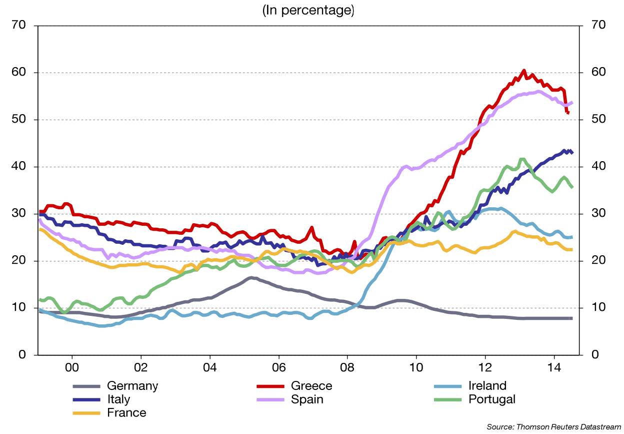


THE RISK OF STALEMATE

Another problem with the internal devaluation strategy is that the decline in wages and costs, which is necessary to improve competitiveness in peripheral Europe, makes its debt overhang problem worse, because deflation reduces incomes, while the value of the inherited debt (public and private) is left unchanged (absent a debt restructuring). So, the more the peripheral nations reduce wages and costs, the heavier their inherited debt load becomes. In addition, as debt burdens become heavier, government spending must be cut further, depressing the economy even further, and creating the need for more internal devaluations, in a vicious circle[13]. There is, in fact, an inherent conflict between the policy designed to regain competitiveness through lower relative prices and the debt reduction objective. The current European strategy of resolving the solvency problem through fiscal austerity and the competitiveness problem through a combination of internal devaluation and structural reforms may only end up in long-lasting losses in output and employment.

Gr18. YOUTH UNEMPLOYMENT

(In percentage)



At the annual central bankers' summit in Jackson Hole (United States), held on 22 August 2014, Mario Draghi stated that without an increase in aggregate demand, the eurozone countries could be confronted with higher structural unemployment rates. He indicated that it would be necessary to support the needed structural reforms by boosting global demand, and that this would require a very accommodative monetary policy combined with the implementation of budgetary stimulus packages across Europe. For the first time, he made explicit reference to a budgetary strategy common to all the member States of the eurozone. This would of course be conditional upon the States jointly tackling the structural obstacles that limit productive supply. Furthermore, he confirmed that the ECB would be ready to stimulate demand as necessary, via quantitative easing and easing of credit conditions[14].

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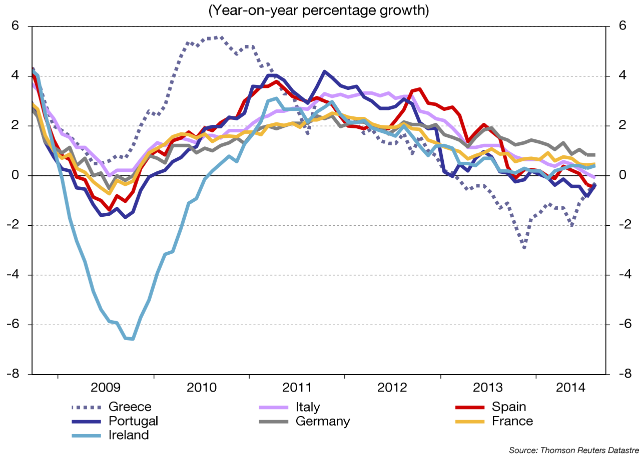
[12] *The output gap is the extent to which actual output differs from potential output.*

[13] *This is the spiral of debt deflation about which Irving Fisher wrote at the height of the Great Depression. See Fisher, Irving (1933), "The debt-deflation theory of Great Depressions", Econometrica, Vol. 1, N°.4. It is important to note here that low inflation can generate a dynamic of "Fisher-style" debt-deflation, making the debt burden less sustainable. See Akitoby, Bernardin, Takuji Komatsuzaki and Ariel Binder (2014), "Inflation and public debt reversals in the G7 countries", International Monetary Fund, Working Paper, June.*

[14] *On 4 September, the ECB announced new measures: a further drop in interest rates (refi, deposit and lending facility); the*

GR19. CONSUMER PRICE INDEX
(Year-on-year percentage growth)



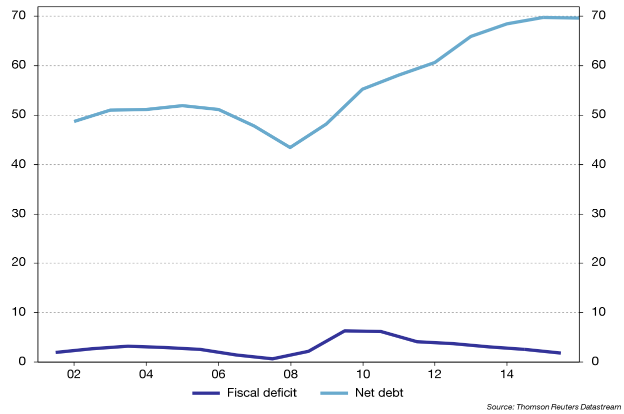
LIQUIDITY CRISIS OR SOLVENCY CRISIS?

A key issue is that of determining whether indebted countries are facing a liquidity crisis or a solvency crisis. Depending on the type of crisis, the solutions differ. To avoid defaulting on payment, a country facing a liquidity crisis only needs a public sector lender (the European Union, the European Union relief fund, the International Monetary Fund or the ECB, for example) to take the place of private sector lenders until the situation returns to normal. However, an insolvent country can never repay its debt in full. It is therefore pointless to lend it more money, and the recommended solution in that case is to restructure/reduce the country's debt to bring it back to a sustainable path. The problem is that it is very difficult to determine *ex ante* whether a country is in the midst of a solvency crisis or a liquidity crisis. Since the beginning of the crisis in the euro zone, European policymakers have tended to dodge this question.

Until now, the European authorities have tried to resolve the crisis in the peripheral markets by offering financial assistance, conditional upon the indebted countries implementing austerity policies combined with structural reforms. The granting of loans from the European Union, the European Union relief fund and the International Monetary Fund, which have increased the debt levels of the indebted countries, suggests that the diagnosis was one of a liquidity crisis. The other policy tools which have, in the past, helped countries escape their debt quagmires have typically included debt monetization, various forms of wealth taxation (such as "financial repression") and debt restructuring.

Within the euro zone, there is an additional option: the use of government debt pooling arrangements between the member States. The establishment of the European Stability Mechanism (ESM) represented a first step in this direction: it granted, subject to certain conditions, loans at very preferential rates to countries (Greece, Portugal, Ireland) that no longer had any access to the financial markets, or had access only at a prohibitive cost. Furthermore, the maturity of these loans was greatly extended (with repayments beginning only in 2025-2030 and extending until 2040). This already resulted in a net reduction in the cost of servicing the debt for the recipient countries.

Gr20. EURO ZONE'S PUBLIC FINANCES
(in % of GDP)



To go further in European government debt pooling, several options could be considered. These include the creation of a fiscal union—which is, however, unlikely anytime soon—or a debt union. Eurobonds that would be jointly guaranteed by the European countries could offer a way for troubled peripheral economies to escape their high-debt traps. Seen as a unit (rather than as a group of individual countries), the euro zone enjoys sound fundamentals, with balanced external and fiscal positions and a sustainable debt position[15]. Of course, debt pooling can only work if it is accompanied by increased sharing of sovereignty between the member States.

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implementation of an ABS (Asset Backed Securities) purchase program in addition to the LTRO (Long-Term Refinancing Operation) for September and December, announced in June; and the end of the sterilisation of the SMP (Securities Markets Program).

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[15] *The establishment of a euro zone-wide unemployment insurance system is another option that has recently been put forward. See Les notes du conseil d'analyse économique (2013), "Completing the euro", n°3, April.*

BOX 1 – ARGENTINA'S EXPERIENCE WITH INTERNAL DEVALUATION

There are many similarities between the current situation in the euro zone periphery and the crisis in Argentina in the late 1990s which should hold valuable lessons for Europe.

In 1999, the Argentine economy was hit by a double-whammy: Brazil (Argentina's biggest trading partner) drastically devalued its currency, and the US dollar (to which the Argentine peso was pegged) appreciated sharply vis-à-vis most currencies. So, Argentina's currency became substantially overvalued. At the turn of the century, Argentina was wrestling with uncompetitive industries, faltering growth, large budget shortfalls and a huge amount of debt denominated in a currency over which it had no control.

Unlike the euro zone member states, Argentina had not given up its own currency, but in 1991 it had adopted a rigid peg of the peso to the US dollar, establishing a "currency board" in which each peso in circulation was backed by a dollar in reserves.

In an attempt to restore its competitiveness, while keeping its exchange rate pegged to the dollar, Argentina tried the deflation adjustment to a real depreciation. In addition, the government implemented stern fiscal austerity measures in order to improve its solvency. To buy time for making the reforms that would allow Argentina to return to the voluntary market in normal conditions, the country received large loans from an IMF-supported international package. The hope was that improved confidence would eventually lead to a resumption of growth, rendering the debt trajectory sustainable.

The austerity program, however, had a deleterious effect on growth. Faltering growth eroded tax revenues, which led the government to introduce more aggressive austerity measures. This, in turn, deepened the recession, causing a worsening of debt ratios, which ultimately triggered a loss of confidence in the debt sustainability. At the end of 2001, Argentina faced a generalized bank run which prompted the government to impose measures that severely curtailed the convertibility of bank deposits. Meanwhile, surging unemployment, combined with the unyielding recession, was feeding growing social unrest, and the government eventually collapsed. In December 2001, Argentina defaulted on its debt—eventually paying only about 35 cents on the dollar. In early 2002, the country scrapped its currency board.

While there are evident parallels between the experience of Argentina and that of the heavily indebted euro zone countries, there are also important differences which will likely lead to a different ending for the euro zone story.

Key differences include:

- Euro zone countries, unlike Argentina, belong to a formal multilateral arrangement which can provide the intensive care and official finance needed to smooth the adjustment over a longer period of time.
- They also have a lender of last resort—the ECB—which can effectively ward off the occurrence of panics and bank runs, thanks to its unlimited power for creating euros. In Argentina, by contrast, the central bank did not have enough dollars to provide banks with sufficient liquidity in case of a panic, while the US Federal Reserve was not willing to resort to its printing press to assist the country.

The main lesson to draw from the Argentine experience is that the heavily indebted euro zone countries have little hope of escaping the currency-growth-debt trap they are in by focusing on austerity and internal devaluation. However, due to the assistance provided by Europe and to the access to potentially unlimited financing from the ECB, the risk of a full-blown currency or debt crisis is quite low. The solvency test for Europe will be the willingness of the countries' social and political systems to accept many years of austerity and loss of welfare.

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