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**A2 GCE ECONOMICS**

**F585/01/SM** The Global Economy

**STIMULUS MATERIAL**

**JANUARY 2013**



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- This document consists of **12** pages. Any blank pages are indicated.

## Introduction

In November 2011, the former vice-president of the European Central Bank (ECB), Lucas Papademos, was named as Prime Minister of Greece. Unelected, he headed an interim government charged with reducing Greece's national debt in order that it could secure a critical rescue package from the European Commission, the ECB and the International Monetary Fund (IMF). Without this rescue package, there were fears that Greece would have to default on its debt and leave the eurozone.

Talk of the possibility of Greece defaulting on its national debt led many economists to compare the Greek debt crisis of 2011 with that in Argentina a decade earlier in 2001. A number of striking similarities between the two crises were identified. The first of these similarities concerned the policy decisions made by both countries a decade before their debt crises. Argentina had chosen to fix its exchange rate to the US dollar in 1991 and Greece had adopted the euro in 2001. These policy decisions had beneficial consequences for both economies at first, but in the long run the disadvantages became apparent.

The second similarity between the debt crisis in Argentina in 2001 and the Greek debt crisis of 2011 was the consequences of external shocks to the two economies. Both economies faced external shocks but lacked the monetary and fiscal policy flexibility to cope with the consequences of these shocks. Both countries had lacked fiscal discipline such that they had accumulated large levels of national debt prior to the emergence of an external shock. In the case of Greece, this was despite the existence of the eurozone's fiscal rules.

In order to restore fiscal credibility, both Argentina and Greece had sought to put in place austerity measures to reduce the fiscal deficit, bring national debt under control and restore economic stability. However, these austerity measures did much to damage economic growth. Joseph Stiglitz, Professor of Economics at Columbia University in New York and former World Bank Chief Economist, argued that the austerity measures were not the way to prevent default in Greece.

A decade earlier, Argentina had defaulted on its national debt. The consequences of its default were initially severe as Gross Domestic Product (GDP) collapsed, unemployment soared and poverty became widespread. However, Argentina soon recovered from this poor economic performance. Some economists have attributed the improvement in Argentina's economic growth since 2003 to the exchange rate, although other factors may have been at least as important.

Despite the increasing role of the state in the Argentinean economy since 2003, inflows of Foreign Direct Investment (FDI) have increased. FDI is just one form of international financial flow and its effect and relative importance in the promotion of economic development is debated amongst economists. Some see FDI as an important way of raising levels of investment in developing economies, whilst others argue that the impact of FDI is not always positive and that a policy of attracting FDI on its own is insufficient.

## **Pre-release stimulus material**

**Extract 1: Policy decisions in Argentina and Greece**

**Extract 2: The impact of external shocks and internal indiscipline**

**Extract 3: The failure of austerity**

**Extract 4: The aftermath of default in Argentina**

**Extract 5: International financial flows and economic development**

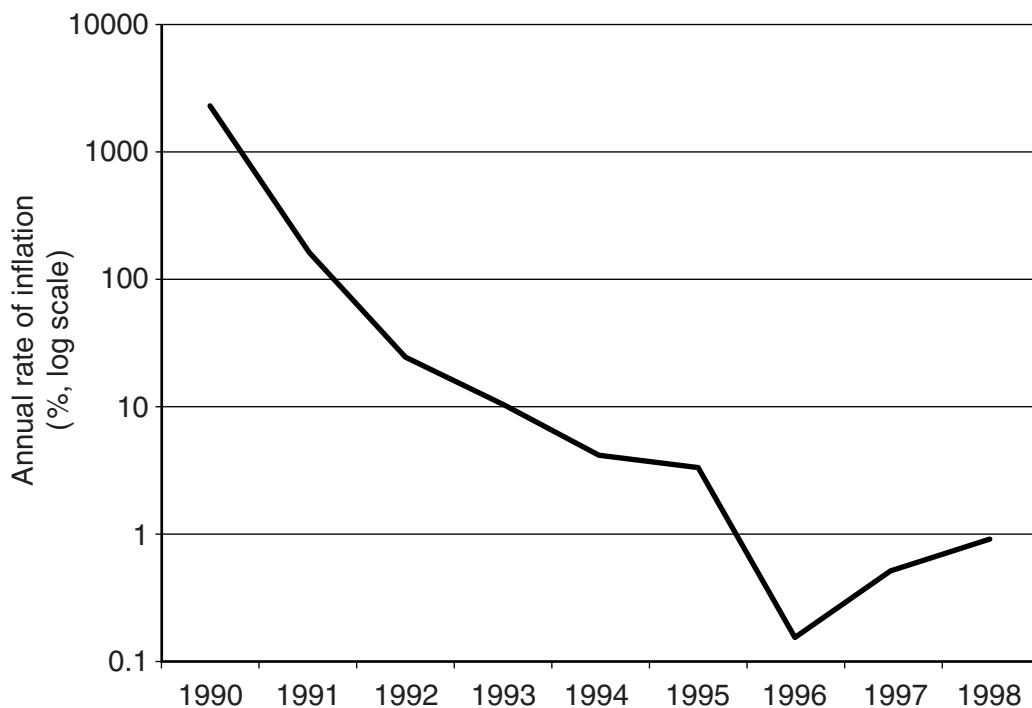
## Extract 1

### Policy decisions in Argentina and Greece

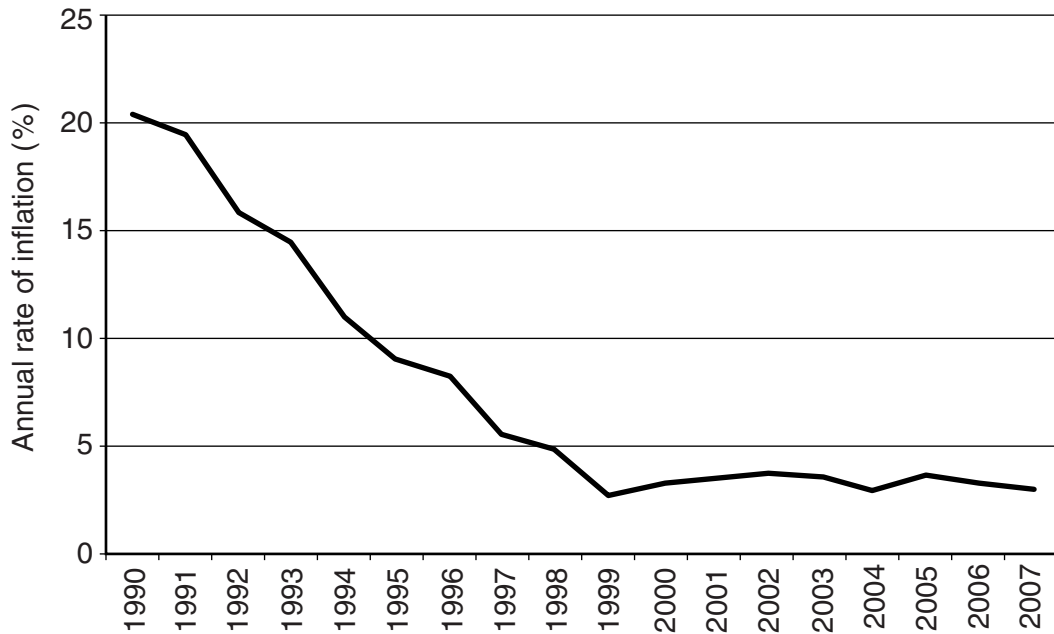
The roots of the 2001 crisis in Argentina and the crisis in Greece in 2011 were very similar. Both countries had made policy decisions which reduced the flexibility of economic policy-makers to deal with external shocks to the economy.

In Argentina it was the radical decision to create a 'currency board' to try to reduce and then to stabilise its rate of inflation. The 'currency board' was an arrangement which guaranteed the convertibility of the Argentinean currency (the peso) to the US dollar at a fixed 1:1 ratio. This had a number of consequences for the Argentinean economy. Initially, there were major benefits of the fixed exchange rate for Argentina's rate of economic growth, as levels of FDI increased significantly, and for economic stability as the rate of inflation (see Fig. 1.1) was brought under control.

In Greece the root of the 2011 crisis was a decision to join the European Monetary Union (EMU) in 2001 and to adopt the euro. Greek inflation, much like that in Argentina a decade earlier, was kept at a low and stable rate (see Fig. 1.2). In addition, adopting the euro almost halved Greek interest rates by the end of 2001, allowing an increase in borrowing by both the public and private sectors.



**Fig. 1.1 – Rate of inflation (annual data) in Argentina, 1990–98**



**Fig. 1.2 – Rate of inflation (annual data) in Greece, 1990–2007**

Whilst these two policy decisions had beneficial consequences at first, they also sowed the seeds of the crisis to emerge in each economy a decade or so later. The creation of a 'currency board' in Argentina meant that the country had effectively replaced its own currency with the US dollar and had lost control over domestic monetary policy. A 'currency board' is essentially a 'quasi' monetary union. Similarly, Greece had surrendered control of its interest rate to the ECB and lost the ability to alter its exchange rate.

The massive inflows of FDI and other financial inflows in both economies led not only to high rates of economic growth but also to high rates of inflation. These rates of inflation were much greater than their major trading partners. In Argentina, the fixed exchange rate regime of the 'currency board' began to resemble a 'straightjacket'. The peso's real exchange rate in terms of its purchasing power parity (PPP) rapidly increased. The problems of high inflation in Greece were compounded by more fundamental competitiveness issues signalled by rising unit labour costs.

## Extract 2

### The impact of external shocks and internal indiscipline

A number of external shocks hit the Argentinean economy in the 1990s after it had taken the decision to create a 'currency board'. These included a significant appreciation of the US dollar in 1995. These external shocks led to a slowdown in economic growth and a widening of the current account deficit which had begun to emerge after the fixing of the peso against the US dollar.

In Greece it was the global financial crisis which started in 2007 that created a large external shock to the economy. The financial crisis increased the perceived risk attached to global capital flows. Economies with weak external balances and high national debt began to be viewed with suspicion. Capital flows into Greece began to fall and, consequently, so did the rate of economic growth.

What made these external shocks more pronounced for both Argentina in the 1990s and Greece in 2011 was the lack of fiscal discipline characteristic of successive governments in both countries. International investors, concerned about budget deficits, national debt and current account deficits (see Fig. 2.1) demanded higher and higher interest rates on government debt (so called bond yields). This made it more costly for the governments of both countries to service their debt and raised fears that debt levels had become unsustainable.

	<b>Argentina Annual Average 1996–2000</b>	<b>Greece Annual Average 2006–10</b>	<b>Argentina 2001</b>	<b>Greece 2011</b>
<b>Budget deficit (% of GDP)</b>	2.9	9.5	6.1	7.5
<b>National debt (% of GDP)</b>	40.1	118.1	53.7	153.1
<b>Current account deficit (% of GDP)</b>	–3.7	–12.3	–1.4	–8.2

**Fig. 2.1 – Budget deficit, national debt and current account deficit in Argentina and Greece**

The lack of fiscal discipline in Argentina was characteristic of economic policy before the 'currency board' was formed. Governments would stimulate the economy by raising government expenditure, thus creating budget deficits. These deficits were 'financed' either by borrowing or by printing money. The result was high inflation and currency devaluations. When the 'currency board' was established, devaluation of the currency was no longer an option.

In many respects the same could be said of Greece which had entered the EMU not having met the Maastricht Convergence Criteria on budget deficits and national debt. The problem for Greece, however, was made worse by a failure of the eurozone's fiscal rules. The fiscal rules of the eurozone were laid down in the Stability and Growth Pact (SGP). These rules, however, failed to control budget deficits in some parts of the eurozone because they made an assumption that governments were in full control of their expenditure and tax receipts. As more eurozone economies broke the fiscal rules as a result of the global economic slowdown and ultimately domestic recessions, the SGP began to lose credibility and political support.

## Extract 3

### The failure of austerity

In order to avoid default both Argentina and Greece sought external help. Argentina secured the assistance of the IMF, but in return the IMF imposed strict conditions to avoid the government defaulting on its debt. Successive budgets sought to reduce government expenditure and raise tax receipts in order to reduce the budget deficit. In July 2001, the then Argentinean government introduced a 'zero deficit law', committing it to a balanced budget by the end of the year. Despite this, the budget deficit turned out to be 6.1% of GDP by the end of 2001 and economic growth, rather than the expected 3.5%, turned out to be -4.5%.

Something similar happened in Greece in 2010–11 as fiscal austerity measures failed to bring the budget deficit and national debt under control. The first attempt in early 2010 envisaged a reduction of the budget deficit from 12.9% of GDP to below 3% in 2012. Despite strong support for the deficit reduction strategy by the European Commission, the plan failed. In mid 2010, a second strategy, this time devised by the IMF, aimed to bring the budget deficit below 3%, but over a longer time period: by 2014. A month after the second strategy was announced, it was judged that Greece was still not on target to achieve the reduction in its budget deficit. As a result, the IMF provided more financial support in return for additional measures to reduce the budget deficit.

In both countries the IMF measures assumed that economic growth would return if budget deficits were reduced and structural reforms to the economy put in place. The austerity measures failed in both countries because they made budget deficits worse, not better. In addition, there was resistance to cuts in public sector wages in both economies.

In November 2011, the then Prime Minister of Greece, George Papandreou, announced a referendum on the latest bailout package offered by the eurozone economies and the further austerity measures required of Greece as a condition for financial assistance to the government to meet its expenditure commitments. The Prime Minister abandoned the referendum plans shortly afterwards, and was forced to resign. He was replaced, without an election, by Lucas Papademos, an economist, a former Governor of the Bank of Greece and Vice President of the ECB.

Social and political unrest in Argentina ultimately meant it was difficult to sustain the austerity measures required by the IMF. In October 2001, Argentina embarked on a 'debt restructuring process' trying to convince creditors to accept lower repayments over a longer period of time. The IMF insisted that Argentina impose capital controls to reduce the risk of capital flight. A run on the banking system followed, violence erupted on the streets and the IMF withdrew its financial assistance: so began a disorderly default.

Towards the end of 2011, it remained to be seen whether Greece would avoid the consequences of the disorderly default experienced by Argentina ten years earlier.

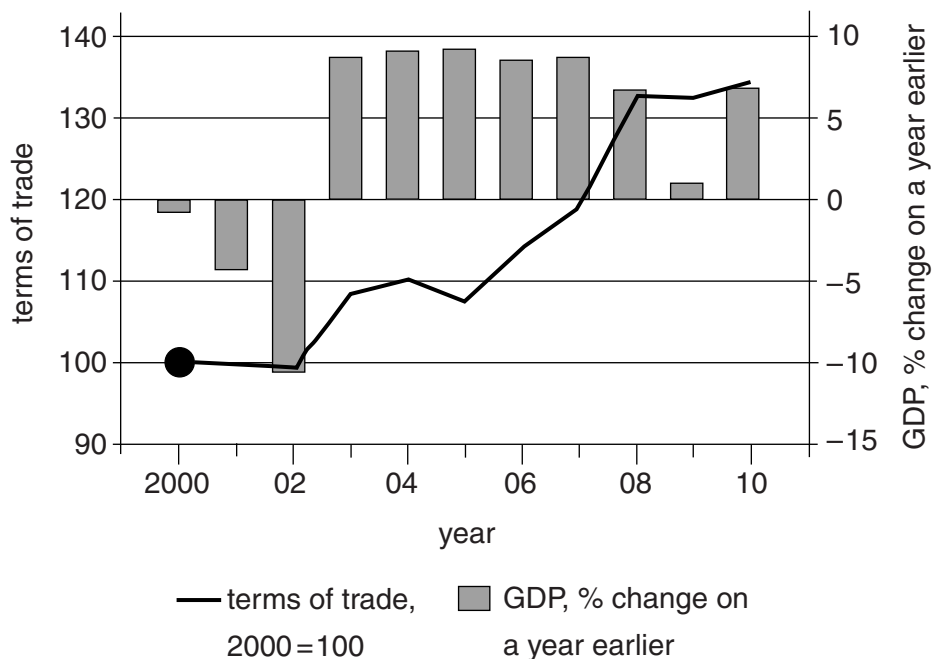
## Extract 4

### The aftermath of default in Argentina

The immediate aftermath of the disorderly default in Argentina was dramatic. The 'currency board' which had linked the peso to the US dollar was abandoned and the peso was allowed to float. Its value, which had previously been pegged at 1 peso = 1 US\$, fell to 4 peso = 1 US\$ within a few months. In 2002, a year after the default:

- economic growth had fallen to –10.9%
- unemployment had reached 21.5% of the workforce
- the percentage of the population living below the poverty line had reached 57.5%
- capital outflows had doubled to over US\$11 billion
- FDI had fallen to US\$1.6 billion from a peak of US\$24 billion in 1999
- Argentina lost access to international capital markets, as it was considered to be too high a risk.

Since 2003, however, Argentina has recovered and has enjoyed high rates of economic growth (see Fig. 4.1). Argentina's recovery can be largely explained by a significant improvement in its balance of trade. From running trade deficits before 2001, Argentina began to experience surpluses in its trade from 2002. These surpluses owed much to the impact of the devaluation of the peso which occurred after it defaulted on its debt. In addition, Argentina has benefitted from an improvement in its terms of trade since 2003 (see Fig. 4.1). Rising demand for food from Asia increased the price of Argentina's exports of agricultural commodities, such as soybeans, increasing export revenue. The Argentinean government has taxed the increased profits of farmers in order to provide subsidies to multinational companies locating in the country.



**Fig. 4.1 – Argentina's rate of economic growth and terms of trade, 2000–10\***

\*2010 data based on Quarter 1

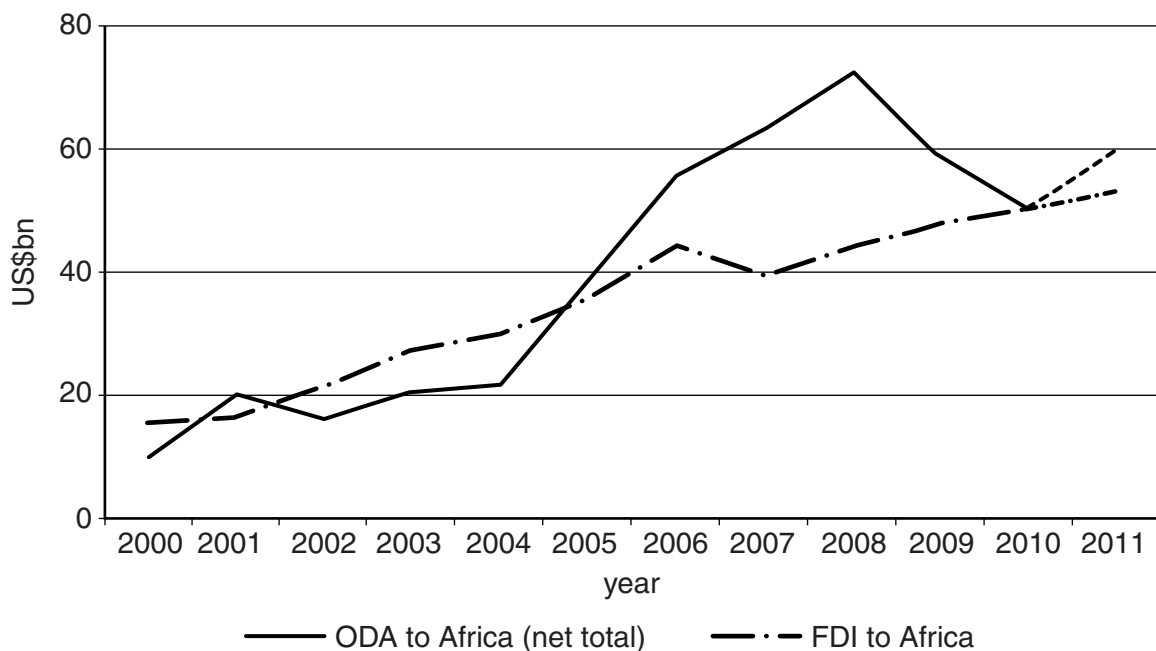


## Extract 5

### International financial flows and economic development

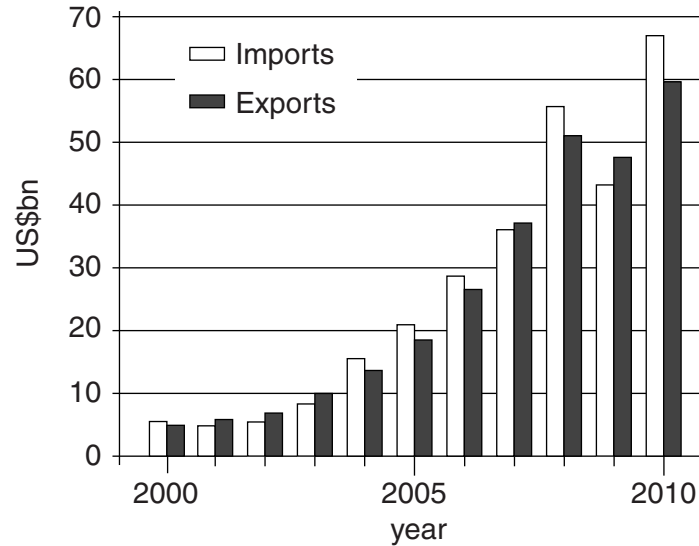
Argentina has been successful in attracting high levels of FDI thus increasing the economy's productive capacity and growth potential. Over 500 US companies have located production in the country and they employ in excess of 155000 workers. Annual real GDP growth rates in excess of 8.5% from 2003–07 have been an important reason for this FDI. However, there have been concerns about the increasing role of the state in the economy, including state control over prices and protectionist measures. As a member of Mercosur, a customs union in South America, Argentina has not been able to increase tariffs on imports. Instead, it has used non-tariff barriers, such as import licensing, to limit imports. Around 600 products require import licences, including toys, pharmaceutical ingredients, tyres, fabrics and farm machinery. In order to overcome such protectionism, some multinational companies have sought to locate production in Argentina. For example, Brightstar has set up a production facility in Argentina to assemble BlackBerrys, despite production costs being 15 times those in Asia. The government predicts imports of mobile phones will be reduced from 96% of the domestic market to under 20%.

The impact of FDI on economic development is debated by economists. According to some, FDI can allow developing economies to compensate for poor economic conditions which make it difficult to achieve the minimum growth rate necessary to meet the Millennium Development Goals set by the United Nations (UN). According to the Economic Commission for Africa, for example, an increase in investment is vital for sustained growth and development in Africa. However, this increase in investment is constrained by unpredictable flows of aid, Africa's low share in world trade, the high volatility of short-term capital flows and Africa's low savings rate. The importance of FDI to Africa has increased since 2000, as shown in Fig. 5.1, and is seen by some as more beneficial than Official Development Assistance (ODA). As well as increasing output, employment and incomes, FDI is thought to generate positive spill over effects on local businesses, add to the productive capacity of an economy and create important tax and export revenues. China's FDI in Africa, for example, has generated a rapid increase in trade (see Fig. 5.2) which some view as beneficial to Africa.



**Fig. 5.1 – Flows of FDI and ODA to Africa, 2000–11\***

\* flows of FDI and ODA to Africa for 2011 are forecasts



**Fig. 5.2 – China's trade with Africa, 2000–10**

Some economists, however, are more sceptical about the benefits of FDI for economic development. They point out that FDI, both in Latin America and Africa, is concentrated in only a few countries. In addition, they argue that whilst FDI has increased in Latin America and Africa, total investment as a percentage of GDP in these regions has decreased. The nature of FDI is also questioned. Andres Lopez, Professor of Economics at the University of Buenos Aires, says much FDI in Brazil and Argentina has taken the form of mergers and acquisitions. Chinese FDI to Africa has been concentrated in the natural resource sector and has raised fears about resource depletion and environmental degradation, although manufacturing's share of total Chinese FDI (22%) is beginning to catch up with mining (29%). Concerns are also raised about the impact of FDI on local product and labour markets. In addition to FDI, China has also increased loans to African governments and now lends more than the World Bank. However, most of these loans are 'tied'.

There is little doubt that investment promotes the development process. Whether FDI does so better than other ways, however, is still open to debate.



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