Global

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Special Report

3 cheers for 5 Star as Latin American heterodoxy comes to Europe

I've been writing recently about the return of interventionist economic policies on account of the unemployment crisis. And it made me wonder whether some of the policies that we used to frown upon in the 1980s might look rather better under a modern spotlight. Latin America was something of a hot-bed of unorthodox (or heterodox) policies in the mid-1980s. But, to be fair to them, this followed an earlier phase of their debt crisis where they adopted a more orthodox approach which didn't work. Not surprisingly, electoral politics eventually took its toll on the textbook and technocratic approach. And that is where Europe comes in. We initially said to ourselves that we were facing a liquidity and not a solvency issue. We've tried textbook austerity but it hasn't helped growth yet. So in Latin American terms, we're starting to see the outbreak of heterodoxy. Of course, heterodoxy didn't have a happy ending in Latin America -- not for the first time, only a devaluation of the claims could provide that palliative. It doesn't have to be thus in Europe - but time is ticking.

Interventionist policy is the order of today, but it wasn't always thus

As you may recall, in the last two weeks I've written about the return of interventionist economic policies on account of the unemployment crisis. And it made me think about how some of these yester-year policies might look through the lens of today's circumstances and today's "new" way of thinking (just in case you've forgotten, "new" turns out in many ways to be "old").

Latin America in the 1980s and 90s was an interesting place to analyse

I was lucky enough in the mid-1990s to spend a couple of years analysing Emerging Market economies, but particularly those with so-called Brady bonds (of course I've long since grown out of writing silly sounding article titles such as "A Man, A Plan, a Canal – Panama" and "To Benn, I win. Nebot": answers on an e-mail regarding what these two titles have in common, by the way). Latin America was ground zero as far as Brady bonds were concerned – they were launched by then US Treasury Secretary Nicholas Brady in 1989 as a means by which "voluntary" debt reduction (mostly for Latin American countries) was accompanied by the conversion of previously in-default loans to tradable bonds, with certain payment guarantees that allowed the lenders to continue to classify their exposures as performing. As I think about it now, it was a similar-looking sleight of hand to the modern-day manoeuvre of rescheduling bond payments without triggering a CDS credit event.

Argentina and Brazil were the darlings of the IMF by the mid-1990s

Anyway, in the mid-1990s (notwithstanding the small matter of the Tequila Crisis of 1995), the stars of the show were Argentina and Brazil with their orthodox stabilisation programmes. In Argentina, Economy Minister Domingo Cavallo had introduced a so-called currency board – called the Convertibility Law – in 2001, and it helped to bring inflation down from above 1,000% to below 10% in the space of barely two years (a currency board is a very rigid form of fixed exchange rate in which the monetary base of the economy has to be backed by a hard currency, in this case US dollars). And in Brazil, Finance Minister (soon to be President) Fernando Henrique Cardoso had brought in the Real Plan, with similarly dramatic results in terms of bringing down what had just-previously been hyper-inflationary conditions. These were the orthodox plans; the "good" ones; the ones that the IMF really looked favourably on. Of course, it didn't hurt that the plans appeared to be working at the time (eventually both exchange rate regimes "evolved", to put it diplomatically: Brazil's in early 1999 and Argentina's in early-2002).

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Heterodox plans were out of favor

Then there were the feared “heterodox” plans (if you’ve never looked it up in the dictionary, “heterodox” means “not orthodox”). And, boy, we frowned on these in the mid-1990s. Of course, they all failed. There was the failed Austral Plan from Argentina in 1985 (I was so down on the word ‘Austral’, given what happened to the Austral Plan, that I once sat in the Buenos Aires City Airport for six extra hours just so I could avoid flying on Austral Airways. I flew Aerolíneas Argentinas instead – only to learn later that both airlines were in fact owned by the same company). And there was the failed Cruzado Plan from Brazil in 1986. But most populist of the lot had to be the poor old Inti Plan from Peru. The Inti Plan was the brainchild of President Alán García, who came to power in 1985 dubbed “Peru’s JFK” on account of his youth – just 35 when he came to office. And, for a time, things looked good. But a toxic combination of public sector real wage increases, price freezes and bank nationalisation left the nation on its knees within three years – with 2000%+ inflation, -10% real GDP growth, a public sector deficit of more than 5% of GDP – and the young President out of office (President García made a successful comeback later in life, by the way. And though his successor President Alberto Fujimori was the one who instigated the real, orthodox shock-therapy -- they called it Fuji-shock at the time -- it was Fujimori who ended up in exile with a multi-decade prison term having been awarded against him in absentia).

Anyway, this all sounds easy enough. Orthodox was good; heterodox was bad. Yeah, right.

Peru’s heterodox approach at least followed a failed, prior orthodox plan

As ever, timing is everything. Peru, it turns out, only turned to the dark side of heterodoxy in 1985 because of the failure of the previous orthodox approach, which had been championed since 1980 by the prior government of President Fernando Belaúnde. You see, they’d already implemented price liberalisation, reduced trade tariffs, tried to carry out some early privatisation efforts, and implemented a crawling peg exchange rate to try to keep inflation down (among other things). It had all been approved by the IMF under a series of lending programmes. The only thing is, it hadn’t worked either: GDP stagnated; inflation doubled; real wages fell by 35%; and external debt rose by 70%. So, Yes, heterodoxy failed: but so too (at that time) had orthodoxy. And this wasn’t just true in Peru.

Contrary to what you might have thought, Latin America did try an orthodox approach to its debt problems before taking a more heterodox tack

Latin America's most infamous heterodox programmes all had their shortcomings, in fact. But spare at least a thought for the fact that most of these supposed wretched plans were hatched in the mid-1980s, in what were still the early days of Latin America’s lost decade. In fact, the stabilisation plans we all tend to think more fondly of (like the Convertibility Plan and the Real Plan) didn’t typically emerge until the 1990s, by which time the Brady Bond solution was on the table, and debtors and creditors were finally getting round to some serious debt restructuring to go alongside new orthodox structural reform measures. On average, Brady deals were savings governments as much as a quarter of their prior external debt servicing bill, which is no small matter. I don’t know if I’ll say it again, but I’ve certainly said it before that devaluation (whether of exchange rates or of claims) does enjoy something of a track record over time (remember countries coming off the Gold Standard and then recovering; or abandoning IMF-advised austerity in the Asian crisis and recovering; or abandoning their ERM bands and then recovering) of offering countries at least a temporary escape path from economic stagnation.

The big creditors had their share of problems in the 1980s, too

Before we bring this all a little closer to home, let’s spare a thought to the creditors, because they weren’t exactly enjoying life either at the outset of the last International

Debt Crisis. In fact, despite repeated warnings to be careful about managing their LDC (Less Developed Countries) loan books, the biggest banks found themselves with crippling exposures by the end of 1982, when 40 countries were in arrears on their external debts (Mexico kicked the ball rolling with its announcement in August 1982). For example, the 13-largest US banks had exposures to just the five largest Latin American countries equivalent to no less than 153% of their capital. Perhaps it was no wonder that everyone agreed to so-called 'Concerted Lending' approach managed via the IMF during the early years of the crisis. After all, it was something of a perfect storm for the countries in question, wasn't it – high oil prices, deep global recession, sky-high interest rates? So really it was a Liquidity issue rather than a Solvency one, wasn't it?

Now, does this sound familiar at all?

Europe has tried orthodoxy. But it hasn't brought unemployment down

I noticed this morning that the Euro-area unemployment rate rose to a new record in January, 11.9%. And that's little wonder when one considers that GDP growth in the fourth quarter was the worst number since the demise of Lehman Brothers at the end of 2008. Believe it or not, the Euro area's unemployment problems appear worse than the problems that Latin America faced during the Lost Decade – their measured unemployment rate didn't even reach double digits.

A Heterodox period beckons

Europe has tried fiscal austerity in the face of its debt difficulties. That might have more obviously been an approach consistent with dealing with an inflation problem (of the "it's too high" variety). But it doesn't appear as consistent with dealing with an unemployment problem at all. And so maybe it is little wonder that calls for an alternative approach are on the rise, just as they were in Latin America by 1985. On Tuesday, Beppe Grillo and his anti-establishment Five Star movement gained 25% of the votes cast in the Italian General Election. On Thursday, the UK Conservatives were pushed into third place by UKIP (UK Independence Party) in the Eastleigh by-election. Even the Dutch are softening their approach to austerity: "we shouldn't only look at cost savings, but also at how we can help revive the economy and create jobs", said the Finance Minister earlier this week. The French finance minister is reported to have reacted to the Italian election results by saying - "The message from Italy is: 'Be careful, when you are in a situation in which you ask populations to make sacrifices for long periods, at the end you risk having protests'. There needs to be another perspective - which is growth again."

Europe is not necessarily destined to follow in all of Latin America's footsteps

Of course, Latin America's affair with heterodoxy did not have a happy ending in the 1980s – the growth petered out, and inflation shot back up. But then again, looser policies were not consistent with getting inflation down, never mind keeping in there. At least in Europe's case, looser policies can serve to support policy-makers' unemployment goals. And what's a little inflation between friends, given its low starting point. If we could just persuade the bond-holders to stick with us a bit longer while we sort this all out. Anyone for a bit more concerted lending?

Some further reading

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Appendix 1

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