Lessons not learned from previous financial crises

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WHY HAVE Greece and Europe found themselves in the current mess? Could there be lessons from the past they should have learned from? Could there have been steps taken to avoid the fiasco that is unfolding?

To understand better the current European debt crisis and the way forward, it is important to examine briefly past international sovereign debt crises. In the last two decades the world has endured some important crises that had a negative impact not only in the affected countries but also in the surrounding region – and in some cases even on a global scale.

The first major crisis of the 1990s happened in Latin America, with Mexico at the epicentre of the shock. On December 20, 1994, Mexico was forced to devalue its currency (the Mexican peso) by almost 13 per cent.

The immediate result was a sharp drop in the Mexican stock market and a steep rise in interest rates as investors feared the risks posed by peso securities. The main drivers behind this crisis (known as the 'tequila crisis') were spiralling budget deficit that led the government to print more money and created fears of inflation, political turmoil, and a loss of confidence by investors in the government's currency policy.

Furthermore, the negative effects of contagion took place as well - investors fearing similar outcomes to neighbouring countries (or elsewhere) transferred the crisis to them.

Following the 'tequila crisis', the next major shock happened in East Asia, the 'Asian flu" of 1997; starting from Thailand, and spreading to other East Asian tigers such as Indonesia, Malaysia, Philippines, and South Korea. Currencies and stock markets plunged across the region, even in places as far away as Latin America, and threatening for a global recession.

There are two main stories behind this crisis – loss of export competitiveness of the above-mentioned countries to countries such as China and Japan, as well as moral hazard (i.e. a situation where a party that is protected against risk behaves differently than if it was exposed to the full level of that risk).

What the second story implies is that traditionally a number of East Asian governments had the tendency to instruct their banking and finance sector to fund certain companies or industries that were viewed as economically strategic for the country.

Thus excessive lending created financial bubbles (especially in the real estate sector) and when the bubble burst then asset prices plunged, created widespread loan defaults and an increasing number of nonperforming loans. Foreign investors fearing the situation, ran for the exit, causing massive capital flights, plunging of currencies, as well as asset markets. As in previous crises, the event proved contagious in other countries with similar problems.

In the year that followed the East Asian crisis, the world was faced with another major setback, the Russian default of 1998 (known as the 'Russian virus'), and the subsequent collapse of a number of financial intermediaries around the world, most notably the Long Term Capital Management Group (LTCM).

Specifically, on August 17, 1998 Russia was forced to default on its corporate and bank debt to foreign creditors. The crisis as well as the actions taken by the government in response to the crisis led to a sharp rise in inflation and a deep recession. The Russian crisis soon became a global crisis as it brought the collapse of a number of financial intermediaries around the world exposed to Russian assets. The main drivers behind Russia's default were massive foreign debt and persistent budget deficit financed by printing more roubles.

Then, in the first years of the new millennium there was another massive sovereign default by Argentina. At the beginning of 2002 Argentina suspended payments on its $132 billion in public debt, the largest sovereign debt default in history.

The immediate outcome was sharp decline in the country's currency value, serious civil unrest with violent riots, and a severe economic contraction. Furthermore, neighbouring countries such as Uruguay were severely affected as Argentine investors were forced to withdraw their deposits to cover the losses incurred from their country's default.

The main reasons behind this massive default were again excessive government spending, as well as other external shocks that occurred in the 1990s (such as the Mexican peso collapse of 1994, the East Asian crisis of 1997, as well as the Russian default of 1998) that shocked the Argentine economy.

Examining the above crises, there are several conclusions one can make. First, countries require a prudent, serious fiscal policy that keeps government spending and public debt under control while the spending is channeled on long-term projects that increase the country's competitiveness and promotes economic growth.

Second, investors demand stability and swift actions (if needed) from governments and central banks.

Third, printing more money to cover public expenses is not a sustainable solution. It will lead to inflation and devaluation of the currency.

Fourth, financial markets are ruthless and will punish corrupt regimes that are wasting public money on unnecessary projects. Finally, a crisis in today's environment cannot be isolated to one entity or country. Because of globalidation the crisis will most likely spill over to others.

To my mind Greece has no other option right now to endure the tough austerity measures imposed by "troika" and try to get the country out of this mess. The debt reduction agreed by the EU leaders last week helps as it brought it to a more manageable level. Obviously though there are still many more issues that need to be resolved.

On the other hand, Cyprus still has time to correct its situation, provided that drastic measures are taken, which reassure investors that the country is moving in the right path.

However, the figures in the last three years point to a very disappointing direction. Since 2008 the country's budget has changed from a 3.6 per cent surplus to a 5.3 per cent deficit (in 2010); public debt has gone up from 48.3 per cent to 60.8 per cent of GDP; real GDP growth rate has declined from 3.6 per cent to 1.0 per cent; unemployment went up from 3.7 per cent in 2008 to 7.2 per cent in August 2011; long-term ratings on the country's sovereign bonds have been continuously downgraded by the international rating agencies, very close to the junk sector.

If we do not act immediately it's possible that we will follow the path of Greece and seek support from the European Financial Stability Facility (EFSF) with all of its unwanted consequences.

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