LATIN AMERICA ECONOMICS UPDATE

"Malbec dollar" won't save Argentina from devaluation

- **A preferential rate to facilitate wine exports is the latest addition to Argentina's myriad exchange rates, but it doesn't address the fundamental problem that the peso is overvalued. We estimate that the currency needs to fall by around 30% to restore competitiveness. The government will do everything it can to avoid devaluation ahead of this year's election, but kicking the can down the road merely raises the threat of a more destabilising correction in the peso further down the line.**
- Argentine policymakers have shown no lack of creativity when it comes to the creation of new exchange rates. Having introduced the "soy dollar" – a preferential rate for soy producers – last year, the government last week announced the launch of the "Malbec dollar" – a special exchange rate for wine exporters.
- While different in name, these exchange rates are similar in that they are weaker than the official rate. The aim here is to incentivise producers to export their products because they will receive more pesos for their dollar revenues (rather than wait for a devaluation), thereby shoring up Argentina's scarce hard currency earnings. **But while these preferential exchange rates might help in the very short term, they fail to address the fundamental issue – that the peso is looking increasingly overvalued.**
- Several indicators suggest that the Argentine peso is severely out of whack with its fundamentals. For one thing, the most closely followed parallel exchange rate, the so-called "dólar blue" is currently trading at a discount of close to 50% to the official rate (a similar spread to that preceding the 2015 devaluation, see Chart 1), suggesting that the peso's fair value is much weaker than the official rate of 201/$.
- Perhaps a more comprehensive indicator is the real effective exchange rate (REER) – that is, the trade-weighted exchange rate adjusted for inflation differentials with trading partners. Chart 2 shows that **rampant inflation coupled with only small falls in the nominal exchange rate have caused the real exchange rate to appreciate sharply.** Although it has edged down recently (reflecting the appreciation of Argentina's trading partners' currencies against the dollar), it is up sharply since early 2021.
- The sharp appreciation of the real exchange rate is eroding external competitiveness – on past form, it points to a sharp deterioration in the current account position. (See Chart 3.) **Ultimately, Argentina needs a weaker currency to boost exports and dampen imports to generate the current account surpluses that are needed to rebuild foreign exchange reserves while also achieving stronger and sustainable growth.**
- To get a sense of the scale of the adjustment in the exchange rate needed, it's worth looking back at the mid-2000s. This was the only period in the past two decades in which the economy grew at a healthy pace, ran a sustained current account surplus and accumulated FX reserves. While the commodities boom played a role, the more important factor arguably was that the currency was competitive (after the dollar peg was abandoned in the early 2000s). That incentivised the substitution of imports for domestic products, while boosting the competitiveness of non-commodity exports.
- In order for the REER to return to its mid-2000s level **we estimate that the *nominal* exchange rate would need to fall by around 30%, from 202/$ currently to around 290/$**.
- **But such a large devaluation would come at the cost of substantial near-term pain**, which explains why the government – and the IMF for that matter – have so far been reluctant to address the issue. For one, it would push up the cost of imports, exacerbating Argentina's already severe inflation problem – data released yesterday showed that the annual rate jumped to a three-decade high of 102.5%.
- **It would also aggravate Argentina's public debt dynamics.** With a large part of Argentina's local-currency debt linked to inflation and/or the rate of devaluation of the peso, a fall in the currency as well as the subsequent rise in inflation would raise debt servicing costs substantially. The crumb of comfort here is

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that, if push comes to shove, the government could lean on the central bank to cover financing needs and roll over peso debts (although this would fuel inflation).

- **There would also be a major impact on Argentina's FX debt.** With two thirds of Argentina's public debt denominated is foreign currency, a weaker peso would cause the public debt-to-GDP ratio to jump. All else equal, we estimate that the necessary adjustment in the peso would push up the debt ratio by around 20%-pts of GDP, to over 90% of GDP this year (see Chart 4), one of the largest debt burdens in the emerging world.
- This would almost certainly dash any hope of Argentina regaining access to international capital markets any time soon (which is the aim of Argentina's current IMF deal). And the IMF might have to deem the debt unsustainable, precluding it from lending to Argentina until another debt restructuring has been completed.
- With inflation a key issue ahead of the general election in October, the ruling Peronists will want to avoid a devaluation ahead of the vote at any cost (although a severe external shock, such as a plunge in global commodity prices or if spillovers from the SVB collapse intensify, could force their hand). In the absence of an adverse shock, the most likely scenario is that the government tries to muddle through with further sticking plaster solutions such as more preferential exchange rates and stricter capital controls.
- **But failing to address the peso's misalignment now raises the risk of an even larger – and potentially more destabilising – devaluation further down the line**. And whichever way you cut it, it's hard to see a way for Argentina to achieve sustained growth and external stability (which requires a weaker exchange rate) without another public debt restructuring.

Chart 1: % Difference Between Official & Parallel Exchange Rates

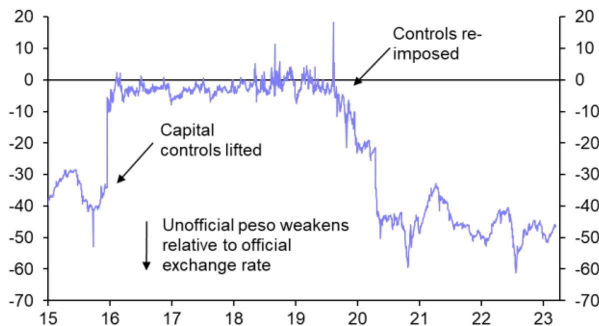


Chart 2: CE Real Effective Exchange Rate (REER) (Jan. 2001 = 100, CPI-Based)*

Chart 3: CE REER & Current Account Balance

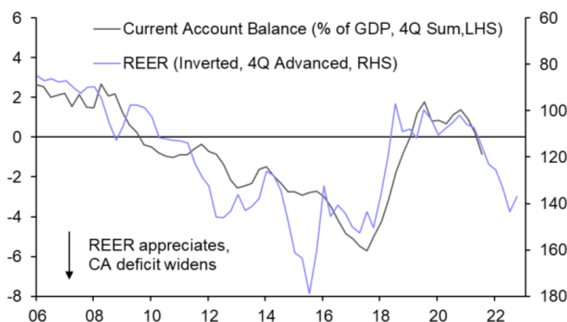
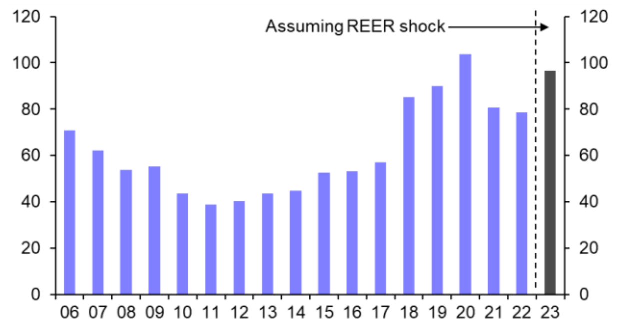


Chart 4: Gross Public Debt (% of GDP)



Sources: Refinitiv, Ministerio de Economía, BCRA, IMF, Capital Economics

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