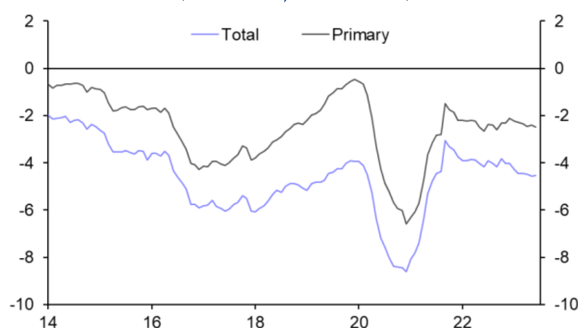
LATIN AMERICA ECONOMICS UPDATE

How can Argentina get out of its crisis?

- **Recently-announced measures by Argentina's government are merely stopgap solutions and appear to be aimed at staving off a disorderly devaluation ahead of upcoming elections rather than stabilising the economy. Ultimately, the way out of the current problems will require tight fiscal and monetary policy as well as a large fall in the peso. Encouragingly, most presidential candidates have vowed to address these issues, but Argentina's recent history shows that it's much harder to walk the walk.**
- The Argentine government's latest efforts to ameliorate the country's economic crisis include more of the same sticking plaster solutions, such as preferential exchange rates and import taxes, as well as getting the IMF to frontload disbursements (Economy Minister Sergio Massa said that there'll be a "very big package of disbursements in August and an additional one in November")
- **We're still waiting for the details of the deal, but what seems to be clear is that the goal is to prevent Argentina from spiralling into a full blown crisis ahead of the elections**. But while these measures might buy Argentina some time, they fail to address the country's severe underlying issues. We think that changes in three key areas are needed to put Argentina's economy on a more sustainable footing.
- **First, fiscal policy needs to be tightened.** Government spending has continued to outpace revenues, causing the primary deficit to widen to 2.5% of GDP (on a 12m sum basis) in June. (See Chart 1.) The government has turned to the central bank to finance the deficit, which is fuelling inflation. **Cutting back on public spending (especially by scaling back subsidies and limiting growth in public wages and pensions) is key to reduce the dependence on the money printing press and reduce price pressures.**
- **This brings us to the second area – monetary policy**. History suggests that positive real interest rates are required to bring down inflation (and inflation expectations). While the BCRA has already lifted the benchmark Leliq rate by 2,200bp, to 97%, this year, further large hikes – probably to 120-130% – are necessary. (Inflation is running at 116% and is set to remain in triple digits this year.)
- **And third, Argentina needs to radically overhaul its convoluted exchange rate regime**. Distortionary import taxes need to be dismantled, preferential exchange rates eliminated, capital controls lifted, and, crucially, the overvalued peso needs to fall. (See Chart 2.) **This is key to making exports competitive, flipping the current account balance back into surplus and rebuilding the central bank's FX reserves**.
- The issue at the heart of the problem is that a large fall in the peso will exacerbate Argentina's inflation problem. And with two thirds of Argentina's sovereign debt denominated in foreign currency, a devaluation will also lead to a sharp rise in the public debt-to-GDP ratio, removing any remaining hopes that the government will be able to avoid another debt restructuring.
- The good news is that most leading presidential candidates have stressed the need to tackle the above mentioned issues (for more on the candidates' key proposals see *here*). This is clearly encouraging. **But one of the lessons from the Macri administration is that even a market friendly government is likely to find it challenging to solve Argentina's deep-seated problems.**

Chart 1: Public Sector Budget Balance (12m Sum, % of GDP)



Sources: Refinitiv, Capital Economics

Chart 2: Real Effective Exchange Rate (Jan. '10 = 100)

Sources: Refinitiv, Capital Economics

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