LATIN AMERICA ECONOMICS UPDATE

Argentina: comparisons with 2001/02

- **There are some unnerving similarities between Argentina's current situation and that which preceded the 2001/02 crisis, including twin deficits, an overvalued exchange rate, and large external FX debts. But there are also some crucial differences which mean that, although the near-term economic outlook is pretty grim, the scale of any downturn should be much less severe than it was back then.**

- Argentina's 2001/02 crisis saw widespread economic and social turmoil. The government was forced to abandon the currency board (the so-called "Convertibilidad" which was introduced in 1991 to peg the peso to the dollar), leading to a 70% fall in the peso against the greenback. A deposit freeze was introduced and the government defaulted on its external debt. The peak-to-trough fall in GDP exceeded 15%, roughly as large as the decline seen during the pandemic.

- **Fast forward to today and it's clear that another crisis in Argentina is brewing**. The currency once again looks overvalued – the official rate is being propped up by various forms of capital controls and the parallel market rate is some 50% weaker. And the central bank's ability to support the currency is becoming more limited by the day – net foreign exchange reserves are now deeply negative.

- Argentina is, similarly, currently running large twin budget and current account deficits. External debt levels now are similar (as a share of GDP) to those seen on the eve of the 2001/02 crisis. And with the country shut out of international capital markets, the economy is reliant on disbursements from the IMF to keep its head above water. These disbursements have had to be front-loaded to prop Argentina up.

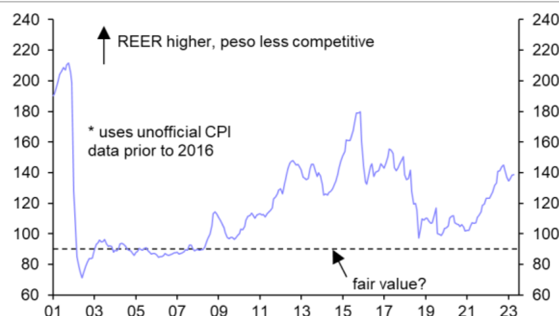
- But there are also some important distinctions between the situation now and that two decades ago. **First, the economy doesn't face the rigid constraints imposed by the currency board, meaning that monetary policy can be set independently**. Under the currency board, the Argentine central bank had to set interest rates in line with those in the US. Now, the central bank can raise interest rates (as it has been doing) to shore up capital inflows – although it needs to do a lot more to be effective.

- What's more, the absence of the currency board has allowed the peso to adjust to an extent. The official rate has fallen by 35% against the dollar so far this year. While far from sufficient, the extent of the currency's overvaluation would otherwise be much larger than what we currently observe.

- **This brings us to the second point which is that the exchange rate doesn't look overvalued to the same extent that it did in 2001**. Based on our measure of Argentina's real effective exchange rate (REER), we think the currency is currently around 40% stronger than its fair value (which we think is approximately where the real exchange rate stood in the early- to mid-2000s). Back in 2001, the REER was about twice as strong as its fair value. (See Chart 1.) In short, the peso doesn't need to fall as far as it did in 2002.

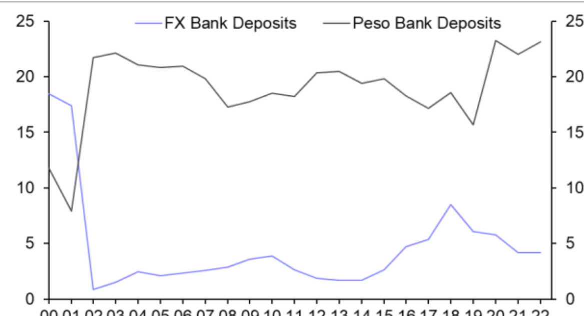
- **The final point of distinction is that the domestic economy is now less vulnerable to sharp falls in the peso**. One of the key reasons why the 2001/02 crisis had such a devastating economic impact was that it triggered a banking crisis (as banks couldn't honour residents' large FX deposits). Now, FX deposits are much smaller. (See Chart 2.) **So while a balance of payments crisis would probably (once again) trigger a sovereign default, it's much less likely to translate into a fully-fledged banking crisis.**

Chart 1: Real Effective Exchange Rate (Jan. 2010 = 100)



Sources: Refinitiv, Capital Economics

Chart 2: Banks' Deposits (% of GDP)



Sources: Refinitiv, Capital Economics

William Jackson, Chief Emerging Markets Economist, william.jackson@capitaleconomics.com

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