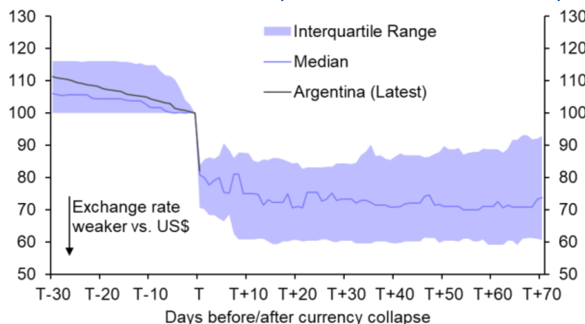
LATIN AMERICA ECONOMICS UPDATE

What happens after EM currency crises?

- **Emerging economies whose currencies have fallen by 15% or more against the dollar in a single day – as the Argentine peso did yesterday – have fallen into recession in more than 80% of cases in the last 30 years. Sovereign debt defaults occurred after roughly half of these currency collapses and Argentina is unlikely to be an exception.**
- Sunday's surprise primary election result caused mayhem in Argentine financial markets and forced the government to devalue the peso by 18%, to 350/$, yesterday. The size of the fall in the Argentine peso is rare outside cases of economic meltdown. Out of a sample of 20 EMs, we found 23 currency crises since 1994 in which the currency fell by 15% or more against the dollar in a single day. (We have left out Russia and Ukraine in 2022 because their currency collapses were driven by sanctions and war rather than macro vulnerabilities.) These episodes provide some insight into what might happen next in Argentina.
- Three points stand out. **First, while a fall in a currency should support stronger growth in the longer-term by boosting the competitiveness of domestic industry, the negative effects tend to dominate in the near term.** Tighter financial conditions, higher inflation – we estimate that inflation could rise to as much as 135% y/y in September – as well as a higher cost of servicing FX debt tend to weigh on activity in the aftermath of a plunge in the currency.
- Indeed, of these 23 episodes we looked at, GDP contracted in the subsequent year in 19 of them. Argentina is unlikely to be an exception. **We were already expecting recession this year, but the downturn is now likely to be ever steeper – a contraction of 3-4% over 2023 as a whole is likely.**
- Second, currencies typically find a floor within a week or so of their collapse. Chart 1 shows moves in these currencies against the dollar before and after the day before the currency collapse (T is the day of the start of the crisis). The median currency fall was around 20% on the day of the collapse, followed by a further decline of about 5% or so over the next few days, but currencies then generally stabilised.
- But in Argentina's case, while the devaluation was a step in the right direction – we estimate that the peso was c.40% stronger than its fair value – **the fact that it will be held steady until October's election means that it will become overvalued again soon, making a renewed devaluation after the election inevitable.**
- **And third, sovereign defaults followed ten of the 23 currency collapses.** One point that stands out from previous currency collapses is that the external government debt-to-GDP ratio tells us something about the likelihood of default. As Chart 2 shows, when public external debt was below 20% of GDP prior to a currency collapse, the sovereign didn't default; when it was higher, the sovereign did default. (The only exception was Argentina's currency collapse in 2018, but it did default after the next currency crisis.)
- We've long argued that Argentina's debt burden looks unsustainable and, with a large share of public debt denominated in foreign currency, the plunge in the peso will cause the public debt-to-GDP ratio to rise even further. While the next IMF disbursement – likely to be approved next week – should keep Argentina ticking over until the election, it's now even harder to see Argentina make repayments on international bonds that ramp up in the second half of this decade. **Another sovereign default is just a matter of time.**

Chart 1: Exchange Rate vs. US$ (Index, T=100, Sample of 14 Currencies that Fell by 15% or more in One Day)



Sources: Refinitiv, Capital Economics

Chart 2: Public Sector External Debt Prior to Currency Collapse (% of GDP)

Sources: Refinitiv, Capital Economics

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