CAPITAL ECONOMICS

# LATIN AMERICA ECONOMICS FOCUS

## Latin America: is another debt crisis brewing?

- **Fiscal risks in Latin America have largely been out of the spotlight over the past year, but we think that public debt concerns will build over the coming years. Sovereign defaults seem more likely than not over the next few years in a handful of countries (Argentina, Ecuador and Bolivia) that still show some of the vulnerabilities that were widespread in the region decades ago. The good news is that the nature of debt problems elsewhere in the region has fundamentally changed and default risks are much lower now. But even so, public debt dynamics across much of Latin America are likely to worsen from 2024.**

- The most acute sovereign debt risks lie in those Latin American countries with large foreign currency debts and limited foreign currency assets that are also locked out of global capital markets. Argentina, Ecuador and Bolivia all stand out in this regard and we think sovereign defaults are more likely than not in all three countries, particularly once foreign bond repayments ramp up from the middle of the decade.

- If we're right, that would mean that sovereign defaults in Latin America will become more frequent than they were in the 2010s. But it's also worth noting that the vulnerabilities that are pushing Argentina, Ecuador and Bolivia towards default are now, thankfully, comparatively rare. **Elsewhere in the region, the nature of public debt risks has fundamentally changed.**

- From the 1990s, most countries adopted flexible exchange rates, made their central banks independent and stopped deficit monetisation. The resulting falls in inflation and interest rates, as well as the deepening of domestic financial markets, allowed much more debt to be issued domestically. And, at the same time, most central banks have built up large foreign exchange reserves. **The upshot is that quick and acute sovereign debt crises that culminate in default are unlikely in much of the region.**

- **As it happens, outside Argentina, Ecuador and Bolivia, worries about fiscal health seem to have eased significantly over the course of the year**. Proxies for fiscal risk, such as the spreads on sovereign dollar-denominated bonds and CDS premia, have fallen and are on the low side by historic standards.

- **Nonetheless, we think some of this calm around the fiscal picture will change going into 2024**. In particular, the factors that have helped to improve debt dynamics over the past couple of years – including the inflation and the commodity price shocks – are reversing. Primary budget positions are now worsening. That's likely to be exacerbated in some cases (notably Mexico) by looser fiscal policy.

- And while bond yields should fall as central banks lower interest rates, nominal GDP growth will probably decline by more. The interest rate-growth differential (so-called "r-g"), which has been negative since 2021 (helping debt dynamics), will probably be positive from next year in the major economies (on average).

- **As a result, public debt-to-GDP ratios are likely to return to an upwards path in most countries in 2024**. The biggest increases are likely to come in Brazil, Mexico and Chile. And we don't think consensus fully appreciates the extent to which public debt ratios are set to rise.

- **It's hard to see debt trajectories improving over the medium term**. Interest rates are likely to be higher than they were pre-pandemic. And it's unlikely that policymakers will undertake the fiscal adjustments needed to stabilise debt ratios. After all, the pandemic seems to have redrawn the relationship between the state and citizens, with much greater demands now for public provision of social welfare.

- **Authorities in some countries may ultimately turn to financial repression policies to improve the public debt dynamics**. Brazil is the most obvious candidate for such measures. But these come at the cost of either a crowding out of private sector credit (and weaker potential growth) and/or higher inflation.

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# Latin America: is another debt crisis brewing?

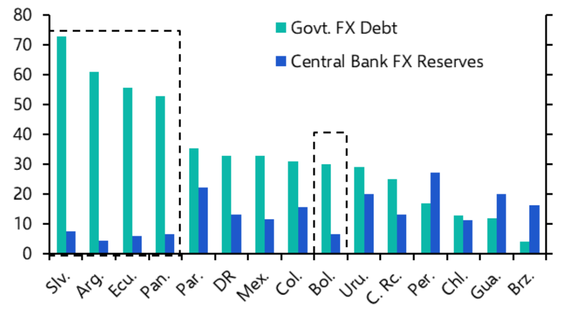
This *Focus* argues that concerns about sovereign debt in Latin America are likely to build from 2024 onwards and that this poses upside risks for bond yields and downside risks for the region's currencies.

### (A few) defaults on the horizon

The most immediate sovereign debt problems lie in those countries whose governments have large foreign currency debts that they will struggle to repay – either due to a lack of foreign currency assets or because they are locked out of global capital markets (or because of both).

Within Latin America, **these problems are most acute in Argentina, Bolivia and Ecuador**. Foreign currency-denominated sovereign debt is higher than elsewhere in the region. (In Ecuador's case, since the economy is dollarised, all debt is in a foreign currency.) At the same time, their central banks' foreign exchange reserves are low, meaning that the official sector has limited resources with which to repay foreign currency debts. (See Chart 1.)

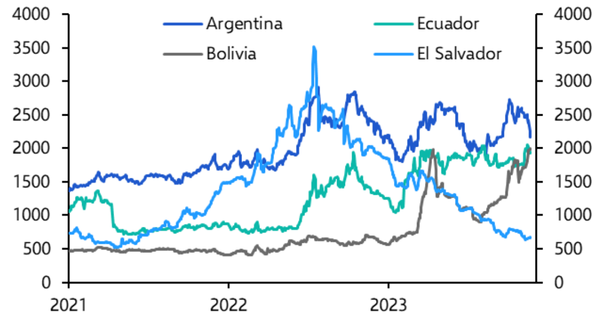
**Chart 1: Government FX Debt & Central Banks' FX Reserves (% of GDP, Latest)**




Sources: IMF, Refinitiv, Capital Economics

And because their debt problems are well known, dollar borrowing costs are extremely high. Sovereign dollar bond spreads over US Treasuries all exceed 1,000bp – a commonly-used threshold of sovereign debt distress. (See Chart 2.) This makes it prohibitively expensive for their governments to borrow in dollars, so they can't roll over their debts and instead have to rely on foreign currency assets (which are insufficient) to make debt repayments.

**Chart 2: EMBI Spreads over USTs (bp)**



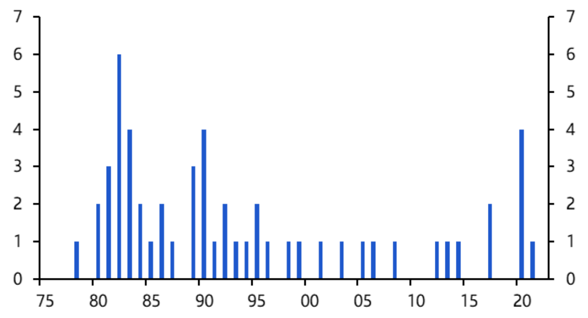

Source: Refinitiv

We've written about these countries' debt troubles before (see here for Argentina, here for Bolivia and here for Ecuador). We don't want to repeat the analysis at length here. But **the short point is that we think sovereign defaults are more likely than not in all three countries**. While hard to predict the timing, crunch points loom in 2025 and 2026 as foreign currency debt repayments ramp up.

In Argentina's case, the country's IMF deal complicates issues. Funding tranches have helped to keep Argentina's head above water for some time. But we think that, eventually, the Fund will be forced to determine that the sovereign's debt is unsustainable, at which point a restructuring will be required before further lending can be disbursed.

If we're right, that would mean that the incidence of sovereign default in the region would be much more akin to the period from the early 1990s to the early 2000s than the 2010s when defaults became less frequent. (See Chart 3.)

**Chart 3: Number of Sovereign Default Events in Latin America**



Sources: IMF, Capital Economics

Besides those countries, two others stand out for the vulnerabilities posed by large foreign currency debts and limited foreign exchange reserves: El Salvador and Panama. (See Chart 1 again.) In El Salvador's case, improving relations with the US as well as debt buybacks that have improved the sovereign's repayment profile have led to a marked reduction in borrowing costs. (See Chart 2 again.)

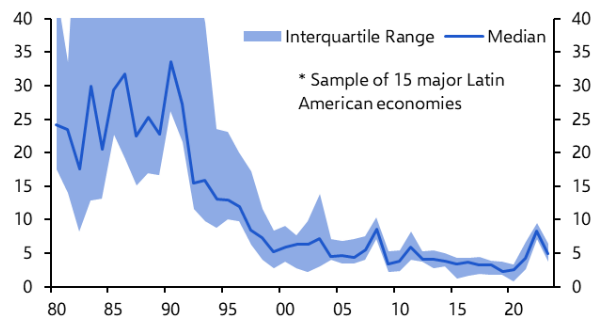
Panama looks altogether stronger. The sovereign's dollar borrowing costs are relatively low. That reflects, among other things, a tight fiscal stance, credible institutions and policymaking, and hard currency inflows resulting from the country's position as a financial centre. The big risk would be if the fiscal stance shifts considerably (towards looser policy), worsening the debt dynamics. This risk has increased recently against the backdrop of protests against a major new mining concession.

### But 'classic' debt crisis risks are limited

The vulnerabilities that are pushing Argentina, Ecuador and Bolivia towards sovereign default bear similar characteristics to those that lay behind the Latin American debt crisis of the 1980s – large foreign currency debts and an absence of hard currency inflows. It's perhaps not surprising that the countries mentioned here are no stranger to default. Indeed, both Argentina and Ecuador restructured their sovereign debts during the depths of the pandemic in 2020.

**But these sovereign debt vulnerabilities are also, thankfully, now comparatively rare elsewhere in the region**. Policymaking has improved dramatically since the 1980s and 1990s. Most countries adopted flexible exchange rates and moved to tackle long-standing inflation problems via tighter fiscal policy, granting central banks independence (*de jure* or *de facto*), halting deficit monetisation and tackling the institutional structures (such as backwards-looking indexation mechanisms) that allowed inflation to propagate. Inflation has, subsequently, declined dramatically. (See Chart 4.)

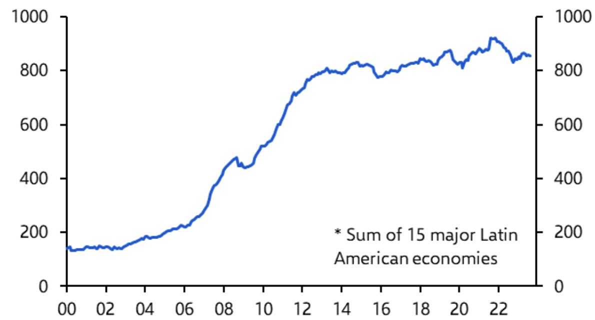
**Chart 4: Latin America* Inflation (%)**




Sources: IMF, Capital Economics

The resulting falls in inflation and interest rates, as well as the deepening of domestic financial markets, allowed much more debt to be issued in local currencies and to a local investor base that is much less likely than foreign investors to take fright when risk appetite sours. The benefits of this became stark during the pandemic when many governments were able to run large budget deficits, of 8-12% of GDP, while also enjoying low borrowing costs. Policymakers also used the windfall from the commodities boom in the 2000s to build foreign exchange reserves. (See Chart 5.)

**Chart 5: Latin America* FX Reserves ($bn)**

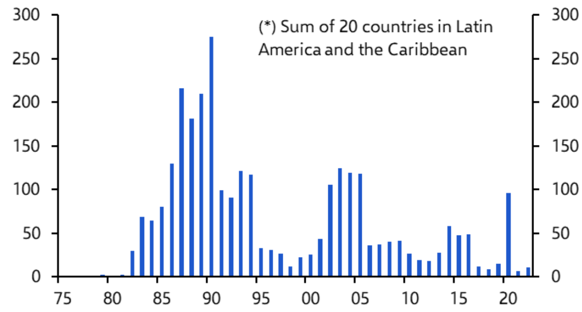



Sources: Refinitiv, Capital Economics

**The key point is that this dramatic change in the composition of public debt means that the nature of sovereign debt risks is also very different**. Quick and acute sovereign debt crises in which an evaporation of confidence that results in a 'sudden stop' in capital inflows and culminates in default are unlikely. After all, debt can be more easily refinanced on local markets. And, ultimately, the central bank can print domestic currency to finance the deficit. Moreover, with much more debt held domestically, governments will be much less willing to default as the pain would be inflicted on to the local investor base (rather than external creditors) – with knock-on effects on the domestic economy.

**So a repeat of the early 1980s when governments in most major Latin American countries defaulted is highly unlikely**. This helps to explain why sovereign defaults have become less frequent. (See Chart 3 again.) Data from the Bank of Canada-Bank of England Sovereign Default Database show that the amount of the region's sovereign debt in default is close to its lowest levels (in dollar terms) since the start of the debt crisis in the 1980s. (See Chart 6.)

**Chart 6: Latin American* Sovereign Debt in Default ($bn)**



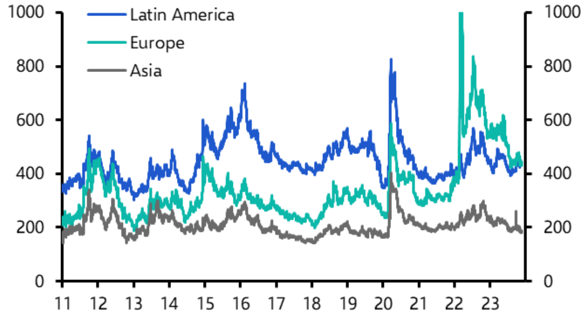

Source: Bank of Canada-Bank of England Sovereign Default Database

When the public debt problem is a local debt problem, the economic consequences manifest in different ways. Investors demand greater compensation to hold government debt, which causes financial conditions to tighten and reduces consumption and investment.

### Outside a few, debt concerns have eased

As it happens, outside the debt-distressed countries mentioned earlier, sovereign debt concerns in the region have eased significantly over the course of this year. Measures of fiscal risk, such as credit default swaps and dollar bond spreads, have fallen significantly this year and are low relative to their recent levels. (See Charts 7 & 8.)

**Chart 7: JP Morgan EMBI Spreads over US Treasuries (bp)**



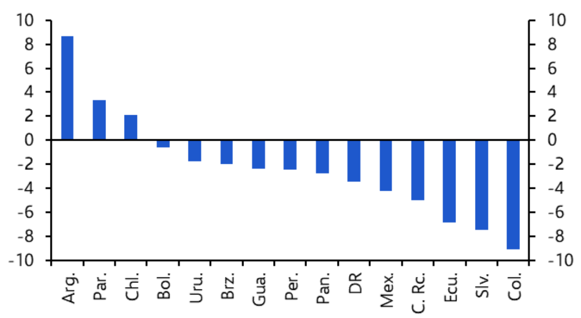

Source: Refinitiv

**Chart 8: Latin America* $ CDS Premia (bp)**


Sources: Refinitiv, Capital Economics

That seems to reflect a combination of factors, including surprisingly resilient economic growth in much of the region, fiscal moderation by left-wing governments (e.g. Lula in Brazil and Petro in Colombia) and, possibly most importantly, the declines in government debt-to-GDP ratios in almost all countries in the region over the past couple of years (with one very clear exception that is Argentina). (See Chart 9.)

**Chart 9: Change in Government Debt-to-GDP Ratios (%-pts, 2021-23, IMF Estimates)**



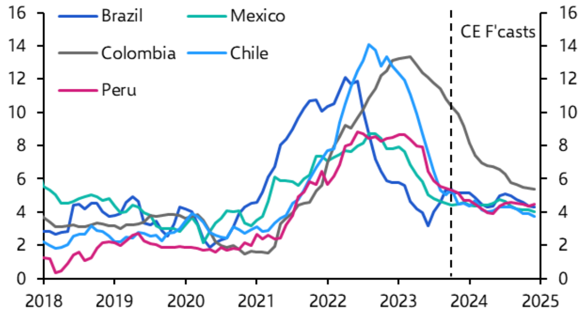

Sources: IMF, Capital Economics

To be fair, the decline in risk premia isn't just a Latin American phenomenon – they have narrowed across many emerging markets over the past year. But as the next section will explain, **this sense of calm around the fiscal picture is less warranted in Latin America compared with other emerging market regions.**

### Debt ratios set to rise again

For one thing, government debt-to-GDP ratios are very high in some Latin American economies – particularly Brazil and Argentina. **But more importantly, the factors affecting debt dynamics – which helped to push government debt ratios down in Latin America in 2022 and this year – are quickly becoming unfavourable**. A crucial one is the inflation shock. In most major countries, inflation has already come down a long way and is unlikely to fall much further. (See Chart 10.)

**Chart 10: Latin America Inflation (%)**




Source: Refinitiv

To understand why this is important for the public finances, it helps to break down the factors that affect moves in the government debt-to-GDP ratio into component parts: the primary budget balance (that is, the budget balance excluding interest payment); and the differential between the average interest rate on government debt and GDP growth (so-called “r-g”). If this interest rate-growth differential is positive, the government needs to run a primary budget surplus to stop the government debt-to-GDP ratio from rising. (For more, see our *Global Economics Focus*.)

The inflation shock helped fiscal positions in several ways. First, it improved the sovereign debt dynamics by lifting nominal GDP growth – and by more than interest rates. And second, higher inflation helped to improve primary budget balances. That’s partly because the inflation shock was given a kick by higher commodity prices, which lifted tax revenues for many governments in the region. But it’s also because revenues (which are more closely tied to inflation) increased at a faster pace than expenditure (plans for which may have been based on lower anticipated inflation rates or previous inflation).

With inflation falling, those forces are likely to reverse. Revenue growth is likely to slow in line with weaker inflation. But it will be harder to bring expenditure growth down – not least because some spending will be linked to past inflation. This will weigh on primary budget balances. Indeed, timely data show that primary budget deficits in Brazil and Mexico have already deteriorated this year.

**To compound matters, some governments in the region are shifting to a looser fiscal stance**. This is particularly so for Mexico, where the government has announced a pre-election giveaway. Elsewhere, fiscal watchdogs in Colombia and Peru have warned that governments will struggle to comply with fiscal rules. And Brazil’s government already appears to be keen to water down its new fiscal rule.

**What’s more, from next year, the average interest rate on government debt is likely to exceed nominal GDP growth in some countries**. In other words, r-g will be positive, having been negative since 2021. (See Chart 11, which shows our estimates of the average interest rate-growth differential of Brazil, Chile, Colombia, Mexico and Peru.)

**Chart 11: CE Estimate of Latin America* Interest Rate-Growth Differential (%-pts)**


Sources: Refinitiv, Capital Economics

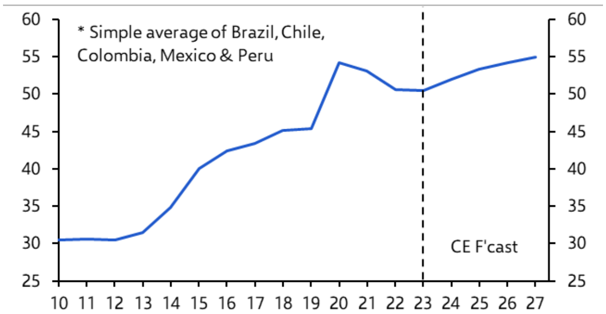
This will arise because, even though central banks in the region are cutting or will cut interest rates and bond yields are likely to fall next year, nominal GDP growth will decline by more. The decline in nominal GDP growth is partly because inflation will be lower on average next year than this year (even though disinflation has largely run its course), reducing the increase in the GDP deflator. But it's also because *real* GDP growth will slow. We'll be explaining this in more detail in our forthcoming *Latin America Outlook* in the next few weeks. The short point is that GDP growth in Latin America is likely to be significantly weaker next year than this year and also weaker than in any other EM region.

At a country level, the interest rate-growth differential will be highest in Brazil (for more on this case, see here), followed by Mexico and Colombia. In this respect, Latin America is an outlier. On the IMF's estimates in its *Fiscal Monitor*, this differential is likely to be negative in most EMs (South Africa being a notable exception).

And, if anything, the reality may end up being worse for Latin America than Chart 12 implies. As we argued in our recent flagship project on r* (the neutral real interest rate), the era of low interest rates in DMs has come to an end. Interest rates will, over the medium term, be higher than most expect. And higher interest rates in DMs will probably keep interest rates higher in most EMs too.

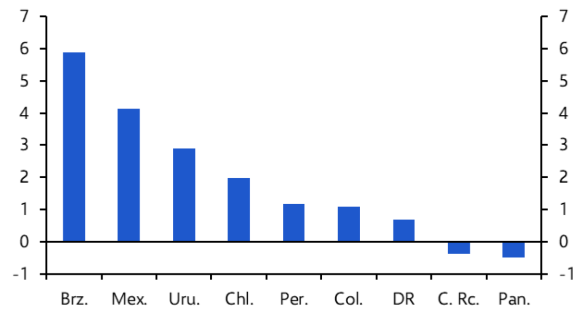
**The net result is that sovereign debt-to-GDP ratios are set to start rising again from 2024 onwards** – largely in line with the pre-pandemic trend. (See Chart 12.) The biggest increases are likely to come in Brazil, Chile, Mexico and Uruguay. (See Chart 13.) Increases elsewhere are likely to be more modest, and debt ratios may even fall in Costa Rica and Panama due to tight fiscal policy in the former and lower interest rates in the latter.

**Chart 12: Latin America* Public Debt (% of GDP)**




Sources: Refinitiv, Capital Economics

**Chart 13: Change in Govt. Debt-to-GDP Ratios (2023-25, CE F'cast, %-pts of GDP)**

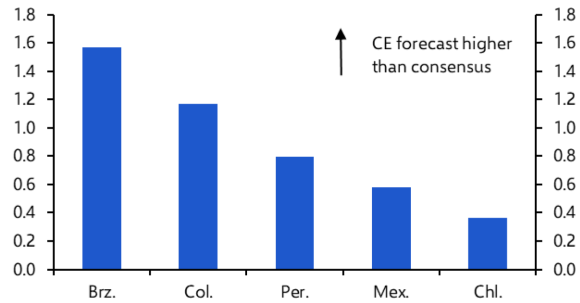



Sources: Refinitiv, Capital Economics

## Rising debt trajectories not yet fully factored in

While hard to gauge, we think the coming rise in public debt trajectories is not fully appreciated by investors. Our forecasts for sovereign debt-to-GDP ratios in the largest Latin American economies by 2025 are higher than the latest analyst consensus projections. (See Chart 14.)

**Chart 14: Govt. Debt-to-GDP Ratios (Difference Between CE & Consensus 2025 Forecast, %-pts)**

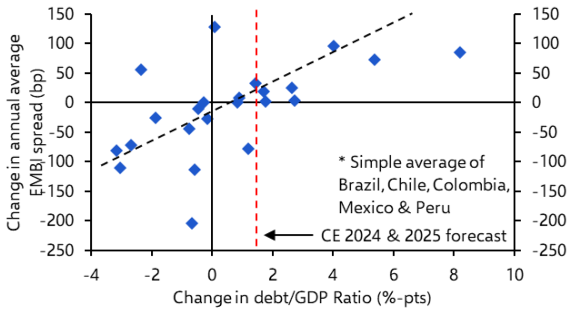



Sources: FocusEconomics, BCB, Capital Economics

Given that – and the decline in fiscal risk premia over the past year – it seems likely that rising debt-to-GDP ratios aren't fully priced into financial markets either.

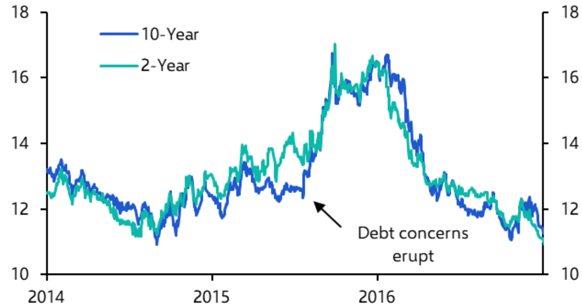
Historically, there has been a reasonable (albeit not definitive) relationship between the annual change in the public debt-to-GDP ratio of the large Latin American economies and the change in their sovereign dollar bond spreads. (See Chart 15.)

Chart 15: y/y Change in Latin America* Public Debt Ratio & in EMBI Spread




Sources: FocusEconomics, BCB, Capital Economics

Chart 16: Brazil Local Currency Government Bond Yields (%)




Source: Refinitiv

Using that past relationship, the rise in debt ratios that we're anticipating – averaging 1.5% of GDP a year – are consistent with an increase in dollar bond spreads of around 25bp a year. Those moves are relatively small – and our central view remains that global factors, including improving risk appetite, will be the key driver of EM dollar bond spreads.

But while rising debt ratios can be a slowing burning problem, when markets get nervous about debt sustainability, this can set off a vicious circle whereby fiscal concerns push up the term premium embedded in the interest rate on government debt, which increases debt servicing costs, worsens the debt dynamics and further fuels investors' concerns. And it's worth bearing in mind that investors are likely to be a lot less forgiving of high debt burdens in Latin American economies than in developed markets.

Because of these dynamics, bond yields can rise sharply. For example, when Brazil's public debt problems flared up in 2015, local currency bond yields spiked dramatically – by 300-400bp within the space of a few months. (See Chart 16.) It took a change in the presidency and the establishment of a fiscal rule to calm investors' nerves and bring bond yields down.

Higher risk premia will have knock-on effects. **They will make it harder to attract foreign capital inflows, putting some pressure on the region's currencies**. In turn, that may limit the scale to which central banks are able to loosen monetary policy. This is particularly so in the case of Brazil, whose central bank is the most explicit in terms of factoring fiscal risks into its monetary policy decisions. Our interest rate forecasts for the region are generally on the hawkish side relative to analysts' expectations. If anything, this analysis would suggest that the risks lie to the upside.

### What's the way out?

It's hard to see public dynamics improving any time soon. Potential GDP growth in the region remains weak (see here, for example, in the case of Brazil). But, as mentioned earlier, interest rates are likely to remain relatively high. So **interest rate-growth differentials will remain unfavourable.**

Governments are unlikely to undertake significant fiscal austerity to arrest the deteriorations in their budget positions. Admittedly, the recent political shift to the left in the region may have run its course. For instance, Ecuadorians and Argentines recently voted for right-wing presidents. The strong showing for right-wing parties in elections for members of Chile's constitutional convention also points to the political winds blowing back in that direction there.

Nonetheless, the pandemic appears to have cemented a couple of broad political trends. One is a shift towards more populist policymaking. The other is a change in the relationship between the state and citizens – and in particular, the need for greater state provision of social welfare. That was evident even under right-wing governments, such as those led by Piñera in Chile and Bolsonaro in Brazil, in the immediate aftermath of the pandemic.

Moreover, the scale of the fiscal adjustment needed to stabilise debt ratios makes it look politically unpalatable. By our estimates, a fiscal squeeze of between 1.0 % and 2.5% of GDP would be needed to stop debt ratios rising by 2025 in Brazil, Chile, Colombia and Mexico.

The short point, then, **is that we think there will be limited political appetite for the kind of fiscal austerity needed to stabilise debt-to-GDP ratios.**

So what options does that leave? As mentioned earlier, default isn't an option given the pain that it would inflict on the domestic economy. One partial exception is that weakening public debt dynamics may make Mexico's government more likely to allow state oil company Pemex to default on its debts.

**Instead, we think it's more likely that policymakers turn to 'financial repression' policies** – essentially, policies that artificially reduce the real interest rate on government debt and improve sovereign debt dynamics. These policies can take many forms, but the most common include:

- Pressure (formal or informal) on the central bank to keep interest rates lower than are needed to meet the central bank's inflation target (so-called 'fiscal dominance').
- Measures that encourage the commercial banking sector to hold more debt – either through regulatory measures or influence on state-owned banks.

We think such policies are most likely in Brazil, partly because the debt dynamics are worse, but also because the state has a relatively large presence in the banking sector. Such policies seem less likely in Chile, where the debt ratio is starting from a much lower place.

But **while these policies help to improve fiscal dynamics, they also come with pernicious economic effects**. If the central bank keeps interest rates too low, that will fuel inflation. It could potentially lead to larger current account deficits and weaker currencies. If commercial banks step in to fund the government, that wouldn't have the same inflationary effect. But banks' lending to the government would come at the cost of lending to the private sector, resulting in a misallocation of resources and weaker potential GDP growth.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