

FINANCIAL MARKETS

THE ARGENTINE
PESO CRISIS



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ANOTHER CURRENCY CRISIS

FOREWORD

Argentina is no stranger to a financial crisis. For the last 60 years, the country has been subject to an economic rollercoaster ride.

Its last financial crash happened back in 2002 - and it looks like it could be set for another, as the peso (Argentina's currency) continues to fall.

In this eBook, we'll look at the cause of what some are calling the 'peso crisis' and what it means for Argentina. We'll also analyse the wider implications for the financial markets.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

THE PESO CRISIS EXPLAINED

A CURRENCY IN DECLINE

The Argentina peso has already fallen 52% against the dollar this year.

The recent crisis began back in May this year. Why? Well, the world's emerging markets suffered as a stronger US dollar broke through and US interest rates increased.

But the peso's problems go beyond US monetary policy.

Problems stem from the previous administration, run by former President Cristina Kirchner. This administration essentially cleaned the Central Bank of the Argentine Republic (BCRA) of its foreign exchange reserves.

These reserves went on to be sold for non-transferable letters of credit. As these were essentially worthless, the administration was getting money in return for unsellable IOUs.

As well as this, the administration chose to use transitory advances to finance public spending. They decided to distribute 12 month IOUs, rather than a formal government debt.

These two things alone make up around 45% of the BCRA balance sheet. That means almost half of its sheet is extremely toxic.

REACTION OF BRCA

In a bid to improve the performance of the Peso, the BCRA did everything that any monetary economics textbook would say.

It chose to raise interest rates and sell foreign-exchange reserves. This was a way to try and defend the exchange rate.

At the same time, the new Argentine President, Mauricio Macri, has not made a significant effort to force change. The large public deficit is still running and the administration is financing this using the same strategy as its predecessors.

The most recent selloff of the peso came on 29th August this year after President Mauricio Macri spoke with the International Monetary Fund. His goal was to secure \$50 billion in credit earlier than initially agreed.

REACTION OF THE MARKETS

EMERGENCY MEASURES

In response to the first signs of downward pressure (back in May 2018), the BCRA raised interest rates from 30.25% to 40%.

More recently, rates have been increased to as much as 60%. Despite the central bank's best efforts, the rapid decline of the peso only seems to continue.

As mentioned, the International Monetary Fund was approached to help move things forward by providing credit. This move, however, has not been widely accepted. Many people blame the International Monetary Fund for contributing to the 2001 recession in Argentina.

The prospect of this deal still didn't change market sentiment. After the announcement of talks with the IMF, the peso still opened down at 0.89%. This left it at 39.4 against the US dollar.

President Macri also announced several measures to try and eliminate Argentina's fiscal deficit by next year. This includes new taxes on exports like grains, large spending cuts and cuts to the number of government ministries.

On 4th September, the BCRA sold \$358 million of its reserves at auction. This was done to try and build up the peso. Despite these efforts, the currency still fell by another 2.18%.

Economists believe that, as a result of this selloff, Argentina's economy could shrink by 1.9% this year. Originally, it was only suspected to shrink by 0.3%, according to a central bank poll.

The President has also warned that poverty levels are likely to increase. This is down to inflation rising by 30%.

HOW IS IT AFFECTING THE MARKETS?

As expected, the financial markets are reacting with anxiety.

In Argentina, the Merval stock index has been directly affected by the peso crisis. Why? Essentially, traders doubt the Argentine government's ability to implement the required fiscal discipline to alleviate the crisis. As a result, the Merval stock index fell 3.72%.

Globally, the full effect of the peso crisis is still playing out - but it's potentially troubling in the context of emerging economies.

For instance, Turkey has also seen its currency collapse in 2018. Combined with Argentina's current problems, investors fear that turmoil could spread through other economies such as South

Africa or Russia.

We've already seen hints of this, with the Indian rupee and Indonesian rupiah facing downward pressure. It's fuelling investor fears that the economic challenges facing Argentina and Turkey could be a pattern.

Investors exposed to bad debt in Argentina and Turkey could also be tempted to shift investments away from other emerging economies, as they look to protect their capital from potential future crises. This dynamic can also apply to other banking and financial institutions.

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