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Argentina's Economic Crisis

Argentina, the world's 21st largest economy, is facing an economic crisis. Its currency, the peso, has lost more than half of its value against the U.S. dollar over the course of 2018. With trouble financing its budget deficit, the Argentine government in June turned to the International Monetary Fund (IMF) for a \$50 billion program, one of the largest programs in IMF history. Despite IMF resources and plans for aggressive austerity measures, the government is still struggling to restore economic stability. In September, a staff-level agreement was reached to increase the IMF program to \$57.1 billion.

Economic Crisis in Argentina

Argentina has a long history of economic crises. It has defaulted on its external debt (debt held by foreigners) eight times since independence in 1816. Argentina has also entered into 21 IMF programs since joining the international organization in 1956. The current economic crisis facing Argentina stems from longstanding challenges, as well as more recent developments.

Economic Reforms but Growing Vulnerabilities

When Argentine President Mauricio Macri was elected in 2015, he ushered in a series of economic reforms aimed to address the unsuccessful economic policies of the previous Kirchner governments, which had governed Argentina since 2003. He cut export taxes, lifted currency controls, and resolved a 15-year long dispute with bondholders, allowing Argentina to resume access to international capital markets. The central bank also raised interest rates to 25% to curb inflation. The economy contracted by 1.8% in 2016, but resumed growth of 2.9% in 2017.

To maintain political support for the reforms and support the country's most vulnerable (one in three Argentines was living below the official poverty line in 2015), the government held off on substantial fiscal reforms to address the budget deficit, which was 4.3% of GDP in 2014. However, the government's financing costs rose. The Kirchners' had financed the deficit through money creation and coercing domestic banks into buying government bonds. As the Macri government shifted to more traditional financing through borrowing in international capital markets, its financing costs grew. It issued \$56 billion in external debt between January 2016 and June 2018. Interest payments facing the government caused the budget deficit to increase to 6.4% of GDP in 2017.

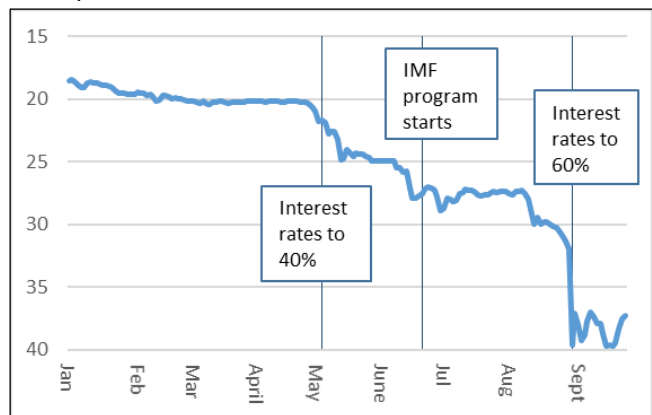
Meanwhile, capital inflows into the country to finance the deficit contributed to an overvaluation of the peso, by 10-25%. This overvaluation also exacerbated Argentina's current account deficit (a broad measure of the trade balance), which increased from 2.7% of GDP in 2016 to 4.8% of GDP in 2017.

Crisis and Policy Response

Argentina's increasing reliance on external financing to fund its budget and current account deficits left it vulnerable to changes in the cost or availability of financing. Starting in late 2017, a number of factors began to create problems: the U.S. Federal Reserve (Fed) began raising interest rates, reducing investor interest in Argentine bonds; the Argentine central bank reset its inflation targets, raising questions about its independence and commitment to lower inflation; and the worst drought in Argentina in 50 years hurt commodity yields, significantly eroding agricultural export revenue.

Investors began selling Argentine assets, putting downward pressure on the peso (**Figure 1**). With most of its debt denominated in dollars, a depreciated peso increased the value of the debt in terms of pesos. To improve investor confidence, the central bank and government announced in April and May higher interest rates (to 40%) and fiscal reforms to cut the budget deficit. Market volatility continued, however, and in June, the Macri government reached an agreement with the IMF for a three-year, \$50 billion program. The government received \$15 billion from the IMF upfront, with the intention to treat the remainder of the program as precautionary (having the resources available but to not actually to draw on them).

Figure 1. Value of the Argentine Peso: 2018 to date
Pesos per U.S. dollar



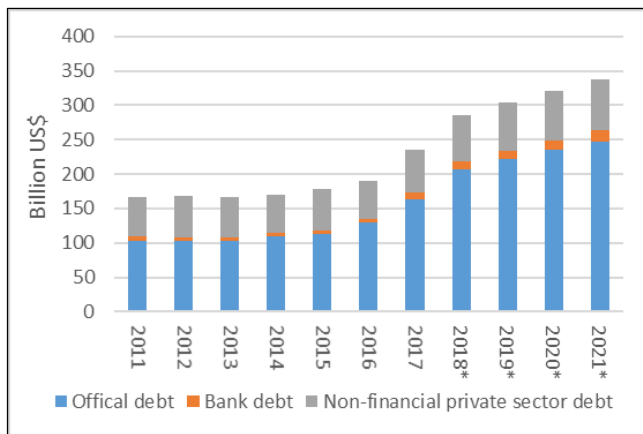
Source: Central Bank of Argentina.

At the program's outset, skeptics raised questions about the fiscal cuts and growth projections underpinning the program. On the fiscal side, the government committed to bringing the primary deficit (the government budget, excluding interest payments) into balance by 2020, from 3.8% of GDP in 2017. The required fiscal reforms require congressional approval, but are politically unpopular and Macri's party controls neither chamber of Argentina's bicameral Congress.

Additionally, the program projects a mild, short-term interruption to growth, falling to 0.4% in 2018 and rebounding to 1.5% in 2019. Given the required fiscal reforms, some analysts questioned whether Argentina would face a more serious economic contraction, which would make it more difficult for the program to meet its targets.

The IMF was aware of the potential risks when the program was approved in June. IMF staff noted in program documents they could not certify under the baseline forecast scenario with a high probability that Argentina's debt would be sustainable. They projected Argentina's external debt to increase by about \$100 billion between 2017 and 2021, to \$337 billion, with most of the debt held by the public sector (**Figure 2**).

Figure 2. Argentina's External Debt



Source: IMF, *Argentina Request for Stand-By Arrangement Staff Report*, July 2018.

Notes: * Forecast.

Despite an infusion of funds from the IMF and commitments on fiscal reforms, the peso continued to depreciate over subsequent months, and the government announced aggressive policies to stabilize the peso. The central bank raised interest rates to 60% in late August, the highest in the world, and the government committed to hastening the pace of fiscal reforms. President Macri requested the IMF accelerate disbursements of its financing. On September 26, they reached a staff level agreement to increase the size of the IMF program to \$57.1 billion. It would also front-load disbursements of financing, roughly doubling the amount available in 2018 and 2019. The staff-level agreement will go to the Executive Board for final approval.

Economic Outlook

Although the Macri government is committed to implementing the prescribed policy measures, including fiscal reforms, higher interest rates, and IMF assistance, the economic outlook is difficult. As the Fed continues to raise interest rates, capital for emerging markets is likely to become more expensive and/or scarce. The combination of fiscal austerity measures and high interest rates may make it difficult for the economy to grow its way out of the crisis. The government projects that the economy will contract by 2.4% and inflation will reach 42% in 2018. For 2019, the government forecasts an economic contraction of 0.5% and inflation averaging 23%.

Implications for the United States

On foreign policy, President Macri has demonstrated a commitment to improved U.S.-Argentine relations, which were strained under the Kirchner governments. However, the austerity measures and IMF involvement are politically unpopular and complicate Macri's bid for re-election in 2019. Some analysts caution that the crisis undermines support for Macri's reform initiatives and could result in the return of populist economic policies from the Kirchner era.

In terms of U.S. economic interests, U.S. exposure to Argentina through direct trade, investment, and financial channels is relatively limited compared to U.S. economic ties with other countries. However, concerns are focused on whether Argentina, together with Turkey, is on the forefront of a broader economic crisis among emerging markets, which could be significant for the U.S. economy. In general, investors sought out emerging markets following the global financial crisis of 2008-2009, because interest rates were so low. There are concerns about the sustainability of dollar-denominated debts in emerging markets as the Fed raises interest rates.

The role of the IMF also has implications for the United States, the IMF's largest shareholder. Argentina historically been a frequent IMF borrower, and previous programs have encountered difficulties. Argentina's default in 2001, while on a sizeable IMF program, led the IMF to substantially revise its lending policies. The U.S. government has supported Argentina's current IMF program; in early September 2018, President Trump expressed strong support for Macri's leadership and engagement with the IMF. However, outside analysts have expressed concerns about whether the current program relies on overly optimistic growth and fiscal adjustment projections, and whether debt will be sustainable over the duration of the program.

Oversight Questions for Congress

- The Macri government is pursuing the generally prescribed policies for responding to the crisis, but is still having trouble securing economic stability. What more could or should the Argentine government do?
- Argentina has been on IMF programs for more than half the years it has belonged to the institution. In what ways is this IMF program similar to and different from previous IMF programs for Argentina?
- If there are concerns about debt sustainability in Argentina, should IMF resources go forward in the absence of discussions about debt restructuring? What risks does the Argentina program pose to U.S. commitments at the IMF?
- Are U.S. financial institutions sufficiently capitalized and diversified to withstand potential defaults on debts by Argentina and/or other emerging markets?

For more on Argentina, see CRS In Focus IF10932, *Argentina*, by Mark P. Sullivan. For more on other emerging market crises, see CRS In Focus IF10957, *Turkey's Currency Crisis*, by Rebecca M. Nelson.

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