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Breaking Argentina’s Default Cycle

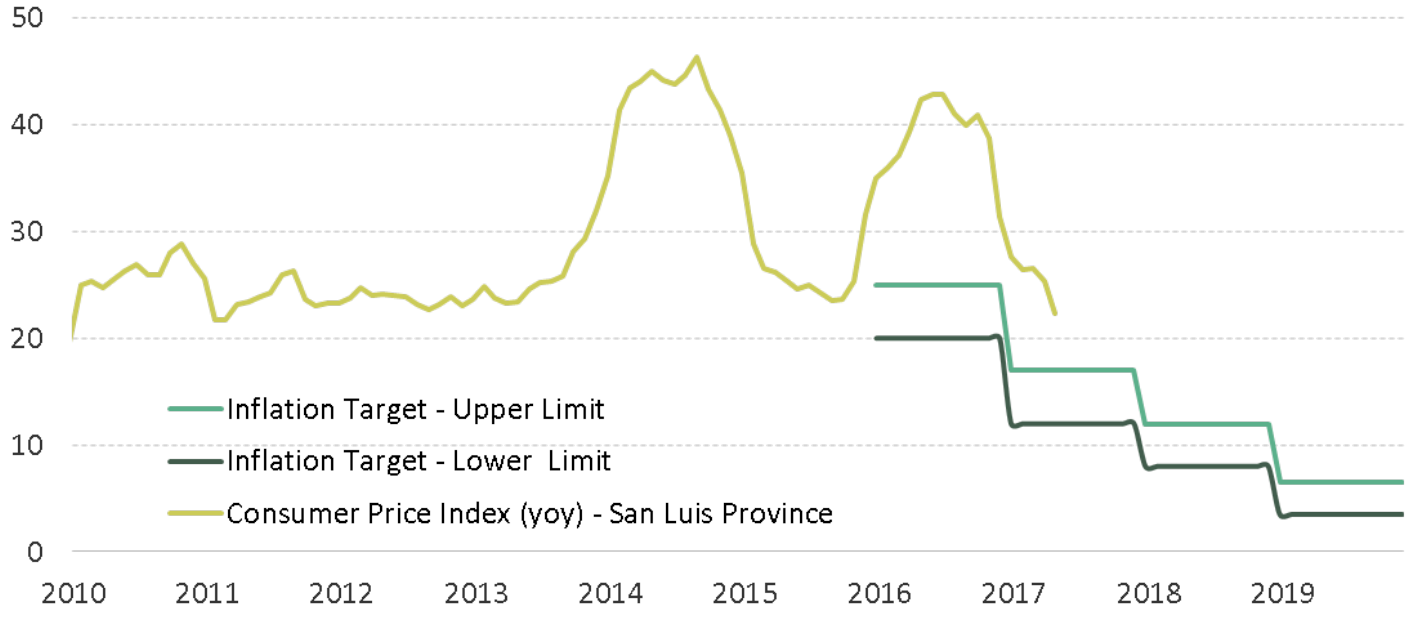
Investments in Argentine debt have performed well over the past year as the macroeconomic policy mix shifts in the right direction. However, given the sovereign’s history of frequent defaults, we and other market participants understandably spend a lot of time thinking about what could go wrong. At the risk of oversimplifying, we would argue that Argentina’s default problem is that it never overcame “original sin.” To paraphrase the Eichengreen and Hausmann economics paper from 1999, “Exchange Rates and Financial Fragility,” original sin is the malady from which countries suffer when they are unable to borrow at long maturities in their domestic currencies.

At Brandywine Global, we view currencies as economic regulators whereby currency weakness can help correct macroeconomic imbalances and lead to virtuous growth cycles. However, the historical composition of Argentina’s balance sheet has constrained this self-correcting mechanism. With Argentina’s debt load mostly denominated in U.S. dollars (USD) while the bulk of revenues were in Argentine pesos, a significant devaluation in the peso would increase the country’s debt loads and quickly lead to insolvency. To his credit, President Mauricio Macri has made incredible headway in addressing this historical vulnerability of currency mismatches.

The improvements begin with more credible monetary policy. Argentina’s central bank recently instituted an inflation-targeting framework with plans to achieve single digit inflation within a few years (see Chart 1). Policymakers were even bold enough to raise rates 150 basis points in an election year in order to bring down inflation expectations. Lower inflation means lower borrowing rates. As the cost of domestic capital declines, the incentive to borrow in domestic currency increases.

Chart 1: Central Bank of Argentina Inflation Targets

%; As of 6/11/2017



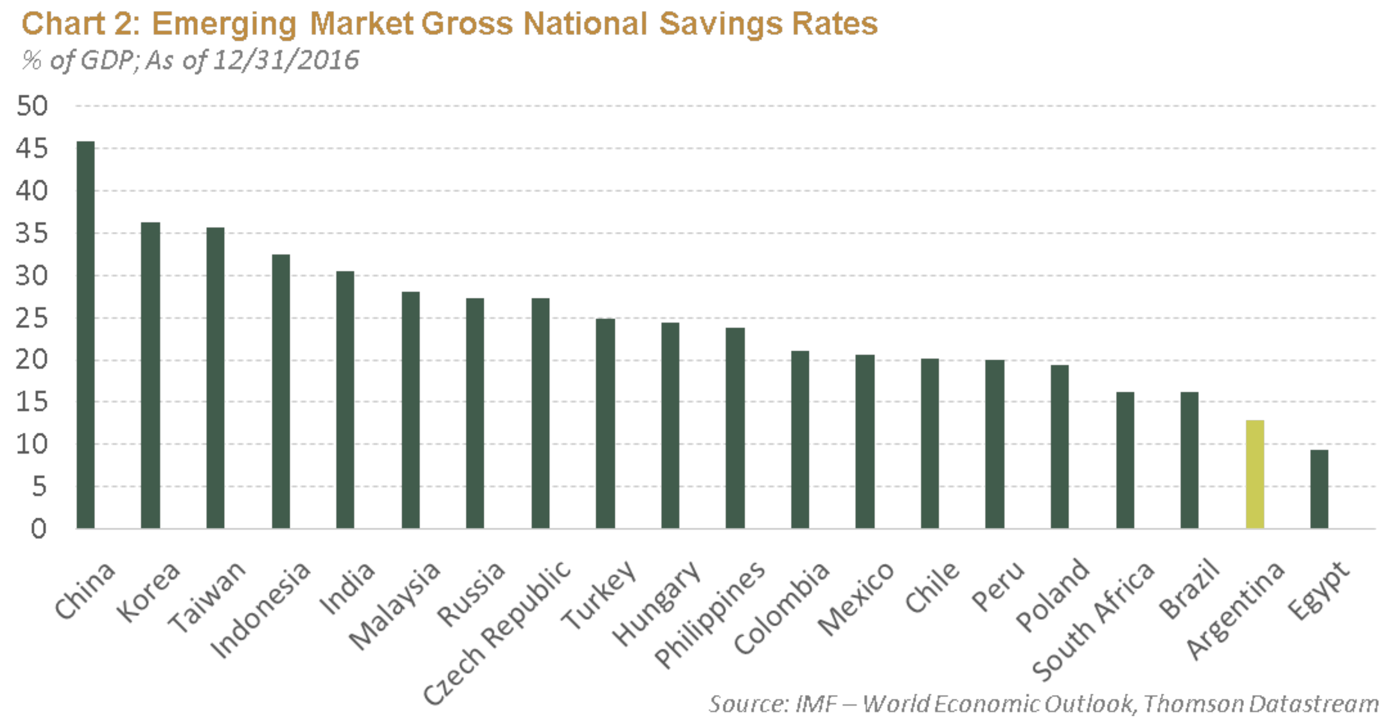
Source: BCRA, DPEyC/Haver

The authorities have also moved from a pegged exchange rate to a free-floating regime. A free-floating currency adjusts to reflect relative macro fundamentals. For example, if a country's exports are not competitive in global markets, its currency may eventually depreciate until the price point at which exported goods become attractive in other countries. If a currency is pegged, exports will languish and trade imbalances will build up over time. A pegged currency encourages companies and individuals to borrow in the lower-yielding foreign currency to save on interest costs. This tendency can make the break of a currency peg particularly painful.

Argentina has also built out a sovereign yield curve in domestic currency to serve as a benchmark for corporate borrowing, mortgage loans, and other peso-denominated credit. In a period of only six weeks in the fourth quarter of 2016, the government was able to issue 2-year, 5-year, and 10-year fixed-rate bullet bonds in sizes over USD 1billion each. Previously, Argentina was known in markets for its diversity of bond structures with bespoke coupon features. In the past, if a local Argentine corporate wanted to borrow 10 years out in pesos, pricing the credit risk properly was challenging, if not impossible. Now, the process is more conventional and hinges on deciding the spread over the sovereign benchmark. As a result, corporates have started to issue peso-denominated debt, although this process is still in its early stages.

Reducing the country's vulnerability to original sin also has required some creativity. Local borrowers are somewhat reluctant to issue in the peso market because if the central bank conquers inflation, they would look foolish having locked in today's high rates. Meanwhile, some locals are skeptical that interest rates can decline and are waiting for higher rates before lending their capital. The Province of Buenos Aires recently circumvented these challenges by issuing a 5-year floating rate note that benefits the issuer if rates decline but also appeases skittish lenders worried about rising rates.

Finally, the ultimate answer to original sin is to have a large domestic savings base so that when borrowing in pesos, there are plenty of willing lenders. Argentina has one of the lowest savings rates in the world which is partly why it has traditionally been reliant on foreign currency borrowing (see Chart 2). Increased predictability in economics and politics will naturally encourage some Argentines to take their money out from "under their mattresses" and introduce it into the formal financial system. Declining inflation will also grow local assets as savers get a positive real return on their investments. Over time, as the country develops a robust financial system with a diversity of savers, borrowing in local currency may become second nature.



No one said overcoming original sin was going to be easy or quick, and a lot of work still remains for the country, but President Macri's team appears to be doing all the right things. If they are able to deliver on their policy goals, we may one day start viewing a 20% decline in the peso as a buying opportunity rather than a potential credit event.

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