14 August 2019

Flash Comment

Emerging markets: forget Argentina; focus on Fed, Trump and China

- **The surprisingly large loss by Argentina's President Mauricio Macri in Sunday's primary election to the left-wing candidate Alberto Fernandez calls into question the future of the IMF programme and, in our view, increases the risk of debt default.**
- **We believe Fernandez will engage with the IMF, as the alternative would be too costly for the Argentine economy. However, we expect the pressure on the ARS to persist and we cannot rule out a debt restructuring.**
- **In our opinion, the contagion from Argentina to other emerging markets will be limited (unless it defaults on its debt) due to the relatively small size of the Argentine economy and easing mode of the Fed and ECB.**
- **In general, emerging markets are driven more by trade war issues, the state of the global economy and the monetary policy stances of the Fed and other big central banks.**

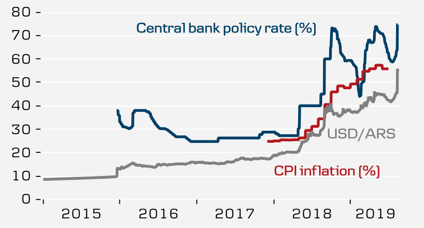
Election result and possible implications for Argentine economy

Argentinian assets have come under significant pressure since the market-friendly incumbent President Macri lost by an unexpectedly large margin to opposition candidate Alberto Fernandez. Fernandez, a left-wing candidate (who is from the same party as former president Christina Kirchner and hence viewed as more of a market sceptic), got 47% of votes versus 32% for Macri. All polls ahead of the election had shown only a few percentage points difference between the two candidates. If the result stands at the election in October, Fernandez would win the presidency even without a run-off (which would happen if the leading candidate gets less than 45% of the votes).

Given the large margin of victory, it is hard to see Macri turning it around before the real presidential election on 27 October, even if some of the votes on Sunday were protest or strategic votes. The main problem for Macri and the IMF is that the Argentinian economy is only very slowly emerging from a recession amid tight monetary policy and fiscal consolidation. The latest market pressures are likely to worsen the macroeconomic outlook, making it even harder for Macri to gain support.

Investors are clearly (and rightly so) concerned about the commitment of Fernandez to the ongoing IMF programme, fearing that he will cut the ties to the IMF and go down the populist route like Venezuela. The market is pricing in around a 60% chance of a hard default. However, at this stage we have no insight into what policies Fernandez would pursue as president. While criticising the policies implemented by Macri and saying the slump in asset prices in recent days is due to these, he also said yesterday that he is not planning to default on the country's public debt. The IMF also noted in its July staff report that there was 'publicly announced support for the broad objectives of the program[me] by the main opposition presidential candidates', implying that Fernandez would continue to work the IMF in some form, although, in our view, negotiations will be extremely difficult. Cutting the ties to the IMF would have quite adverse consequences for the Argentinian economy given its sizeable external financing needs and the risk of damaging capital controls.

Argentina's central bank has helplessly fought against high inflation

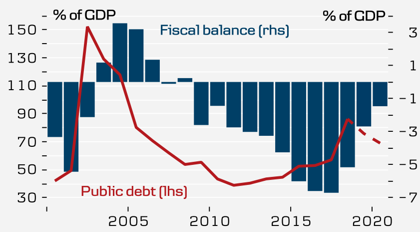


Source: Bloomberg, Macrobond Financial, Danske Bank

Economy is marred in a deep recession

Source: Bloomberg, Macrobond Financial, Danske Bank

As the country is undertaking a sharp fiscal adjustment



Source: IMF WEO database April 2019,, Macrobond Financial, Danske Bank

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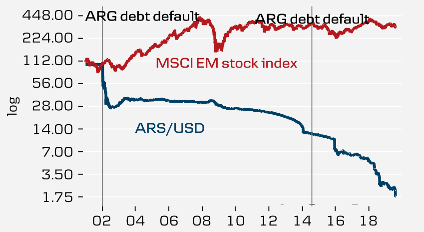
Argentina has a high FX debt burden and with the weakening of the exchange rate, this burden has increased even further. Hence, even if Fernandez chooses to co-operate with the IMF, the IMF may deem the debt unsustainable and ask for a debt restructuring. The level for the exchange rate after a Fernandez potentially takes office is crucial for this decision.

Contagion to other emerging markets?

The slump in the Argentinian peso and other assets on Monday had an immediate impact on neighbouring countries' currencies. The BRL weakened by around 2% against the USD on opening on Monday morning. However, following yesterday's positive news on the trade war between the US and China, emerging market FX recovered ground to the pre-ARS devaluation levels and some emerging market currencies have ended even higher. Looking at the current mix of factors, we see the major impact on emerging markets, including Argentina's neighbouring Brazil, coming from changes in risk sentiment, which, in our view, are driven mainly by the Fed's monetary rhetoric, the state of the global economy and news on China-US trade war developments. The reason is that Argentina is a fairly small economy (slightly more than USD500bn, or one-quarter the size of the Brazilian economy). While Brazil has fairly limited trade exposure to Argentina, other countries in the region have greater exposure, including Bolivia and Uruguay. Hence, unless Argentina completely implodes and defaults on its debt, we think the contagion will be limited. The Fed and ECB being in easing mode will also contain contagion to broader emerging markets, in contrast with summer 2018's emerging markets rout, when the Fed was in a tightening phase.

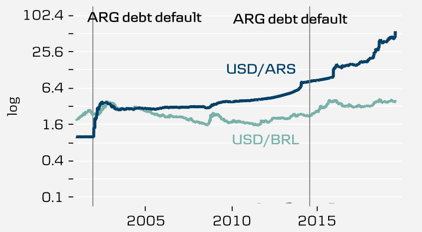
If Argentina defaults, we think there could be a major negative impact on emerging market assets, including currencies, with the largest hit on Latin American countries, including Brazil's fragile currency and economy. Yet, the negative shock would be much milder than in 2001, as emerging economies have significantly improved their macro stability over the past 20 years, including increased credibility and functionality of their central banks. Thus, they depend less on substantial portfolio flows than they did some 10 years ago.

Emerging markets would react negatively to Argentina's default but global factors are more important



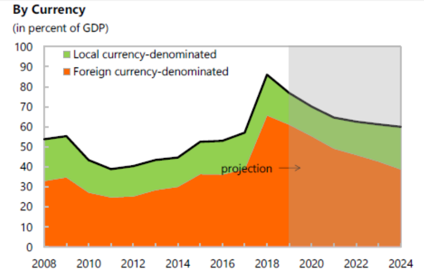
Source: Bloomberg, Macrobond Financial, Danske Bank

BRL has become more stable after the 2008 financial crisis, being much less volatile than ARS since 2008



Source: Bloomberg, Macrobond Financial, Danske Bank

A large part of Argentina's public debt is denominated in foreign currency



Source: IMF Staff report for Argentina, no 19/232, July 2019.

Trade links with Argentina are sizeable for some Latin American countries

	Export to Argentina (% of total export)	Import from Argentina (% of total import)
Brazil	6.2	6.2
Bolivia	16.0	11.6
Chile	1.1	4.5
Colombia	0.7	1.4
Uruguay	5.5	11.9

Source: IMF direction of trade statistics, Macrobond Financials and Danske Bank

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None.

Date of first publication

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