

Is Latin America heading for another debt crisis?

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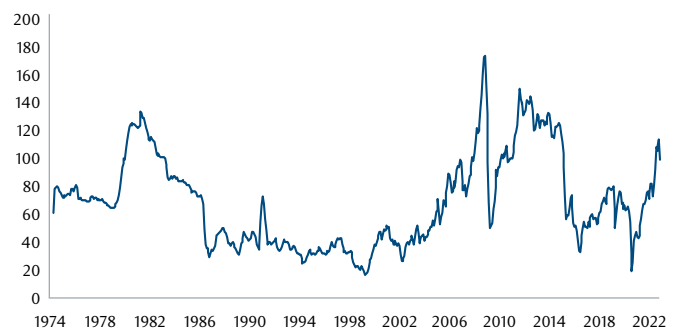
There are eerie parallels between the current global backdrop and the causes of the debt crisis that erupted in Latin America and some other emerging markets in the 1980s. Back then, the 1970s oil price shocks created a need for both foreign borrowing (to finance swollen current account deficits) and the available resources (as large money-centre banks recycled Middle East petro-dollars into commercial loans). The US Federal Reserve (Fed) notes that Latin American borrowing from US commercial banks and other creditors increased dramatically during the 1970s. At the end of 1970, total outstanding debt from all sources equalled only USD29 billion, but by the end of 1978, that number had skyrocketed to USD159 billion. By 1982, the debt level had reached USD327 billion.¹ The oil price move since April 2020 has been of a similar magnitude to that seen over the course of the 1970s.

The second trigger for the 1980s debt crisis was the sharp tightening in US monetary policy implemented to tackle rising inflation, which peaked at 14.8% in March 1980. In response, the lending banks further shortened repayment periods and hiked interest rates. Latin American governments, led by Mexico, declared that their debts were unsustainable. There followed a succession of failed reschedulings that culminated in the Brady deals of the late 1980s and early 1990s, which in turn marked the birth of emerging markets fixed income as a tradable asset class.

At first glance, these parallels are clear – there has been an oil price shock and the Fed is tightening policy. **But if we dig a little deeper**, we can see that there are important differences between the structure and magnitude of those developments forty years ago and the situation now facing Latin America, and indeed most emerging markets.

Most importantly, the petro-dollars arising from the latest oil price windfall, or any previous commodity boom, have not been recycled by banks into commercial lending in the same way. Instead they have been invested domestically or saved in sovereign wealth funds. They have, of course, boosted global liquidity, but the intermediaries and borrowers learned lessons from that previous crisis episode. The systemic risk to the global financial system is much lower and the borrowing governments have reduced their dependence on foreign financing by running tighter fiscal policies and developing deeper domestic markets. Local currency bond markets simply did not exist in the 1970s, yet in 2022 the finance ministries of Brazil, Mexico, Colombia and Chile planned net domestic issuance of more than USD160 billion². When they do borrow abroad to finance budget deficits, they can generally do so long term at fixed rates. In the 1970s, governments were borrowing short term at floating rates, which is why the Volcker Fed's hikes proved so painful.

Chart 1: Inflation-adjusted oil price (US imports)



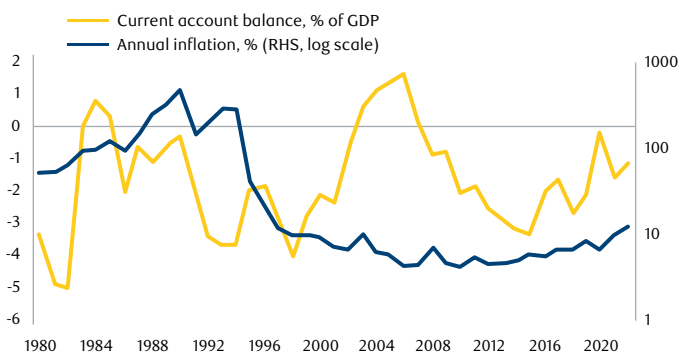
Source: MacroBond

¹ Latin American Debt Crisis of the 1980s | Federal Reserve History

² In practice we estimate net issuance of less than USD100 billion because budget performance has been better than expected.

The data below showed Latin American external borrowing growing ten-fold, in dollar terms, between 1970 and 1982 – an average annual growth rate of more than 20%. In the following four decades, the region's external debt stock has risen less than six-fold – an average annual growth rate of less than 5%. The economy has grown at around the same pace, leaving external debt-to-GDP at roughly the same level as in 1982.

Chart 2: Current account balances and inflation in Latin America



Source: MacroBond

On the other side of the ledger, the region is much more resilient. The 1980s debt crisis went hand-in-hand with a balance of payments crisis. Countries were running current account deficits and had no dollars on hand to make debt repayments. Currency depreciation fuelled inflation, which **averaged** across the region between 8% and 23% from 1973 right through until the mid-1990s but spiked into hyper-inflationary territory in several countries, including Argentina, Peru and Brazil.

Now, in contrast, the region has around USD835 billion of international reserves, equivalent to more than 40% of the external liabilities, and currencies mostly float freely rather than being managed in unsustainable pegged or crawling regimes. Current account deficits are either much smaller, or comfortably financed with long-term capital flows such as foreign direct investment. Meanwhile a few decades of inflation-targeting central banks have delivered relatively well-anchored inflation and inflation expectations, in line with levels in the US and Europe.

In aggregate, therefore, Latin America does not appear to be at risk of a renewed debt crisis. Those averages nevertheless mask individual countries where poor policy choices have exposed the sovereign to stresses that might appear similar to those suffered in the early 1980s, although they generally pre-date the oil price shock and Fed hikes. Argentina, for example, is a perennial defaulter and restructured sovereign bonds in 2020 as a precursor to a rescheduling of IMF repayments. Federal government debt stands at a relatively modest 74% of GDP (with just over one-third held by public entities), but Argentina's debt service capacity is chronically weak, particularly under the populist economic policies of the current Peronist administration. We believe that prevailing debt prices of around 25 cents on the dollar fully reflect these challenges and will rise closer to recovery values of 40-50 cents, as the market prices in the probability of a more market-friendly government in 2024.

Outside Latin America, are we heading for a broader EM debt crisis? Again, we do not believe so. The same lessons have been learned by borrowers and lenders since the 1980s, reinforced by other regional challenges such as the Asian balance of payments crises and Russian default of the late 1990s. Floating exchange rates, reserve accumulation, fiscal rules and the development of domestic capital markets have all significantly mitigated the risks. Money-centre banks have stepped away from the market. As with Argentina in Latin America, there are exceptions where poor policy choices and volatile political systems have tipped countries over into debt distress, particularly where Chinese banks tried to ignore the experiences of their western peers in the 1980s or were directed into lending more than now seems prudent. Sri Lanka and Zambia are prime examples. **Generally speaking, however, fears of a widespread EM debt crisis look misplaced.**



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