

## Latin America – Shielded from a Global Slowdown?

### Risk Insights

- Latin America is set to record robust economic growth in 2010 despite subdued demand in its traditional export markets, the US and the EU.
- Several of the region's major economies have liberalised their trade and investment environments, implemented inflation-targeting monetary policy and prudent fiscal policy, improving the overall business environment.
- The region presents a growing market for exporters and investors.
- The region's export and capital markets remain vulnerable to a more pronounced global economic slowdown and a major exogenous shock such as a sovereign default from the euro-zone.
- The rapid economic rebound experienced in countries such as Brazil and Peru could fuel inflation.
- Rapid currency appreciation in countries such as Brazil, Chile, Colombia and Peru has eroded export competitiveness and could lead to capital controls being implemented.

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### Recommendations

*There are a number of significant risks to consider when doing business*

While Latin America will be affected by a significant slowdown in global economic activity over the second half of 2010, many countries in the region will continue to post relatively robust economic growth. This will provide valuable opportunities in terms of trade and investment and will mitigate the risk of failure to honour contractual obligations. Nevertheless, there are a number of significant risks that will affect doing business in the region, notably the risk of a market correction in exchange rates and asset prices as global risk appetite cools, rising inflation, ongoing political uncertainty as well as a more subdued economic recovery (or even recession) in certain countries. Therefore, while the region can offer a lucrative market for exporters and high returns on investments, downside risks are still present, making an in-depth assessment of country risk imperative.

1. Liberalised trade and investment environments, increased integration into global supply chains, and growing domestic markets across Latin America are providing significant business opportunities for trade and investment.
2. Currencies should continue to strengthen owing to high levels of speculative capital, as investors take advantage of significant spreads over US dollar, euro and yen assets, as well as rising levels of foreign direct investment (FDI). However, there is a risk of currency depreciation in the event of a more pronounced economic downturn as risk appetite retrenches. As a result, exposure to Latin American currencies should be hedged in order to guard against adverse currency movements.
3. The prospect of lower demand from the US, EU, Japan and even China is likely to dampen exports and cause a significant correction in equity markets across Latin America over the second half of 2010.
4. We recommend a flexible approach to setting trade terms by monitoring whether counterparties are benefiting from rising domestic demand and currency appreciations or whether this is eroding the competitiveness of their industry.

Country Risk Services' products such as monthly *Country Riskline Reports* can provide this information.

5. Political risk will remain high in a number of countries in the region such as Argentina, Bolivia, Ecuador and Venezuela owing to these governments' nationalist policy agendas damaging their countries' business environments.

**Background: What is Happening and Why?**

*Robust economic structures have aided the region's economic rebound*

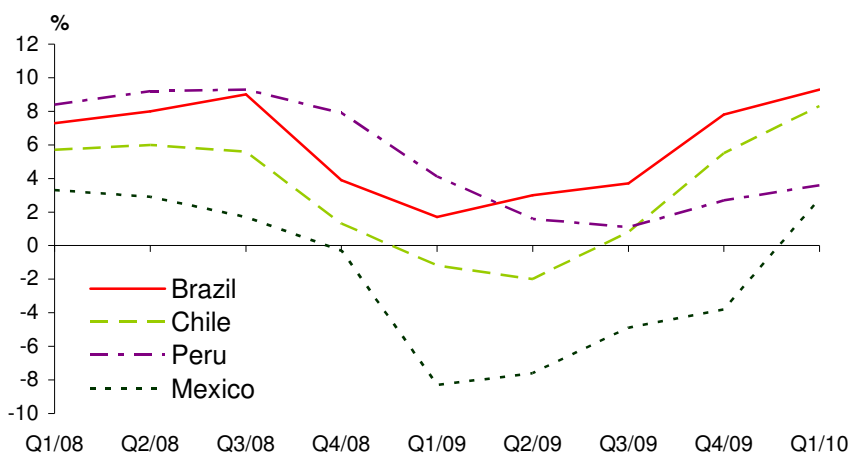
After weathering the global economic crisis of 2008-09 relatively well, the Latin American region has experienced a strong economic rebound since Q4 2009, driven by a rapid increase in investment, a healthy rebound in exports and rising consumer spending. This is a result of several countries improving their economic structures with counter-cyclical fiscal and monetary policies, flexible exchange rates and liberalised trade and investment environments, which have boosted exports and FDI. This has enabled several of the region's major economies to build up their foreign exchange (FX) reserves, narrow their budget deficits and curb external debt levels thereby minimising their vulnerability to external shocks and reducing credit risk.

*The private consumption rebound*

*Consumer demand has risen rapidly across the region*

Although a large part of the economic recovery in countries such as Peru and Brazil has been spurred by a rapid rise in investment (largely into the commodities sector), a consequent rise in liquidity has given rise to growth in private sector credit as risk aversion among banks has eased. Credit to the private sector in Brazil, for example, grew by an average of 15.3% over the first six months of 2010. The concurrent rise in private consumption and a strong real appreciation has boosted consumer demand for imported goods and has provided a growing market for exports elsewhere in the world. However, a deeper structural element is also at play; Latin America's middle classes (albeit with some countries such as Venezuela and Ecuador not registering this trend) are growing rapidly as investment boosts employment and income levels rise. Furthermore, as inflation-targeting monetary policy has controlled price rises, consumer confidence has risen. This trend suggests that Latin America will be a growing market for exporters over the next few years.

**Real Private Consumption Growth (y/y)**



Sources: Central Banks

*A rapid rise in speculative inflows*

*Inflation pressures mean interest rates have reverted to an upward trajectory...*

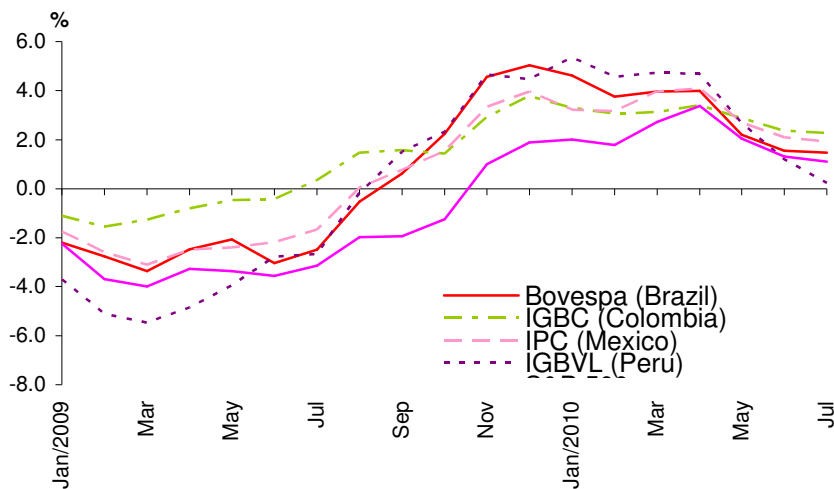
As developed world economies struggle to boost domestic demand and as governments are forced to cut spending owing to concerns over the sustainability of their budget deficits and high sovereign debt, interest rates have remained extremely low. However, rising consumer spending in countries such as Brazil, Chile and Peru has put significant upward pressure on inflation and in order to dampen inflationary pressures, central banks in these countries have opted to increase interest rates.

*...providing opportunities for carry trade*

**Emerging Market Bond Indices (sovereign spread)**

Even in countries which have maintained interest rates at record lows, such as Mexico, rates remain significantly higher than in most developed world economies. This has attracted the attention of speculative investors hungry for higher yielding assets resulting in a rapid rise in carry trades (where an investor borrows in a low yielding currency, e.g. the US dollar, to invest in assets denominated in a higher yielding currency, such as the Brazilian real). The rapid increase in capital inflows has, in turn, resulted in a drop in yields on government debt; however, the spread on yields in Latin America remain significant, while lower yields also mean rises in the price at which bonds can be sold. Furthermore, lower yields limit the cost to a government wishing to borrow from the international capital markets to fund expenditure, thereby minimising the risk of sovereign default and promoting economic growth.

**Stock Market Performance (12 month rolling average growth)**



Sources: Financial Times; Bolsa Mexicana de Valores

*Healthy corporate earnings and speculative inflows boosted stock prices*

Meanwhile, healthy corporate earnings and a rise in investment led to a rapid growth in stock markets between September 2009 and May 2010. The stock markets of Brazil, Colombia, Chile, Mexico and Peru all grew at faster rates than the S&P 500 over this period. However, stock market performance has deteriorated markedly since May owing partly to more subdued commodity prices and increased risk aversion triggered by concerns over the sovereign debt crisis in the euro-zone and more subdued economic performance in the US and China. As a result asset value growth has fallen in line with developed world markets suggesting that the asset price rally could be about to run out of steam as speculative capital retrenches. This could lead to investor returns falling significantly although certain sectors such as the retail continue to benefit from rising profits amid the private consumption-led rebound.

*Currencies continue to appreciate*

*Currencies have appreciated rapidly over 2009-10...*

The rapid upturn in capital inflows into the region has also caused currencies to appreciate very rapidly. For example, as of mid-August, the Colombian peso had appreciated by over 28% since reaching a nadir in February 2009 while the Brazilian real, Chilean peso and Peruvian nuevo sol have experienced similar appreciations. However, the strength of these currencies is damaging the competitiveness of domestic currency denominated exports, particularly in the manufacturing sector and risks curbing the economic rebound. Although this is also likely to exacerbate trade imbalances in net importers such as Colombia and Mexico, any resulting increase in the external financing requirement in these countries should be adequately funded by capital inflows.

*...eroding export competitiveness but encouraging investment*

In order to stem this currency appreciation without lowering interest rates and stoking inflationary pressures, monetary authorities in several countries have intervened heavily in the FX market in order to dampen demand for the domestic currency. The central banks of Peru and Mexico have, for example, purchased large amounts of US dollars so far this year while Peru has implemented a new tax on foreign investment in short-term currency futures (designed to curb speculative investment in the nuevo sol) and Brazil has implemented a new tax on transactions realised in foreign currency. Although FX purchases have boosted FX reserves in Mexico, Colombia and Brazil (with FX reserves in Peru only just short of record highs reached in 2008) increasing taxation on foreign currency transactions risks damaging the business environment and FDI. Furthermore, there is a chance that tighter FX controls could be implemented over the remainder of 2010 and into 2011 should currencies continue their pace of appreciation, potentially hindering cashflow, making it harder to obtain FX to pay for imports.

*Riskier countries remain a concern*

*Several countries continue to present a higher risk proposition*

Meanwhile, there are a handful of Latin American countries which have not experienced the healthy economic rebound seen elsewhere in the continent. Although Argentina, Latin America's third largest economy, has emerged from recession and has executed a successful debt swap on 66% of the sovereign debt liabilities it defaulted on in 2002 (and which are still in arrears), the country's operating environment has remained constrained by weak economic fundamentals and the government's flawed policy agenda. Meanwhile, Venezuela, Latin America's fourth largest economy, remains mired in a deep recession as a result of the government's nationalist policy agenda, declining levels of investment and subdued oil production. Furthermore, credit risk has increased dramatically as a result of a tightening of FX controls in early 2010, as well as banking sector stress. Ecuador is another example of a country with a left-wing government which has continued to worry investors though the implementation of nationalist economic policies, most recently through a controversial reform of the hydrocarbon sector, forcing the re-negotiation of contracts in the oil sector.

## **Outlook: What Will Happen Next?**

*What are the key opportunities in Latin America?*

- Latin America will continue to offer a lucrative export market and investment destination (albeit bearing in mind a number of risks outlined below) over the short-term despite a likely slowdown (or even recession) in the developed world.
- D&B expects the region as a whole to experience economic growth of around 4.4% in 2010, in regional terms only lagging Asia Pacific with growth of 5.4% and well ahead of growth rates forecasts for North America of 2.0% and the EU (plus Norway and Iceland) of 1.0%. In 2011, we expect Latin America's economic growth to outstrip that of Asia Pacific to become the world's fastest growing regional market as commodity exports remain strong, buoyed by improved demand in China and as investment continues to rise.
- Over 2010-11, despite some upward pressure on inflation from rising demand and imported food inflation, prices should remain low in countries operating inflation-targeting monetary policy, allowing real incomes to rise across households and businesses, while improved financial sector regulation will mitigate credit risk.
- Many governments in the region will continue to implement prudent fiscal policy and with comparatively low levels of external debt, this will minimise the risk of sovereign default; indeed sovereign debt in the region will remain a target for global investors seeking relatively high returns against low underlying risk.
- Over the medium term, most of the region's largest economies will grow at a faster pace than population growth while inflation-targeting monetary policies in many countries will continue to promote price stability, causing real incomes to rise fairly leading to a growth in consumer demand.

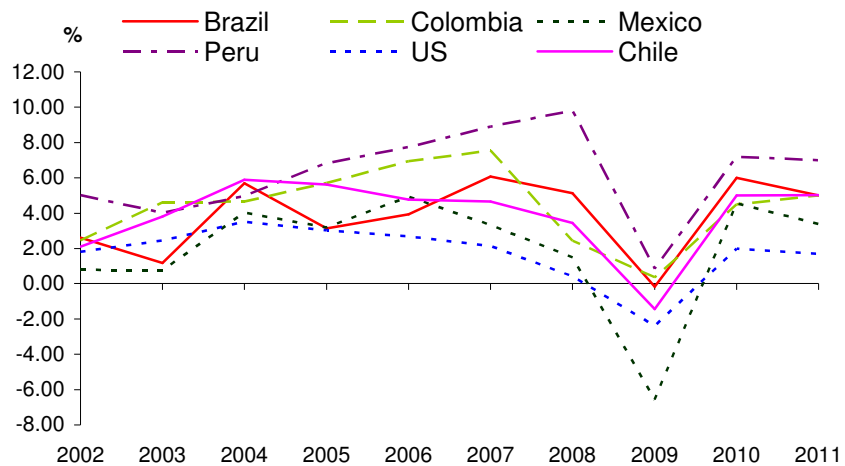
- Growing levels of investment in countries such as Brazil and Chile, as well as increased diversification in economies such as Brazil, Chile and Colombia, suggest that economic development is more sustainable and is providing a wider array of opportunities for investors than was previously the case. Meanwhile, more traditional heavy industries such as oil, gas and minerals will ensure that the region remains a target for investment into these sectors.

*What are the key risks?*

Despite the opportunities presented by Latin America for exporters and investors, there are a number of short-term risks that should be taken into account when dealing with the region.

- Latin America will not be immune from a downturn in investor sentiment as economic growth in the developed world stalls over the second half of 2010.
- The slowdown in asset price growth seen across the region’s stock markets over the second quarter of 2010 could be followed by a strong asset price correction as overvalued stocks fall as a result of speculative capital flight.
- In the event of a more pronounced economic slowdown in the US and EU and/or a major shock such as a sovereign default in the euro-zone, there is also a high risk of currency depreciation across the region as a result of investor appetite retrenching, particularly in terms of currencies such as the Brazilian real, which has received the largest speculative capital inflows. This would cause rapidly falling asset values, and an increase in credit risk, as foreign currency-denominated liabilities become more expensive to meet.
- In the event that Latin American currencies continue on a strengthening trajectory, several countries may act to curb demand for FX by limiting the flow of FX into the country. Although some countries (such as Peru and Brazil) have already done this through increased taxation on foreign investment, more rigorous capital controls could have a negative impact on doing business with a country, constraining cashflows and liquidity in the banking sector.

**Real GDP Growth**



Sources: Central Banks; D&B

Several of the region’s economies, notably Mexico and the Central American countries, are overly reliant on the US as an export market and as a source of investment and remittances. This leaves these countries vulnerable to any further downturn in the US.

- As a result of subdued output in the US over the second half of 2010 and into 2011, we expect Mexican GDP growth to slow significantly with a possibility of a moderate contraction in GDP in Q4. This will negatively affect corporate profitability with a concurrent increase in credit risk.
- A downturn in exports to the US and a fall in remittances will widen current account deficits in Mexico and Central American countries. Although Mexico has built up record levels of FX reserves with which to fund external financing requirements several other countries in Central America, notably Costa Rica and Honduras, will continue to have relatively low levels of FX, increasing their reliance on capital inflows and donor funding. This also increases the risk of non-payment from these countries.

A number of the region's major economies continue to offer a very challenging environment for exporters and investors:

- Venezuela's economy will experience a further contraction in 2010, hindering profits and government revenue while a tightening of FX controls will constrain cashflow and exacerbate credit risk. As FX reserves are run down in order to preserve a pegged currency, and as oil revenue declines as a result of subdued production and prices, there is a heightened risk of government default and/or further currency devaluation over the remainder of 2010 and into 2011.
- Argentina's economic stability will continue to be undermined by high levels of government spending, unorthodox methods of government revenue generation and strong upward pressure on inflation.
- Ecuador and Bolivia are two other countries that pose a greater degree of risk for investors owing to their respective government's nationalist populist policy agendas and the risk of political unrest.

### **Implications for D&B Customers**

***Risk should continue to be monitored closely across the region***

Customers doing business in Latin American countries will continue to benefit from the region's growing markets and could enjoy significant returns on their investments. However, developments in the region should be monitored closely, particularly given the uncertainty currently surrounding the outlook for the global economy. In-depth assessment of the risks associated with the region will remain paramount.

1. Increasingly liberal trade and investment environments across the region (with notable exceptions such as Argentina, Bolivia, Ecuador and Venezuela) will continue to stimulate trade and investment in Latin America. The number of free trade agreements entered into by Latin American countries has risen exponentially in recent years and is testament to the regions growing integration into global supply chains.
2. Interest rates will remain well above the level of interest rates in the developed world over the foreseeable future, providing strong returns for international investors. Meanwhile, the risk of sovereign default will be kept low by prudent fiscal policies and comparatively low levels of external debt across a group of Latin American countries including Brazil, Chile, Colombia, Mexico and Peru.
3. Over the short term companies involved in exporting goods priced in domestic currency from countries such as Brazil, Colombia, Peru and Chile may find demand for their exports waning as the strength of these currencies hinders export competitiveness.
4. Currencies are likely to continue benefiting from high levels of speculative capital inflows as well as FDI over the short term. However, in the event of a sharper economic slowdown in the US and EU and/or a large exogenous economic shock

such as a sovereign default from a euro-zone country, a market correction in the value of freely-floating currencies (or a devaluation of pegged currencies) could ensue. This would result in asset values being written down and increased credit risk. As a result, exposure to Latin American currencies should be hedged in order to guard against adverse currency movements.

5. Political risk remains high in countries such as Argentina, Bolivia, Ecuador and Venezuela where there is a risk of government policy harming commercial interests. Foreign companies in these countries run the risk of having assets nationalised or even expropriated with compensation not always forthcoming. There is also a risk from arbitrary taxation being introduced and of contracts being forcibly re-negotiated. Adequate due diligence is therefore a priority when conducting business in these countries.
6. Although improving, governance remains poor across many countries in Latin America, even in countries that have implemented significant pro-business reforms in recent years. For example, Peru and Colombia stand out as having poor judicial environments despite their pro-investment credentials while, despite a broadly adequate judicial environment in Brazil, the country's regulatory environment remains hindered by high levels of bureaucracy. Chile stands out as having the best governance in the region owing to strong institutions, rule of law and relatively low levels of bureaucracy and corruption, improving the ease of doing business in the country.

#### **D&B Country Risk Services**

D&B Country Risk Services has a team of economists dedicated to analysing the risks of doing business across the world (we currently cover 132 countries). We monitor each of these countries on a daily basis and produce both shorter analytical pieces (Country RiskLine Reports, at least one per country per month for most countries) as well as more detailed 50-page Country Reports. For further details please contact Country Risk Services on +44 (0)1628 492595 or email [CountryRisk@dnb.com](mailto:CountryRisk@dnb.com).

#### **Additional Resources**

The information contained in this publication was correct at the time of going to press. For the most up-to-date information on any country covered here, refer to D&B's monthly *International Risk & Payment Review*. For comprehensive, in-depth coverage, refer to the relevant country's Full Country Report.

*Credits:* This paper was produced by D&B Country Risk Services, and was written by Tom Christie.