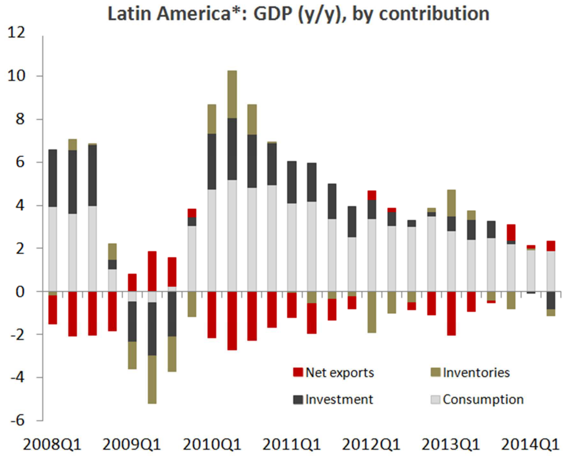
Risk Watch: Identifying Latin America's Leaders and Laggards

After nearly a decade of prosperity, the region entered turbulent waters in 2008 and waited for the storm to pass. Half a decade later, the storm persists. Meanwhile, auxiliary provisions are withering. Intra-regional responses have differed, helping to create roughly two groups: (1) those that have managed to generate growth gains by turning inwards (e.g. via reforms) and (2) those that have not seen a pickup in activity while failing to offer a viable alternative to waning exports. A brief examination of our Fundamental Balances identifies Mexico and Colombia as among the leaders. The laggards, on the other hand, include Brazil and Uruguay.

Since 2000, Latin America has been buffeted by a confluence of favorable factors: robust foreign demand, the rise of China, a commodity super cycle, and the implementation of significant reforms. Where are we now a decade later? The Twilight Zone, where up is down and down is up. These favorable conditions essentially saw a complete inversion (e.g. tepid foreign demand, declining commodity prices, and the presence of reform fatigue) that has thus far remained far longer than many anticipated. Having burned through current account buffers and available fiscal and monetary policy space, a number of Latin American economies saw Economic risk climb through 2012 and 2013.

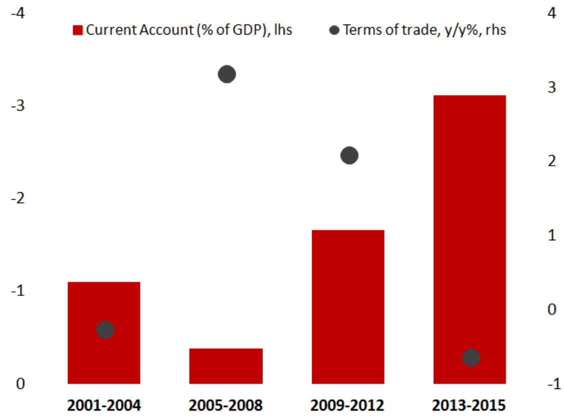
Latin America*: GDP (y/y), by contribution



* Brazil, Chile, Colombia, Mexico, Peru, and Uruguay Source: IMF

Rising uncertainty, whether related to global economic conditions or civil unrest, has served to severely sap investment spending, motivating a sustained drop in productivity for some while for others supporting upward price pressures. In the absence of foreign demand and investment gains consumption has remained resilient, consistently contributing more than 50% of Real GDP growth.

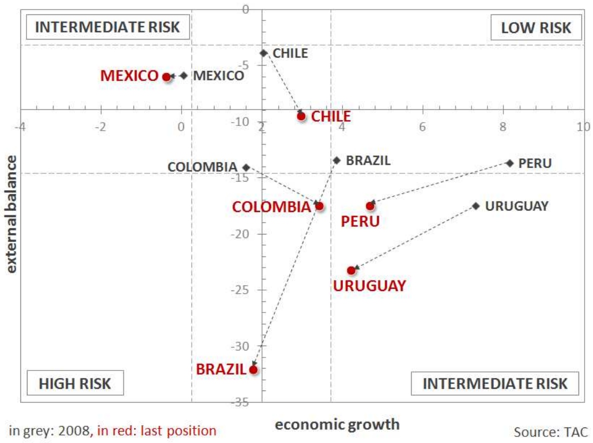
Latin America*: Current Account vs. Terms of Trade Dynamics



* Brazil, Chile, Colombia, Mexico, Peru, and Uruguay Source: IMF

The resilience of consumption, anemic foreign demand, and the stark deterioration in the region's terms of trade helps to explain the rapid pace at which the current account has eroded. As depicted in the above graph, on average the current account deficit went from a modest deficit during the 2005-2008 period to more than three times the size.

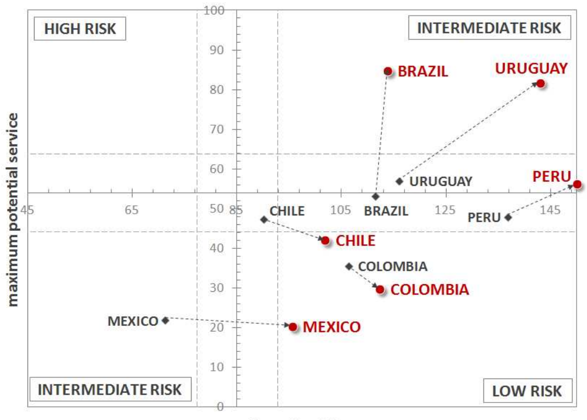
Growth Balance



in grey: 2008, in red: last position Source: TAC

As highlighted by our Growth Balance, while the current account deficit did widen across Latin American economies, the extent of deterioration differed. Furthermore, not all countries registered a slowdown in growth relative to their 2008 position. The extent of deterioration has been greatest in Brazil and Uruguay whereas it is quite modest for Mexico. Meanwhile, Chile and Colombia have managed to register a pickup in growth; however, while the former transitioned from *low risk* to *intermediate risk*, the latter has successfully exited *high risk* territory. Brazil, on the other hand, appears worst off as it presently suffers from a lack of domestic support while facing the largest exposure to international swings in market sentiment.

Liquidity Balance



in grey: 2008Q4, in red: last position

Source: TAC

By extension, those that saw the largest expansion in the current account gap, i.e. Brazil and Uruguay, also saw a jump in fx borrowing requirements or *maximum potential service* on the Liquidity Balance. Nonetheless, it is important to keep in mind that the same countries that saw an increase in *maximum potential service* were those who also had a high level of *fx liquidity*. This should help to somewhat ease concerns for at least Uruguay, but not necessarily Brazil, which did not benefit from a significant pickup in reserves. On the upside, Mexico stands out as the only economy not only to increase its fx reserve levels, without an increase in fx borrowing requirements. In sum, two groups appear to emerge: (1) those that either transitioned or moved further into the *low risk* quadrant (i.e. Mexico, Chile, and Colombia) and (2) those that either transitioned or moved further into the *intermediate risk* quadrant (i.e. Brazil, Uruguay, and Peru). In other words, group 1 has thus far managed to orchestrate an improvement in liquidity risk whereas the same cannot be said of group 2.

Looking ahead, the same countries that have the lowest risk on economic activity (i.e. Mexico and Colombia) are set to see an improvement in risk conditions over the 1-3 year horizon. Likewise, this will be accompanied by easing payment risk. Brazil and Uruguay are not as fortunate. Both countries are unlikely to see a clear improvement in activity risk between now and 2017, this especially being the case for Brazil. Meanwhile, Uruguay is set to see a strong pickup in payment tensions over the next couple years while Brazil sees little to no change.