2012 Outlook: Latin America Sovereign Review

Creditworthiness Trends Stable

Outlook Report

Rating Outlook
STABLE

Latin America Ratings

Country	Foreign Currency IDR	Outlook
Argentina	B	Stable
Aruba	BBB	Stable
Bermuda	AA+	Stable
Bolivia	B+	Stable
Brazil	BBB	Stable
Chile	A+	Stable
Colombia	BBB−	Stable
Costa Rica	BB+	Stable
Dominican Republic	B	Positive
Ecuador	B−	Stable
El Salvador	BB	Stable
Guatemala	BB+	Stable
Jamaica	B−	Stable
Mexico	BBB	Stable
Panama	BBB	Stable
Peru	BBB	Stable
Suriname	B+	Stable
Uruguay	BB+	Stable
Venezuela	B+	Stable

Related Research

Sovereign Review (December 2011)

Global Economic Outlook (December 2011)

Latin America: Between Two Giants Impact of a Potential Renewed US Recession or a Chinese Slowdown (October 2011)

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Stable Trend in Creditworthiness: Fitch Ratings expects the region's sovereign creditworthiness to be broadly stable in 2012 following a positive rating cycle in the last 18 months. The improved profile is underpinned by sound economic policies, moderate external and fiscal imbalances, modest government debt burdens, and improved external liquidity. This will provide protection in the unfavourable global environment.

Risks to Economic Outlook: While not Fitch's base case, the main risks to the region's economic outlook and sovereign credit profile include: a double-dip in the US; a disorderly unraveling of the eurozone crisis; a hard-landing in China; a sharp and sustained fall in commodity prices; and political shocks that undermine economic policies. Amid high external financial volatility, the main challenge for policymakers is to balance the need for domestic stimulus while maintaining the credibility of the overall policy framework.

Economic Slowdown: Fitch forecasts that Latin America's real GDP will grow by 3.4% in 2012 compared with an estimated 3.9% in 2011, although downside risks remain. While exports will suffer from weak demand, domestic demand will falter due to spillovers from the external sector and weaker consumer and business confidence. Both Brazil and Mexico are expected to record moderate growth rates while Colombia, Panama, Peru, and Uruguay will be more dynamic. Jamaica and El Salvador will continue to underperform.

Inflation Likely to Abate: Concerns about economies over-heating and rising inflation are likely to abate in 2012 owing to the economic deceleration, easing of global commodity price pressures and well-anchored inflation expectations. With the exception of Brazil, other inflation-targeting central banks have not cut interest rates. However, they may do so if the international economy worsens and domestic demand loses momentum.

Fiscal Consolidation: Economic slowdown, no significant improvement in the terms of trade and continued spending pressures will detract from fiscal consolidation in 2012. Fitch expects moderate fiscal deficits and continued economic growth to result in stable to declining debt dynamics for most countries. The improved currency composition of government debt has reduced the vulnerability of debt dynamics to exchange rate shocks.

Strong External Buffers: With the exception of countries in Central America and the Caribbean, Latin American countries' external imbalances are moderate. The commodity price cycle has supported favourable external accounts dynamics. Fitch expects the region's current account deficit will deteriorate to 1.9% of GDP in 2012 from 1.3% in 2011. The stock of international reserves is forecast to reach USD750bn by year-end up from USD635bn in 2010, which provides a strong buffer.

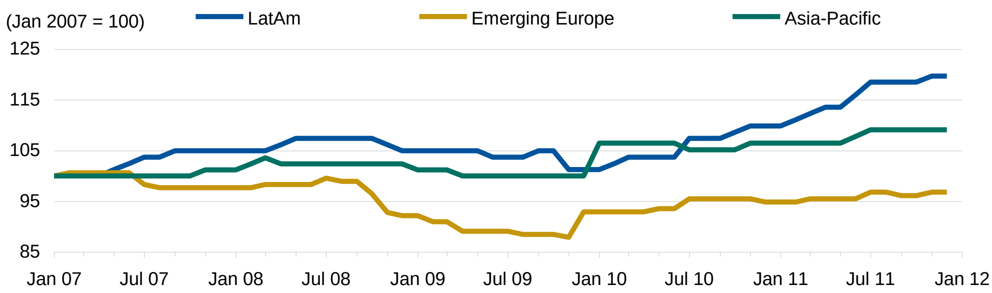
Reform Outlook: While policies to maintain macro stability are likely to continue in most countries, Fitch does not foresee significant momentum for structural reforms, which would enhance the region's competitiveness, promote economic diversification and improve human capital.

Credit Trends Stable in 2012

Sovereign creditworthiness in Latin America is expected to be broadly stable in 2012 following the positive credit cycle of the last 18 months. Improved credit fundamentals underpinned by sound economic policies, strong economic performance, moderate government debt levels and improved currency composition of debt, robust external buffers, and healthy banking systems should allow most countries to withstand pressure from the unfavourable external conditions.

Figure 1

Change in Average Regional Ratings



Source: Fitch

With the exception of the Positive Outlook on the Dominican Republic, all ratings are on Stable Outlook suggesting stability in sovereign ratings in 2012. However, selective positive rating actions are possible if countries mitigate their respective rating constraints and demonstrate resilience in the difficult global economy.

Amid volatile global financial conditions and weakening external demand, Fitch does not rule out negative rating actions on sovereigns in the 'B' category due to their weak and unpredictable policies and limited external and fiscal buffers. Central American countries such as Guatemala and El Salvador ('BB') that have faced increased fiscal pressures and negative debt dynamics are vulnerable to the weak growth in the USA.

The main risks to the region's economic outlook and sovereign credit profile stem from:

- A double-dip in the USA, which could adversely affect growth in Mexico and Central American and Caribbean countries that would increase fiscal pressures and government debt burdens. However, the risk of a double-dip in the USA has diminished.
- An escalation of the eurozone crisis leading to a significant increase in risk aversion and possibly capital outflows from the region, which would exert pressure on regional currencies and hit confidence. A serious aggravation of financial problems in Europe could possibly lead to the retrenchment of banking sector credit in Latin America, thereby hurting economic growth.
- A hard-landing in China, which is likely to have knock-on effects on commodity prices. A sharp and sustained fall in commodity prices would be negative given the high commodity dependence of most countries. Capital flows to the region could also suffer in this scenario.
- Political shocks that undermine policy making. While there has been greater political stability in recent years, high poverty rates and income inequality combined with institutional weaknesses can lead to unexpected shocks.

Upgrades in 2011

In 2011, Fitch did not downgrade any sovereign rating in the region. The agency upgraded eight sovereigns including Brazil, Chile, Colombia, Costa Rica, Panama, Peru, Suriname and Uruguay.

Related Criteria

New Sovereign Rating Model (October 2011)

Figure 2

2011 LatAm Rating Changes

	Upgraded	
	From/to	Date
Brazil	BBB−/BBB	04 Apr
Chile	A/A+	01 Feb
Colombia	BB+/BBB-	22 Jun
Costa Rica	BB/BB+	04 Mar
Panama	BBB−/BBB	02 Jun
Peru	BBB−/BBB	10 Nov
Suriname	B/B+	29 Jul
Uruguay	BB/BB+	14 Jul

Source: Fitch

Brazil's upgrade reflected Fitch's assessment that the country's sustainable potential growth rate has increased, which is supportive of its medium-term fiscal outlook. The country's much improved external liquidity strengthens its capacity to withstand external shocks. The incoming Rousseff administration has shown commitment to tightening fiscal policy, which is important for reducing the heavy general government debt burden and facilitating a reduction in real interest rates.

Chile's upgrade recognized years of prudent macroeconomic management that has delivered healthy public finances, an effective and credible monetary regime and an economic model based on competitive markets and trade deepening through multiple free trade agreements. These features and a proven track record allowed Chile to remain resilient despite two severe shocks from the 2008/09 global credit crisis and the devastating earthquake in 2010.

Colombia regained its investment grade status this year. Its upgrade was supported by its track record of prudent economic policies, resilience to external and domestic shocks, as well as the improvement in its external credit metrics. The administration of President Juan Manuel Santos demonstrated a visible success with extensive reforms to bolster the credibility and predictability of public finances and enhance the country's growth.

Costa Rica's upgrade was supported by its better-than-expected economic resilience during the global credit crisis, steadily improving macroeconomic stability underpinned by lower inflation, higher international liquidity and reduced banking sector vulnerabilities as well as the country's modest external indebtedness.

Panama's upgrade reflected its solid economic growth prospects and favourable government debt dynamics. Panama's highly favourable investment cycle is underpinned by the Canal expansion, an ambitious public investment programme and strong foreign direct investment flows. Economic growth combined with fiscal discipline has allowed for a sustained decline in government indebtedness and its convergence with the 'BBB' median.

Peru's upgrade reflected the country's solid credit metrics and reduced uncertainty about macro policy continuity and changes to the fiscal contribution of the mining sector following the election of President Ollanta Humala. Peru's strengthened resilience to external and confidence shocks is underpinned by the sovereign's robust net external creditor position (49% of CXR), rising international reserves and moderate external indebtedness, which partly balance high commodity dependence and still significant financial dollarisation, two of Peru's key credit weaknesses.

Suriname's upgrade recognized its comparatively strong external credit metrics, structural improvements in balance of payments dynamics and positive growth momentum. In July 2011, the Surinamese authorities reached a final agreement to clear the outstanding external arrears with the USA of USD32m (1% of GDP) in overdue principal, interest and penalty payments. This improved the sovereign's debt repayment record. Government disbursements started in August 2011, based on an agreed three-year payment schedule.

Uruguay moved closer to investment grade with its recent upgrade. This recognized its reduced external and fiscal vulnerabilities owing to improvements in its external and fiscal solvency ratios, strengthened external liquidity as well as better currency composition and maturity structure of government debt. Uruguay's economic performance and outlook are favourable. Fitch believes policy continuity and political stability are solidly anchored by a strong institutional framework.

Economic Growth to Decelerate Amid Well-Tamed Inflation

Economic Growth

Fitch expects Latin America's real GDP growth to decelerate to 3.4% in 2012 from 3.9% this year. While exports will suffer from external demand weakness, domestic demand will also decelerate due to spillovers from the external sector and weaker consumer and business confidence. There are threats to growth, especially if the eurozone crisis escalates and commodity prices fall steeply. However, several countries have the fiscal and monetary policy flexibility to provide stimulus should external conditions turn for the worse.

Figure 3
Latin America: Key Indicators

(USDbn)	2009	2010	2011f	2012f	2013f
Real GDP growth (%)	-2.0	6.0	3.9	3.4	4.2
Inflation (%)	6.2	6.2	6.7	6.7	6.4
Government balance (% of GDP)	-3.2	-2.5	-2.5	-2.6	-2.5
Government debt (% of GDP)	46.2	44.0	45.0	44.7	44.1
Current account balance	-19	-55	-69	-109	-133
%of GDP	-0.5	-1.2	-1.3	-1.9	-2.1
Debt Service	155	142	155	164	159
% of CXR[a]	18.0	13.4	12.4	12.3	11.0
Gross financing need[b]	133.7	159.9	190.2	222.2	230.8
% of reserves	26.6	26.9	26.9	29.5	28.7
Net external debt	-135	-138	-143	-101	-53
% of CXR[a]	-15.7	-13.0	-11.5	-7.6	-3.6
Net public external debt	-88	-100	-175	-180	-186
% of CXR[a]	-10.2	-9.5	-14.0	-13.6	-12.9
Reserves incl. gold	547	635	750	782	806

[a] Current external receipts
[b] Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need
Source: Fitch

Among the larger countries, Brazil and Mexico are expected to record moderate growth rates in 2012. Brazil is forecast to grow at a below-potential rate of 3.2%. While growth will be hurt by the international financial volatility, the economy will be supported by growth in wages, a large rise in the minimum wage, monetary stimulus and the recent easing of credit restrictions imposed in late 2010. Recent policy initiatives to stimulate domestic demand and enhance certain capital flows should support growth. Mexico's growth is expected to decelerate from 3.7% in 2011 to 3% in 2012 due to weaker external performance as 80% of the country's exports are destined for the USA. Chile's open economy will also suffer from weakening external demand.

While the economies of Colombia, Panama, Peru and Uruguay will slow, they are forecast to still grow by over 4% in 2012. The investment cycle is positive for these countries as they benefit from greater macroeconomic stability and strong foreign direct investment flows. With the exception of Panama, high commodity prices favour their growth dynamics.

Figure 4
GDP Growth

(%)	2011	2012
Argentina	7.5	4
Aruba	9.6	3.5
Bolivia	4.8	4.1
Brazil	2.8	3.2
Chile	6.0	3.7
Colombia	5.2	4.3
Costa Rica	4.3	4.0
Dominican Republic	4.4	4.9
Ecuador	6.0	4.8
El Salvador	1.8	2.0
Guatemala	3.0	3.1
Jamaica	1.2	1.0
Mexico	3.7	3.0
Panama	8.5	7.0
Peru	6.3	5.5
Suriname	4.5	4.9
Uruguay	5.4	4.4
Venezuela	2.8	3.2

Source: Fitch

Argentina's growth is forecast to slow sharply to 4% in 2012 from over 7% this year due to less favourable terms of trade, tighter monetary conditions (the 'Badlar' interest rate has doubled in recent weeks) and the adverse impact of recent policies that are hindering the private sector's access to foreign exchange. Moderate growth in Brazil will also dampen Argentina's exports. On the other hand, Venezuela, which had been mired in recession in 2009-2010, is recovering and is expected to gain steam next year due to higher fiscal spending. Pre-2008 growth rates are difficult to foresee owing to electricity shortages, tighter FX controls and higher inflation.

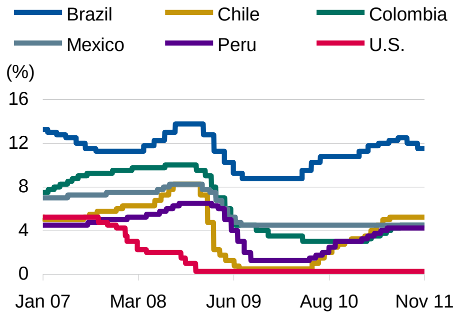
Fitch expects El Salvador and Jamaica to be the least dynamic performers in the region. Both countries have limited policy flexibility to stimulate domestic demand and are vulnerable to the sluggish growth in the USA.

Inflation

Concerns about economic over-heating and inflation are likely to abate in 2012 owing to the economic slowdown, easing of global commodity price pressures and well-anchored inflation expectations. The main risks to low inflation include a material increase in commodity prices and/or depreciation of regional currencies if the eurozone crisis leads to a large, sustained increase in risk aversion and capital outflows. However, the inflation-targeting central banks have gained credibility, which should limit the pass-through of exchange rate depreciation to inflation.

Figure 5

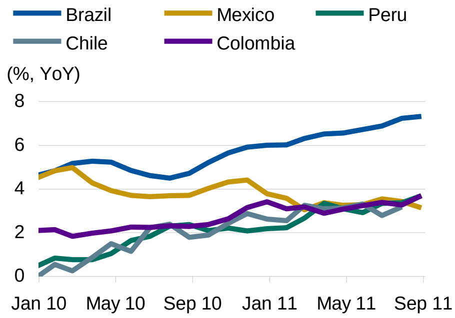
Monetary Policy



Source: IFS, Bloomberg

Figure 6

Consumer Price Index



Source: IFS

Brazil has faced considerable inflation pressures this year. Its inflation rate is likely to end 2011 close to the upper band of the target range of 4.5%+/-2%. Expectations are above the middle point for 2012. The backward indexation of certain prices makes it difficult to get inflation down aggressively in Brazil. Fiscal rules that allow the minimum wage to increase by the inflation rate of the previous year exacerbate inertia.

Despite high inflation and elevated inflation expectations for 2012, the central bank cut interest rates by a total of 150bps from the peak of 12.5% this year owing to its concern about the deteriorating global outlook.

Mexico was successful in bringing inflation down in 2011. The negative output gap, elevated unemployment rate and moderate wage increases have aided disinflation. Greater competition in certain sectors is also breaking the long-standing rigidities that prevented lower inflation. Inflation should remain within the central bank's target range of 3%+/-1% in 2011 and 2012.

Expansionary economic policies have led to the most unfavourable inflation dynamics in Argentina[1] and Venezuela. The removal of certain subsidies as well as a depreciating currency could limit the decline in Argentina's inflation rate in 2012 notwithstanding the economic slowdown and a potentially more aggressive government stance towards wage negotiations. Inflationary pressures are forecast to remain high in Venezuela due to structural shortages in several products and higher fiscal spending.

With the exception of Brazil, other inflation-targeting central banks have refrained from cutting interest rates[2]. However, rate cuts can't be ruled out should the global economy take a turn for the worse and hit their domestic economies.

Robust External Balance Sheets Provide Buffer

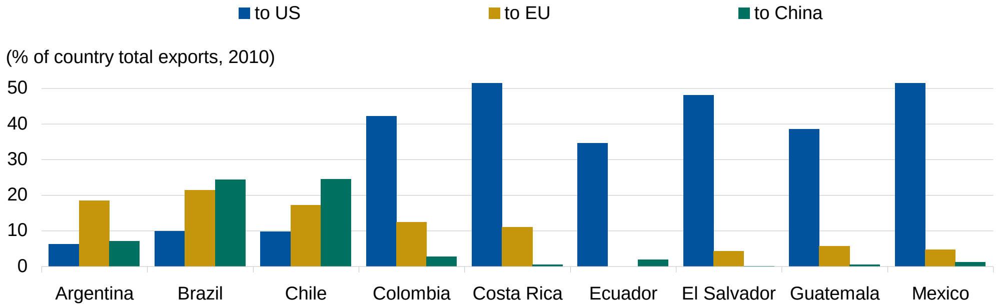
With the exception of countries in Central America and the Caribbean, external imbalances are moderate in the region. The favourable commodity cycle has supported external accounts and allowed domestic demand to grow faster without putting pressure on current account balances. Fitch expects the region's current account deficit to deteriorate moderately in 2012 owing to external demand weakness and softness in commodity prices (for example, Fitch's average Brent oil price forecast for 2012 is USD100, down from USD110 this year).

[1] Officially reported inflation in Argentina is significantly lower than private sector estimates.
[2] Colombia recently hiked interest rates due to buoyancy of domestic demand and credit growth.

Latin America's direct trade exposure to the eurozone is limited. Among the larger countries, Brazil and Argentina have the most extensive trade links with Europe. The banking sector could be a source of vulnerability as large Spanish banks have subsidiaries in several Latin American countries. However, self-funding (mostly through local deposits) and minimal dependence on parent banks in Europe makes the regional banks less vulnerable to parents' funding and balance sheet woes. While profit and capital repatriation can't be ruled out if there were financial distress, some local regulators are tightening rules to contain the size of such leakages (eg, according to new regulations in Mexico, related party lending cannot exceed 25% of capital compared with 50% previously).

Figure 7

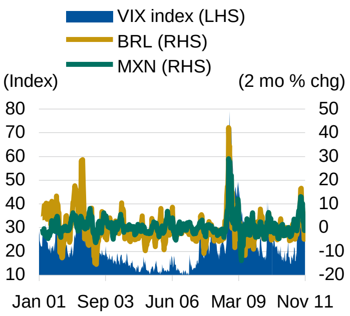
Exports by Destination



Source: Central Banks, DANE, Statistical Institutes, Fitch

Figure 8

VIX Index vs. MXN-BRL



Source: Fitch

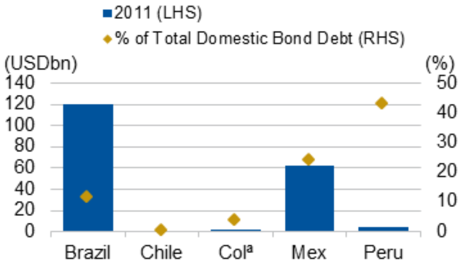
The higher risk aversion stemming from the escalation of the eurozone crisis has led to volatility in commodity prices, regional currencies, and domestic asset prices. While non-resident holdings of local government debt have been stable, a serious escalation in risk aversion could lead to capital outflows. Brazil, Mexico and Peru would be the most exposed through this channel.

The international reserves of the region are at an historically high level (estimated to reach USD750bn by year-end) and give several countries the flexibility to respond should capital outflows accelerate owing to deteriorating external conditions. The shock-absorption capacity of several countries is enhanced by the flexibility of their exchange rates.

Mexico and Colombia benefit from the IMF's flexible credit line. IMF Stand-by programmes also provide a strong policy anchor and access to foreign currency (FX) liquidity support for the smaller countries of the Dominican Republic, El Salvador and Jamaica. However, the Dominican Republic and Jamaica have not received IMF disbursements recently due to delays in completing their respective quarterly reviews with the Fund.

Figure 9

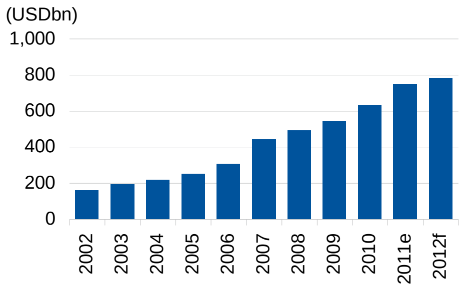
Foreign Participation in Government Local Debt Markets



[a] Colombia debt market reflects till Feb 2011
Source: Fitch

Figure 10

Latin America Reserves Incl. Gold



Source: Fitch

Both Argentina and Venezuela are exposed to confidence and commodity price shocks, which could lead to an abrupt loss of international reserves. Notwithstanding FX controls, a high level of capital flight, the lack of access to IMF financing, the real appreciation of their currencies and unsustainable economic policies renders them vulnerable to currency pressures.

International reserves were under pressure in Argentina in 2011 as authorities intervened to stabilise the peso. The country introduced measures including mandatory repatriation of offshore assets and export earnings of some sectors. There may be further tightening as authorities seek to avoid a disorderly currency deprecation and rising inflation.

Similarly, Venezuela's fixed exchange rate regime and FX controls are costly to maintain as they have led to a significant increase in public sector external debt. Venezuela's policy announcements (toned down later) related to repatriating the offshore gold and foreign currency assets hurt investor confidence.

Figure 13

General Government Balance (% of GDP)

	2011f	2012f
Argentina	-1.3	-1.6
Bolivia	-0.2	-1.7
Brazil	-2.8	-2.9
Chile	-0.8	-0.8
Colombia	-2.9	-2.0
Costa Rica	-5.4	-5.3
Dominican Republic	-1.8	-1.2
Ecuador	-3.9	-4.2
El Salvador	-3.5	-3.0
Guatemala	-2.9	-2.5
Jamaica	-4.7	-2.9
Mexico	-2.7	-2.4
Panama	-2.5	-2.8
Peru	1.1	0.3
Suriname	-3.3	-3.2
Uruguay	-0.7	-0.9
Venezuela	-3.8	-4.3

Source: Fitch

Limited Fiscal Consolidation In 2012

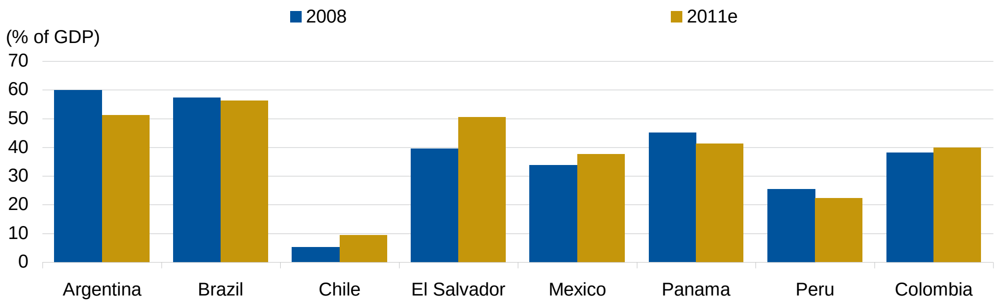
Economic slowdown, no significant improvement in the terms of trade and continued spending pressures will detract from significant fiscal consolidation in 2012. Fitch expects moderate fiscal deficits and economic growth to result in stable to declining debt dynamics for most countries. The improved currency composition of government debt has reduced the vulnerability of debt dynamics to exchange rate shocks.

None of the countries (with the exception of Peru and more recently Brazil) have announced counter-cyclical fiscal packages for next year but such initiatives may be in the offing should domestic economies materially slow. Chile and Peru have the maximum space to implement fiscal stimulus due to their lower debt burdens and sizeable commodity stabilization funds. Panama's lower debt burden than in 2008 also accords it some fiscal flexibility. Fiscal flexibility is more limited for Argentina, Brazil, Colombia, Mexico, and Uruguay.

While fiscal restraint was encouraging in 2011, Brazil will be challenged to meet its 2012 non-financial public sector primary surplus target due to the strong growth in the minimum wage and a less robust revenue growth. Fiscal consolidation will also be limited in the case of Mexico due to spending pressures and a limited upside from oil income.

Figure 12

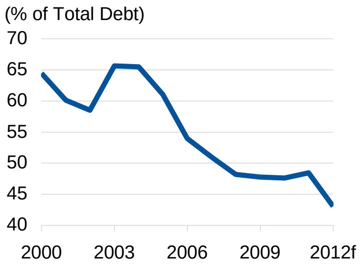
Central Government Debt



Source: Fitch

Figure 11

Latin America Median Public FC Debt



Source: Fitch

Peru's fiscal surplus is expected to decline as it increases social spending and implements a small counter-cyclical package. On the other hand, Colombia is expected to continue consolidating its fiscal accounts as it benefits from already-approved revenue measures, expenditure restraint and moderate growth.

Fiscal spending will remain high for Argentina and Venezuela although the former has announced a modest reduction in subsidies. Financing constraints will limit Argentina's ability to incur large deficits. High oil prices, the presence of off-budget financial assets and captive local markets will allow Venezuela to boost spending and fund a larger deficit ahead of the 2012 presidential elections.

Fiscal flexibility is limited for several countries in Central America. El Salvador will be challenged to meet the 2012 fiscal target set under the IMF programme owing to its sluggish growth and increased spending from the recent flooding. Fitch notes that the Salvadoran Congress has recently approved a revenue-enhancing reform to address some of the above-mentioned pressures. Guatemala's rising debt burden is also eroding its fiscal space and increasing the importance of widening its low tax base. Costa Rica's fiscal deficit remains high, making the passage of a tax enhancing reform (currently in Congress) important for its medium-term fiscal sustainability.

Sluggish Pace of Reform

While most countries are following market-friendly policies that have sustained macroeconomic stability, structural reforms that can improve competitiveness, increase economic diversification and support the development of human capital are lacking. Fitch does not foresee a material increase in the reform momentum in the region.

Policy unpredictability and state intervention is likely to remain high in Argentina, Bolivia, Ecuador and Venezuela although this is largely captured in their low ratings. The recent tightening of foreign exchange controls in Argentina, the nationalization drive in Venezuela, the renegotiation of oil contracts in Ecuador and plans to use international reserves to fund projects in Bolivia highlights the fickleness of policymaking in these countries. Such policies detract from investment and sustained high growth.

Important Elections in 2012

The Dominican Republic, Mexico and Venezuela will hold presidential elections in 2012.

Six months ahead of the presidential elections in the Dominican Republic, former President Hipolito Mejia of the centre-left opposition PRD remains the frontrunner. However, the results of the latest polls show positive momentum for Danilo Medina of the ruling centre-right PLD, suggesting that either of the two candidates could win in May 2012. The electoral campaign coincides with the end of the IMF's Stand-by Arrangement, which is likely to put pressure on fiscal accounts during H112. Fitch expects the new government to renew the Dominican Republic's engagement with the IMF to anchor business confidence, restore fiscal discipline and address external vulnerabilities.

Enrique Pena Nieto of the PRI (the main opposition party) is the leading presidential candidate for Mexico's presidential elections. While Mexico's macroeconomic policy framework will continue under a potential PRI administration, it is difficult to assess whether and at what pace the next government will be able to push through the long-pending structural reforms. Besides economic reforms, it would be important to monitor progress in democracy and transparency under a PRI presidency given the historical record of the party.

Political and policy uncertainty will remain high in Venezuela as it approaches elections. Despite health concerns, President Chavez remains a formidable candidate due to the government's extensive social programmes and his overwhelming control over the economy and the state apparatus. On the other hand, opposition parties appear to be more united than in the past and are in a better position to challenge President Chavez. Even if the opposition candidate wins the presidential elections, changes to the current economic model are likely to be gradual.