

## The Day After: What if Latin America Devalues?

- *Currency risk in Latin America is high and rising. Export competitiveness has been undermined by appreciating real effective exchange rates. Capital inflows are highly vulnerable to contagion from Asia.*
- *In the medium term, devaluation will hit Latin America hard. Its export sector is relatively small, its debt-service burden high, and there is a significant risk that inflation will accelerate.*
- *Devaluation can be averted, but at a cost of significant economic slowdown. Given the negative political ramification of a currency meltdown, particularly in Brazil and Argentina, monetary policy there has already tightened sharply.*

The sharp downward correction in Latin America has made many of its equity markets attractive from a valuation perspective. In some markets – notably, Brazil and Mexico – robust earnings growth is likely to improve valuation even further in the months ahead.<sup>1</sup>

However, investors need to weigh these positives against the risk of devaluation. This risk has short-term as well as long-term implications:

- In the short term, a Latin American devaluation is bearish for financial assets, at least until the currency stabilizes. The first question, then, is whether Latin America *needs* to devalue? In other words, are its currencies “too expensive” given its increasingly open economies?
- In the longer-term, the implications for financial assets are more complicated. The key issue is whether gains in exports will outweigh the cost of higher interest rates, a slower domestic economy, and rising investor angst.

In general, the prospects for a *regional* replay of a Mexican-style, export-led recovery are small. On the export side, the Latin American economies do not

enjoy Mexico’s preferential access to the US, Asia is now much more competitive in third markets, and G7 import demand as a whole is more vulnerable. And with the currency crisis now spreading throughout the emerging markets universe, the likelihood for a speedy revival of capital inflow is significantly smaller.

### Does Latin America *need* to devalue?

The short answer is yes. Constrained by a low saving rate, growth spurts in Latin America have forced periodic currency “corrections.” The current growth spell now calls for another correction, although the precise timing is difficult to determine.

Over the past decade, Latin America’s share of world exports dropped to 4.1%, down from 5.3% in 1986. Developing Asia’s share, on the other hand, has risen to 19% of the total, up from 11%.

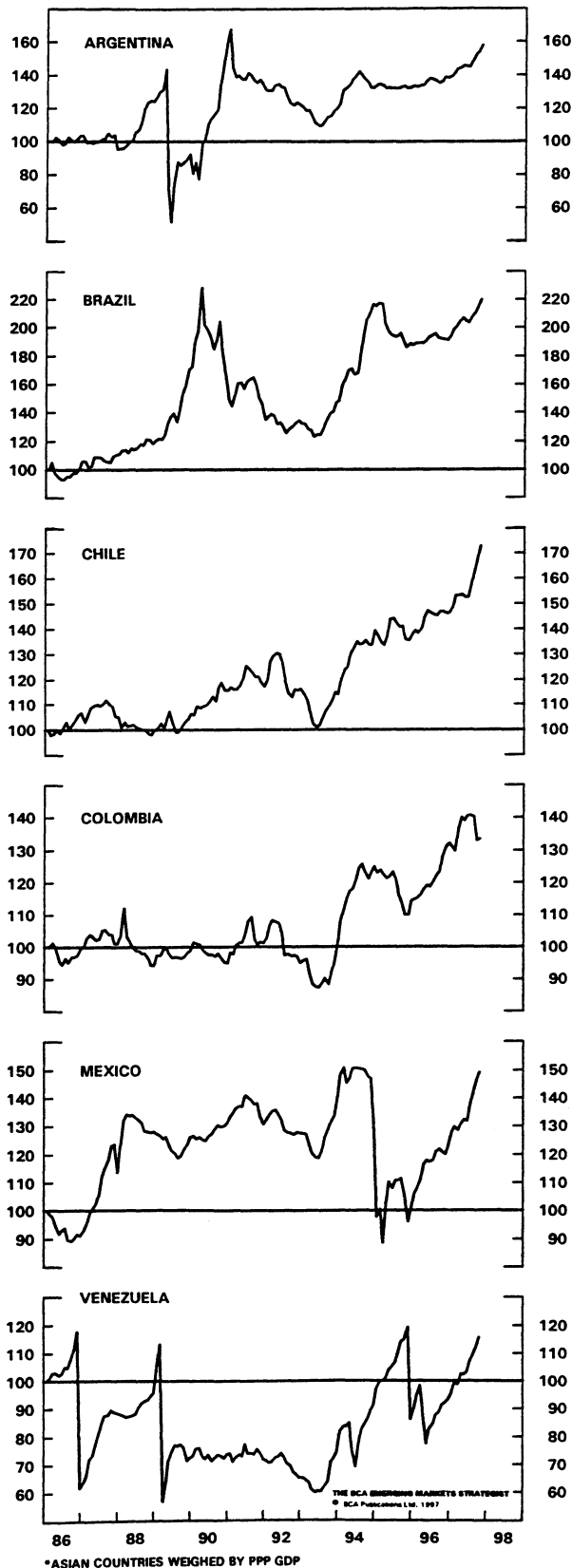
Part of the reason is the gradual *differential* appreciation of the Latin American currencies against their Asian counterparts. The real effective exchange rate of a country reflects the “competitiveness” of its currency – relative to its trading partners, as well as relative to other countries with which it competes indirectly in “third markets.” However, because the *level* of the real effective exchange rate is set arbitrarily, it cannot tell us whether a currency is “cheap” or “expensive” in any absolute sense. The best we can do, therefore, is look for *relative movements*, as we do in Chart 5. The chart plots the real effective exchange rates of six Latin American currencies, divided by a weighted-average real effective exchange rate for the developing-Asia region (results are normalized with January 1986=100). Upward movement on these charts indicates the currency is losing competitiveness relative to the Asian average.

In general, the data suggest that Latin America’s *currency* competitiveness has deteriorated relative to Asia. Of course, the currency alone does not paint the full picture of *export* competitiveness, which is also affected by differential productivity gains. Here, too, however, Asia was probably doing better: its per capita GDP growth over the past decade averaged 5.9% annually, against 1.3% Latin America. This is an admittedly imperfect measure of productivity in the traded-good sector, but it nevertheless conveys the general trend.<sup>2</sup>

<sup>1</sup> See “Emerging Markets Earnings: The ‘Good’, the ‘Bad’ and the ‘Ugly’”, Special Report, *The BCA Emerging Markets Strategist*, November 10. For a copy, please contact our circulation department (Tel: (514) 499-9706; e-mail: circ@bcapub.com).

<sup>2</sup> The inaccuracy arises first because GDP per capita reflects output in the traded sector as well as the non-traded sector and, second, because it is based on population rather than employment levels.

Chart 5  
Real Effective Exchange Rates Relative to  
Developing Asia\*



Now, although *on the whole*, Asia's export share was rising as its currencies were becoming relatively cheaper, it was there rather than in Latin America that the currency crisis struck first.

The reason is probably rooted in Asia's infamous overcapacity problem and inflated asset markets, but the implications for Latin America are dire all the same:

- First, with Asia having devalued, Latin America's *relative* competitiveness – falling as it was going into the crisis – is now even weaker. And much like in Asia, once a major Latin American country devalues, pressure to do the same will quickly radiate to its neighbors.
- Secondly, currency contagion is affected by investors' panic no less than by trade-balance fundamentals. Once the Asian crisis began gathering momentum, *everything Asian* appeared risky. As illustrated by the 1995 Mexico crisis, portfolio investors have traditionally treated Latin America *en bloc*, so if they panic, the negative chain reaction will likely spread much faster than in Asia.

These considerations do not make a Latin American devaluation cycle imminent, nor do they tell us anything about timing. They do suggest, however, that the prospects for devaluation are high and rising.

### The external impact on growth

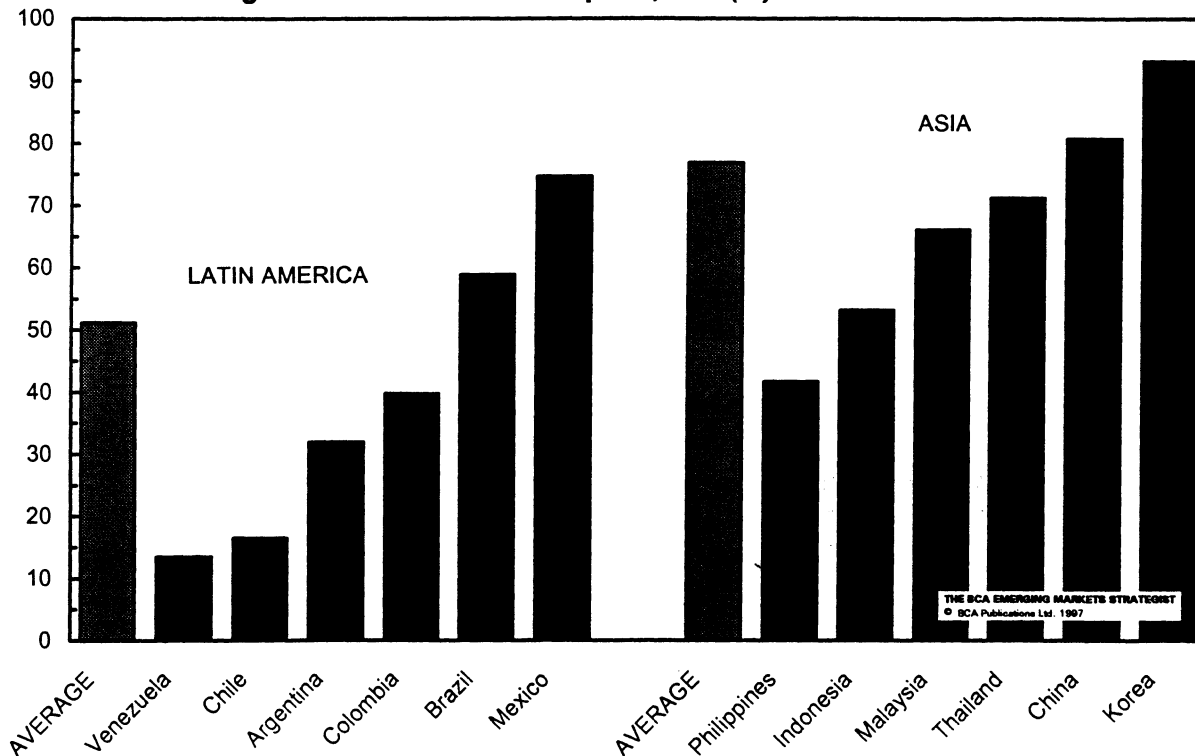
The second issue for investors is the economic cost/benefit of a devaluation aftershock. The *external* aspect of this issue is the extent to which a devaluation can lead to export-led growth, which in turn depends on several factors.

#### (1) Export market share

The principal growth benefit from devaluation is a rise in export volume: the cheaper currency allows a country to undercut its competitors and win market share. However, this impact works mainly for *manufactured goods*. Primary commodities such as agricultural staples, petroleum, or minerals, have a more or less uniform world price, so devaluation here merely raises the local currency revenue from export, not its volume.

The implication is that the gain from devaluation is proportionate to the manufacturing share of merchandise exports. On this count, Latin America has a clear disadvantage relative to Asia. As illustrated in Chart 6, only 51% of its merchandise exports are in manufacturing, compared with 77% for Asia. Within Latin America, the most vulnerable are Venezuela (an oil exporter), Chile (minerals)

Chart 6  
Manufacturing Share of Merchandise Exports, 1993 (%)



Source: World Bank

and Argentina (agriculture). Brazil and Mexico, with their larger manufacturing sectors, are better situated to gain export market share.

The relative disadvantage of Latin America vis-à-vis Asia could be somewhat offset by trade patterns (Chart 7). The key issue here is the extent of intra-regional trade. Regional integration is much more advanced in Asia than Latin America: the Asian region (including Japan), absorbs over 53% of developing Asia exports; the comparable figure for Latin America is only 19%. This means that Asia's ability to raise export volumes will depend largely on its own growth, whereas for Latin America the key is growth in the developed economies, particularly North America and Europe (where most of its exports go). If Asian growth continues to slide relative to the G7, the negative impact for exports will be bigger in Asia than in Latin America.

A prolonged economic slowdown in Asia, however, could spill over into the G7, with negative effects for Latin American exporters. On the whole, therefore, export benefits from a devaluation are likely to be smaller in Latin America than in Asia.

### (2) Export capacity to import

Developing country growth is highly import-dependent. Most of these economies rely on

imported capital goods to build their infrastructure and manufacturing capacity, as well as on high-tech semi-finished products (such as microchips) to feed their production runs.

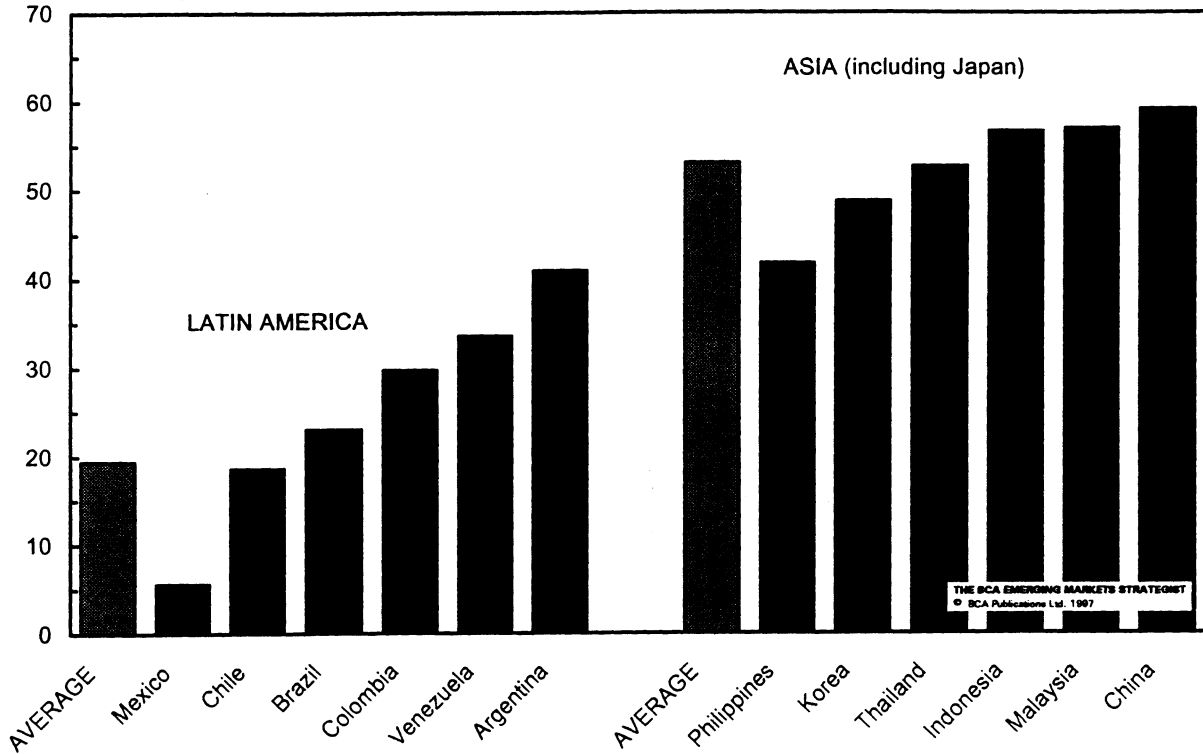
A country's "export capacity to import" is affected by two principal factors: the volume of its exports (measured in real terms rather than dollars), and its terms of trade (the ratio of export to import prices). The way to measure this capacity, therefore, is to deflate export revenues by import prices, with the result indicating how many "physical units" of imports the country could buy for what it exports.

Here, too, Latin America seems more vulnerable (Chart 8). Over the 1991-95 period, its exports were able to finance imports equivalent to 17.5% of GDP, compared with over 30% in Asia. Particularly vulnerable are Brazil and Argentina, whose export capacity to import is a mere 10% of GDP.

### (3) The debt-service burden

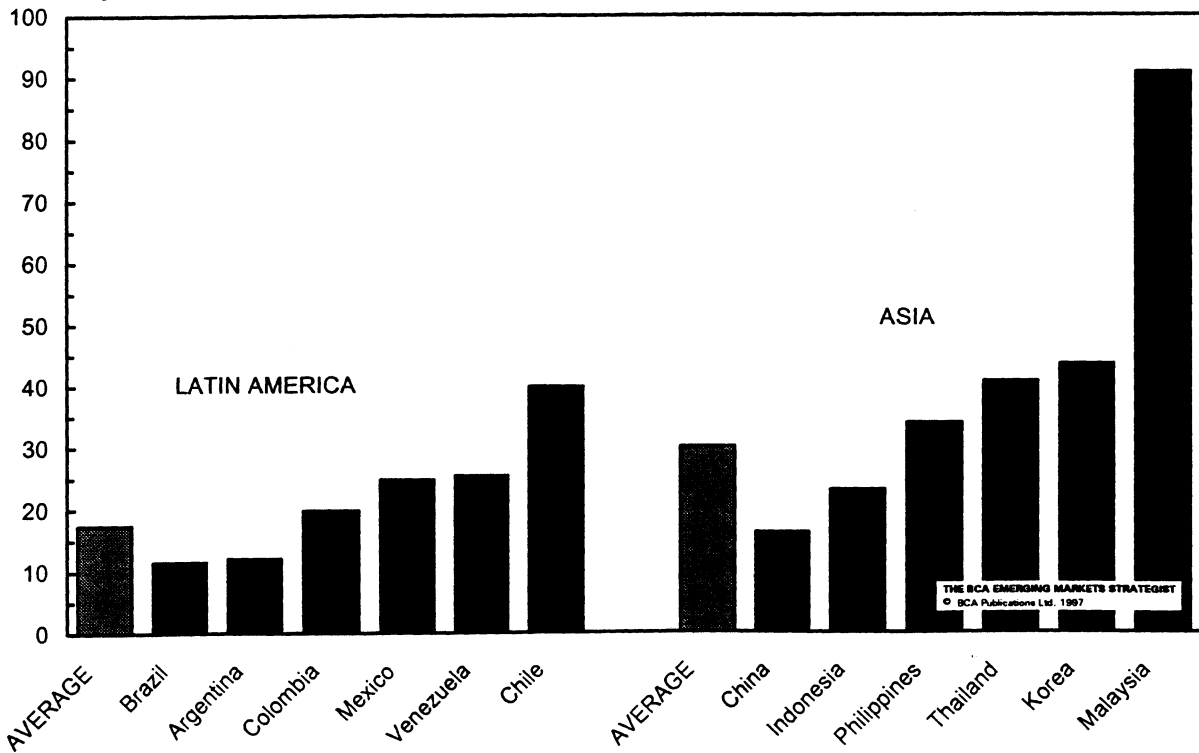
Of course, not all exports revenues go to the purchase of imports. For most developing countries, at least part of these revenues must be used to service the external debt – in the form of interest and the repayment of principal. The key variable to watch here is the ratio of debt services to export (Chart 9).

Chart 7  
Intra-Regional Exports / Total Exports (% , 1995)



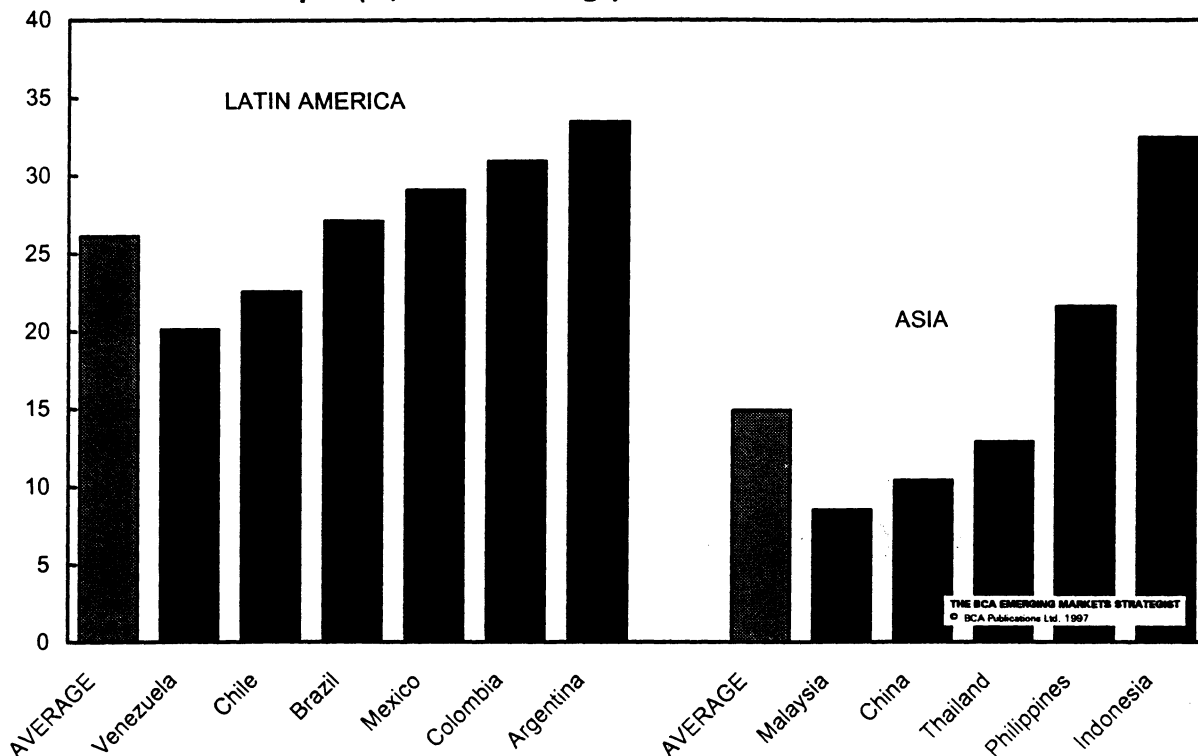
Source: World Bank

Chart 8  
Export Capacity to Import / GDP (% , 1991-95 average)



Source: World Bank

Chart 9  
Debt Services / Export (% , 1995-96 average)



Source: World Bank

Devaluation works to raise the debt-service burden in two ways. The immediate impact is to force the country to export more units for every dollar of debt services. The second effect is to raise the country's risk premium, and eventually the cost of servicing the debt.

As the data in the chart suggest, Latin America's opening position is inferior to Asia's. Its debt service costs account for 26% of its exports, compared with 15% in Asia.

#### (4) Export-driven growth?

Finally, as illustrated in Chart 10, Latin America's export sectors are generally smaller than Asia's – 16% of GDP in the former, compared with 27% in the latter. Allowing for debt services, far less remains to contribute to economic growth: in the case of Latin America, the ratio of the "remaining exports"-to-GDP ratio falls to 12%, roughly half of the corresponding figure of 23% in Asia.

The implication is that in order to add 1% to overall GDP growth, Asian exporters need to raise their sales volumes by 4%; in Latin America, they need to raise them by 8%.

#### Ranking

Based on these considerations, devaluation will be no panacea for Latin American growth:

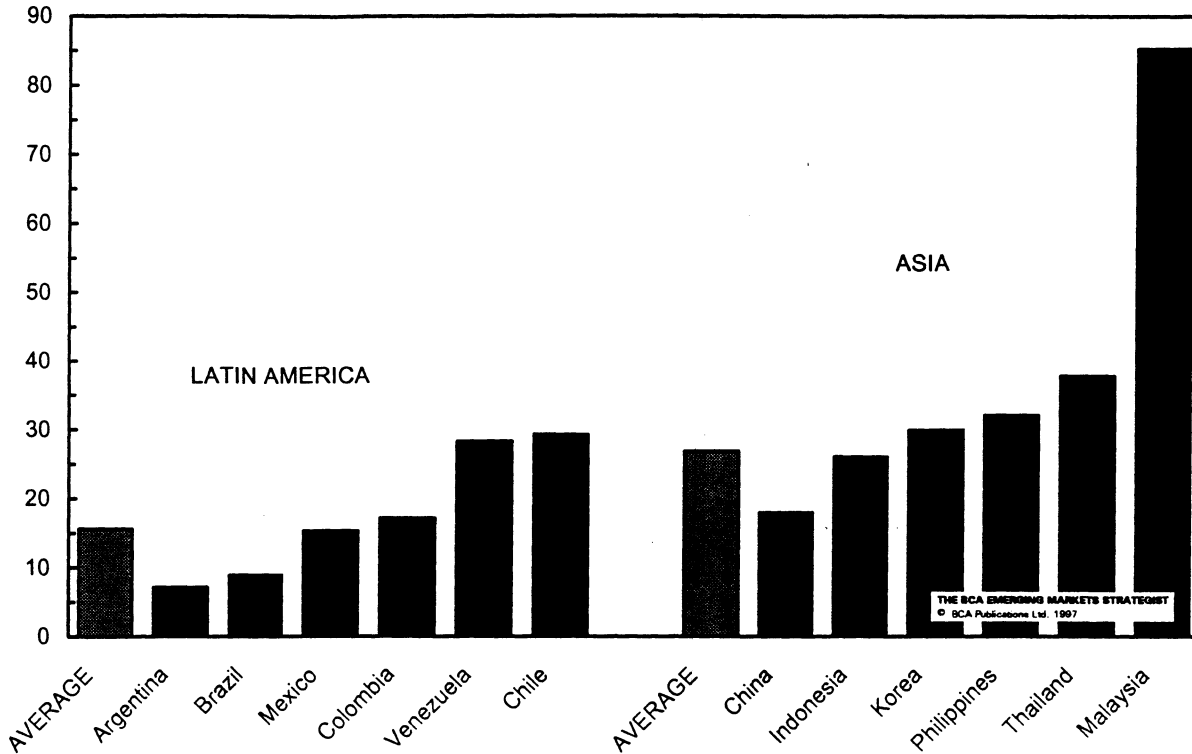
- Its exports will have to grow twice as fast as Asia's to make the same contribution to overall growth;
- its export ability to import is almost half as that of Asia;
- and its higher reliance on primary commodities will make it more difficult to win market share.

Although these considerations are difficult to aggregate quantitatively, it is possible to give a rough indication for the relative position of different countries in the two regions.

Chart 11 ranks these countries on the basis of the criteria discussed earlier. For each criterion, countries are ranked relative to the group's average (expressed in standardized deviations from that average). A country's overall position is a simple average of its ranking on the different criteria.

The results confirm the relative vulnerability of Latin America to a devaluation. The risk for growth appears greatest in Argentina, and is also large in Colombia, Venezuela and Brazil. For these

Chart 10  
Export / GDP (% , 1991-95 average)



Source: World Bank

countries, devaluation is unlikely to generate export-led growth. From the Asian countries, the most vulnerable is **Indonesia**, whose high dependency on Asian demand and large debt-service burden will cap its growth potential.

In contrast, **Chile** and particularly **Mexico** are relatively better positioned to weather the storm. In Chile, the main weakness is excessive dependency on price-inelastic raw material exports, but that is more than offset by relatively good readings on the other criteria. In Mexico, the main strength comes from a high manufacturing contents of exports, and reliance on strong demand from the US (which absorbs a full 84% of Mexican exports).

The countries where devaluation is most likely to bear positively on export-led growth are all Asian. In **Korea** the principal positive is the large manufacturing contents of exports, in **Thailand** it is the relatively small debt-service burden, and in **Malaysia** it is the high capacity to import, the low debt-service burden and the very high share of export in GDP.

#### The domestic cost of devaluation

In contrast to its direct impact on exports, which is generally beneficial for growth, devaluation also has a negative, albeit indirect effect on growth.

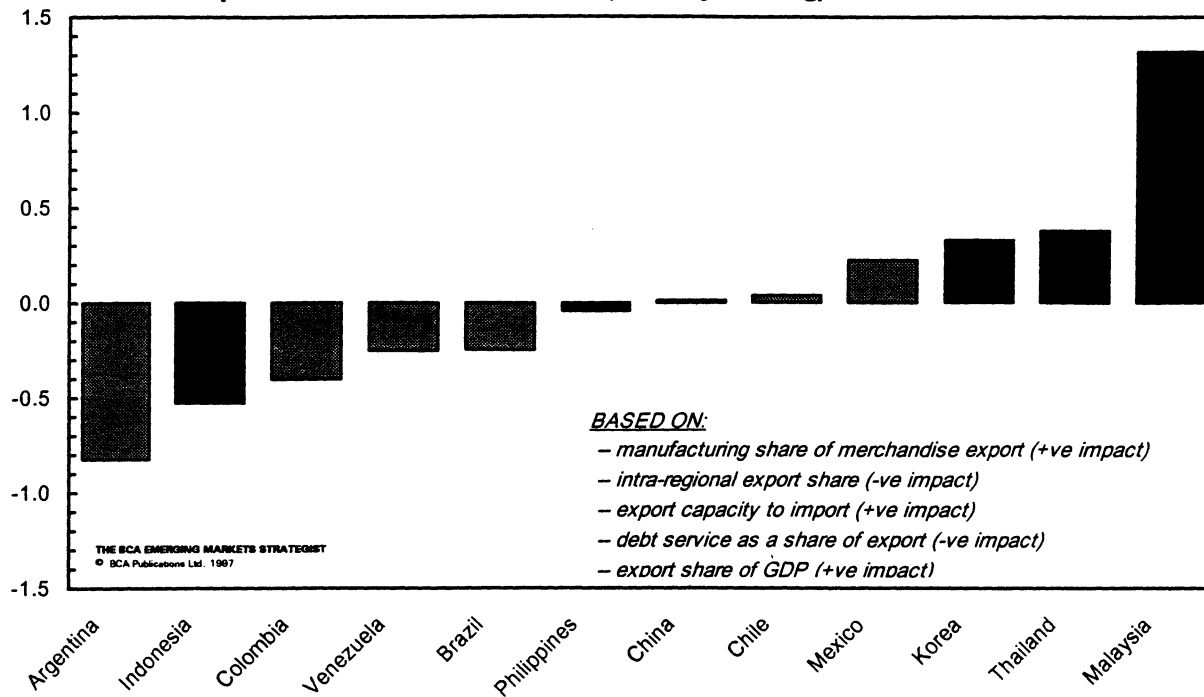
The main reason is the need to maintain tight monetary policy. First, investors demand a higher risk premium to hold the currency; second, rising import prices are feeding into domestic inflation and stoke inflationary expectations; and third, slower growth in the immediate period after the devaluation often lowers government revenues, thus loosening the fiscal stance.

The key question, then, is how vulnerable is the *domestic* sector of Latin America to higher interest rates? Although this is hard to quantify, several considerations suggest the risk here is larger than commonly believed.

Over the past few months, much has been made of the relatively strong domestic fundamentals in Latin America. The main argument is that, following the aftershock of the 1994 Mexican crisis, Latin America has shaken much of its financial excesses. Unlike Asia, it has not developed a property bubble, it does not face the overhang of years of excessive liquidity growth, and its banking sector is relatively well capitalized.

Chart 12 contrasts industrial growth in the two regions. It shows, that while devaluation caught Asia at the trough of its cycle, for Latin America the risk comes at a cycle peak. On the face of it, then, it

Chart 11  
**Potential Export Benefit from Devaluation (country ranking)**



Source: World Bank

seems that the latter is in a better shape to withstand the shock. This, however, is only part of the story.

The main problem for Latin America is inflation. As illustrated in Chart 13, inflation has been falling across the board in emerging markets. However, the backdrops in Asia and Latin America are rather different. In Asia, the situation is one of excess capacity, and *deflationary* or at least disinflationary pressures.<sup>3</sup> This is not the case in Latin America, where investment growth has only begun picking up after years of stagnation.

More importantly, however, is the fact that hyper-inflation is still a vivid memory in Latin America. Indeed, with the exception of Argentina, the region's economies continue to experience inflation levels far higher than Asia's, and although trade liberalization and foreign investment are potent anti-inflationary forces, the risk that inflation may reaccelerate cannot be dismissed.

The implication is that Latin America may need far higher real interest rates to offset the inflationary pressures of a devaluation. This was the case in Mexico after 1994. The devaluation pushed its

inflation rate to 55%, up from less than 10%, and it took a prolonged period of very high real interest rates to tame it down.

Real interest rates are already very high in Latin America, particularly in Brazil and Argentina. If they were to stay high for an extended period of time – either to prevent a devaluation or to stabilize the currency in its aftermath – the negative impact on domestic growth could end up being far larger than the export gains from devaluation.

Last but not least, authorities in Latin America must pay more attention to their electorates. Brazil and Venezuela enter an election year, Mexico's Congress is controlled by the opposition, and Argentina's ruling party has just suffered a mid-term election defeat from the center-left coalition. All of this makes for a strong anti-devaluation stance across the region.

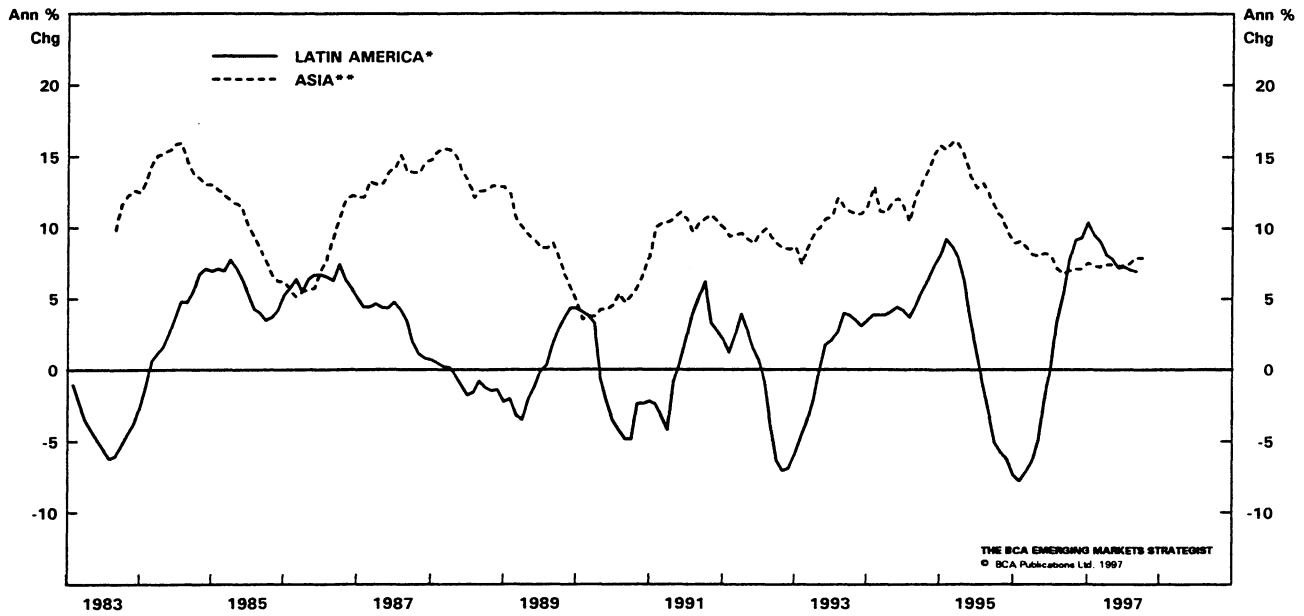
The situation is particularly delicate in Brazil. President Cardoso is credited for ending Brazil's hyper inflation. If inflation were to return, his reelection aspirations will likely be dashed. He therefore prefers having to cool his economy without inflation, than with it.

#### Investment conclusions

- The short-term risk of a Latin American devaluation is high. The region's loss of

<sup>3</sup> See 'The "Asian Miracle": How Close to Maturity?', *The BCA Emerging Markets Strategist*, November, 1997.

Chart 12  
Industrial Production

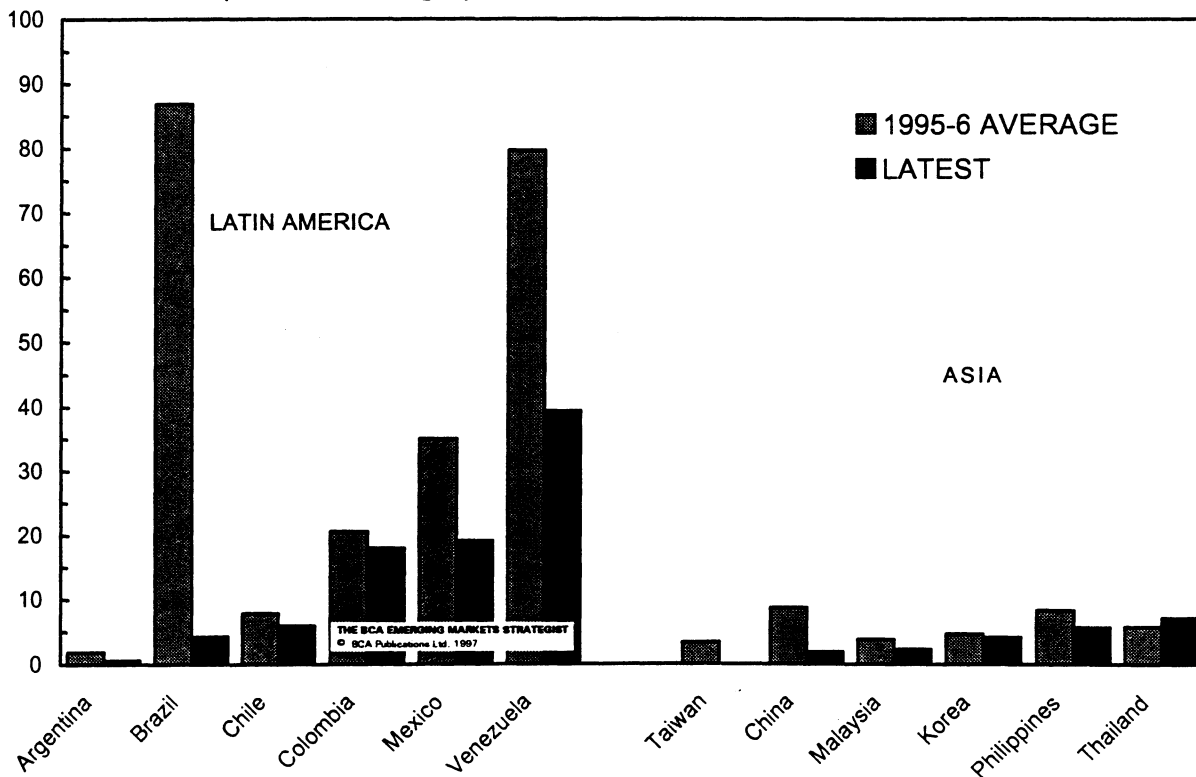


NOTE: Series are smoothed as 3-month moving averages

\* Argentina, Brazil, Mexico

\*\* China, HK, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand

Chart 13  
CPI Inflation (annual % changes)



Source: World Bank



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competitiveness has been amplified by the Asian currency crisis. If one of the Latin American countries devalues, contagion could spread rapidly to its neighbors.

- Following a devaluation, exports will likely contribute less to growth in Latin America than in Asia. In addition, higher inflation suggests Latin America will need to keep interest rates higher and for a longer period than in Asia. This has negative implications for both the economy and domestic liquidity.
- With stronger and more vocal opposition parties throughout the region, authorities have a strong stake in defending their currencies. This is particularly the case in Brazil, where devaluation will likely undermine President Cardoso's reelection campaign.
- In the aftermath of a regional devaluation, the most vulnerable economies will likely be those of Argentina and Colombia. The least vulnerable are Chile and Mexico.
- Given its outlook for robust profit growth in the months ahead, Mexico offers the best risk-return combination in the region for equity investors. However, with the threat of currency contagion being high, investors should hedge their peso holdings.



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