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Latin America: The winners and losers of “Trumponomics”

Political changes in the US have caused uncertainty over the trade policies that could be implemented and the region’s vulnerability to tighter financial conditions. Since Donald Trump’s victory, the currencies of many emerging countries have fallen against the dollar. Mexico’s currency was the most greatly affected in the world, with 19 % depreciation against the USD in 2016. This is the country’s worst depreciation since the Tequila crisis in 1994. By contrast, the US stock market reacted positively following Trump’s victory announcement.

On the trade side, the possible application of import tariffs would potentially affect manufactured products. The position of Central American countries (Honduras, El Salvador and Costa Rica), as well as Mexico, is particularly sensitive (given their trade exposure to the US, which is mainly focused on manufactured goods). In addition to having large exposure to the US, the GDPs of these countries are more dependent on exports than they are for other countries in the region. Based on the assumption that Trump’s administration is expected to initially focus on countries with which the US has a strong deficit, Mexico’s position appears to be the most vulnerable in the region.

Moreover, if Trump is able to implement an expansionary fiscal policy, the Federal Reserve would continue with its monetary tightening cycle, which would imply further appreciation of the USD. Among Argentina, Brazil, Chile, Colombia, Peru and Mexico, only the latter has increased interest rates in response to the interest movement. Though the risk related to the local credit market is undermined by Mexico´s low credit depth. A stronger USD could also concern economies with high indebtedness in foreign currencies. So far these economies have shown moderate volatility against the US dollar. The same is also true for the risk perceptions related to these economies.

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Trade relations: Mexico and Central American countries are the most exposed to US protectionism measures

Latin America, Mexico and Central American countries (El Salvador, Honduras and Costa Rica) are first in line in terms of trade exposure to the US, compared to their peers across the region. Mexico's trade exposure to the US (+80% of all exports) is by far the greatest in the region, followed by El Salvador (47.2%), Honduras and Costa Rica (42.5% on average). Exports from South America are less exposed to the US market, with the exceptions of Ecuador (nearly 40% of its total exports went to the US in 2016) and Colombia (28.3%). Exports from Peru, Chile and Brazil to the US represent, on average, 13.6%, while Argentina's exposure is less than 7%.

In addition to their heavy exposure to the US, Honduras, El Salvador and Mexico also appear to be more dependent on their exports than other countries are in the region. Exports from Honduras to the US represent 31.7% of country's GDP, followed by El Salvador (25.1%) and Mexico (24.4%).Exports from Ecuador, the fourth most dependent country on trade with the US in terms of GDP, represent only 10.4%. Despite its important trade exposure to the US, Costa Rica's exports to the US market only account for 6.6% of its GDP, while for Colombia they are 4.3% of GDP. Exports from Chile, Peru, Brazil and Argentina have a much lower share at, on average, 2.5% of their GDP. **In terms of the representation of exported manufactured goods in relation to GDP, El Salvador (22.3%), Mexico (21.1%) and Honduras (20.3%) would appear to be the most exposed if the US were to implement tariffs on imports (as these tariffs are likely to only concern manufactured products).**Exports from South American countries were mainly primary goods, which are less likely to be affected by the US protectionism policy *(chart1)*.

Based on the assumptions that Trump's administration is expected to initially focus on countries with which the US has a strong trade deficit, Mexico's position is particularly sensitive. The US's trade deficit with Mexico is not only larger than with other countries in the region, but also larger than with most of its other major trading partners around the world, including Canada. In 2016, Mexico's trade surplus with the US was only exceeded by China, Japan and Germany. Last year, Mexican trade represented 9% of the US's total trade deficit in goods (nearly 0.35% of US GDP). This is relatively weak when compared to the US shortfall with China (which is 5.2 times larger), but still bigger than with any other country in Latin America.

The US administration therefore intends to renegotiate NAFTA (the North American Free trade Agreement), which is a treaty which has existed between the United States, Mexico and Canada for 22 years. Nevertheless, the Trump team seems to be focusing on Mexico, given the steady deterioration of bilateral deficits, particularly surrounding transport equipment (mainly vehicles), and, to a lesser extent, others types of domestic and commercial machinery. According to the Peterson institute for International Economics[1], if NAFTA was to come to an end, the peso would probably devalue by more than 25%. Mexican produced cars would therefore be likely to become more competitive in the United States, which would further add to the trade deficit – in contrast to what the US administration is trying to achieve.

Within the region, only two others countries analysed in this focus, Ecuador and Colombia, reported trade surpluses with the US in 2016 and therefore could eventually be targeted by the US administration. However, this possibility does not need to be a primary focus for the US administration, given the irregular and weak contribution of these countries to the US's total trade deficit.

Assuming that US trade policy will target imports by categories of products with which the country has the highest deficit, transport equipment and machinery would be at forefront and Mexico would therefore be the first affected in the region. Together, these two categories represent 73% of Japan's total exports to the USA, with 68% for Mexico, 62% for Germany, 48% for China and 31% for Canada. These four countries are those with which the US has the largest trade deficits. Within Latin America, Mexico seems to be by far the most exposed to an eventual retaliation from USA (as more than two-thirds of its total exports are made up of transport equipment and machinery), followed by Honduras (17%), Costa Rica (14%) and El Salvador (5%). However, the big difference between the latter three countries and Mexico is that the US does not have a trade balance deficit with them.
Conversely, Trumponomics could have a positive net effect on trade balances for Chile and Peru. If Trump

CHART 1
Total exports in the USA (% GDP)

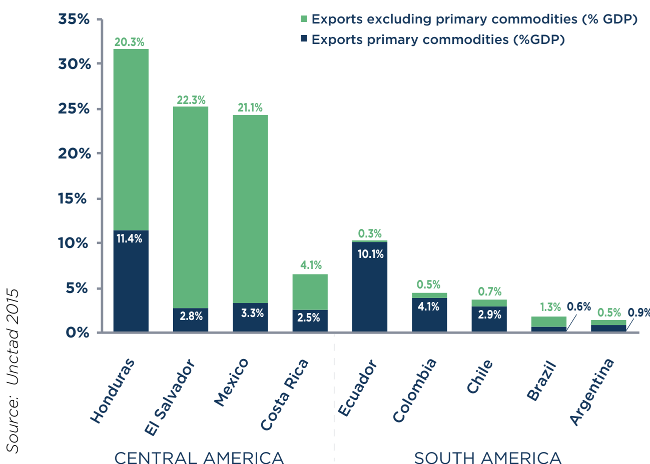
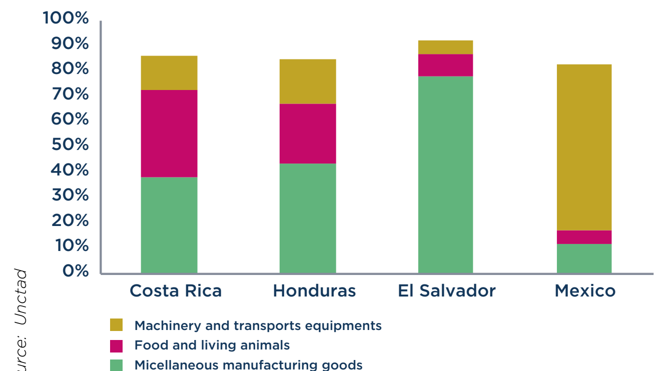


CHART 2
Main exports in the USA (2015)



1 - PIIE: Trump's NAFTA Approach Could Worsen US-Mexico Trade Deficit, March 2017.

succeeds in his projects to boost infrastructure, this could improve international copper prices. Ever since the first announcements from Trump's economic agenda were made, the price of copper has been rebounding. The IMF forecasts that the metal's average price in 2017 will be 5705,94 USD/MT - up 17.2% YoY. Chile and Peru are in a good position to benefit from this. They are, respectively, the first and third largest copper producers in the world and geographically closer to the USA than China, the second largest producer.

In addition to foreign trade, the uncertainties surrounding the NAFTA agreement could also delay investments (reducing the inflow of foreign direct investment). Another issue which has caused concern is Trump´s threat to tax the remittances of Mexican labourers in the US to their country of origin. So far these resources have not been impacted. They achieved a peak of 27.6 billion USD in the 12 months accumulated until May 2017 (or roughly 2.6 % of GDP), driven by the low unemployment rate observed in the US in recent months. This amount exceeds the revenues from oil exports, tourism and foreign direct investment into the country. With all factors considered, the idea of taxing remittances is unlikely to be put into practice. Taxing only resources on course to Mexico would not work. People would find alternative routes, such as asking a friend or sending from a third country. Finally, another concern is also looming for Latin American economies, as if the Federal Reserve intensifies its monetary tightening cycle, this would lead to an appreciation of the USD.

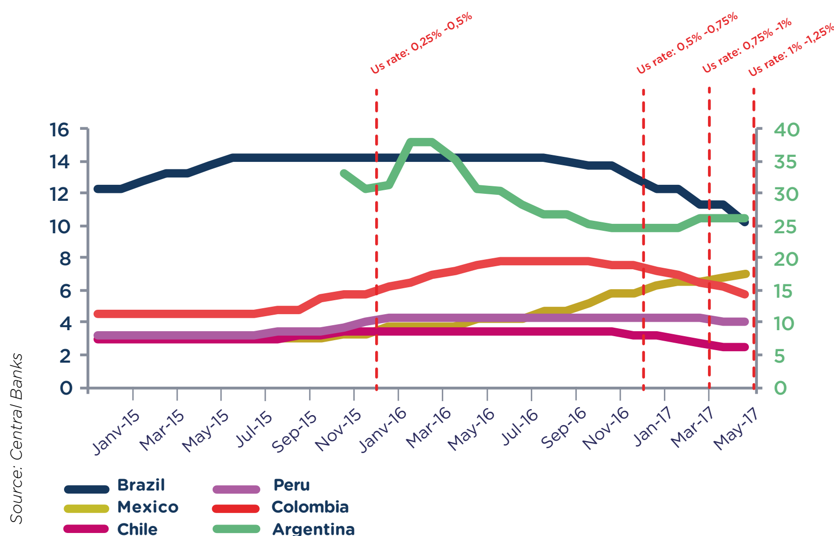
Trumponomics: impact on financial aspects

Tightening monetary cycle in the US and possible spillover effect

Alongside the threats directed at free trade and immigration, Trump also pledged during his campaign to pursue tax cuts and to boost investments in infrastructure. A scenario where Trump is able to accomplish these promises is unlikely to cause a climb in policy rates in Latin America (with the exception of Mexico). Inflation generally hiked in Latin America throughout 2016. These rises came within a backdrop of challenging weather conditions, which put pressure on food prices. Notwithstanding that tendency has dissipated in 2017. In response, the Central Banks of Colombia, Chile, Peru and especially Brazil have eased their benchmark interest rates (see chart 3). Further cuts could follow, due to a scenario of benign inflation and weak activity. This cycle is less clear, however, in Argentina, due to the slow convergence of inflation towards the target range of 12-17 % that was established for the current year. In Ecuador´s dollarised economy, inflation will remain low, due to weak domestic demand and the strong US dollar. Contrarily, as the chart below reveals, the Mexican Central Bank (Banxico) has clearly followed the FED´s movements. Prices have been trending up in Mexico, mainly driven by the end of subsidies on gasoline prices. The lagged effect of the strong currency depreciation reported in the previous year also contributed to this movement.

The risks related to hawkish monetary policy in Mexico are mitigated by the country´s low level of credit. According to an IMF study[2] on Mexico, bank credit in the country is about a quarter of the level of other emerging economies and just one-sixth of advanced economies. The organisation believes that

CHART 3
Monetary Policy in Latin America (annual rate %)



the explanation for this is related to the country's history of banking crises, the large informal sector and the inefficient legal system. According to Banxico figures, the total volume of commercial bank credit to companies and individuals with commercial activities reached 2.1 trillion Mexican Pesos in May 2017, which is roughly 118 billion USD, or 9.6 % of GDP. Domestic credit to businesses has been increasing at a strong pace in the country (+8,7% YoY in May 2017). Nevertheless, as the proportion of credit to GDP is still low, the anticipated hikes in the benchmark rate should not represent a strong threat to domestic financial stability.

Currency risks and the impact on debt denominated in foreign currencies

To evaluate the possible spillover effect of trumponomics on debt denominated in foreign currencies, the evolution of Latin American economies' CDS[3] and the recent behaviour of their exchange rates *(charts 4 and 5)* needs to be taken into account. Looking at the evolution in the last 5 years, it can be seen that risk perception improved since early 2017 in all of the analysed countries over the last year. These is true even for Mexico, which faced high volatility from the moment Trump´s candidacy began to gain strength during electoral race, until his first days in office in January 2017. It seems that the CDS began to retreat when the new US president's rhetoric calmed down and it became clearer that he could not count on having the necessary autonomy to implement arbitrary measures alone - especially in the short term.

Taking into account the nominal exchange rate, none of the Latin American countries reported a strong depreciation when Trump won the presidential elections. Once again, the strongest volatility was seen with the Mexican Peso. In 2016, the currency depreciated by 19 % against USD, but since mid-January 2017 it has started to rebound. In fact, for the year to date, the MXN has been the best performing currency in Latin America (up by 12 % in the year to June 2017). This strong rise is not only related to lower risk perception, but also to Banxico´s 20 billion foreign exchange programme, which was unveiled at the end of February and the lagged effect of the tightening monetary cycle currently in place. In summary, so far, Trumponomics have not increased currency risks in Latin America. Despite the weak

2 - IMF- Financial Deepening in Mexico, January 2017
3 - CDS - Credit Default Swap is a financial swap agreement that the seller of the CDS will compensate the buyer (usually the creditor of the reference loan) in the event of a loan default (by the debtor) or other credit event.

CHART 4
Year CDS (Credit Default Swap)

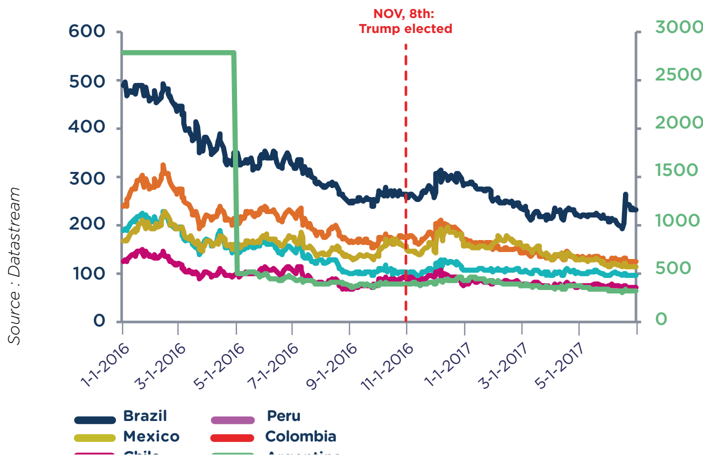
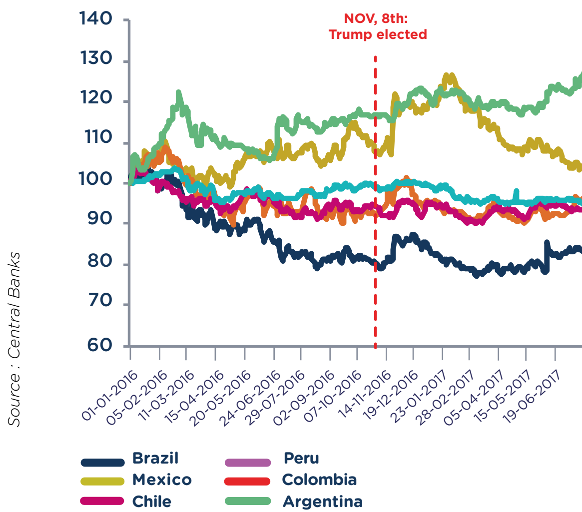


CHART 5
Nominal Exchange rate vs USD / Index number Jan 2016 = 100)

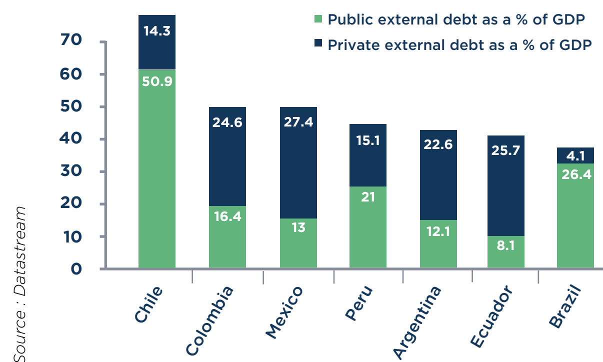


growth reported by the region, it is showing resilience, thanks to the important gains accumulated over recent decades – including generally lower public external debt *(chart 6)*, controlled inflation and higher levels of international reserves.

Breaking down the foreign private and public debts of the various countries, Chile is by far the economy with the highest ratio to GDP. External debt, which in total represents roughly 65.2 % of Chile's GDP, is concentrated in the private sector (at 50.9 % of GDP). In terms of ratio, the second highest country in the region is Colombia, which holds a debt representing 41 % of GDP – although, contrarily to Chile, the major part of this debt (24.6%) is public. Fitch, the ratings agency, recently warned that reducing external debt will be the main challenge for Colombia's economy. Next in the ranking of foreign debt is Mexico (with 40.4 % of GDP), followed by Argentina (with 34.7 %), Ecuador (33.8 %) and Brazil (30.5 %).

The level of external debt alone is, however, insufficient to assess an economy's exposure to risk. Another important factor to be analysed concerns the amount of interest paid by governments and companies to financiers from international markets. These rates of interest are strongly dependent on the risks associated with each economy. The higher the risk, the higher the interest rates required by lenders. As can be seen in *chart 4*, Chile's economy holds the lowest 5-year CDS in the region. This means that, despite holding a relatively high external debt, the country pays the lowest interest in the region. Mexico and Colombia benefit from similar levels of external debt and risk perception. Moreover, it should be noted that there are some countries that count with a high dollarization of the credit market. This is, for example, the case with Peru. In first quarter 2017, its domestic market dollarization coefficient reached 28.5 %. Nevertheless, this ratio has been considerably declining, on an annual basis, since 2007 (when it represented 55.7 %).

CHART 6



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