

Sovereign Risk Rating - Strapped In For A Turbulent 2009

Latin America - Economic Activity - 13 Nov 2008

LATIN AMERICA SOVEREIGN RATINGS - EVOLUTION OF ABILITY TO PAY

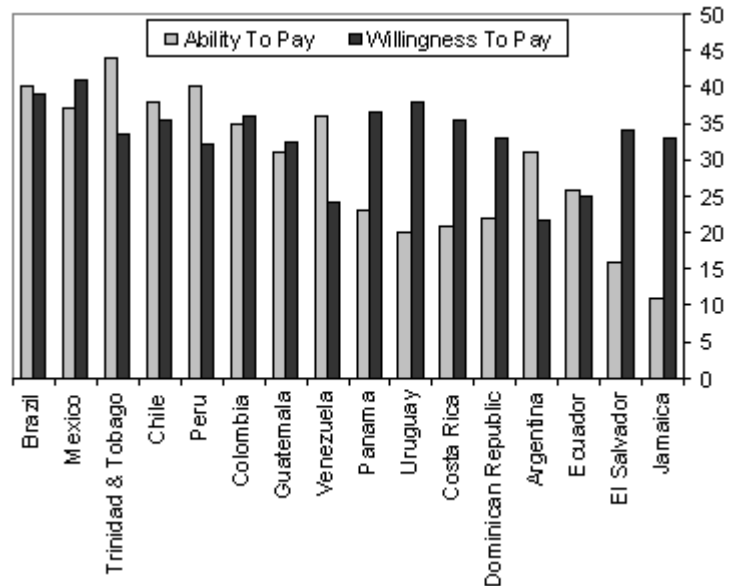
Country	Total	Sovereign Rating	Market Outlook			Ability To Pay	
	2009	2009	2009	2006	2007	2008	2009
Brazil	79	B+	3	38	43	41	40
Mexico	78	B+	3	40	40	36	37
Trinidad & Tobago	78	B+	3	46	43	43	44
Chile	74	B	3	47	43	41	38
Peru	72	B-	3	34	38	44	40
Colombia	68	C+	3	33	37	35	35
Guatemala	64	C	3	29	31	29	31
Venezuela	60	C-	4	35	37	40	36
Panama	60	C-	2	18	22	21	23
Uruguay	58	D+	3	22	19	24	20
Costa Rica	57	D+	4	21	21	18	21
Dominican Republic	55	D	3	26	28	23	22
Argentina	53	D	5	34	37	29	31
Ecuador	51	D-	5	31	27	28	26
El Salvador	50	D-	3	15	15	16	16
Jamaica	44	E	3	11	6	10	11

Sovereign ratings in ranges from A to E, with + indicating that a credit is in the top of its range (eg B+ is 77, 78, 79), and - indicating it is near the bottom (e.g. B- is 70, 71, 72). Market outlook is on a scale of 1 to 5, from very bullish to very bearish, with 3 being neutral. Ability to Pay is a mark out of 55. Total is out of 100. Source: BMI,

No 'A' Grade This Time Around

Latin America - Ability And Willingness To Pay In 2009

The sovereign credit profile in Latin America has deteriorated markedly since the last edition of our proprietary risk ratings, to the point where the region's creditworthiness is now facing its greatest stress test since Argentina's spectacular default in 2001-02. Growing external imbalances have not come as a major surprise to us: indeed, we highlighted back in March 2008 that the triple threat of a US recessionary scenario, commodity price deflation and tighter capital markets would spell danger for emerging market assets, not least sovereign debt. Nonetheless, **the sheer scale of global deleveraging and risk aversion in H208 has seen global investors rush for the exit doors, pushing up Latin American debt servicing costs, exposing structural economic shortcomings and raising default concerns in the process.**



Source: BMI

BMI's weighted 5-Year LatAm credit default swap (CDS) - which provides a useful gauge of global market sentiment towards the region's credit markets - has almost trebled to 1,182 basis points (bps) in the past three months. To put this into context, the index measured an average spread of just 143bps in 2007.

Unsurprisingly, then, the bearish tone set by global economic and financial factors has undermined the quality of creditworthiness in the most recent update of our **sovereign risk ratings**. Indeed, **for the first time since our ratings were launched, no Latin sovereign has managed to keep hold of an 'A' grade rating.** An inferior macroeconomic climate has seen the mean score for 'ability to pay' fall by two points to 29 (out of a possible 55). Further complicating matters is the general rise in political risk in the region - due in part to slowing economic activity and still-elevated inflation levels - which has resulted in downgrades in the 'willingness to pay' category of the ratings

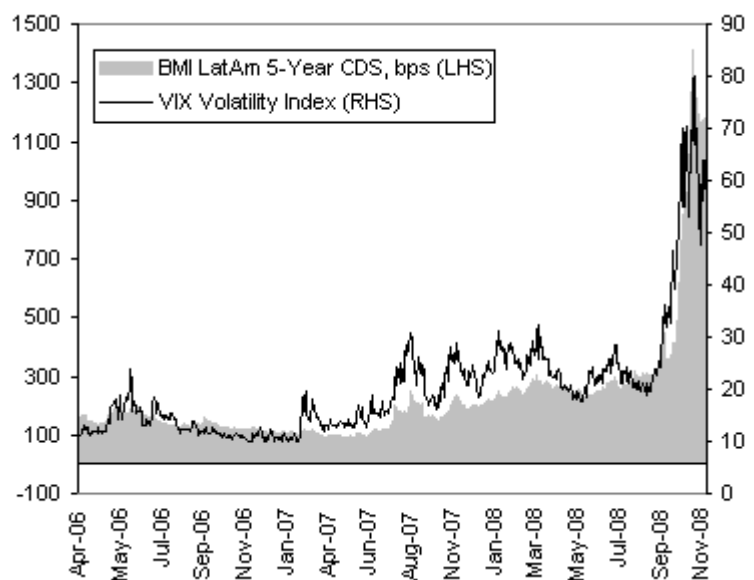
In this article, we have divided the prevailing risks into three distinct categories, in order to identify the major sovereign credit 'hotspots' in Latin America. The threats are neither exhaustive nor mutually exclusive, but instead try to examine the validity of default risk concerns that have spiked in recent months. Our damage assessment starts with the sovereign impact of a prolonged US economic recession, before moving onto the consequences of commodity price deflation, and finishing with the possible contagionary effects of a credit shock in the region.

Threat 1: Born In The USA

No region is more exposed to the US growth story than Latin America. For all the rise in EM demand (especially for commodities) in recent years, and efforts by regional governments to diversify commercial links, **almost half of Latin**

A Painful Repricing Of Risk

BMI LatAm 5-Year CDS & VIX Volatility Index



Source: BMI

exports are still destined for American shores. With this in mind, the impact of a US consumer retrenchment should not be underestimated. We estimate that roughly one third of US household wealth has been wiped out over the past two years, when the housing market, pension funds and equities are taken into consideration. Simply put, Latin export growth looks set to stumble.

In our view, those most at risk are **Mexico (B+3)**, **Colombia (C+3)**, and pretty much all of Central America and the Caribbean. The interconnectedness of the Mexican and US business cycle is becoming increasingly apparent. Roughly 80% of Mexico's exports head to the US and we expect Mexico's economic growth and current account deficit to take a serious hit in 2009 (with the outside chance of a full-blown recession). Nevertheless, as far as credit risk is concerned, **Mexico remains a 'low-threat' sovereign, as reflected by the country's high standing in our ratings league table.** Mexico retains its investment grade credentials thanks to high levels of reserves and low levels of external debt. If further testament were required, a US\$30bn foreign exchange swap line granted by the US Fed should put any lingering doubts over creditworthiness to bed. It's a similar story in Colombia, although a weaker external sector and heavy reliance on the Venezuelan economy, along with the indefinite stalling of a trade deal with the US, pose additional risks. Twin deficits (fiscal and current account) will expose the country's overarching reliance on uncertain external financing channels, primarily US-borne foreign direct investment (FDI) inflows. However, again the recent drive to re-profile external liabilities into pesos should now start to prove its worth. All in all, we believe that credit risk is again well contained, although **the Colombian government's investment-grade aspirations may have to take a back burner, probably until 2010.**

From a historical perspective, Central America and the Caribbean has tended to be penalised excessively in our ratings, due to the region's relatively high levels of debt and external account shortfalls relative to GDP. Nevertheless, we would argue that such criteria have become all the more important in the current global economic climate. Take **Costa Rica (D+4)**, for example, where confidence in the local currency, the colón, has taken a beating in recent months, forcing the authorities to plough through their reserves to defend its crawling band exchange rate regime. **Should investors continue to offload their local currency positions, an outright balance of payments crisis in Costa Rica is not out of the question.** Would a default scenario potentially follow? Unlikely, in our view. In nominal terms, external debt loads are small enough that help would likely arrive via an IMF rescue package. Moreover, given that Central America's external debt is predominantly in the form of multilateral loans, the region's creditors are likely to take a more conciliatory stance towards repayment.

Threat 2: Raw Dealers Exposed

Commodity price deflation is another high-profile risk for Latin America's major exporters of raw materials. As the accompanying chart shows, the commodities boom witnessed since 2002 has played a massive role in boosting current account surpluses across the region, and with prices now in freefall, we are fully expecting deficits to emerge in 2008 and 2009. Diminishing commodity export earnings will, in turn, impinge upon the ability of governments to pay off sovereign debt obligations over the medium term.

We start by taking a look at the oil credits of **Venezuela (C-4)** and **Ecuador (D-5)**. With regards to the former, we believe that **credit risk in Venezuela is more of a medium-term story, and that the probability of a near-term default is low.** International reserves (the bulk of which are in cash and are therefore easily accessible) are roughly 1.5 times the size of external debt, underlining the government's relatively robust liquidity position. Moreover, the government's 2009 repayment schedule is light, with interest and amortizations due payments equivalent to just US\$2.8bn (or 1% of GDP). Nevertheless, we remain decidedly bearish on the country's medium-term creditworthiness given our belief that the economic imbalances in Venezuela are the largest in the region and, if anything, its reliance on petro-dollars is increasing. If crude prices continue to fall towards US\$35 per barrel as we expect, the ability of the government to repay its debts will rapidly deteriorate given that the government's savings are used to boost economic growth. Moreover, as economic growth comes unstuck, there is a chance that sovereign repayment obligations may slip down the government's priority list, as President Chávez comes under political pressure to spend.

In the case of Ecuador, the threat of a credit event is much more pressing, in our view. With the economy facing declining terms of trade and reduced export competitiveness (thanks to a dollarised currency), our

bleak medium-term outlook for Ecuador's economy means we are becoming increasingly concerned about the government's ability to pay its obligations. With international reserves at just US\$5.6bn (equating to 3.7 months of import cover), we believe the government will be hard pushed to pay back their US\$1.63bn interest and amortization costs on public sector debt due in 2009. Another threat to the government's fiscal position is President Rafael Correa's public spending promises, which are likely to continue until the general elections in early 2009. Our concern is that if re-elected, Correa would be under pressure to meet these promises, particularly given the introduction of tax exemptions and the continued exodus of Ecuador-based foreign multinationals. Under such a scenario, Correa may be tempted to take a more belligerent stance towards external debt commitments.

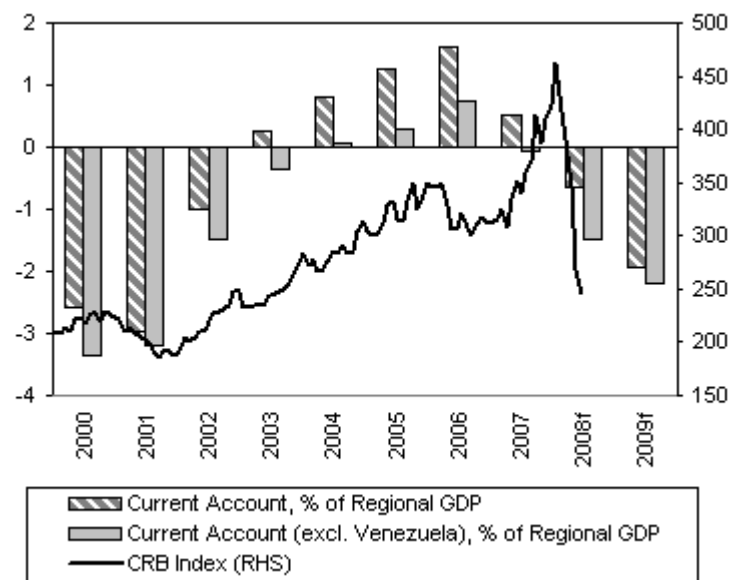
The mining heavyweights of **Brazil (B+3)**, **Chile (B3)** and **Peru (B-)** are 'low-risk' threats, in our view. This is largely thanks to the prudent monetary, fiscal and debt policies implemented in recent years, which now allows for a slackening of fiscal belts in order to prop up growth. Nevertheless, **Chile's slide down our ratings table from top performer to fourth place (losing its A-grade status along the way) should serve to highlight that no sovereign credit in Latin America has been immune from the current crisis.** The country's dependence on copper export receipts will keep the local economy vulnerable to ongoing demand destruction and slowing economic activity across the world. Moreover, rising unemployment levels, slower wage growth and a consequent drop in consumer spending are on the cards. As such, while a default scenario is nowhere on the radar, we do expect a severe deceleration in economic growth in 2009 to 1.8%, which would mark the slowest rate of expansion in a decade.

That leaves us with **Argentina (D5)**, which we fear is again wrestling with the spectre of default. **The uncertain outlook on Argentine debt is underscored by the colossal spike in the country's 5-year CDS to 4,000bps - the highest of any EM sovereign credit.** Indeed, we believe that the cavalier expropriation of private pension funds to ease the government's financing needs has only delayed, rather than extinguished, default concerns. Firstly, the pension fund windfall will have to be paid at some point, raising the government's liabilities down the road. Secondly, the move has dispelled any lingering hopes that the Fernández administration would adopt a more market friendly policy mix. Finally, the taking over of pension fund assets has undermined confidence in the banking system amongst local residents and business leaders, raising the risk of a run on the peso.

We refuse, therefore, to rule out the possibility of a credit event in Argentina by 2010. Declining export revenues, due to falling soft commodity prices, and the erosion of export competitiveness through domestic inflation, will put tremendous pressure on the heavily managed exchange rate. With raw materials prices plummeting, the likelihood that the government will weaken the exchange rate to boost the fiscal coffers is growing by the day. We see a marked deterioration on the fiscal front in 2009, as the government's pro-cyclical economic policies of the past are set to make the impending down leg of the business cycle particularly difficult. We also expect higher debt financing costs to weigh on the government's ability to gain access to credit, as investor risk aversion remains elevated over the medium term.

Boom Time Over

Latin America - Regional Current Account & CRB Index



Threat 3: The Domino Effect

In addition to these challenges, our final threat focuses on the possible systematic impact of a sovereign default in the region (as mentioned above, the most likely candidates for which are Ecuador and Argentina). While this is largely a theoretical exercise, we would cite the deleterious impact of Argentina's debt restructuring in 2001-02 as evidence of the risk of contagion. While we believe that the direct effects of a default in Ecuador or Argentina would be limited, given the extent of decoupling seen within the region over recent years, a shock credit event could certainly weigh on the risk perception of Latin America as a whole, potentially pushing up sovereign bond spreads across the board.

First in the firing line would be **Uruguay (D+3)**, which plunged into recession after the Argentine crisis earlier this decade (real GDP growth contracting by a staggering 11% in 2002). A similar shock could prove fatal to Uruguay, despite the government's commendable management of the local economy in recent years. Worryingly, **Uruguay's outstanding external debt pile, which we forecast to stand at US\$12.8bn (46.6% of GDP) in 2008, is the highest as a proportion of GDP in South America..** As such, we doubt whether Uruguay would be able to escape unscathed should larger economies fall elsewhere in the region.

Source: BMI, Regional Central Banks

LATIN AMERICA SOVEREIGN RATINGS - EVOLUTION OF WILLINGNESS TO PAY

Country	Total	Sovereign Rating	Market Outlook			Willingness To Pay	
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Colombia	68	C+	3	36	38	36	36
Guatemala	64	C	3	34	33	33	33
Venezuela	60	C-	4	24	23	24	24
Panama	60	C-	2	39	39	37	37
Uruguay	58	D+	3	38	38	37	38
Costa Rica	57	D+	4	35	38	35	36
Dominican Republic	55	D	3	35	36	34	33
Argentina	53	D	5	28	27	23	22
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Economic Analysis - On The Verge Of Default

Ecuador - Debt Policy - 17 Nov 2008

BMI View: With Ecuador's government mulling over whether to pay the latest coupon on its external debt, we are bracing ourselves for potentially the first sovereign default since Argentina in 2001-02. Using economic rationale, it is difficult to call such an event given the country's still-decent 'ability to pay' credentials. However, political factors should not be taken lightly, and we refuse to rule out a sovereign bond restructuring over the coming weeks.

President Correa's decision to exercise the 30-day grace period before deciding whether to pay the US\$30.6mn coupon due on Ecuador's **US\$ Global 2012** bond has left the country teetering on the verge of default. The president claims that a final verdict has yet to be made, but in light of the government's belligerent stance this time around (despite similar political noise in early 2007, the authorities eventually honoured their coupon payment on time) we urge global investors to be prepared for the worst. The ratings agencies appear to share our anxiety: immediately after Finance Minister Elsa Viteri's press conference on November 14, both **Standard & Poor's** and **Moody's** slashed their credit ratings on the sovereign to CCC- (from B-) and Caa1 (from B3), respectively. These downgrades echoed the long-held bearish assessment expressed in our own **Sovereign Risk Ratings**, with Ecuador (at **D-5**) stuck firmly at the foot of our South American league table.

BMI SOVEREIGN RISK RATINGS VS. MAJOR RATINGS AGENCIES

	BMI	Moody's	S&P	Fitch
Brazil	B+	Ba1	BBB-	BBB-
Mexico	B+	Baa1	BBB+	BBB+
Chile	B	A2	A+	A
Peru	B-	Ba1	BBB-	BBB-
Colombia	C+	Ba1	BBB-	BB+
Venezuela	C-	B2	BB-	BB-
Argentina	D	B3	B-	B
Ecuador	D-	Caa1	CCC-	CCC+

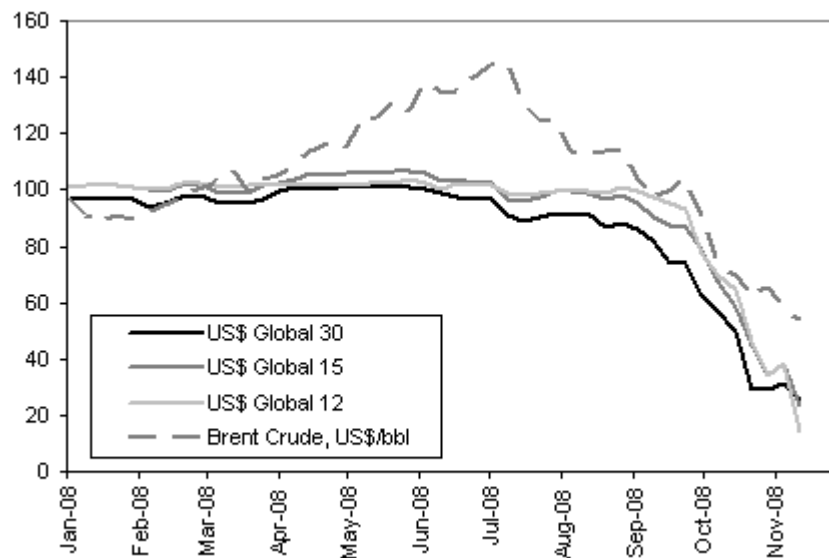
Source: BMI

The US\$30.6 Million Dollar Question

The next key development will be the conclusion of the Auditing Commission, assigned by the government to decide upon the legitimacy of Ecuador's US\$ Global 2012 and **US\$ Global 2030** sovereign bonds. During a radio broadcast on November 15, Correa stressed that a final verdict would be announced before December 15 (at which point the grace period expires), stating that '...if there is enough basis to say that we cannot pay this debt because it is illegitimate, we will do so... That the bonds fall and the country risk rises isn't of the least bit of interest to us'. It appears, then, that all bets are off until the commission reaches a decision. At this point, however, we would not rule out any possible event playing out, and below assess the factors which are likely to determine whether the country defaults or not.

A Rapid Deterioration

Ecuador - Benchmark Sovereign Bonds & Oil Prices



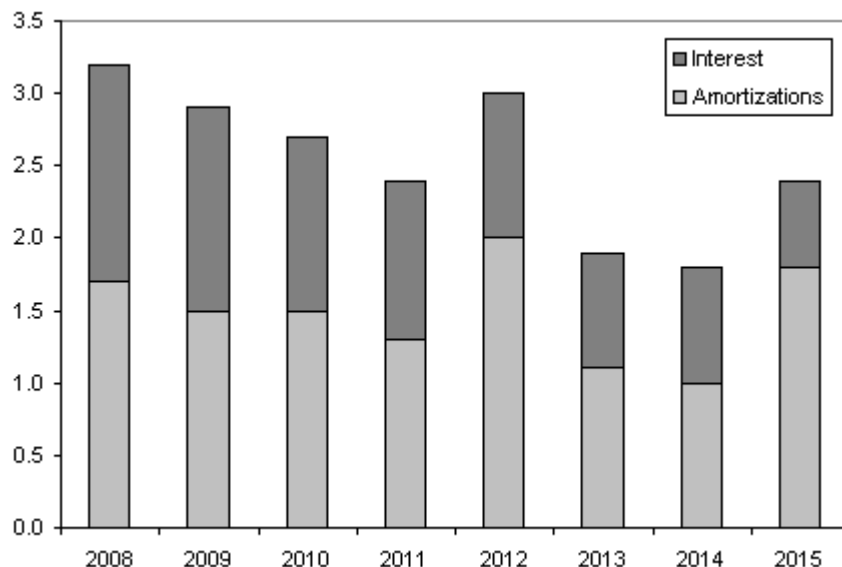
Source: BMI

Scenario 1: Ecuador Repays - The President Who Cried Wolf

Going on previous track record - and the seriously damaging implications of a sovereign default on macroeconomic stability - President Correa may yet back down. **It is important to remember that the rapid deterioration in Ecuador's credit profile has not been 'ability to pay' driven (at least not near-term).** Indeed, given the country's anticipated US\$2.4bn (5.0% of GDP) fiscal surplus and US\$5.6bn foreign reserve cushion, we do not believe that the authorities would have any immediate problems servicing their external debt costs in 2008 or 2009. Ecuador faces external debt servicing costs of US\$390mn over the next three years, before a scheduled US\$980mn repayment as the US\$ Global 2012 reaches maturity. As a proportion of GDP, this would mean that public external debt servicing is unlikely to creep significantly above 3.0-3.2% of GDP over the next four years - well within the government's financing constraints (even taking into account a subdued oil price over the coming years).

Not An Ability To Pay Issue Yet

Ecuador - External Debt Servicing Schedule, % Of GDP



Source: BMI

On the willingness to pay front, should Correa fail to respect his government's debt obligations, this would not only slam the door on the country's developed world creditors (where investors are hardly rushing to lend in any case) but also on the country's key political ally. The Venezuelan government has around US\$800mn in structured notes (including Ecuadorian bonds) on its books, and any potential losses would potentially stoke tensions between Caracas and Quito and block a potentially vital avenue of funding (and political support) for the Correa administration should oil prices continue to plummet.

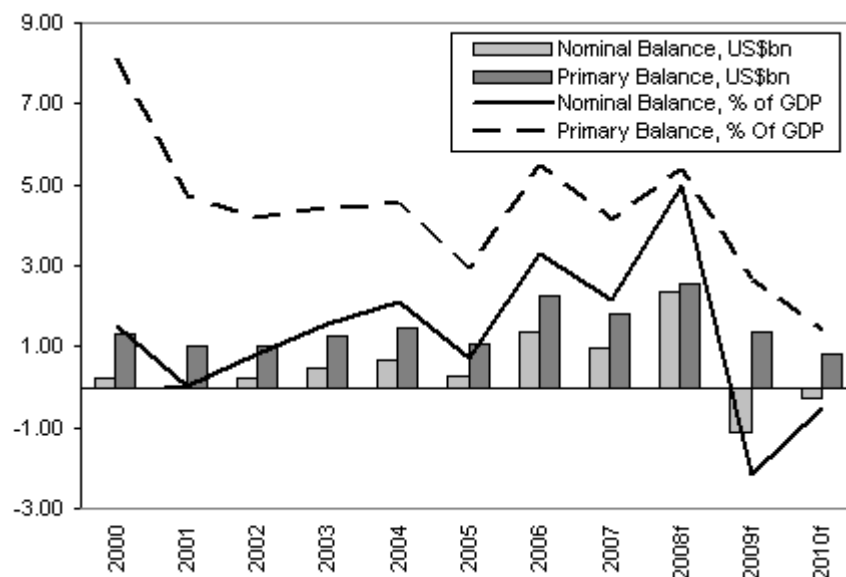
Even if the government decides to pay the upcoming coupon payment, we would argue that the damage has already been done for the Correa administration, and that the authorities would find it extremely difficult to stave off a default in the years ahead. Having threatened to take evasive action on a number of occasions now, the risk premium on Ecuadorian paper is set to remain elevated for the foreseeable future. As such, when the country's fiscal accounts and balance of payment position start to degenerate over our five-year forecast horizon in line with worsening terms of trade and reduced export competitiveness, the government is likely to find it harder to roll over their external liabilities.

Scenario 2: An Ugly Restructuring Process

With 'ability to pay' concerns likely to rise over the medium term as mentioned above, **President Correa may be using the 'legitimacy' issue as an excuse to restructure the country's external liabilities before things get really bad.** Indeed, while the negative ramifications of a preventable credit event are undeniable (for one thing, it would be almost impossible for the private and public sector to gain access to external financing), it is unclear to us at this stage whether Correa is looking beyond his own near-term political position. Firstly, the country has hardly been a major recipient of foreign inflows in recent years, and falling crude prices makes the country's investment appeal even worse now in any case. Secondly, our earlier contention was that an immediate sovereign default would not necessarily be politically opportune and that 'refusal to pay could be used nearer the time (of April's presidential elections) as a populist move to garner electoral support' (see *'Moment Of Truth For External Debt', November 14*). Nevertheless, plummeting oil prices may have convinced Correa to take more a more aggressive stance in order to secure sufficient fiscal resources to guarantee re-election come next year. Under our baseline scenario, we expect to see Ecuador's nominal fiscal balance to slip into the red next year to a deficit of 2.1% of GDP (from a projected 5.0% surplus in 2008).

Tough Times Ahead

Ecuador - Fiscal Accounts



Source: BMI, Central Bank

With current default risk in Ecuador a 'willingness to pay' issue, any move on the government's part to restructure its outstanding external obligations would be a painful process, in our view. We would expect to see poor recovery rates for the US\$ Global 12 and US\$ Global 30 bonds (both of which are under investigation by the commission) - as reflected by prices well below 30.00 on both instruments (*see charts*). However, the **US\$ Global 2015** would continue to suffer given the government's estrangement from bilateral and multilateral financing channels, and our belief that the fundamental macroeconomic outlook for Ecuador is set to worsen over the coming years. A credit event in Ecuador could also have an impact on risk perceptions across Latin America, potentially pushing up sovereign bond spreads across the board.