JONES DAY®

MAY 2016

COMMENTARY

Credit Default Risk in Latin America: A Regional Outlook

IN BRIEF

In our January 2016 *Commentary*, "Are You Ready for the Emerging Market Credit Bust?," we noted that with emerging market debt levels soaring to unprecedented heights and the inevitable cross-border repercussions of defaults, creditors were going to need a well-planned, multijurisdictional strategy to avoid being outflanked by debtors and better prepared investors. This *Commentary* takes a broad look at the financial challenges facing the Latin American region generally and some of its important markets, and suggests creditors take stock of their current exposure and proactively prepare appropriate plans to protect themselves in the current climate.

A REGIONAL OUTLOOK

For Latin America and the Caribbean, growth in 2016 is now expected to be negative for the second consecutive year—the first time since the debt crisis of 1982–83, which triggered the "lost decade" for the region. This decline to date has been principally explained by a combination of external factors applying to the region generally, such as changes in Chinese economic activity, a strong U.S. dollar, and a sharp decline in commodity prices, and internal factors applying to the various countries within the region specifically, such as political instability, macroeconomic fragilities, and corruption scandals. However, the regional recession masks the fact that most countries continue to grow at a modest rate, with country specifics being determined by the interplay between external shocks and domestic fundamentals.[1] Indeed, the negative growth projections for the region are driven by Argentina, Brazil, Ecuador, and Venezuela (see table).[2] Of these countries, in 2015 foreign direct investment was significant only in Brazil.

Real GDP Growth in Latin America and the Caribbean

	2015	2016
	(in percent)	
Latin America and the Caribbean	-0.1	-0.5
Central America	4.1	4.3
Caribbean	4.0	3.5
Latin America		
Argentina	1.2	-1.0
Brazil	-3.8	-3.8
Chile	2.1	1.5
Colombia	3.1	2.5
Mexico	2.5	2.4
Peru	3.3	3.7
Venezuela	-5.7	-8.0
Ecudor	0.0	-4.5

Data source: International Monetary Fund, "World Economic Outlook: Too Slow for Too Long," April 2016.

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South America

Chile, **Colombia, and Peru.** Chile, Colombia, and Peru have strong fiscal, monetary, and financial policies that have so far effectively staved off contraction. The foundations for growth remain in place, including credible institutions and favorable foreign borrowing costs. Governments in these countries to varying extents are continuing to work to take advantage of these circumstances with ambitious infrastructure development plans that continue to attract the financial support of international investors. The International Monetary Fund ("IMF") expects Peru, Chile, and Colombia to grow in 2016 at a rate of 3.7 percent, 1.5 percent, and 2.5 percent, respectively. In these countries, although there is an uptake in default and insolvency cases, there are no signs of a widespread credit crisis.[3]

Brazil. In Brazil, macroeconomic fragilities (weak domestic economy, weak fiscal position, high inflation, and high interest rates) combined with political instability, the slump in commodity prices, and the bribery scandal roiling Petroleo Brasileiro S.A., known as Petrobras, have dominated the economic outlook. According to the IMF, Brazil's output is expected to fall 3.8 percent in 2016, after a 3.8 percent contraction in 2015. Unemployment has risen sharply, and inflation is in the double digits.[4] Last year, a record 1,287 Brazilian companies—most of them oil equipment, construction, and manufacturing firms—requested court protection from creditors, about 55 percent more than in 2014. The Brazilian Corporate Recovery Institute estimates that half of such companies may go bankrupt during their turnaround attempts.[5] While this conclusion demonstrates that the Brazilian bankruptcy law needs to continue to improve in order to provide additional mechanisms for struggling businesses to survive, it also shows that many companies, including large corporate enterprises, have been able to utilize *recuperação judicial* to successfully restructure. Inspired by the U.S. bankruptcy code's Chapter 11 procedure, the new Brazilian law was designed to revive ailing companies and prevent them from slipping further. As a result of this potential for value preservation, we are seeing a dramatic increase in debt restructurings aimed at providing companies with a manageable path to recovery.

Venezuela. In Venezuela, the collapse in oil prices has intensified a full-fledged economic and political crisis. With widespread shortages of consumer goods and prices spiraling down, the IMF expects that Venezuela will experience a fall in output of 8 percent in 2016 with inflation rate rising to 720 percent from a world-high inflation rate of about 275 percent in 2015. In 2014, Venezuela issued a new foreign investment law that further reduced foreign investors' rights in the country, making conditions for foreign investment unlikely to improve in the near term.

Argentina. In Argentina, the new government of Mauricio Macri has taken significant steps toward eliminating restrictions on the foreign exchange market, removing several constraints on international trade and announcing the main guidelines of a macroeconomic framework, including negotiating a deal with the holders of $900 million of bonds on which Argentina defaulted in 2001. The new approach has improved prospects for growth in the medium term, although for 2016 the GDP is still expected to contract. After a 15-year absence, Argentina has returned to the international capital markets with a successful $16.5 billion bond offering, the largest emerging market bond sale on record.[6] Inflation is, however, in the double digits, and a significant increase in foreign investment is likely to ramp up slowly. From a legal standpoint, in the next few years we expect to see a strengthening of the country's institutions and, one hopes, an increase in corporate governance and legal compliance in the private sector.

Mexico, Central America, and the Caribbean

Mexico. Mexico is expected to continue to grow in 2016 at a moderate pace (2.4 percent), supported by healthy private domestic demand and spillovers from a strong U.S. economy.[7] The IMF anticipates that the depreciation of the peso (by 16 percent in real effective terms in 2015) and lower electricity prices will boost manufacturing production and exports and have a positive impact on domestic demand. In addition, the implementation of structural reforms continues broadly on track. In 2015, the telecommunications reform and the latest auction of oil fields were successful in attracting foreign investment, while

the financial reform helped strengthen consumer protection and led to increased competition in the banking sector.[8] The sharp decline in oil revenues was largely offset by a combination of higher-than-expected fuel excises and income taxes (related to the 2013 tax reform) and the oil-price hedge of oil export receipts. In spite of this situation, oil and construction companies started to show signs of distress in 2015, which are deepening in 2016. In February 2016, faced with the prospect of a continuing drop in oil revenue, the Public Finance Secretary of Mexico announced $8.3 billion in budget cuts, slashing the budget of Petroleos Mexicanos ("Pemex"), the state oil company. Pemex faces $90 billion in unfunded pension liabilities and $11 billion in debt obligations in 2016. It also accounts for approximately one third of Mexico's federal spending.[9] On April 13, the Mexican government granted Pemex a $4.2 billion aid package and a $2.9 billion tax cut.[10] The rescue package is conditional on Pemex cutting spending by $5.8 billion this year, approximately 19 percent of last year's total spending. Rating agencies are closely watching Pemex's success in the ongoing sales of non-key assets and the farming out of oil fields to joint ventures. Overall, however, the fundamentals of the Mexican economy remain relatively sound, and it is expected that the budget cuts, which are larger than anticipated, will help build a buffer against a weaker economy.[11]

Central America and the Dominican Republic. Central America and the Dominican Republic, like Mexico, have benefitted from a strong U.S. economy and higher remittances and, as they are net commodity importers, from lower commodity prices. However, the recent softening of world coffee and banana prices could reduce this trend.[12]

The Caribbean. On the other hand, with the exception of the Dominican Republic, the Caribbean region has become one of the most indebted in the world, and its economies are more vulnerable to external shocks. The key factors contributing to debt distress in the Caribbean region are natural disasters, economic volatility, banking and currency crises, and socioeconomic challenges such as high crime, poverty, and unemployment.[13] The four Caribbean states with the highest debt-to-GDP ratios are Jamaica at 133 percent, Antigua and Barbuda at 107 percent, and Barbados at 103 percent. Following Puerto Rico's default, Jamaica could be the next Caribbean country to face a sovereign default given its debt levels, persistent low growth (at less than 1 percent a year in the last decade), weak government, and intermediate institutional strength.

ASSESSING RISK AND PREPARING TO TAKE PROTECTIVE MEASURES

The Latin American region as a whole remains particularly vulnerable to a stronger-than-expected downturn in China and to further declines in commodity prices. However, the extent to which these external macroeconomic factors will have a negative effect on the various countries in the region continues to depend largely on the particular internal circumstances of such countries, with possible spillover effects in the case of the largest markets. For example, a continued deterioration of the situation in Brazil could lead to a reduced demand for exports from the Mercosur countries and to a repricing of regional assets, given Brazil's weight within Latin American debt markets as an assets class and its comparatively high degree of liquidity in the financial markets. Such spillover effects could present a risk for the otherwise moderately positive current outlook on countries such as Chile, Colombia, and Peru (although not others, such as Mexico).

Given this outlook, we expect the need for debt restructurings to continue to increase throughout the year and advise creditors to take stock of their exposure in order to start the process of laying out plans as to how best protect their rights. While no single strategy or plan is optimal for all cases, advance planning is critical due to the fact that most countries have ineffective bankruptcy laws and/or processes and weak mechanisms for efficient enforcement of creditors' rights. Although it is true that in the last 15 years, most Latin American countries have adopted insolvency statutes that favor organized debt restructurings over liquidations, experience has shown that creditors still face substantial challenges to make effective recoveries in the region.

THREE KEY TAKEAWAYS

1. The Latin American region remains particularly vulnerable to a stronger-than-expected downturn in China and to further declines in commodity prices. A further deterioration of the situation in Brazil could have a significant negative impact on several countries in the region that are currently weathering the crisis, such as Chile, Colombia, and Peru.
2. Given the current climate, creditors are advised to take action to protect their rights. We expect the need for debt restructurings to continue to increase throughout the year.
3. With complex cross-border structures common, effective relief may require simultaneous action in more than one country. Advance planning is critical, particularly since most countries in Latin America lack effective bankruptcy laws and debtor-in-possession regulations.

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ENDNOTES

1 Alejandro Werner, World Economic Forum, "IMF: Latin America's economies have a tough year ahead," Jan. 21, 2016; and International Monetary Fund, "World Economic Outlook. Too Slow for Too Long," Apr. 2016.

2 *Id.*

3 Roberto Junguito, *Portafolio*, "La coyuntura económica del 2016," Jan. 26, 2016; Statistics from the Superintendencia de Sociedades de Colombia, Mar. 31, 2016; Superintendencia de Insolvencia y Reemprendimiento de Chile, Boletín Estadístico, Ley No. 20.720, Apr. 30, 2016; Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual de Perú, Anuario de Estadísticas Institucionales, 2014 and 2015; and International Monetary Fund, "Colombia: Concluding Statement of the March 2016 Article IV Mission," Mar. 18, 2016.

4 Although the new government headed by interim President Michel Temer—which took office on May 12, 2016 after the Senate voted to suspend President Dilma Rousseff from office for up to 180 days pending an impeachment trial by the Senate—is expected to be more business friendly than the previous one and to seek to adopt measures designed to revive the economy, it will probably take some time before positive effects are felt in the country's economy, notwithstanding the recent improvement in the business and economic outlook.

5 Tatiana Bautzer and Guillermo Parra-Bernal, *Reuters*, "Insight—Brazil a bright spot for debt restructuring advisors as recession bites hard," Jan. 28, 2016.

6 Julie Wernau and Carolyn Cui, *The Wall Street Journal*, "Argentina Returns to Global Debt Markets With $16.5 Billion Bond Sale," Apr. 19, 2016.

7 International Monetary Fund, "World Economic Outlook. Too Slow for Too Long," Apr. 2016.

8 International Monetary Fund, "IMF Executive Board Concludes 2015 Article IV Consultation with Mexico," Nov. 17, 2015.

9 Dimitra DeFotis, *Emerging Markets Daily*, "Pemex: How To Fund $90 Billion Deficit? Hire An Economist," Feb. 10, 2016.

10 *The Economist*, "Turning the tanker," Apr. 23, 2016.

11 Adam Williams, *BloombergBusiness*, "New CEO to Accelerate Reforms at Mexico's Indebted Oil Company," Feb. 9, 2016.

12 Alejandro Werner, World Economic Forum, "IMF: Latin America's economies have a tough year ahead," Jan. 21, 2016; and Ernesto Talvi *et al*, *Brookings*, "Latin America: Back to the 1980s or heading for rebound?" Nov. 23, 2015.

13 *Latin American Herald Tribune*, "Jamaica Could be the Next Caribbean Country to Face Debt Crisis," Feb. 4, 2016.

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