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Brexit: Limited Implications for Latin America

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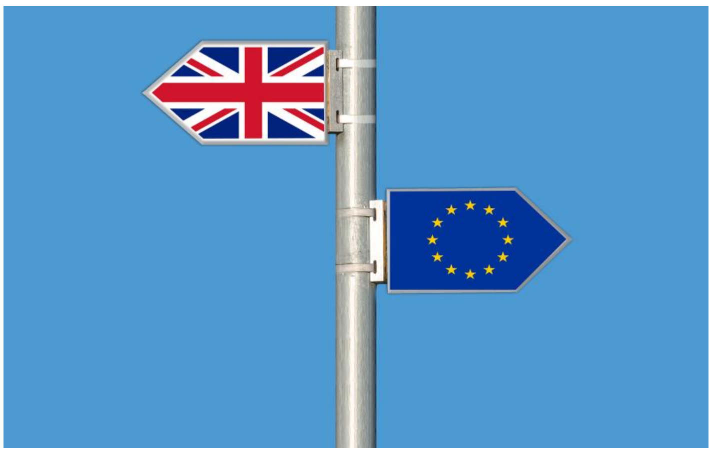

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The June 23rd British referendum result – a 52-to-48 percent vote to leave the European Union (EU) – has roiled the world's leading financial markets, but contrary to many opinions issued in the referendum's wake, the economic and financial implications of Brexit for Latin America have been either mild or favorable. Hard line Brexit statements made earlier this month by UK Prime Minister Theresa May, and various rebukes from policymakers on the Continent, have had financial-market repercussions for the pound. Most notably, sterling has fallen sharply, and it is now down more than 15 percent from its high on the day of the fateful vote, plummeting to three-decade lows against the dollar.

- The market reaction initially led to a mostly regional (UK and Europe) correction in stock prices. Even this was short-lived: for example, the FTSE 250, an index of domestically focused UK firms, at first dropped by 14 percent but recovered fully by early August – and has since been trading above the pre-referendum level. Moreover, the UK recession many feared did not materialize, at least not during 3Q16.
- Financial markets priced in fairly quickly the conclusion that the Brexit shock would lead to greater dovishness among the world's major central banks. Most relevant to Latin America and the emerging markets (EM) generally, the Brexit helped to persuade the U.S. Federal Reserve to delay its tightening until at least the end of 2016. While Latin America's trade and investment ties to Europe are not insignificant, the region's major

economies are far more dependent on the health of the U.S. economy and on the mood in the U.S. financial markets, and secondarily on trends in China.

- If the UK and the Eurozone had stumbled and were headed for a recession, however, one likely casualty of Brexit would have been a noticeable drop in world commodity prices, with strong implications for the major economies of Latin America. While commodity prices have softened somewhat (non-oil commodities have averaged 2¼ percent lower since the Brexit vote, and oil has traded 7½ percent below), confirmed expectations of loose monetary conditions in the U.S. and Europe during 3Q16 have more than compensated. This is why most EM stocks, bonds and currencies have rallied, with the parade led by the Brazilian Real (BRL), so far the best-performing of 24 EM currencies tracked by Bloomberg (up about 20 percent year-to-date).

The medium-term implications of Brexit for Latin America will depend on how much "noise" emanates from London, Brussels and other European capitals during the negotiation process (likely, 2Q17-2Q19). Prime Minister May has now made three statements that define her bargaining position: Article 50 (exit) negotiations will begin by next March; the imposition of migration controls on EU citizens coming to the UK is non-negotiable; and the UK will no longer be under the jurisdiction of the European Court of Justice. The latter two points mean that Britain cannot remain a member of the single market, and is therefore committed to forging a customized free-trade agreement with the EU, which could sow uncertainty and thus depress economic growth in Europe and beyond.

The most probable scenario – slow and halting Brexit negotiations, with progress hard to achieve until close to the end (in 2019) – will encourage uncertainty and speculation among economic agents and thus will be a drag on economic growth especially in the UK, and much less so in the rest of the EU. However, it need not generate the kinds of waves that will reach, never mind derail, Latin America's economic trajectory. It is much more likely that what does or does not happen in Buenos Aires, Brasilia, Caracas or Mexico City, and above all in Washington, DC – courtesy of the Fed, the White House, and the U.S. Congress, in that order – will overshadow just about any headlines generated by the Brexit negotiations in Europe. There is room for Latin America to clock higher GDP growth numbers in the years ahead when compared to the disappointing regional averages of 1 percent growth in 2014, zero growth in 2015, and a contraction of about -0.6 percent in the current year (as per IMF estimates). This assumes that the Fed's tightening is gradual (namely, no more than 0.25 percent increases in the Fed's target rate per trimester) and that the UK's divorce proceedings are not overly hostile. This scenario foresees that creditworthy governments, banks and corporations in Latin America will retain access to the international capital markets on reasonable terms, despite some initial retraction in investor interest ahead of, and right after, the resumption of the Fed tightening cycle.

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