World Economic Situation and Prospects

2019

United Nations

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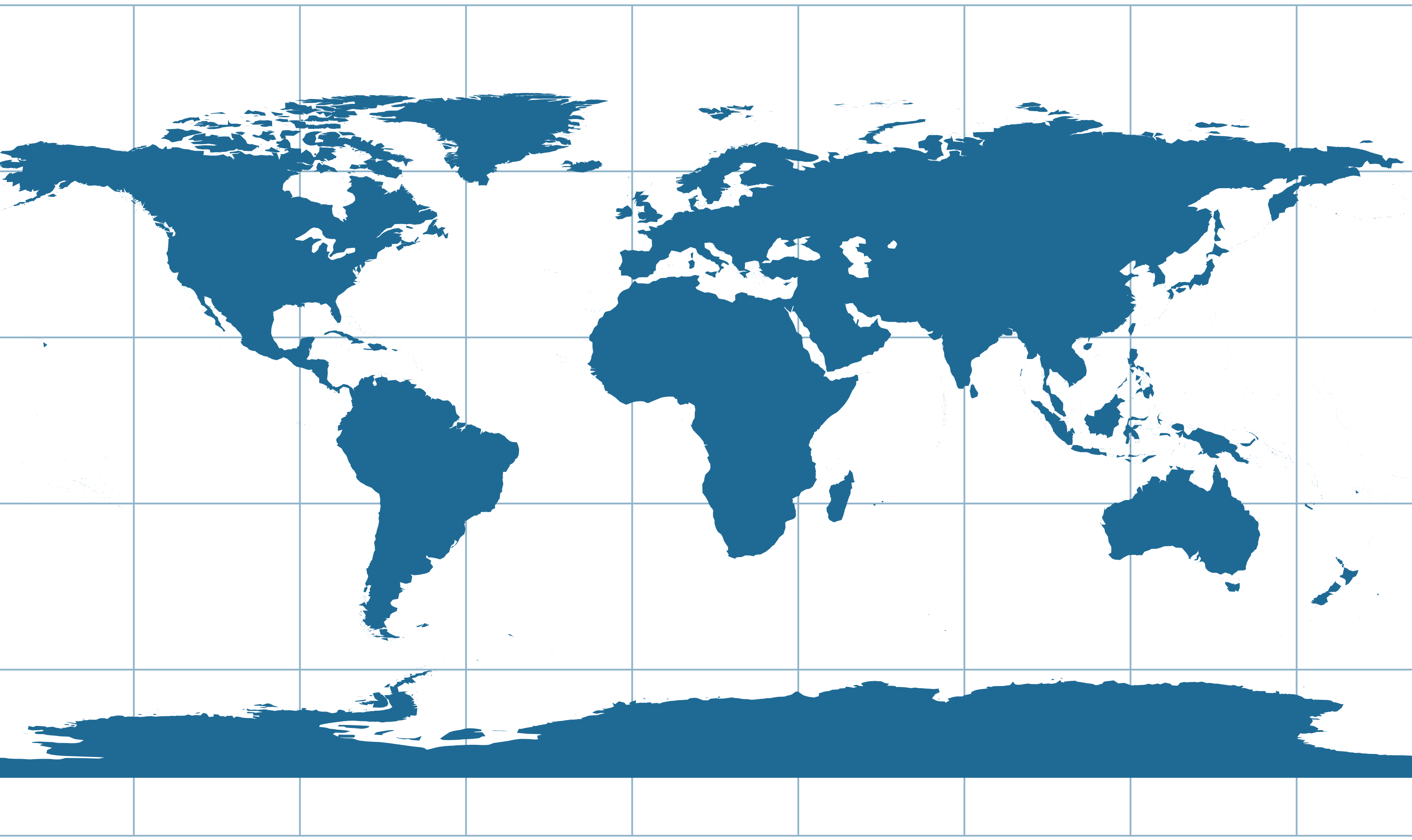
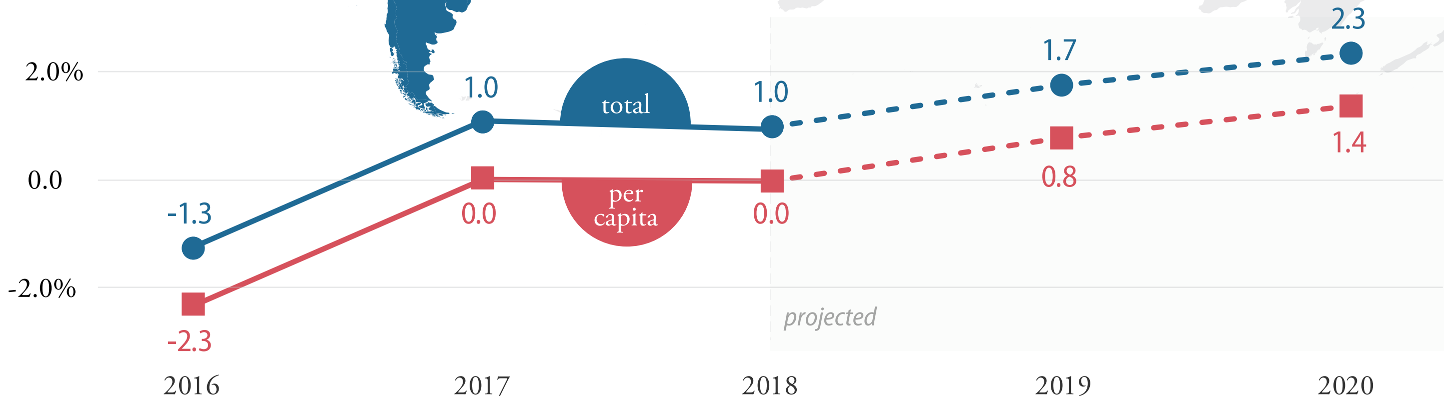


United Nations
New York, 2019

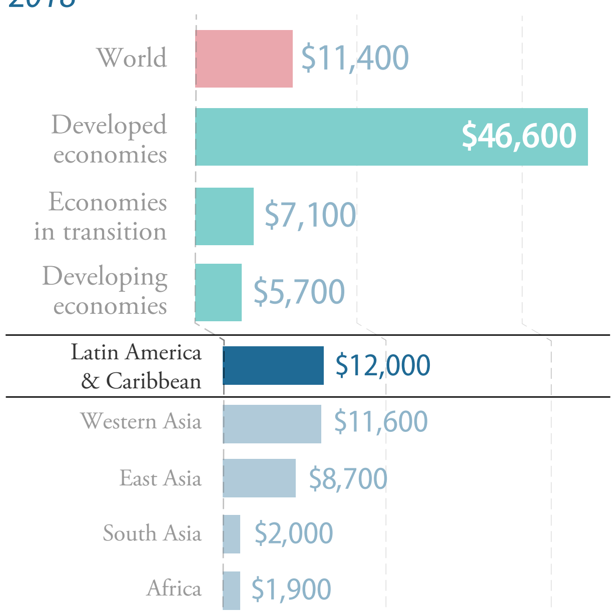
Latin America and the Caribbean

GDP Growth



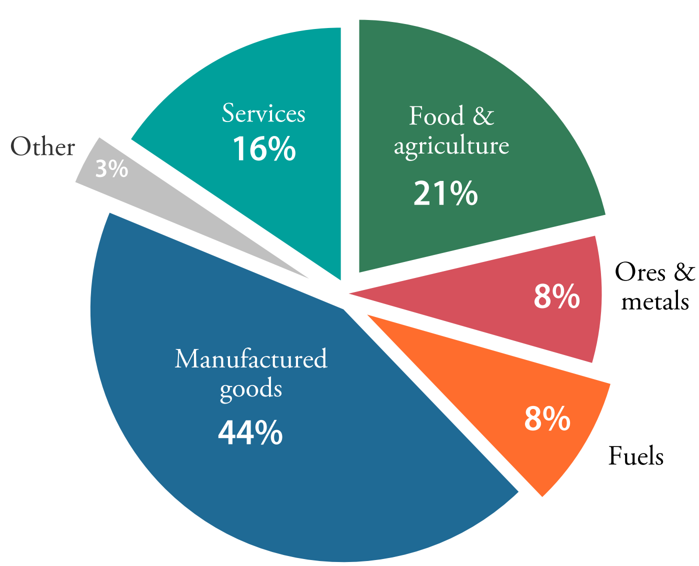
GDP per capita

2018



Exports structure

2016



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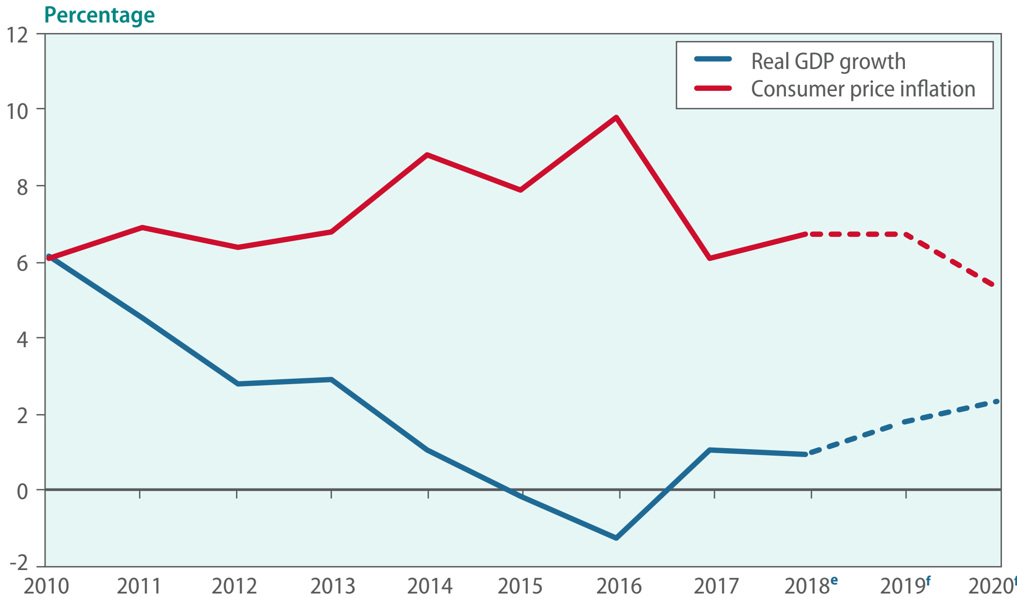
Latin America and the Caribbean: growth is projected to gradually pick up, but major downside risks remain

- Weakness in several large economies weighs on the region's growth
- Macroeconomic policy space is limited, with some countries facing considerable need for fiscal adjustment
- Protracted poor economic performance creates serious risks for social progress

Economic recovery has lost momentum and become more uneven

Amid a more challenging external environment, the economic recovery in Latin America and the Caribbean[5] has lost momentum and become more uneven. Economic activity in some of the region's largest countries was much weaker than expected in 2018 as tighter global financial conditions exacerbated domestic vulnerabilities. This has resulted in a significant downward revision of regional growth. Aggregate GDP is estimated to have grown by only 1 per cent in 2018, the same rate as 2017. A moderate pickup in growth is projected for the next two years, with GDP in Latin America and the Caribbean forecast to expand by 1.7 per cent in 2019 and 2.3 per cent in 2020 (figure III.26). This recovery in regional growth will likely be supported by gradually improving economic conditions in Argentina and Brazil and a less severe contraction in the Bolivarian Republic of Venezuela. The risks to the outlook remain tilted to the downside. Many of the region's economies are vulnerable to a further tightening of global financial conditions, an escalation of international

Figure III.26
Annual GDP growth and consumer price inflation in Latin America and the Caribbean, 2010–2020



Source: UN/DESA.
Note: e = estimate, f = forecast. Consumer price inflation excludes the Bolivarian Republic of Venezuela.

5 The country classification is based on the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). The region of Latin America and the Caribbean comprises three subregions: South America; Mexico and Central America (which includes Caribbean countries that are considered part of Latin America, namely, Cuba, the Dominican Republic and Haiti); and the Caribbean.

trade tensions and continued commodity price volatility. Macroeconomic policy space is generally limited because of significant fiscal deficits, elevated debt levels and considerable external financing needs.

Weak growth performance poses challenges for SDGs

Latin America and the Caribbean's economic performance over the past year fell well short of expectations. In per capita terms, the region's annual GDP stagnated in 2018. This means that GDP per capita has not grown for five consecutive years, underscoring the difficulty the region faces in returning to a robust growth path in the aftermath of the commodity price collapse. While the poor aggregate growth performance reflects a high degree of vulnerability to external and domestic shocks in parts of the region, it is also indicative of a long-standing and deep-rooted weakness in productivity. Between 2000 and 2015, increasing labour inputs accounted for the bulk of GDP growth, whereas rising productivity contributed relatively little. Lifting productivity growth is critical for strengthening economic growth going forward and for ensuring progress towards the Sustainable Development Goals, including the eradication of poverty by 2030. Recent United Nations Economic Commission for Latin America and the Caribbean (ECLAC) estimates highlight the urgency of this challenge: as per capita economic activity contracted from 2014 to 2016, the number of people living in poverty in Latin America and the Caribbean rose from 168 million to 186 million, with the poverty rate increasing from 28.5 per cent to 30.7 per cent (ECLAC, 2018c).[6]

Recovery in investment is expected to continue

Amid a relatively bleak economic picture, a positive development was the mild recovery of aggregate investment in 2018, following four consecutive years of contraction. The improvement was fairly broad based across countries (box III.6). In many cases, most notably Brazil, accommodative monetary policy supported private investment. Commodity exporters such as Colombia and Peru recorded significant gains, while Mexico benefited from reduced uncertainty as the new trade agreement with the United States and Canada was finalized. Reconstruction building, in the aftermath of severe hurricanes and natural disasters in 2017, has also increased investment spending in parts of the region. Household consumption growth decelerated slightly in 2018, in part reflecting weak labour market trends and a sharp deterioration in Argentina's economic situation. At the regional level, investment and consumption growth are projected to strengthen gradually in 2019 and 2020, but tighter financing conditions and commodity price volatility could act as a brake. Both exports and imports expanded at a solid pace in 2018 as weakness in Argentina was offset by strong improvements in other South American commodity exporters and solid growth in Mexico and parts of Central America and the Caribbean. Robust expansions in the region's main trading partners, in particular the United States, supported the region's export markets. The near-term outlook for trade activity is generally positive, but the ongoing international trade tensions pose a substantial risk for the region as many countries have strong ties with China and the United States.

Outlook for Argentina and Brazil remains challenging

A pickup in economic activity in South America is projected to be the main driver of the region's recovery in the forecast period. Aggregate growth in the subregion is forecast to accelerate from 0.4 per cent in 2018 to 1.4 per cent in 2019 and 2.3 per cent in 2020. The gap between fast- and slow-growing economies is expected to gradually narrow. This would reverse last year's trend of more uneven growth, when the recovery slowed sharply or came to a halt in Argentina, Brazil, Ecuador and Uruguay, while gaining strength in Chile, Colombia and Peru.

6 The rate of extreme poverty also increased from 8.2 per cent in 2014 (48 million) to 10.0 per cent in 2016 (61 million).

Box III.6

The determinants of investment and their relative importance

The dynamics and behaviour of investment are central to understanding the economic cycle and patterns of growth over the medium and long terms, as investment is one of the bridges between the economic cycle and trend growth. This box presents a quantitative analysis of the determinants of investment and their relative importance for six Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico and Peru. This set of economies represents a significant share of the region´s GDP and investment. The determinants of investment in the analysis include the rate of change of economic activity; a commodity price index; domestic real interest rates and external interest rates; an indicator of access to external credit (Emerging Market Bond Index (EMBI)); and the rate of change of the real exchange rate.[a]

The index of economic activity is included, as it has a strong statistical association with investment. For its part, the domestic interest rate is the main transmission channel from monetary policy to the real economy. The effect of the short-term rate on long-term rates—which are the basis for investment decisions—obviously depends on a number of other considerations, including the structure of financial markets, firms' balance sheets, and external conditions. The external interest rate and EMBI variables reflect the conditions of access to external financing.

A fourth variable that has gained importance as a determinant of investment is commodity price trends. Natural resources and natural-resource-based sectors represent a significant part of real activity in a number of countries of the region, primarily in South America. Finally, the real exchange rate is directly linked to investment through its impact on exports and imports. Improved external competitiveness can be an incentive to increase investment expenditure. At the same time, a real exchange rate that is favourable to imports can also boost investment since capital goods and imported machinery and equipment are an important component of imports.

The econometric estimates for this group of countries as a whole show that the most significant variables include the rate of variation in the index of economic activity, the monetary policy rate and the commodity price index (ECLAC, 2018d). A 1.0 percentage point increase in the rate of growth of economic activity results in a 1.7 percentage point increase in investment growth rates. This implies that investment has a more volatile cycle than GDP. By contrast, an increase of 1.0 percentage point in the monetary policy rate leads to a 0.24 percentage point slowdown in the rate of growth in investment. An increase of 1.0 percentage point in the commodity price index edges up investment growth by 0.38 percentage points.

In a second stage, the relative importance of each of these variables was assessed separately for each country by estimating their contribution to the explanation of the goodness of fit of the respective regression. This is reflected by the value of R^2: the greater the value of the R^2, the greater the goodness of fit of the regression (Grömping, 2006).

As seen in table III.6.1, the results show that the influence of the level of activity on investment is higher in economies that are larger and that are more diversified such as Argentina, Brazil and Mexico. Commodity prices are important in economies of medium size and that are specialized in natural resources (Chile, Colombia and Peru). In these countries, natural resources explain a large part of the behaviour of both exports and investment. Natural resource exploitation is also the main determinant of long-term financial flows. For its part, the domestic monetary policy rate and the long-term interest rate explain a small percentage of the goodness of fit of the regression. This finding is explained, in part, by the fact that the pass-through of policy rates to the banking system tends to be weak. It also agrees with the literature on the subject (Claessens and Kose, 2018) that shows the impact of interest rates on the real economy is more complex than is generally thought, and that it depends on companies' balance sheets, including the terms of maturity of assets and liabilities. The real exchange rate is important in the case of Brazil and Chile in reflecting greater flexibility of the exchange-rate regime. In Latin America, variations in the real exchange rate tend to be driven by variations in the nominal exchange rate.

This analysis shows that, in general, in the case of the larger economies, investment is largely driven by economic activity. As a result, these economies can have more space to undertake demand-oriented policies to increase growth. Sustainability of investment-driven growth will depend on the ability to finance imports (investment has a significant import content) and the potential to absorb the

(*continued*)

a The variables are entered as panel data on a quarterly basis. The number of observations varies by country: for Argentina, the data correspond to the period 2005–2017; for Brazil, 2004–2017; for Chile, 2004–2017; for Colombia, 2006–2017; for Mexico, 1994–2017; and for Peru, 2004–2017.

Box III.6 (*continued*)

Table III.6.1

Latin America (selected countries): results of the estimation of the relative importance of investment determinants, 1995–2017

Country	Goodness of Fit R^2	Rate of variation in index of economic activity (IA)	Commodity price index (IPCM)	External interest rate (TLP)	Emerging Market Bond Index (EMBI)	Monetary policy rate (TPM)	Rate of variation in the real exchange rate (TCR)
		Per cent contribution to the Goodness of Fit measure					
Argentina	90.7	67.9	2.2	2.7	21.2	6.0	…
Brazil	90.5	67.2	11.8	2.7	6.5	11.7	24.7
Chile	58.0	34.7	39.7	4.6	4.3	16.8	44.7
Colombia	55.4	12.8	67.7	4.7	10.2	4.6	4.7
Mexico	77.8	71.0	10.7	10.9	6.0	1.3	1.8
Peru	87.1	49.0	31.6	12.6	3.3	3.5	13.4
Average	76.6	50.4	27.3	6.4	8.6	7.3	17.9

Source: ECLAC, on the basis of Grömping (2006).

consequent capital and production capacity expansion. In this sense, articulating capacity utilization, given the interlinkages between investment, imports, output and capacity, is a significant challenge for economic policy. Medium-sized economies depend to a greater extent on external variables, such as commodity prices, and are thus vulnerable to the fluctuations of commodity cycles. This highlights the need to introduce countercyclical buffer stock mechanisms to confront commodity price volatility, and, in the long run, to diversify their productive matrix. In most countries, the monetary policy rate is not largely significant, which points to the need to better understand how it is transmitted to the financial and real sectors of the economies of the region.

Author: Esteban Perez (UN/ECLAC).

The economic downturn in 2018 has been particularly severe in Argentina. After experiencing a currency crisis in the second quarter, the country has fallen into recession. The macroeconomic adjustment plan agreed upon by the Government and the IMF as part of a Stand-By Arrangement includes severe fiscal and monetary tightening. While these measures aim at restoring market confidence and stabilizing the economy, they come with a high cost. Annual GDP is projected to contract in both 2018 and 2019, before a modest recovery gets underway. Brazil's recovery from its longest-ever recession hit a speed bump in the first half of 2018 amid a truckers' strike and external headwinds, including a stronger dollar and widening risk premiums. With consumer confidence improving and the labour market strengthening, economic activity is projected to gain traction in 2019–2020. However, given pressing needs for fiscal adjustment and an expected tightening of monetary policy, the pace of the recovery will likely remain subdued. At the same time, persistent structural bottlenecks, such as a low savings rate and widespread skill deficits in the workforce, will constrain growth in the medium run.

Venezuela's socioeconomic downward spiral continues

The Bolivarian Republic of Venezuela is in its fifth year of recession. While the true extent of the crisis is difficult to gauge, the economy is estimated to have contracted by more than 40 per cent since 2013. The collapse in economic activity has been accompanied by rapid increases in unemployment and underemployment, shortages of food and medical supplies, and rising violence. The socioeconomic downward spiral has led to mass migration of Venezuelans to other Latin American countries, creating challenges for local infrastructure and administrative capacities. With oil production continuing to decline and inflation soaring, an end to the country's economic collapse is not in sight.

Prospects remain favourable in several South American commodity exporters

The prospects for Bolivia (Plurinational State of), Chile, Colombia, Paraguay and Peru, by contrast, are largely favourable. In 2018, improved terms of trade, along with stronger consumer and business confidence, boosted household consumption and investment. While lower commodity prices, in particular for oil, copper and zinc, could weigh on economic growth, solid macroeconomic fundamentals and robust private sector demand will support activity in 2019–2020.

Mexico and Central America benefit from the strong United States economy….

Mexico and Central America will likely continue to see steady but modest economic growth in the outlook period. After expanding by an estimated 2.4 per cent in 2018, the economy is projected to grow by 2.5 per cent in 2019 and 2.3 per cent in 2020. The subregion continues to benefit from the strong performance of the United States economy, which is not only the main trading partner for most countries, but also the main origin of remittances. The latest data show persistently strong increases in remittance flows to Mexico and Central America, providing support to private consumption, the main driver of growth. However, political uncertainty and structural impediments, such as weak productive capacities, poor infrastructure, a low-skilled work force and high degrees of violence, weigh on economic activity in many countries.

…but the growth outlook remains subdued for many economies

The subregion's modest average growth continues to mask large differences between individual countries. On the one hand, the outlook remains positive in the Dominican Republic and Panama, two of Latin America's fastest-growing economies in the past decade. In both countries, growth is supported by strong investment, especially in infrastructure, and government consumption. On the other hand, growth prospects are subdued in many other economies, most notably in Cuba, El Salvador, Haiti, Mexico and Nicaragua. In Mexico, the newly signed United States-Mexico-Canada Agreement (USMCA) removed some uncertainty over the outlook for trade. A strong domestic labour market—at about 3.5 per cent, the unemployment rate remains near a low for the decade—improved consumer confidence, and a buoyant United States economy continued to support demand. However, relatively tight monetary and fiscal policy, along with institutional weaknesses, will weigh on growth in 2019–2020. Among other economies, Nicaragua has seen a severe deterioration in the economic outlook. Political instability and violent unrest have negatively affected tourism, construction and foreign direct investment. Consequently, economic activity and employment in the formal sector have declined. While further downside risks for growth exist, a mild recovery is projected for the latter part of the forecast period, provided that macroeconomic and financial stability can be preserved.

The economic situation in the Caribbean has improved, but growth remains modest

In the Caribbean, a moderate economic recovery materialized in 2018 as Suriname and Trinidad and Tobago returned to positive growth, benefitting from higher oil prices. Economic growth in Suriname is also supported by increased gold production, whereas Trinidad and Tobago has managed to expand natural gas production. Aggregate GDP in the subregion is projected to expand by 2.0 per cent in both 2019 and 2020, following estimated growth of 1.9 per cent in 2018. This constitutes a significant improvement over the poor performance of recent years. However, the subregion continues to face severe structural obstacles to development, such as high burdens of debt, significant infrastructure deficits and high rates of unemployment, particularly among youth. High exposure to climate risks poses a constant threat to economic prospects for the countries in the subregion.

Accommodative monetary policy continues to support activity

In many of the region's economies, particularly in South America, accommodative monetary policy continues to support activity. Average inflation (excluding the Bolivarian Republic of Venezuela) picked up slightly in 2018. However, in most countries inflation remained within the target range of central banks, due to limited demand pressures and well-anchored inflation expectations. The main exceptions are Argentina and the Bolivarian Republic of Venezuela. In the latter, shortages of consumer goods (partly due to widespread government price controls), the monetization of large fiscal deficits, and a rapid depreciation of the currency in the parallel market have resulted in hyperinflation. Without wide-ranging structural reforms to rebuild public finances, stabilize the currency and resolve the debt situation, the inflationary spiral will continue in 2019. In Argentina, inflation and inflation expectations have risen strongly during 2018, mostly because of a markedly weaker peso. In October, year-on-year inflation reached 45.5 per cent. The central bank has responded by adopting an extremely tight monetary policy stance. The benchmark rate is maintained at a record high of 60 per cent. At the same time, the inflation-targeting regime has been temporarily replaced with a monetary base target, which caps growth of money at 0 per cent per month. These measures are expected to gradually bring down inflation over the forecast period, creating room for the central bank to ease monetary policy.

Some monetary tightening is likely in 2019

Price pressures started to build in the second half of 2018 in parts of the region, caused by higher energy prices and weaker currencies. Several central banks (for example in Brazil, Chile, Colombia, the Dominican Republic and Peru) are likely to raise interest rates in 2019. With United States interest rates projected to further increase, Latin America and the Caribbean is likely to be subjected to capital outflow pressures. A significant challenge for many monetary authorities across the region is to preserve domestic financial stability through this period of tightening global financial conditions, while providing support for the ongoing economic recovery.

Fiscal adjustment remains a priority for many countries

Across the region, fiscal space is constrained. Many Governments will face significant fiscal adjustment pressures during the outlook period. In 2017, all of the region's economies except Jamaica recorded fiscal deficits (figure III.27). Despite some improvements in 2018, primary fiscal deficits often exceeded debt-stabilizing levels. Persistent fiscal deficits over the past few years have led to a notable increase in government debt. The region's weighted average government-to-GDP ratio rose from 48.5 per cent in 2013 to 60 per cent in 2017. Government debt-to-GDP ratios and debt services costs are high in several countries, especially in South America (Argentina, Brazil, Uruguay) and the Caribbean (Barbados, Jamaica). Rising global interest rates, a strong dollar and capital flow volatility add to pressures for fiscal consolidation. When implementing adjustment measures, most Governments will continue to pursue a gradual approach in order to minimize the negative impact on economic activity and on social conditions for the most vulnerable segments of the population.

In Argentina, fiscal policy will remain strongly contractionary in 2019–2020. The Government's deep fiscal adjustment programme includes both large spending cuts and tax increases and aims to eliminate the primary deficit by 2019. Barbados is also undertaking a stringent fiscal adjustment programme, allied with a $290 million lending arrangement under the IMF Extended Fund Facility, targeting a primary surplus of 6 per cent of GDP in 2019/20. In Brazil, a combination of moderate primary deficits and high interest expenditures has resulted in large overall fiscal deficits, averaging almost 9 per cent of GDP in 2015–2018. As a result, general government gross debt increased from 60 per cent of GDP in 2013 to an estimated 88 per cent of GDP in 2018. Brazil's new Government therefore faces strong pressures to consolidate public finances, including a comprehensive reform of the pension system.

Figure III.27

Fiscal balances and government debt in Latin America and the Caribbean, 2017

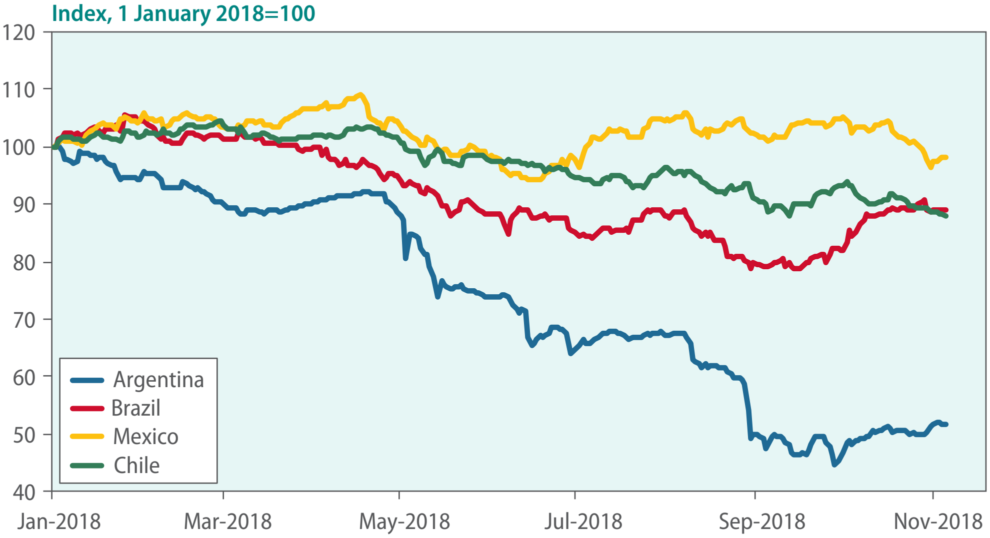
Source: IMF World Economic Outlook October 2018 database.

Note: "Fiscal balance" refers to general government net lending/borrowing. "Government debt" refers to general government gross debt.

Figure III.28

Selected Latin American exchange rates against the US dollar

Index, 1 January 2018=100



Source: UN/DESA.

Note: A declining value indicates a depreciation of the currency against the US dollar.

Higher United States interest rates and a stronger dollar pose a risk to the outlook

With limited space for countercyclical monetary and fiscal policy, the risks to the Latin America and the Caribbean outlook are tilted to the downside. Over the past year, countries with weaker macroeconomic fundamentals and higher political uncertainties have already been negatively affected by the combination of rising United States interest rates and a stronger dollar. While significant net capital outflows led to a weakening of many local currencies (figure III. 28), the impact on the real economy was concentrated in only a few countries, most notably Argentina. A sharp tightening of global financial conditions during the forecast period could trigger further capital outflows from the region (in particular South America), potentially affecting investment prospects and thus undermining the projected recovery in economic activity. Additional risks are associated with a potential slowdown of the United States economy and a renewed downturn in the prices of oil and metals. Weaker growth in the United States would in particular weigh on the prospects of Mexico and Central America and the Caribbean, while lower commodity prices would mostly affect South America's economies.