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Latin America: the tide has turned

Special
Alexandra Dumitru

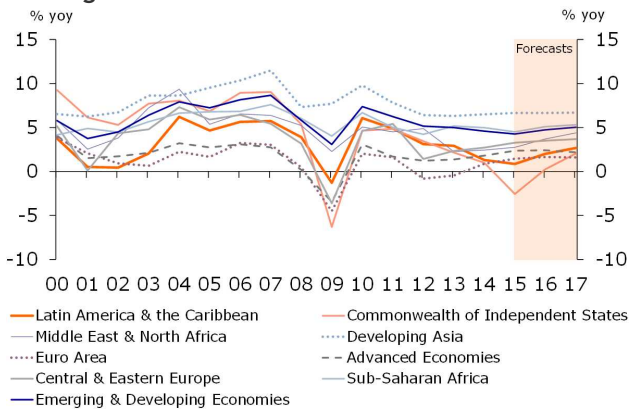
This publication is part of the [Latin America after the commodity boom](#) series

- Most Latin American countries are expected to continue the slowdown seen in recent years in 2015, and lower commodity prices play a prominent role.
- A mild recovery is expected in 2016, while the longer-term economic outlook depends on the region's success in tackling structural issues on the supply side and improving productivity
- Most Latin American countries are small, open economies and therefore vulnerable to developments in the external environment, although strong FDI inflows and comfortable FX reserves should provide sufficient mitigation. In Argentina and Venezuela the situation is critical, however
- Also, room for both monetary and fiscal stimulus is limited in most countries
- Softening labour markets and a fairly low level of savings and investments are not conducive to growth. On the positive side, the level of indebtedness is modest and is not likely to act as a drag on growth

Economic growth is slowing down...

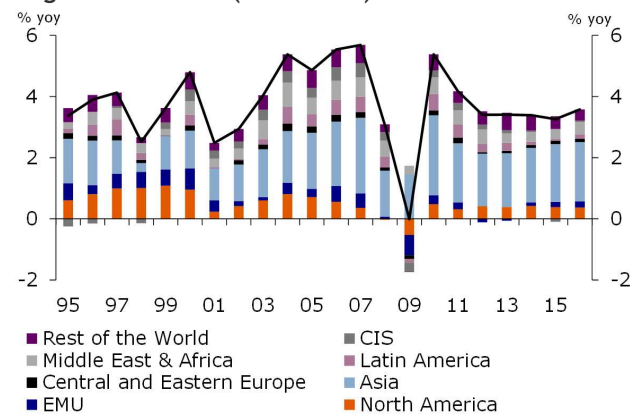
The majority of economic reports emerging from Latin America in recent years have been disappointing. Economic growth in the region has been slowing down markedly since 2010 - from 6% in 2010 to 1.3% in 2014 - and is projected to fall further to 0.9% in 2015 (figure 1). The region has faced a less favourable external environment, particularly due to falling commodity prices since 2011 (figure 3) and the end of the US quantitative easing programme.

Figure 1: Real GDP in Latin America has been slowing down faster than elsewhere...



Source: IMF WEO, ICE

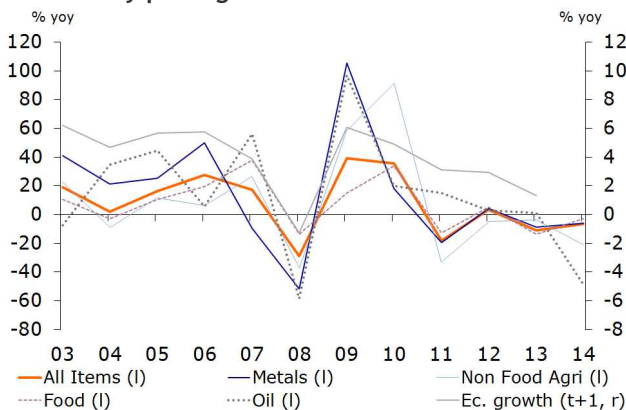
Figure 2: reducing Latin America's contribution to global real GDP (PPP-based)



Source: IMF WEO, Rabobank

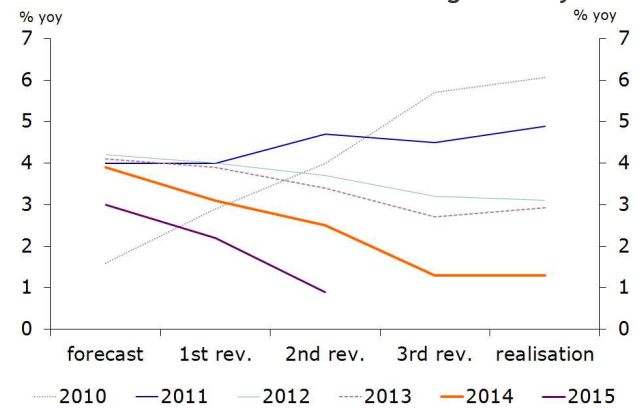
Until 2011, Latin America benefitted from a long period of historically high commodity price growth, known as the 'commodity super cycle'. This commodity cycle or boom period lasted from roughly 2003 to 2011 and was broad-based, though the price increases witnessed in energy and metals markets were much higher than those recorded in food markets. The drop in commodity prices that followed not only dampened export growth, but it also took its toll on investment, which has been in decline since 2011. The IMF revised forecasts downwards significantly for the period 2012-2015 (figure 4) on the back of underperforming exports and fixed investments, as the projections "seem to have assumed a more persistent boost to growth from past increases in commodity prices than eventually materialized. Investment, in particular, quickly started to fall behind projections when the commodity price boom petered out in 2011." (IMF, 2014). According to Gruss (2014), even if commodity prices remained at the still-historically-high levels of 2014, stalling price growth alone would reduce average economic growth in Latin America commodity exporters in 2014-2019 by 1.3ppts compared to the boom years of 2003-2011 and by 0.8ppts compared to 2012-2013. [1]

Figure 3: Economic growth in Latin America lags commodity price growth



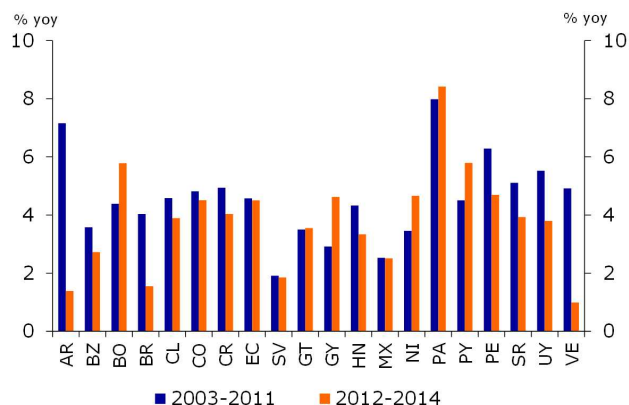
Source: EIU, IMF WEO

Figure 4: Latin America economic growth for 2011-2015 has been revised downwards significantly



Source: IMF WEO

Figure 5: Most countries in Latin America have been slowing down, but there are regional differences



Source: IMF WEO

Domestic factors such as policy uncertainty and low private sector confidence have also played a role in many countries, increasingly so in recent years. Relatively high levels of inflation and widening current account deficits suggest that structural supply bottlenecks such as inadequate infrastructure and education also played their part.

The 2.4% average economic growth rate over 2011-2014 is almost half the rate of 4.2% recorded over 2003-2011, even though the latter includes the Great Recession of 2008/2009 (figure 2). The slowdown was particularly severe in Argentina, Brazil and Venezuela (figure 5[2]), where domestic factors (the result of past unsustainable policies also made possible by the commodity windfall) have played an important role.

... leaving Latin America externally exposed but resilient

Lower commodity prices have also resulted in a weaker external position and some Latin American countries are more vulnerable to such deterioration than others. Small, open economies prevail on the continent (table 1), excepting Brazil and Mexico. The combination of a small size and a high degree of openness translates into a high vulnerability to external developments. Given its low degree of openness, Brazil is a clear exception, while the same applies to a lesser extent to Argentina, Chile, Colombia, Mexico, Peru and Uruguay.

Table 1: Economic structure indicators

	Number of Inhabitants (m.)	Size of the economy (in USD bn.)	Size of the economy (% of world GDP)	Openness of the economy (Exports + imports as % of GDP)	Share goods in exports	Share goods in imports	Share commodities in good exports	Share commodities in goods imports
	2014	2014	2014	2013	2013	2013	2013*	2013*
South America								
Argentina	41.96	540	0.88	30	85	79	67	21
Bolivia	11.25	34	0.07	77	90	79	96	23
Brazil	202.77	2,353	3.02	25	86	74	64	28
Chile	17.82	258	0.38	65	86	82	86	31
Colombia	47.66	385	0.59	36	90	82	82	25
Ecuador	16.03	101	0.17	61	93	88	93	25
Guyana	0.80	3	0.01	130	89	79	94	47
Paraguay	6.90	30	0.05	96	94	92	92	24
Peru	31.42	203	0.34	48	89	85	85	28
Suriname	0.55	5	0.01	105	93	78	96	40
Uruguay	3.40	55	0.07	51	75	78	76	33
Venezuela	30.46	206	0.50	75	98	73	98	29
Central America								
Belize	0.36	2	0.00	132	58	81	99	53
Costa Rica	4.78	48	0.07	66	57	88	38	26
El Salvador	6.35	25	0.05	72	67	87	27	37
Guatemala	15.87	60	0.11	59	80	86	59	35
Honduras	8.26	20	0.04	89	62	84	68	44
Mexico	119.72	1,283	1.98	65	95	92	24	21
Nicaragua	6.22	12	0.03	106	71	84	51	38
Panama	3.93	44	0.07	138	64	83	86	20

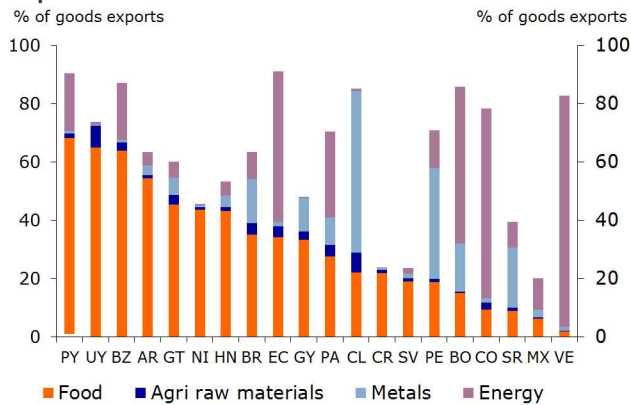
Source: IMF, World Bank * 2012 data for HN, 2011 data for SR

A closer look at exports further reveals that the majority of countries mainly export goods, the bulk of which are commodities. Export revenues in most countries are therefore vulnerable to trends in international commodity markets. Costa Rica and El Salvador seem to have a broader export base, given the lower share of goods (and/or commodities) in total exports of goods and services. Exports are more diversified towards services and manufacturing in Central America. Mexico and El Salvador are regional outliers, as manufacturing products account for the bulk of their exports.

In terms of the composition of commodity exports, food accounts for a large share of these exports in most countries (figure 6). This is reassuring in the light of the rebalancing of the Chinese economy towards consumption (and in light of a downturn in global investment in general).

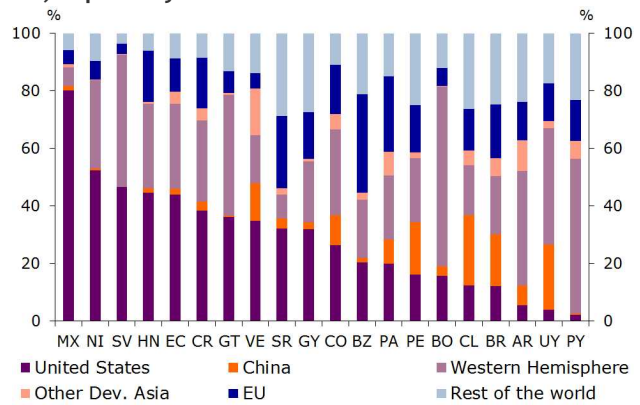
The share of metals in the export basket makes Chile, Peru, Suriname and, to a lesser extent, Bolivia and Brazil more susceptible to a Chinese rebalancing, while Bolivia, Colombia, Ecuador and Venezuela are vulnerable to a persistence of low oil prices. In general, countries with a narrower export base, such as Chile and Colombia, are more vulnerable. A closer look at the export destinations (figure 7) shows that Central American exports have a higher degree of concentration and are highly exposed to the United States. Mexico stands out in this respect, as the United States accounts for 80% of its exports. Direct exposure to China is highest in Brazil, Chile, Peru and Uruguay, but nevertheless remains modest. Intraregional trade seems to be limited to immediate neighbours. Bolivia, Uruguay and Paraguay, in particular, are susceptible to developments in neighbouring Argentina and Brazil.

Figure 6: Food accounts for the bulk of commodity exports



Source: UNCTAD

Figure 7: Exports are highly concentrated in the US, especially in Central America



Source: IMF DOTS

Imports are also concentrated around goods. At the same time, the share of commodities in imports is much lower. Most Latin American countries are net commodity exporters, and that applies to all product categories except energy. Consequently, most countries are poised to benefit from the low oil prices, particularly in Central America where dependence on energy imports is higher. The opposite is the case for net exporters like Bolivia, Venezuela, Colombia, Ecuador and Mexico. Besides, as non-commodity imports tend to be more price-elastic, the low dependence on commodity imports contributes to the flexibility of the current account to external shocks, especially in countries with floating exchange rates.

Table 2: External position indicators

	Current account balance (% of GDP)	Net international investment position (% of GDP)	Net FDI (% of GDP)	Import cover (months)	Gross foreign debt (% of GDP)	FX regime
	2014	2013	2014	2014*	2014**	
South America						
Argentina	-0.9	7.9	0.8	4.4	25.8	Crawl-like arrangement
Bolivia	0.7	15.1	2.0	12.5	23.9	Stabilized arrangement
Brazil	-3.9	-31.1	3.0	13.6	23.8	Floating
Chile	-1.2	-13.8	3.9	5.9	56.5	Free floating
Colombia	-5.0	-27.0	3.2	7.4	26.3	Floating
Ecuador	-0.8	-11.2	0.6	1.3	24.8	Dollarized economy
Guyana	-15.9		8.3	4.0	71.6	Stabilized arrangement
Paraguay	0.1	-34.4	1.7	5.2	49.8	Floating
Peru	-4.1	-26.0	3.8	15.7	29.0	Floating
Suriname	-7.3	-9.5			20.1	Stabilized arrangement
Uruguay	-4.7	-15.2	4.9	14.5	31.7	Floating
Venezuela	4.3	67.2	-0.2	1.0	53.2	Conventional peg
Central America						
Belize	-5.7		8.2	5.1	73.7	Conventional peg
Costa Rica	-4.5	-37.4	3.5	5.1	39.3	Other managed arrangement
El Salvador	-5.0	-60.5	-0.8	2.7	58.0	Dollarized economy
Guatemala	-2.3	-19.8	2.3	4.2	30.3	Crawl-like arrangement
Honduras	-7.4	-59.0	5.7	3.6	36.1	Crawl-like arrangement
Mexico	-2.1	-39.1	1.4	5.3	37.1	Free floating
Nicaragua	-6.2	-118.8	6.5	2.7	87.0	Crawling peg
Panama	-12.0	-83.4	10.6	1.7	42.0	Dollarized economy

Source: EIU, IMF, World Bank

* 2013 data for EC, GY, HN, PY, PE & VZ ** 2013 data for GY

Almost all countries in the region have current-account deficits (the only exceptions being Bolivia, Paraguay and Venezuela, see table 2). Thus, the majority of the Latin American countries rely on external capital flows to

finance their current account transactions. However, most current account deficits are largely covered by foreign direct investment (FDI). This strongly reduces the vulnerability to a sudden reversal of more volatile portfolio investment inflows and also limits the extent to which current account deficits result in growing external debt liabilities. Nevertheless, Latin America is susceptible to a decline in gross capital inflows and this vulnerability is stronger than in other emerging markets (IMF, 2014). Still, most countries have a foreign exchange import cover higher than the critical level of three months. Buffers are lower in Central America. Ecuador and Panama are fully dollarized economies, a regime that has restored macroeconomic stability in these countries. These countries are vulnerable to a fall in the inflow of USD, however, particularly as the import cover is very low and, in the Ecuadorian case, USD revenues have collapsed due to the fall in oil prices. A combination of high current account deficits and fairly low levels of import cover make El Salvador, Guyana, Honduras and Nicaragua particularly vulnerable to external shocks. The same applies to the extremely low level of import cover for Venezuela. At the other end, a combination of high FDI coverage of the current account deficit and high import cover make Bolivia, Brazil, Peru and Uruguay much more resilient.

The majority of Latin American countries have a negative net international investment position. On the positive side, the level of foreign debt remains fairly low in many countries, though higher in Central American countries. Panama's high net liability position reflects its role as a regional financial and transportation centre. Nicaragua's high foreign debt is a result of years of support from Venezuela under the Petrocaribe programme.

In recent years, Latin America could easily tap into international markets to cover its financing needs, as liquidity was abundant. However, with monetary tightening on the horizon in the US, that is set to change and the high needs for external financing make the Latin America countries vulnerable to developments and sentiment in international capital markets (see also [Latin America: external vulnerabilities and FX pressure valves](#)).

...and there is limited room to respond

Strong economic fundamentals and/or sound macroeconomic policies provide the countries with some resilience against external shocks, such as an interest rate hike in the US. [3] The effect of commodity prices on output depends on the quality and flexibility of the macroeconomic policy framework (Adler & Sosa, 2011). Thus, sound macroeconomic policy places countries in a better position to withstand external shocks and allows for countercyclical measures to support growth.

All countries in the region run budget deficits (table 3) and public debt levels are sizeable in many countries (though not particularly high when compared to the average of 44% of GDP found in emerging and developing economies globally). Thus, there is room for moderate fiscal stimulus at most. Fiscal space is particularly limited in Brazil, Costa Rica, Ecuador, Guyana, Suriname and Venezuela. The situation is especially critical in Venezuela, where double-digit budget deficits, hyperinflation, economic contraction and a currency selling at a 99% discount on the black market leave no room for countercyclical measures and significantly increase the chances of a balance of payments crisis or/ and the risk of default. In Argentina, stagflation, low FX reserves and high currency depreciation pressures also make for a fairly critical situation.

However, there are also countries with a primary surplus and a fairly low level of public debt, such as Colombia, Paraguay and Peru. Fiscal room for stimulus is ample here, though there is a risk that due to supply constraints too much stimulus could result in growing macroeconomic imbalances, such as rising inflation or widening trade deficits. The low level of public debt and the net creditor position also provide ample room for fiscal stimulus in Chile. We do note that the room for fiscal stimulus in all the countries also depends on the medium-term commodity market outlook. As the commodity boom appears to be over, low commodity prices might be here to stay for quite some time. More expansionary fiscal policies can sometimes smoothen the adjustment process, but should thus not be seen as permanent fixes.

Inflation is fairly high across Latin America. In countries where inflation targets are in place, inflation is running against the upper limit of the target band. This leaves little room for monetary stimulus and could also hurt private consumption, as inflation erodes purchasing power. Besides, in countries where inflation expectations risk getting unanchored on the back of lingering high inflation, such as in Brazil (inflation reached 9.6% yoy in July 2015) and Uruguay, this could also weigh on future investments. Here, governments need to tighten monetary policy, although this will hurt economic growth in the short term. Meanwhile, there seems to be a regional difference between South and Central America, with the countries in the latter region having lower inflation rates and therefore enjoying some space for monetary stimulus, especially as inflation is also set to fall on the back of lower oil prices.

Table 3: Indicators of economic performance & macroeconomic policy

	GDP growth (%)	Unemployment (%)	Inflation (%)	Inflation target (%)	Gross national savings (% of GDP)	Fixed investment (% of GDP)	Credit to the private sector (% of GDP)	Credit to the private sector real growth (% yoy)	Budget balance (% of GDP)	Primary balance (% of GDP)	Government debt (gross) (% of GDP)	Government net debt (% of GDP)
	2014	2014	2014		2014	2014	2014	2014	2014	2014	2014	2014
South America												
Argentina	0.5	7.3	37.6		18.8	19.6	35.9	14.5	-2.7	-1.0	49	
Bolivia	5.4	4.0	5.8		22.7	20.4	53.6	16.3	-3.2	-2.3	32	12
Brazil	0.1	4.8	6.3	2.5-6.5%	16.2	20.0	108.3	5.2	-6.2	-0.6	65	34
Chile	1.8	6.4	4.4	2-3%	20.3	21.5	120.3	5.4	-1.4	-1.4	14	-5
Colombia	4.6	9.1	2.9	2-3%	19.4	24.4	71.1	8.2	-1.4	0.9	38	28
Ecuador	3.6	5.0	3.6		27.2	28.0	31.8	11.2	-5.2	-4.0	30	
Paraguay	4.4	5.5	5.0	3-7%	15.3	15.2	40.6	13.0	-0.5	0.3	21	
Peru	2.4	6.0	3.2	1-3%	22.7	26.8	24.8	15.7	-0.1	0.8	21	3
Suriname	2.9	8.9	3.4		10.9	16.8	31.5	19.4	-5.0	-4.1	34	
Uruguay	3.3	6.5	8.9	3-7%	17.3	22.1	35.2	5.1	-3.4	-0.5	63	23
Venezuela	-4.0	8.0	62.2		20.8	19.0	61.9	22.3	-14.8	-10.9	46	
Central America												
Belize	3.4	12.9	0.9		10.4	16.1	58.3	2.6	-2.6	0.1	76	76
Costa Rica	3.5	8.2	3.2	3-5%	14.3	18.8	63.0	12.7	-6.0	-3.1	40	40
El Salvador	2.0	5.5	1.1		9.5	14.5	73.2	1.1	-3.5	-1.1	56	
Guatemala	4.0	n.a.	3.4	3-5%	11.7	14.0	41.8	5.0	-1.9	-0.4	24	
Guyana	3.8	n.a.	1.0		3.5	19.4	58.0	9.9	-5.2	-4.4	66	57
Honduras	3.1	4.5	6.1	4-6%	14.4	22.1	58.8	4.5	-4.3	-3.8	46	
Mexico	2.1	4.8	4.0	2-4	19.9	21.9	50.8	2.3	-4.6	-2.0	50	44
Nicaragua	4.5	4.8	6.0	6-7%	18.8	25.1	47.2	0.1	-1.1	-0.6	32	
Panama	6.2	4.1	2.6		17.8	29.8	83.7	32.1	-4.3	-2.4	46	43

Source: IMF, World Bank, EIU

The high inflation is closely linked to tight labour markets, particularly in South America, where high inflation rates and tight labour markets indicate countries are heading towards a cyclical downturn. Unemployment rates are on average low and most importantly are below historic averages in many countries. Consequently, against the backdrop of a challenging external environment, labour markets are likely to soften, which should limit real wages and private consumption growth. The resulting domestic weakness only adds to the growth slowdown. The situation is slightly more upbeat in Central America, where unemployment rates are not expected to increase, even though they are also fairly low from an historical perspective. In some countries, such as Belize and Mexico, unemployment is even expected to keep falling, which should boost private consumption.

Credit to the private sector tends to be pro-cyclical, so high levels of indebtedness could actually become problematic and constrain growth during the slowdown. However, debt levels in Latin America are relatively modest, though elevated in Central America and very high in Brazil and Chile.^[4]

While there is room for expansion in countries with lower debt levels, it is important that such expansion is in line with income fundamentals, so that it does not create bubbles in the future.

The double digit real credit growth in many South American countries therefore needs to be closely monitored.

Weak demand adds to the investment challenge

As we have seen, the domestic and external environment for most Latin American countries is less favourable than in the past and room for policy stimulus is limited. This can hurt investments, which have already fallen in recent years, and could raise concerns about potential future economic growth, especially as investments in Latin America have already been low for some time by international standards. On average Latin American countries invest 20% of GDP, which is not much lower than the 21% of GDP invested in advanced countries, but

still far below the 32% of GDP invested in emerging and developing countries. Countries like Colombia, Ecuador and Peru buck this trend and invest larger amounts, relieving pressure on future economic growth potential. Still, investments in these economies have been concentrated in the commodity sectors and the outlook for these markets is bleak.

Low levels of investment are related to low levels of savings. At an average of 16.6% of GDP, gross national savings in Latin American countries are lower than the 21% of GDP recorded in advanced economies and the 32% of GDP recorded in emerging and developing economies. Bolivia, Ecuador, and Peru stand out with gross national savings rates higher than in the advanced economies. Savings are particularly low in Belize, El Salvador, Guatemala, Guyana, Paraguay and Suriname. Also, given the level of economic development, savings are also surprisingly low in Brazil, Costa Rica and Uruguay.

The outlook for Latin America is dim

In the past decade Latin America has ridden the waves of booming commodity prices and abundant liquidity in international capital markets. Both are now petering out, though expansionary monetary policy in Europe and Japan is still to stay for a while. Besides, global economic growth should strengthen next year. However, a slowdown or rebalancing in China could hurt commodity prices, especially the non-agricultural products, and that tilts the risks to the downside for Latin America commodity exporters.

Most Latin American countries are expected to reach a low in GDP growth this year and a steady pace or a slight rebound in 2016. The recovery is stronger in Central American countries, which will benefit from the recovery in the United States and lower import oil prices. Despite the lower oil prices, the largest economy in the region (Mexico) will maintain a growth pace of around 3% in 2016. South American countries will not return to the growth rates recorded during the commodity boom, but we should see a slight increase in growth in most places next year. The largest economy in the region, Brazil, is confronted with one of the sharpest economic contractions in its history this year and will see only a modest improvement in 2016, though that translates to a milder contraction. Domestic Brazilian woes add to the challenging external environment (see also [Brazil: Headwinds intensify](#)). The recovery will be stronger in Chile and Peru.

In the longer run, Latin America's economic prospects will be determined by the extent to which countries will be able to reform in order to remove bottlenecks on the supply side and raise their productivity (see [Latin America: locked up in the middle-income trap?](#)).

Footnotes

[1] Collier and Goderis (2007) conclude that the impact of commodity price increases on economic growth is positive in the short term, but not always so in the long term (see also [Latin America: progress through populist policies? A mixed picture](#)). Specifically, non-agricultural commodity exporters with poor governance witness adverse effects in the long term.

[2] As Latin American countries account for 98% of GDP in Latin America & the Caribbean, the latter is used as a proxy for Latin America in regional comparisons.

[3] Strong economic fundamentals could also be supportive of growth (see also [Latin America: locked up in the middle-income trap?](#)).

[4] Panama's high degree of indebtedness and fast pace of credit expansion are probably related to its aforementioned role as a regional financial centre.

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Abbreviations for sources: WEO: World Economic Outlook, EIU: Economist Intelligence Unit, IMF: International Monetary Fund, WEF: World Economic Forum, DOTS: Direction of Trade Statistics

Abbreviations used for countries: AR: Argentina, BZ: Belize, BO: Bolivia, BR: Brazil, CL: Chile, CO: Colombia, CR: Costa Rica, EC: Ecuador, SV: El Salvador, GT: Guatemala, GY: Guyana, HN: Honduras, MX: Mexico, NI: Nicaragua, PA: Panama, PY: Paraguay, PE: Peru, SR: Suriname, UY: Uruguay, VE: Venezuela

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Author(s)

Alexandra Dumitru

International Research (IR)

 +31 30 21 60441

 A.M.Dumitru@rn.rabobank.nl