Latin America and the Caribbean: Adjusting Under Pressure

By Alejandro Werner

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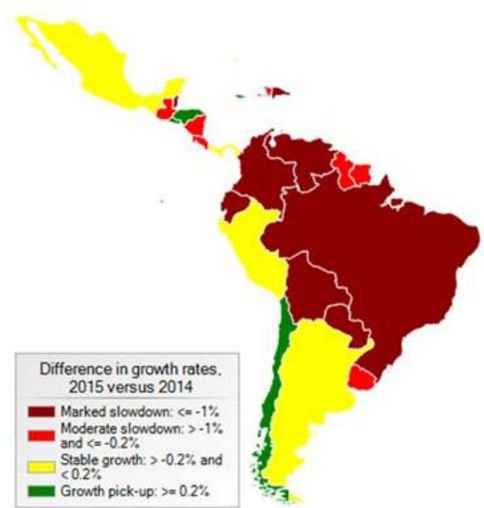
The economic outlook for Latin America and the Caribbean has once again been revised downward. The new projection implies that the average growth of real GDP in the region may be slightly negative this year (-0.3 percent) before recovering modestly in 2016 (0.8 percent).

Chart 1. Real GDP Growth
(percent)

	2013	2014	2015 (Projections)	2016 (Projections)
Latin America and the Caribbean[1]	**2.9**	**1.3**	**-0.3**	**0.8**
Financially integrated economies (LA6)[2]	4.0	2.4	1.5	2.1
Brazil	2.7	0.1	-3.0	-1.0
Chile	4.3	1.9	2.3	2.5
Colombia	4.9	4.6	2.5	2.8
Mexico	1.4	2.1	2.3	2.8
Peru	5.8	2.4	2.4	3.3
Other commodity exporters[2]	6.0	2.0	-0.6	0.1
Argentina	2.9	0.5	0.4	-0.7
Ecuador	4.6	3.8	-0.6	0.1
Venezuela	1.3	-4.0	-10.0	-6.0
CAPDR[2]	4.2	4.4	4.0	4.1
Caribbean: tourism-dependent[2]	1.5	2.4	2.3	2.3
Caribbean: commodity exporters[2]	2.8	2.5	2.0	2.5

Growth Momentum, 2014-15



Sources: IMF, World Economic Outlook database; and IMF staff projections.
Note: LA6 = Brazil, Chile, Colombia, Mexico, Peru, and Uruguay; Other commodity exporters = Argentina, Bolivia, Ecuador, Paraguay, and Venezuela; CADR = Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
[1] Purchasing power parity GDP-weighted average.
[2] Simple average.

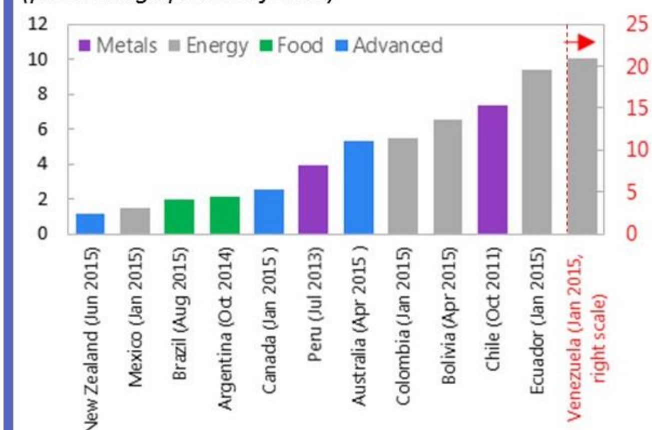
Clearly, the outlook is not so gloomy all around. The regional average is particularly affected by the economic deterioration in a few large economies that are facing severe domestic problems. Many other economies are undergoing a gradual deceleration while adjusting to a new reality, characterized by much less favorable external circumstances than those recorded a few years ago.

Of particular note is the marked decline in commodity prices, partly attributable to the economic slowdown in China. Copper prices, for example, fell more than 25 percent last year, and soybean prices declined by about 20 percent during the same period. Oil prices tumbled further in recent months, leading to a cumulative drop of more than 50 percent since June 2014. The impact on the various countries depends, of course, on which commodities they produce and their weight on the economy as a whole.

A few economies are contracting sharply…

Two of the main economies in the region, Brazil and Venezuela, are enduring sharp economic contraction this year. This is not only a result of the deterioration in the international environment; it also stems from deepening domestic imbalances, albeit of different types in each country.

Chart 2. Peak to Trough Change of Commodity Terms of Trade
(percentage points of GDP)



Sources: Gruss (2014); and IMF staff calculations.
Note: Through period of current commodity terms of trade cycle in parentheses for each country.
Excludes precious metals, except for Bolivia, Colombia and Peru.

Venezuela is trapped in a vicious cycle of distortionary interventions, weak policy frameworks, and economic and social deterioration. As a result, the country has the highest inflation rate in the world, a severe shortage of goods, and an exchange rate on the informal market that is about 100 times higher than the official rate. In this context, and given the collapse in oil prices, output is expected to contract by 10 percent in 2015.

After an excessive use of demand stimulus policies in the past, the authorities in **Brazil** have had to adopt more stringent monetary and fiscal policies to restore confidence in the sustainability of the country's public finances and to stabilize medium-term inflation expectations. Moreover, a political crisis has demolished the confidence of consumers and firms to historic lows, further affecting economic activity and public finances. The level of economic activity is expected to fall by about 3 percent in 2015.

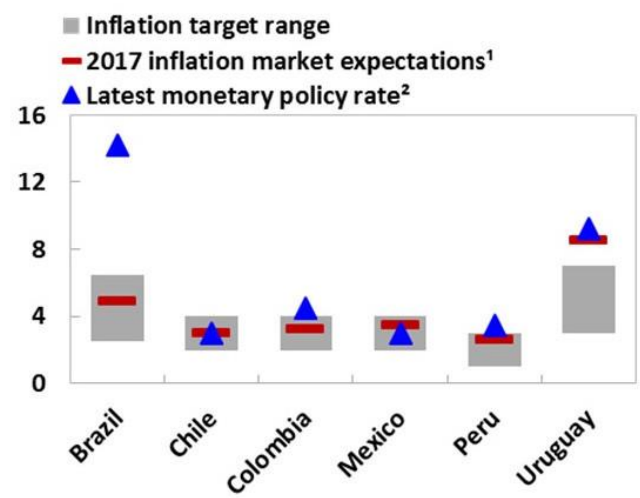
Although the growth projection for 2015 remains slightly positive for **Argentina**, partly because of a major fiscal incentive, the economy is expected to contract in 2016. Furthermore, the broad mix of monetary and fiscal policy continues to exert pressure on the gap between the official and market exchange rates, on inflation, and on net international reserves. In **Ecuador**, the drop oil prices has had a large impact on national income, leading to a sharp slowdown in economic growth, projected at -0.6 percent for this year.

… while others are decelerating in tandem with external deterioration…

The external context faced by the region has continued to worsen. However, the timing and the severity of the impact of the decline in commodity prices vary from one country to the next, largely because of the dissimilar evolution of individual commodities.

Whereas the fall in metal prices has been affecting **Chile** and **Peru** continuously since 2011, requiring economic adjustment on their part, the oil price collapse has been recent, beginning since mid-2014. Thus, the region's crude oil exporting countries have only recently begun the process of adjusting to this new reality. Indeed, whereas in Chile the current account deficit fell from 4 percent of GDP in 2012 to nearly zero, in **Colombia** it increased until recently and currently stands at 6 percent of GDP.

Chart 3. LA6 Monetary Rates
(percent)



Sources: Bloomberg, L.P.; national authorities; and IMF staff calculations.
[1] Data come from national authorities surveys and market participants.
2In the case of Uruguay, the figure shows the one-month Uruguayan peso rate.

Growth in **Peru** slowed abruptly in the past year because of the decline in investment and temporary supply disruptions in the fishing, mining, and agricultural sectors. As some of those shocks continued in 2015 and were accentuated by the further drop in metal prices, Peru's economy is expected to grow this year at a rate similar to that of 2014 (about 2½ percent) before rebounding to 3¼ percent in 2016.

Mexico has a more diversified economy that is more integrated commercially with the United States. It is therefore relatively less affected by the oil price decline. However, the projection of GDP growth for this year was cut to 2.3 percent (from 3 percent in our April report), partly resulting from a further fall in oil production.

…increasing the need to strengthen economic policies

Reality has changed in Latin America and the Caribbean, and various economies in the region have sound fundamentals for dealing with this new environment. However, an adjustment in economic policies will also be necessary.

First, foreign exchange flexibility can play a pivotal role in the adjustment of the economies to this new reality. In that sense, currencies depreciation caused by terms of trade changes and a worse growth outlook should be welcomed and accepted. But in countries where medium-term inflationary expectations have remained above the midpoint of the target range, or where dollarization is intense, it is more difficult to take advantage of foreign exchange flexibility—which highlights the benefits of continuing to improve the credibility and soundness of policy frameworks.

Generally speaking, and given the degree of economic deceleration being experienced in the region, maintaining an accommodating monetary policy seems appropriate in those economies with well-anchored medium-term inflationary expectations.

In these circumstances, and for the purposes of maintaining fiscal sustainability, it is essential for fiscal policy to be tailored to lower medium-term growth and less income from commodity-producing sectors. As we have argued in a recent blog, the speed of economic adjustment will depend on the policy room available to each country, this being a function of the country's level of debt and primary surplus. Generally speaking, however, there is a need to reconstitute fiscal buffers in the region.

Lastly, the region needs to continue encouraging reforms to increase productivity and potential growth. Without sustainable growth that is less dependent on the dynamism of commodity production, it will be hard to meet the demands for social improvement that are now widespread in Latin America and the Caribbean.

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Alejandro Werner assumed his current position as Director of the Western Hemisphere Department of the International Monetary Fund in January 2013. A Mexican citizen, Mr. Werner has had distinguished careers in the public and private sectors as well as in academia. He served as Undersecretary of Finance and Public Credit of Mexico from December 2006 until August 2010 and was Professor of Economics at the Instituto de Empresa in Madrid, Spain, from August 2010 until July 2011 and Head of Corporate and Investment Banking at BBVA-Bancomer from August 2011 until end-2012). He has also served as Director of Economic Studies at the Bank of Mexico and Professor at ITAM. He has published widely. Mr. Werner was named Young Global Leader by the World Economic Forum in 2007. Mr. Werner received his Ph.D. from the Massachusetts Institute of Technology in 1994.