Global Economic Policy Lab

Current Macroeconomic Trends in Latin America: Implications for Public Debts

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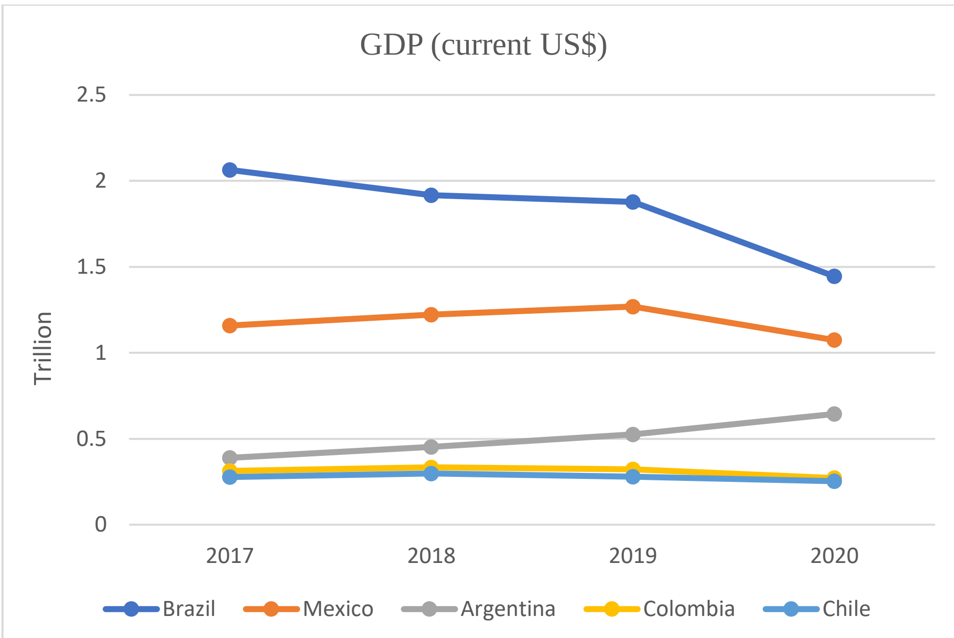
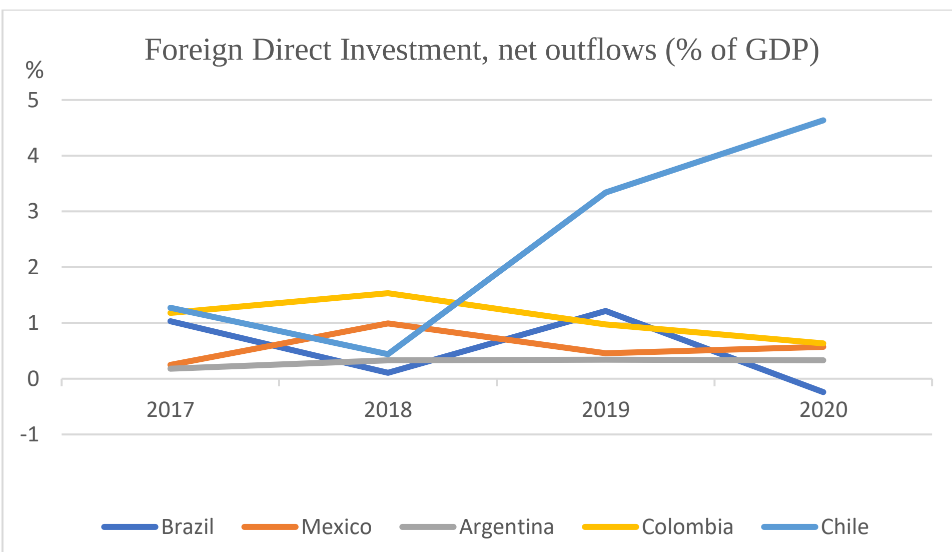
Overview of Latin America Current Macro Trends

The pandemic has caused contractions in income, employment, productivity and economic growth across the globe over the last three years. Low-income regions, like Latin America ("Latam"), struggling with high public debt are the most affected by the pandemic. In 2020, GDP shrank by 6.8%, and public debt rose by 9% of GDP. The Economic Commission for Latin America and the Caribbean (ECLAC) forecasted that the current account deficit would widen from 1.4% to 4.5% of GDP in the coming years due to multiple factors (i.e. monetary policy and political movement). Though it should be noted that prior to the pandemic, Latam already showed signs of economic stagnation.



Source: The World Bank



Source: The World Bank

In 2021, a quick economic recovery in the U.S., China, and other developed countries led to an increase in the price of raw materials and other commodities. As of January 21, 2022, global commodity prices were up 74.9% from their lowest point in April, 2020. While this should be good news for Latam currencies, appreciation to the U.S. dollar was not sustained and most currencies recorded massive depreciations in the second half of 2021, thanks to political uncertainty and the resurgence of COVID. In Chile, one of the world's largest copper exporters, the peso crashed 17% to the U.S. dollar in 2021, even though the price of copper went up 25%. External factors such as high energy prices and supply chain disruptions–are also to blame for the raging inflation. As a net energy importer, Latam's chronic inflation seems to be not only structural, but mostly imported.

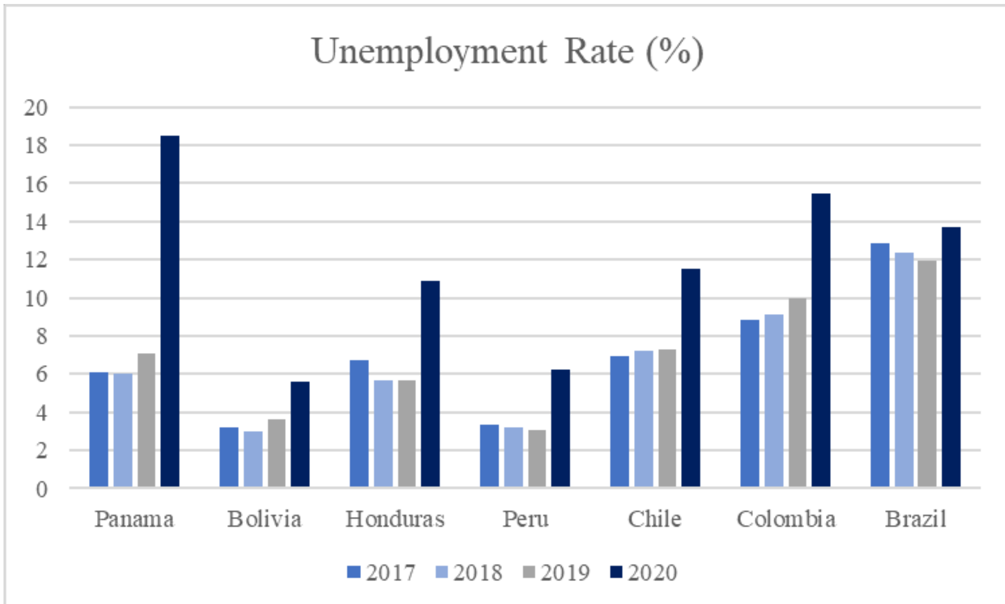
According to Brazil Central Bank Corresponder at Bloomberg, the average inflation rate across Latam in 2021 was 11.9% and estimated to decrease to 10.4% in 2022. The unstable market environment in Latam signals a weak return on investment, which triggers an outflow of investment. During 2020, the total outflow of investment in the region was estimated to be $88 billion, equal to about 45% of all investments, causing record levels of unemployment. Moreover, economic growth in Latam was tepid prior to the pandemic with GDP growth of 0.1% in 2019. While growth does appear to be relatively stronger looking forward with GDP growth forecast to be 2.9% in 2022, this is in part due to the fact that regional GDP is not yet back to pre-pandemic levels.

Inflation Rate v.s. Country	Argentina	Brazil	Colombia	Chile	Mexico
2021	52%	10.7%	5.6%	6%	6.2%
2020	39.9%	3.2%	2.5%	3.1%	3.4%
2019	50.9%	3.7%	3.5%	2.6%	3.6%
2018	42%	3.7%	3.3%	2.4%	4.9%
2017	26%	3.4%	4.3%	2.2%	6%

Source: World Bank, Bloomberg & Trading Economics

Impact of Political Dynamics

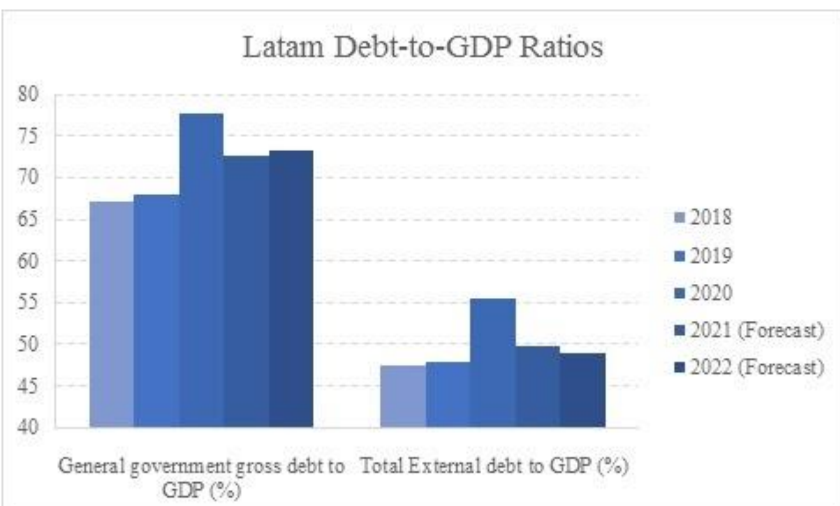
Since the election of Mexican President Andres Manuel Lopez Obrador in 2018, there has been a rise in the election of left-wing Presidents in Latam. Apart from El Salvador, Uruguay and Ecuador, countries are voting against right-wing leaders in favour of candidates who promise to attack national inequality and expand government welfare. While such promises are attractive to populations that have endured economic inequality exacerbated by a poor COVID-19 response, investors are wary as it will require an increase of public expenditure, thereby increasing perceived risk of default. Furthermore, with record breaking unemployment, the extractive sector is likely to be targeted to supplement lost tax revenue. Peru's newly elected President Pedro Castillo has threatened natural gas companies to comply with higher taxes or face nationalisation, and the Chilean President-elect Gabriel Boric, promises to nationalise the pension plan. In anticipation of left-of-centre policies, investors grew anxious and since 2019, both Peru and Chile have suffered mass capital flight, $15 billion and $50 billion respectively. The most impactful elections are to come with Brazil, one of the largest economies in the region, and Colombia, whose main export partner is the US. Given the rise in left-of-centre leaders, investors will be looking closely to see if stronger economic ties are formed with China due to new ideological similarities.



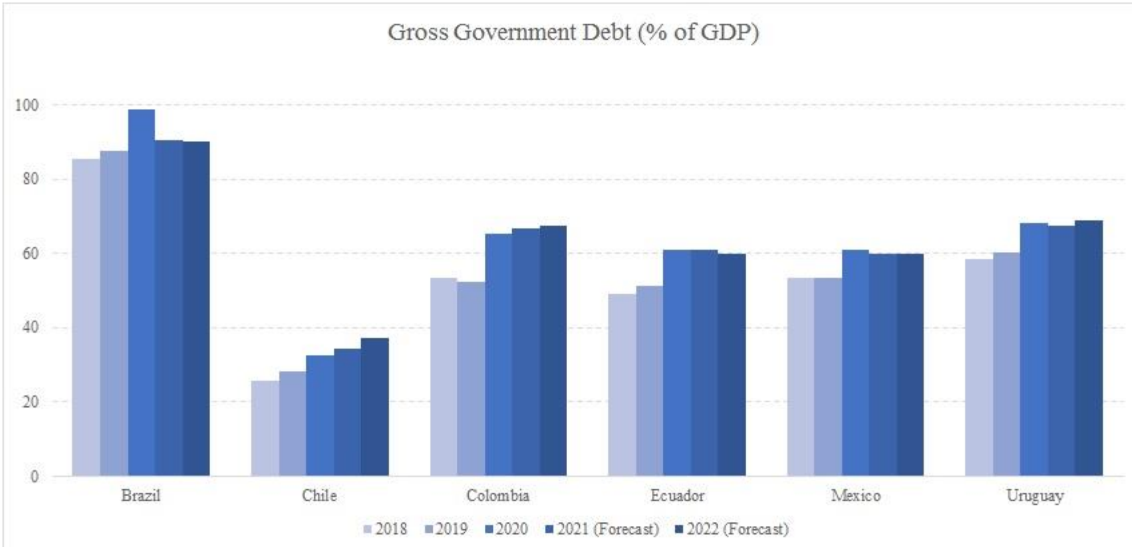
Source: World Bank and Trading Economics

Fiscal Policy Response

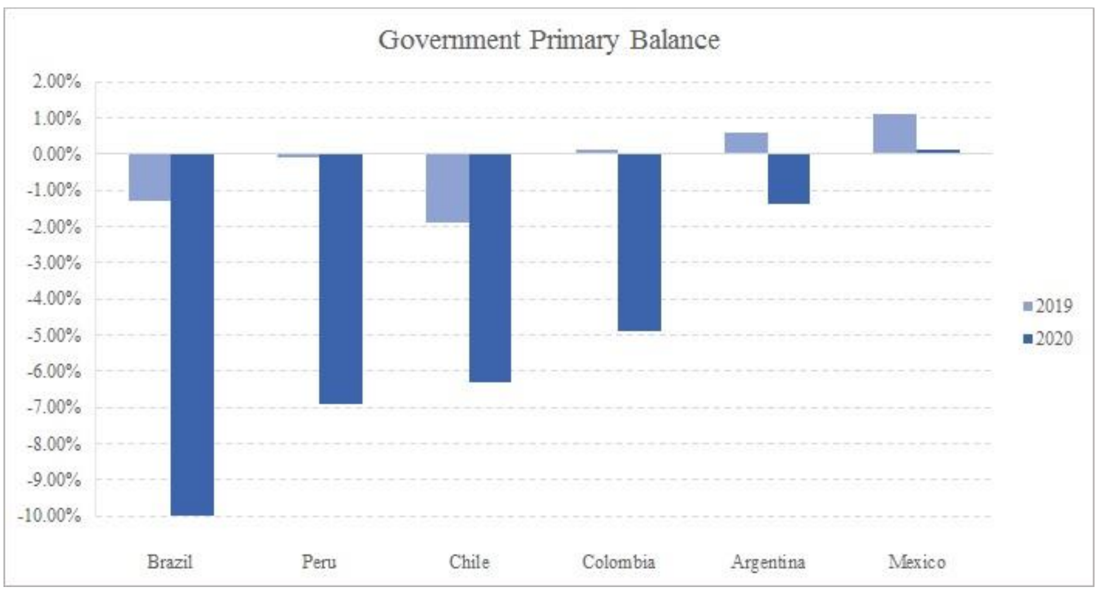
Latam governments responded to the pandemic with a significant fiscal expansion, averaging 8.5% of GDP, though this pales in comparison to the 19% of GDP enacted in advanced economies. While necessary, this stimulus has important implications for debt sustainability as it contributed to the increased debt-to-GDP ratios across the region which climbed from 68% to 77% in 2020. Increased spending has coincided with a fall in government revenue of 2.3% in 2020, leading to a primary deficit of 4.2% in 2020 and 2.4% in 2021. This fiscal picture is complicated by the already limited extractive capacity in the region as tax effort in Latam is



about [60% contrasting with about 77%]() in advanced economies. Furthermore, higher interest rates and depreciating currencies will raise the debt service burden, limiting fiscal space.



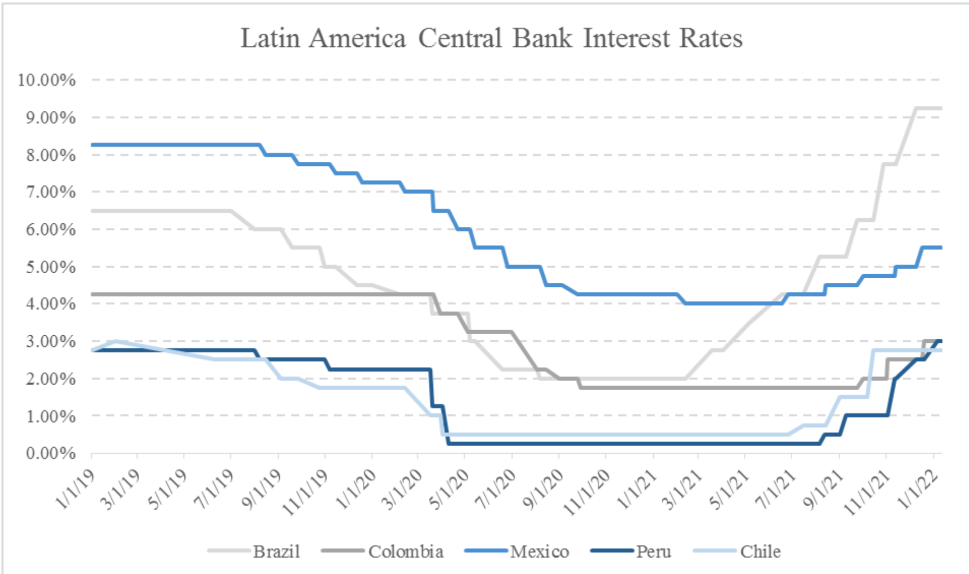
Source: World Economic Outlook Database - IMF



Source: Economic Commission for Latin America and the Caribbean on the basis of official figures

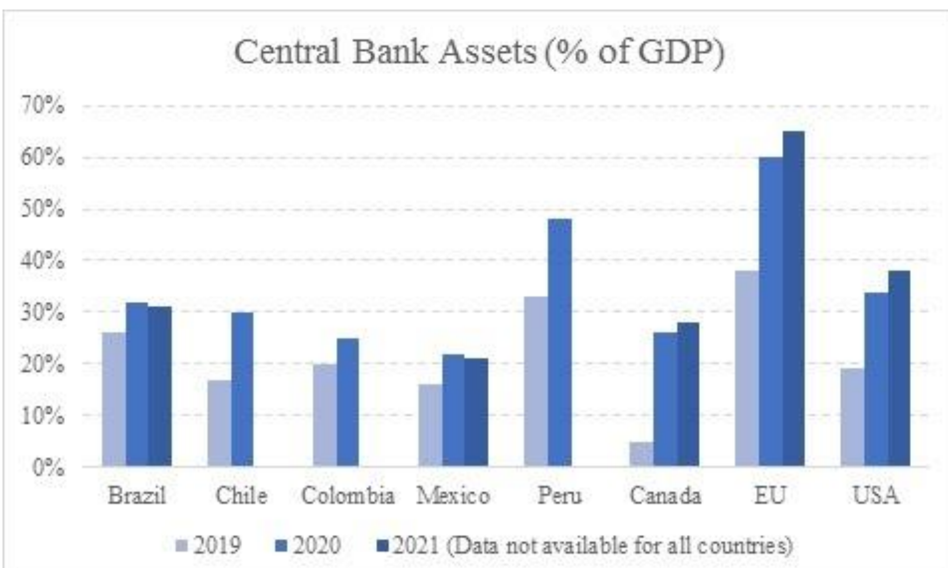
Monetary Policy Response

Central banks ("CBs") in Latam initially responded to the Covid-19 pandemic by cutting interest rates to shore up domestic economies and encourage demand. As inflation persisted through 2021, CBs responded by raising interest rates from pandemic lows to tame inflation. In some countries, rates have been raised above their pre-pandemic levels highlighting the degree of concern among policymakers about inflation. This concern stems from struggles with significant inflation, including bouts of hyperinflation, and the associated economic difficulties faced historically by countries in Latam. The likely normalization of monetary policy in advanced economies, and particularly the Federal Reserve, through 2022, has also factored into the need to lift rates.



Source: Trading Economics

Most CBs in Latam provided liquidity beyond lowering interest rates to their respective financial systems, including lowering bank reserve requirements and providing credit support. Some CBs engaged in asset purchases however, purchases have been smaller than those seen in advanced economies highlighting their comparatively smaller ability to intervene in markets. For instance, the quantitative easing programs in Colombia and Chile have been relatively small, ~$3 billion and ~$8 billion respectively. This in part reflects the large proportion of external debt issued by Latam governments as significantly increasing the money supply through quantitative easing could simultaneously lead to a depreciation of the domestic currency increasing debt service costs.



Source: Atlantic Council QE Tracker, data retrieved from central banks of aforementioned countries as well as IMF and IFS.

Analysis and future implications

Interest rate hikes by Latam CBs follow two main objectives: tame inflation and reduce capital outflow from local-currency bond markets. Given the external origins of inflation, it is doubtful that hikes will have any impact on domestic inflation. Furthermore, the informal labour market in Latam is of considerable size and half of the adult population do not have a bank account which makes any changes to the monetary policy unlikely to achieve full effect.

Nonetheless, the increase in interest rates by Latam CBs is expected to continue in 2022, as the FED in the U.S. is closing in on interest rate hikes. CBs in Latam hope that higher interest rates in their countries will help attract or retain investors to their local-currency government-issued bonds. In the U.S., bond yields have already increased in anticipation of future interest rate hikes which could occur in early 2022. Similarly, yields on local-currency bonds also soared in Latam countries because of CB hikes. In Brazil, yields on the 2025 bonds issued in local currency reached more than 11.50% from 10.65% in the first two weeks of 2022, while in Colombia, they went up above 8% from 7.4%.

It is thus unclear that higher interest rates will be enough to keep money in local-currency bond markets, and in the economy more generally. Chile–a poster child in Latam for investment retention–is now facing substantial capital flight. In the past two years, $24.3 billion left the country, more than 9% of the annual GDP. Moreover, conversions by domestic depositors from Chilean pesos to foreign currencies–mostly U.S. dollars–has tripled over the same period.

As such, capital outflow is likely to sustain the depreciation of Latam currencies. Moreover, higher interest rates will make debt servicing more costly. This comes at a moment when social spending related to the pandemic has inflated the sovereign debt, which is reaching 30-year highs. Nevertheless, Latam sovereigns do not appear to be at immediate risk of default (Argentina notwithstanding) but conditions are on a weak footing as demonstrated by the credit rating downgrades seen across the region since the start of the pandemic.

A weak economic recovery from the pandemic, further limited by rising borrowing costs, may threaten Latam countries' ability to grow their way out of the increased public debt. Congruently, weakening currencies will increase the debt service burden on existing debt and rising interest rates will limit further fiscal stimulus that encourage growth and provide social support. While CB responses will likely be welcomed by markets, political volatility across the Latam region adds an element of concern on the fiscal policy front. Certain electoral outcomes may warrant a reevaluation of debt sustainability and fiscal conditions in Latam.

Select Latam Long-Term Foreign Currency Credit Ratings						
	S&P		Fitch		Moody's	
Country	Jan 2020	Jan 2022	Jan 2020	Jan 2022	Jan 2020	Jan 2022
Brazil	BB- (Positive)	BB-	BB-	BB- (Negative)	Ba2	Ba2
Chile	A+	A	A	A-	A1	A1 (Negative)
Colombia	BBB-	BB+	BBB (Negative)	BB+	Baa2	Baa2
Mexico	BBB+ (Negative)	BBB (Negative)	BBB	BBB-	A3 (Negative)	Baa1 (Negative)
Peru	BBB+	BBB+ (Negative)	BBB+	BBB	A3	Baa1

Sources: S&P Global Ratings, Fitch Ratings, Moody's Investors Services