Growth in an uncertain global environment
The outlook for Latin America
A special report from The Economist Intelligence Unit
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Introduction

The growth rates witnessed in markets across Latin America in the decade to 2010 pulled millions out of poverty, led to rapid growth of the middle class and helped to demonstrate the promise of emerging markets. Since then, however, growth has slowed dramatically across the region. 2015 will mark the fifth successive year of deceleration in Latin America, which has slowed more than any other emerging market region. With concerns over the ability of emerging markets to withstand a slowdown in China and monetary policy normalisation in the US growing, risks to the growth and financing outlook for Latin America persist. However, as economic recovery starts to gather pace in the region, opportunities for investment and growth will also re-emerge. This report provides a snapshot of the current political and economic landscape in the region, and in some of Latin America’s largest economies: Brazil, Mexico and Argentina. Each article analyses key concerns and presents our view of the outlook going forward, helping you to influence decision-making and economic outcomes for your business.
LATIN AMERICA

Rapid currency depreciation sounds the alarm bells

Although many emerging-market currencies have been hit by a wave of volatility in recent weeks, reflecting the prospect of an interest rate rise in the US and concerns about the strength of the Chinese economy, Latin American currencies have weakened in a particularly dramatic fashion. Moreover, there is little to suggest that an imminent recovery in the value of local currencies is likely. This will deepen monetary policy dilemmas for many central banks, which risk choking off an already-weak economic recovery by raising interest rates. With commodity prices also remaining low, the region is at risk of becoming mired in a prolonged period of extremely low growth.

Many Latin American economies have been affected by currency volatility since mid-2014, when speculation about the beginning of a monetary tightening cycle in the US and a fall in global commodity prices prompted most local currencies to depreciate. The weakening has not been linear, with bouts of stabilisation and even some strengthening, but these periods have never been prolonged.

However, even against this backdrop, the sell-off seen across most of the Latin America region in late August was notable. The Colombian peso hit a record low of Ps3,261:US$1 on August 26th, compared with around Ps1,900:US$1 a year earlier, making it among the world’s worst-performing currencies (an accolade that it shares with the Russian rouble and the Ukrainian hryvnia). The Brazilian Real has not fared much better, also hitting a record low against the US dollar in late August, when the currency was trading at R3.67:US$1. Meanwhile, the Mexican peso also fell to new depths, breaching Ps17:US$1 for the first time at the end of the month, while the Chilean peso broke through Ps700:US$1, a level last breached in 2003.

Broader emerging-market turbulence

There are several reasons for the sell-off. Wider international economic factors are playing a big part, with many emerging markets also suffering from sharp currency depreciation in recent weeks. As capital flows back to the US in response to expectations of higher interest rates—The Economist Intelligence Unit expects the first rise in the US policy rate at the December meeting of the Federal Reserve (the Fed, the US central bank)—many emerging-market currencies have experienced renewed pressure on their currencies. Currencies including the Turkish lira, the Malaysian ringgit and the Indonesian rupiah have also experienced sharp sell-offs.

However, the fact that many of the major Latin American economies are large commodity producers has made matters worse, as the sharp fall in most commodity prices since mid-2014 (aggravated by concerns about growth in China) has stoked market fears about the economic outlook in Latin America, which in many cases has deepened the sell-off of local currencies. The collapse in oil prices is...
hitting the region’s main oil producers (Venezuela, Mexico, Colombia and Ecuador), but with global metals prices and agricultural prices also down sharply, metals producers such as Chile, Peru and Bolivia, and agricultural producers such as Brazil and Argentina, have been affected.

**Monetary policy dilemmas**

The collapse in the value of many currencies will have an immediate impact on local economic conditions. Weaker currencies will make imports more expensive and exports more competitive, but with commodities comprising a large share of most countries’ exports, the fall in global prices will result in a fall rather than a boost in export earnings. In many cases, this will more than offset any fall in import spending, resulting in a deterioration in the current-account position. Coupled with larger capital outflows, the steady accumulation of international reserves that many countries in the region had recorded in recent years may slow, or even reverse.

Local currency depreciation will also raise significant monetary policy dilemmas for the region’s central banks. Inflation looks set to increase across the region as rising import costs are passed on to consumers through higher retail prices. However, inflation is already above target levels in many countries: in July it reached 9.6% in Brazil (compared with a targeted 4.5%), 4.6% in Chile (compared with a 2-4% target range) and 4.5% in Colombia (compared with a 2-4% target range). Mexico is the only major Latin America economy in which inflation has remained subdued (falling to 2.7% in July), but the sharp depreciation of the peso in recent weeks is likely to reverse this trend in the coming months.

With the Fed likely to start raising the policy interest rate in the December, Latin American central banks will come under significant pressure to begin raising rates as well, particularly in the light of above-target inflation and the most recent bout of currency depreciation. In contrast to many other emerging markets, most of Latin America’s central banks have kept policy interest rates on hold for the past 18 months—the exceptions are Brazil, where sharply-rising inflation has already prompted monetary tightening, and Peru, where authorities have been cutting rates in an effort to stimulate domestic demand.

However, the decision to start raising rates for the rest of the region will not be an easy one for many policymakers, as domestic demand remains weak in many economies, so raising rates would risk choking off an already-weak economic recovery. In Brazil’s case, further monetary tightening would be likely to deepen the recession. Even before the most recent bout of currency volatility, we had been forecasting extremely weak GDP growth in Latin America (0.7%); recent developments therefore look set to depress this projection even further.

**Stronger balance sheets provide some insulation**

On the positive side, the region is better insulated to deal with sharp currency depreciation than it has been in the past. Reserves accumulation in recent years (stocks have more than tripled in the past decade) provide central banks with greater firepower to smooth out periods of volatility, while
coverage ratios also remain good. Aside from Venezuela, there is little risk of a balance-of-payments crisis in the region as a result of the recent currency depreciation (ironically, Venezuela remains one of the few countries in the region to retain a fixed exchange rate, although real depreciation and lower average oil prices have long undermined the peg and put the country at a high risk of a disorderly adjustment).

Although we had already factored some currency volatility into our economic projections, in most cases currencies have weakened beyond expectation. This is likely to prompt revisions to our exchange-rate and inflation forecasts. It is possible that several currencies may touch new lows as speculation about US monetary policy mounts in coming weeks. Given the time lag between currency movements and the pass-through effect into inflation, our projections for 2016, as well as 2015, will be affected, which, in turn, will hamper GDP growth in the medium term. With the external economic backdrop expected to remain relatively weak, and commodity prices not expected to rebound significantly, Latin America risks becoming trapped in a prolonged period of extremely weak growth.
BRAZIL

Recession puts fiscal targets at risk

Brazil’s recently released national accounts data underscore the severe crisis that has overtaken the country, damaging prospects for fiscal adjustment well into 2016. In the second quarter, real GDP fell by 2.6% year on year and by 1.9% in seasonally adjusted quarter-on-quarter terms, marking two consecutive quarters of negative growth. The extent of the contraction not only underscores the depth of Brazil’s recession, but places severe strains on the proposed fiscal adjustment, particularly in view of the expectation that the economic slump may last well into 2016. As headlines have been quick to point out, Brazil has not suffered from such a long-running recession since the Great Depression.

Although the government attempted to play down second-quarter GDP results immediately after their release, figures show cause for grave concern. On the supply side, every category saw steep declines, with construction taking the lead and dropping by 8.4% in the quarter, followed by manufacturing, which contracted by 3.7%. The construction sector has been heavily affected not only by the ongoing slump, but also by the involvement of many of Brazil’s largest contractors in the bribery investigations at Petróleo Brasileiro (Petrobras, the state-controlled oil company). Manufacturing activity has been dropping for several consecutive quarters, chiefly on account of Brazil’s grave competitiveness bottlenecks and severe lack of confidence in the wake of the current political and institutional crisis.

Political crisis weighs on domestic demand

The political crisis has also had very visible effects on aggregate demand components: investment fell by around 12% in the second quarter, the sharpest drop since 1996. Consumption, on the other hand, fell by around 2%, affected mainly by rising inflation and the erosion of household income, as well as by rising unemployment. In July unemployment reached 7.5% after hitting 6.9% in June. The jump in unemployment signals growing weakness in labour markets and increasing expectations that the number of displaced workers as a share of the working population could quickly rise to double-digits by year-end. This would pose severe problems for the president, Dilma Rousseff, whose approval ratings currently stand at an all-time low of just 8%. Exports have shown a slight reaction to the recent depreciation of the Brazilian Real, having risen by around 3.4% in the second quarter. However, imports have once again underscored the weakness of activity, dropping by more than 8%.

Based on these numbers, as well as on the continuing political crisis and the very high level of uncertainty it creates, it seems unreasonable to expect any improvement in economic activity this year. As a result, our expectations of a GDP contraction of 1.5% in 2015 are being revised to a drop of 2.5%, and the risks still appear to be on the downside. We also now expect recession to extend into 2016, with GDP to decrease by 0.5% next year.
Fiscal consolidation at risk

This scenario poses grave risks for the government’s fiscal consolidation plans. It has now been acknowledged even by some government officials that the recently revised primary surplus target of 0.15% of GDP may be missed this year. Most analysts actually expect the government to post a primary deficit for a second consecutive year. In order to raise the chances that the target of 0.7% of GDP set for 2016 will be met, the government has flirted with the resurrection of Brazil’s financial transaction tax (CPMF), a contentious tax that would have helped to close the revenue gaps estimated for next year. However, in the light of Ms Rousseff’s increasing political isolation—the vice-president, Michel Temer of the Partido do Movimento Democrático Brasileiro (PMDB) has just left his role of chief political negotiator in the Rousseff administration, allegedly as a result of mounting tensions between his party and the PT—plans to reintroduce CPMF had to be abandoned. In view of this, the budget proposal recently sent to Congress now envisages a primary deficit of 0.5% of GDP for 2016. This is the first time that a government has presented a budget proposal with an unequivocal disequilibrium—it is a tenet of Brazil’s fiscal institutions that budget proposals for the following fiscal year be balanced, or in surplus.

Political considerations at play

In the light of grave tensions between the government and Congress, the budget proposal for 2016 has been seen by some as a political ploy: if Congress does not approve new revenue measures, such as the recreation of CPMF, Brazil may be well on the way to losing its coveted investment grade status. By being so explicit about this possibility, Ms Rousseff and her economic team are hoping to cross some of the hurdles recently created by an increasingly hostile legislative branch. Be that as it may, it is becoming increasingly clear that the government’s ability to follow up on the promises that it made earlier this year is rapidly dwindling, which does not bode well for the country, nor for its ability to stave off a damaging loss of its investment grade rating.
MEXICO

Peso continues to depreciate sharply

The Mexican peso continues to depreciate against the US dollar, reaching Ps16.5:US$1 at interbank rates and even breaching the Ps17:US$1 at some retail currency exchanges on August 20th.

Weakening of the peso has intensified over the past month, driven by numerous global and domestic factors. On a global level, the main driver has been the continued strengthening of the US dollar, as well as investor aversion towards emerging-market currencies ahead of a probable rise in the Federal Reserve (the US central bank) policy interest rate, expected in September. Although in recent months the peso has depreciated against some global currencies, including the euro and the pound, it has fared better against other Latin American currencies: it has strengthened against the Colombian peso and the Brazilian Real, but weakened relative to the Peruvian nuevo sol.

Domestically, the sluggish economy (which expanded by just 2.2% year on year in the second quarter, according to recently released data), as well as a continuing crisis of confidence facing the government and the political establishment, have not helped improve sentiment. Initial perceptions that weakening of the peso was a transitory phenomenon now appear increasingly misplaced, which may result in imported prices beginning to adjust to the reality of the exchange rate not falling below Ps16:US$1 at any point soon. Thus far, imported inflation has not manifested itself, but with a large share of consumer goods imported from abroad, particularly the US, this situation could begin to change in the second half of the year. Even without a major inflationary impact, the effect on consumer sentiment could still be significant, as Mexicans typically associate a period of sharp depreciation or devaluation with the onset of an economic crisis (as occurred most recently in 1982, 1994 and 2008).

On the positive side, the government can count on an ample reserves cushion, at US$190.8bn at end-July, although this too has fallen from the end-2014 level of US$193.2bn.

Impact on the forecast

Our forecast of an end-2015 exchange rate of Ps15:8:US$1 will be revised significantly to reflect greater than expected weakening.
ARGENTINA

Scioli ahead, but election could still be close

Recent open primary elections put the governor of Buenos Aires province, Daniel Scioli, in the lead ahead of the presidential election on October 25th. Mr Scioli has a comfortable but not insurmountable lead, and a second-round runoff remains a distinct possibility. Both Mr Scioli and his main challenger, Mauricio Macri, the mayor of the city of Buenos Aires, the capital, will now have to work hard to attract undecided voters. Much could depend on the state of the economy in coming months, and perhaps on contingent events such as recent floods that hit parts of Buenos Aires and Santa Fe provinces.

Simultaneous open primary elections have been held for all candidates in Argentina since they were introduced in an electoral reform in 2009. With most parties still tending to decide their candidates through backroom negotiations ahead of the primaries, in practice the polls serve mainly as an indicator of voting intentions and as a dry run for the election itself. A good primary performance is therefore considered vital. In the August 9th primary, Mr Scioli, who is running for the ruling Frente para la Victoria (FV), the pro-government faction of Argentina’s dominant Peronist party, obtained 38.4% of the vote. This was more than any other candidate, but compares badly with the 50.2% obtained by the president, Cristina Fernández de Kirchner, in the 2011 primaries. In that year’s presidential election, Ms Fernández achieved an easy victory. The current race looks set to be closer.

Ups and downs for Mr Scioli

Mr Scioli scored a large margin of victory in the Northern and Patagonian provinces, but his performance in the Pampean and Cuyo regions was less impressive, and he was defeated in important areas including Córdoba, Mendoza, San Luis and the city of Buenos Aires. In Buenos Aires province Mr Scioli’s performance was also less positive than he will have hoped: he obtained 39.4% of the vote, slightly less than the 40.3% obtained by the FV in gubernatorial primaries held at the same time.

Mr Scioli’s strong performance in the Northern provinces reflects the importance of political clientelism and the strong grip of Peronism in the country’s poorer provinces, where more of the population depends on government aid and public employment. By contrast, in Pampean and Cuyo provinces the electorate has a higher weight of middle-income urban households—indepen dent voters who in recent years have suffered a loss of real incomes driven by high inflation, and for whom insecurity is a major concern. The FV also lost the vote of farmers, who continue to face export taxes, despite rising domestic costs and falling commodities prices.
Macri remains in second place

Cambiemos, an electoral alliance comprising the right-wing Propuesta Republicana (Pro), the centrist Unión Cívica Radical (UCR) and the centre-left Coalición Cívica (CC), was 8 percentage points behind Mr Scioli, with 30.1% of the vote. Although Mr Macri won the Cambiemos primaries (the alliance had not yet named Mr Macri as candidate and he did face challengers, although it has long been assumed that he would win), the victory was bittersweet, as he obtained only 24.3% of the vote, well below Mr Scioli. This suggests that his “purist” strategy, which has centred on Pro figures, and which has caused him to reject alliances with key Peronist politicians in the belief that Argentinians want a radical change from traditional politics, is not working.

Perhaps the best news for Pro was the performance of María Eugenia Vidal, the vice-mayor of the city of Buenos Aires, in the primaries for governor of Buenos Aires province: she obtained 29.4% of the vote, more than any other candidate, in what is traditionally a Peronist stronghold. Before the primaries there were few expectations of a positive result for Ms Vidal, who is a near-unknown in the province. Ms Vidal’s performance was particularly strong in the interior of the province, probably driven by an anti-government farmer vote, and also demonstrating the discontent among urban middle-income households with Mr Scioli’s poor management in important provincial matters such as security.

Massa as kingmaker

Another key result from the primaries was the still-significant vote for the third-placed presidential candidate, Sergio Massa, leader of the Una Nueva Alternativa (UNA) alliance. UNA, which is made up of anti-government Peronists, obtained 20.6% of the vote, and Mr Massa himself obtained a not-insignificant 14.2%. Mr Massa’s campaign got off to a good start when he left the government benches to much fanfare in 2013, but he has since faltered. However, he has managed, against expectations, to hold on to a core base of support, comprising voters who oppose the government but continue to identify themselves as Peronists and who are unfamiliar with the Pro (which remains politically strong in the capital only). This sets Mr Massa up as possible kingmaker in the October election, with both Mr Scioli and Mr Macri vying for the former’s backing. Mr Massa is a Peronist like Mr Scioli, but Mr Scioli’s more hardline rhetoric in the first part of the election campaign, designed to secure the president’s support, may well put Mr Massa off. However, relations with Mr Macri have not been easy either, and Mr Massa is, publicly at least, suggesting that he will not ally with any other candidate.

A scramble for votes

The scenario ahead is complex. Mr Scioli’s main challenge is to attract the vote of the independent electorate, especially those who voted for Mr Massa in the primaries. To achieve this goal, he will need to moderate his discourse and emphasise how he is different from the Fernández government. However, this could result in new conflicts with the hardline left within the FV, potentially undermining the support of ultra-Kirchneristas for his campaign. Mr Scioli also faces the challenge of avoiding a backlash from any anti-government sentiment that may crop up between now and October over
issues such as the economy—which remains in a precarious state—corruption and deteriorating infrastructure (evidenced by devastating recent floods in parts of Buenos Aires province)

Mr Macri has a double challenge: firstly, to retain the support of those who voted for Ernesto Sanz (UCR) and Elisa Carrió (CC) in the Cambiemos primaries, but who could still potentially be tempted to support other centrist candidates, including a former UCR leader, Margarita Stolbizer, who is running for the Alianza Progresistas. Mr Macri must also attract new votes to close the gap with Mr Scioli. In this context, an agreement with Mr Massa would be a huge boost. To achieve this, he may have to trade key cabinet posts, but this could be worthwhile if he is to force a run-off vote against Mr Scioli in November.

To avoid a second-round runoff, Mr Scioli would need to gain 45% of the vote in the first round, or 40% of the vote plus a margin of victory of at least 10 percentage points. Achieving 45% of the vote will be a hard task for Mr Scioli, but he is not far off 40%. For Mr Macri, the challenge is to remain within 10 percentage points of Mr Scioli in the first round, and to perhaps then hope to garner the backing of a wide swathe of opposition candidates in a run-off. On balance, we still consider a victory for Mr Scioli to be the most likely outcome of the election, but in the event of a run-off the race could be close. Alliance-building in coming weeks could then provide the key to victory.
CONCLUSION

These articles provide an analytical insight in to how a variety of political and economic factors can directly affect markets and regional growth. With the prospect of an interest rate rise in the US, concerns being voiced about the strength of the Chinese economy and commodities producers suffering the effect of the recent step drop in global prices, Latin America is experiencing a period of stagnation during what was an already-weak economic recovery. However this does not mean the region is void of opportunities for organisations looking to enter into new or emerging markets. Now more than ever, it is important for organisations to be able to filter out the noise and stay on top of the most important developments, and to be aware of risks as well as opportunities. Every day presents a new issue or event somewhere in the world, and The Economist Intelligence Unit’s country analysis services can help you to put these into context, enabling you to pinpoint the potential opportunities and challenges facing your organisation in an ever-changing business environment.
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