Executive Summary

Following an early setback in 2015, the pace of global activity rebounded, but the outlook remains modest in both the near and medium term. The recovery in advanced economies is becoming more firm, though it is weaker than previously anticipated. After a slow start this year, the U.S. economy regained momentum on the back of resilient consumption, while a gradual recovery in the euro area continues and Japan is returning to positive growth. Emerging markets, however, continue slowing. Notably, China is transitioning to slower growth as its economy rebalances. At the same time, current and projected global commodity prices remain soft, well below their 2011 peaks, including renewed weakness in oil prices. While financial conditions remain accommodative in advanced economies, financial pressures and market volatility in emerging markets have risen, with some retreat in capital flows and downward pressure on asset prices and currencies. On balance, risks to the global outlook are tilted to the downside, amid uncertainty about slowing growth in China and prospective lift-off of U.S. interest rates, as well as concerns about medium-term global growth and secular stagnation.

Against this global backdrop, activity in Latin America and the Caribbean (LAC) continues to decelerate. Real GDP growth is projected to decline for a fifth consecutive year, turning slightly negative in 2015, before rebounding modestly in 2016. This reflects underlying weakness in both aggregate demand and supply in the context of a less favorable external environment. While stronger U.S. growth should benefit the region, especially for those economies with tighter links through trade, remittances, and tourism (Mexico, Central America, and the Caribbean), weaker commodity prices will continue to hurt South America's net commodity exporters—lowering national incomes, reducing investment, and worsening fiscal balances. With commodity prices expected to remain low for the foreseeable future and dampened investment prospects, the region's productive potential has also declined. These developments could, in turn, impede progress made in recent years in reducing poverty and inequality. Key global risks—including an abrupt tightening of U.S. interest rates or a further slowdown in China—may disproportionately affect Latin America.

The credibility of policy frameworks and the resolve of policymakers are likely to be tested in the context of heightened market pressures and weakened underlying fundamentals. This is because, alongside the terms-of-trade shock, domestic headwinds have played an overarching role in the region's slowdown, interacting with changing external conditions. For instance, political crises have intensified in some economies and past policy decisions have limited the space for supporting growth in the wake of lower commodity prices. In economies facing more dire circumstances, severely distortive policy interventions and flawed macroeconomic frameworks have led to large domestic imbalances. Finally, various structural considerations (for example, a high degree of dollarization) have acted as further constraints to how well some economies can respond to external shocks. In these circumstances, labor markets are generally deteriorating, unemployment rates are increasing, and real wage growth is slowing, while private sector confidence has weakened.

From a policy standpoint, exchange rate flexibility remains a first line of defense and should facilitate external adjustment. Fiscal space remains limited across most countries, limiting the scope for a countercyclical policy response. Maintaining an accommodative monetary stance in the context of shifting terms of trade and changes in relative prices from currency depreciation remains broadly appropriate, although with inflation above target in many economies, possible second-round effects and inflation expectations need to be monitored closely. From a longer-term perspective, the ongoing slowdown underscores the importance of structural reforms to alleviate serious supply-side constraints and bolster long-term growth, including by boosting productivity, closing infrastructure gaps, and promoting economic diversification.

These policy recommendations broadly apply to *financially integrated economies*, tailored to individual country circumstances. Brazil needs to continue fiscal consolidation efforts to stabilize public debt while reining in high inflation. Colombia and Mexico are feeling the weight of lower oil prices, but economic activity will continue to expand despite the planned fiscal consolidation to put public debt on a downward path. Chile and Peru are in different stages of the adjustment to the weaker external context. However, their initial strong fiscal and monetary positions and credible macroeconomic frameworks will help them navigate the transition.

Within *other commodity exporters*, unsustainable policies in Venezuela (with possibly dire social consequences) need to be fixed with urgency. Exchange rate rigidity in Bolivia and, especially, Ecuador—a fully dollarized economy—has placed the adjustment burden squarely on fiscal policy, which should continue alongside structural reforms. Eliminating price and exchange rate distortions, together with a fiscal adjustment and somewhat tighter monetary policy, would raise private sector confidence and boost medium-term growth in Argentina.

The current external environment offers an opportunity for *Central America*, a net oil importer, to consolidate fiscal accounts and strengthen monetary frameworks to better anchor inflation expectations. Most *Caribbean* countries should use the breathing room from lower fuel prices to continue reining in unsustainable debt paths and to shore up the fragile financial sectors.

This issue of the *Regional Economic Outlook* features analytical chapters assessing Latin America's monetary autonomy and exposure to global financial shocks; evaluating regional trade integration and its potential benefits; and analyzing the link between financial depth, growth, and economic stability in the region. Key findings are:

- As the Federal Reserve appears set to start raising policy rates, some central banks may not have much room to support economic activity. The actual effect on domestic *interest rates* will depend on whether the U.S. rate lift-off is gradual and in line with an improving economic outlook, or abrupt and accompanied by uncertainty, increased risk aversion, and a larger term premium. Ensuring exchange rate flexibility, enhancing policy credibility, and reducing financial dollarization would raise the region's degree of monetary autonomy.
- Despite efforts to deepen *trade integration*, LAC remains relatively less open to trade and most countries in the region appear to be "under-trading" given fundamentals. Successful exporters have been able to penetrate large markets, including in advanced economies. Deeper integration into global value chains is beneficial, but the direct trade impact is likely to be small. Trade agreements should increase global competitiveness and avoid the creation of regionally protected trade blocs.
- LAC lags behind other emerging markets in financial development, particularly in markets. Many of its financial systems fall short of levels consistent with current macroeconomic fundamentals. The near-term priority is to close these gaps. In the longer term, LAC's growth and stability can benefit from further financial development as fundamentals progress. The sequencing and speed of reforms matter, however, as excessive market development without adequate institutions could threaten macroeconomic stability.