Economic Recovery in Latin America and the Caribbean: A Tale of Two Adjustments

By Alejandro Werner

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The economies of Latin America and the Caribbean are slowly recovering from the regional recession in 2016. This gradual improvement can be understood in terms of ongoing external and fiscal adjustments to earlier commodity terms-of-trade shocks and country-specific domestic factors. But headwinds from both are gradually fading, paving a path for real GDP to grow by about 1 percent in 2017.

Activity is expected to pick up further momentum in 2018, but at a slower pace than previously anticipated, while medium-term growth is projected to remain modest at about 2.6 percent.

Risks to this outlook reflect both internal factors, including corruption concerns in some countries and upcoming elections, as well as heightened external risks—notably greater global policy uncertainty, a rising tide of economic nationalism in advanced economies, and a potential tightening of global financial conditions.

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Individual country prospects will be shaped by the interplay of these external and domestic forces:

- **External conditions** are improving with a modest uptick in demand from key partner countries and some recovery in commodity prices, and relatively easy financial conditions. Following the U.S. elections, prospects of a stronger economy and likely fiscal stimulus in the United States should benefit its trading partners. But expected changes in the U.S. policy mix (including a faster pace of monetary policy normalization) and uncertainty about the nature and extent of other changes in U.S. policies can affect investment and consumption.

- On the flip side, the recovery in domestic demand has broadly been weaker than expected, as consumer and business confidence remain subdued, reflecting both uncertainty about future trade relations with the United States in Mexico and continuing corruption scandals in others. At the same time, domestic inflation pressures are receding in several countries, as the pass-through from past depreciations is fading, creating space for a cut in interest rates.

**Tale of two adjustments**

For many countries in the region, the outlook is being determined by the ongoing adjustment in the external and fiscal balances in response to a severe commodity price shock. In particular:

- The region’s current account deficit corrected in 2016 after reaching a peak in 2015. Focusing on commodity exporters, while metal-exporting countries (such as Chile and Peru) appear to have already adjusted to the negative terms-of-trade shock, the adjustment in oil-exporting countries is still ongoing.

- The primary fiscal deficit in the region increased from 0.2 percent in 2013 to 2.6 percent in 2016. Several countries have embarked on fiscal consolidation, but adjustment in many is significantly backloaded.

**Latin America and the Caribbean: External and Fiscal Adjustment**

(percent of GDP)

![Graph showing external and fiscal adjustment in Latin America and the Caribbean](image)

Sources: IMF, World Economic Outlook database, and IMF staff calculations.
Note: Dashed lines refer to projections. Regional aggregates are purchasing power parity GDP-weighted averages.
The divergence in growth outcomes is declining, as deep contractions in some of the largest economies are nearing their end, but there is still significant differentiation in growth rates.

In **South America**, growth bottomed out in 2016. Domestic factors compounded by a large terms-of-trade shock took a toll on the region’s economic performance and led to sharp recessions in some major economies.

In **Argentina**, the economic recovery is expected to continue in 2017, driven by a rebound of private consumption (as the central bank’s resolute commitment to lower inflation towards its end-of-year target will re-establish positive real wage growth), stronger public capital spending, and a pickup of exports. Growth is projected to remain at about 2½ in 2018 and 2019. The gradual reversal of macroeconomic imbalances inherited from the past administration is expected to lay the foundation for stronger and durable growth in the medium term.

In **Brazil**, following a cumulative decline in output of about 8 percent over the past three years, growth is expected to return to positive territory in 2017, supported by, among other things, a bumper crop, a one-time boost to consumption from the release of inactive severance accounts, higher iron ore prices, and a faster-than-expected decline in inflation. While the constitutional amendment mandating a constant real level of federal noninterest spending is welcome, the pursuit of an ambitious social security reform is imperative both to restore fiscal sustainability and to ensure that the pension system is capable of supporting future generations of Brazilians.

In **Venezuela**, the economy is expected to remain in a deep recession and on a path to hyperinflation, driven by the monetization of wide fiscal imbalances, combined with extensive distortions and a severe restriction in the availability of intermediate goods imports. A serious humanitarian crisis is unfolding with worsening poverty, collapsing of the health system, rising security concerns, and an increasing outflow of people to neighboring countries.

Despite some improvement in external conditions, the outlook for **Chile** remains subdued, reflecting lingering domestic weaknesses, and growth in 2017 is expected to remain at 1.7 percent, only slightly up from 1.6 percent in 2016.

In **Colombia**, guided by timely policy tightening, the orderly economic slowdown continued last year as domestic demand has been adjusting to a permanent shock to national income. At the same time, a nation-wide strike and other one-off factors led to weaker-than-anticipated growth, but a mild rebound is expected for 2017.

**Peru**’s economy grew at a rapid pace in 2016, supported by expanding copper production and robust private consumption. Domestic headwinds arising from a bribery investigation in

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connection with the Brazilian company Odebrecht, along with the worst flooding and landslides in decades, is expected to be a drag on investment and growth in 2017.

Shifting external landscape

For **Central America** and **Mexico**, the outlook and risks are being influenced by their exposure to the United States through trade, migration, and foreign direct investment linkages in a context of changes in the U.S. economy and its policies.

**Mexico**’s real GDP growth is expected to decelerate to 1.7 percent in 2017 (down from 2.3 percent in 2016), before recovering somewhat to 2 percent in 2018. Uncertainty about future trade relations with the United States and higher borrowing costs are expected to weigh particularly on investment but also on consumption, more than offsetting the positive impulse stemming from stronger U.S. growth and the sharp depreciation of the peso in real effective terms. Inflation is running above target, owing mainly to the liberalization of domestic fuel prices in January 2017, compounded by the pass-through of the depreciation of the peso to domestic prices. Mexico’s policy priorities should be to maintain macroeconomic stability and market confidence in an environment of heightened uncertainty, and to strengthen the fiscal framework to bolster the credibility of fiscal policy.

Growth in **Central America, Panama, and the Dominican Republic** has remained broadly stable and robust, supported by a recovery in the United States and low oil prices. Countries in the region would benefit from institutionalizing fiscal discipline and strengthening fiscal policy frameworks.

Prospects for the **Caribbean** region are improving, reflecting the recovery of commodity exporters from the recession in 2016 and increasing growth of tourism dependent economies supported by higher growth in the United States. Public sector debt, however, remains a major vulnerability for the region.

**Setting the course for higher growth**

Exchange rate flexibility has been a key mechanism for absorbing global and domestic shocks for many countries in the region, and maintaining this flexibility is critical given heightened global uncertainty. Recent declines in inflation, reflecting limited pass-through of sizable depreciations, have attenuated trade-offs for monetary policy and created space for interest rate cuts.

Given structurally low commodity prices and subdued potential output, countries should persevere with fiscal adjustment. Some countries have implemented plans, but more needs to
be done given that primary balances for many remain below debt-stabilizing levels. The desired size and pace of adjustment will vary across countries depending on debt dynamics, fiscal risks, the macroeconomic outlook, and market conditions. Adjustment plans should be carefully designed to prioritize much needed physical and human capital spending.

With adjustment ongoing and medium-term growth projected to remain subdued at 2.6 percent, tackling structural bottlenecks are essential to support and raise medium-term growth. Among other things, priorities include improving quality infrastructure and education, encouraging further female labor participation where it is needed, and enhancing the business environment and governance.

Our upcoming *Regional Economic Outlook*, which will be released on May 18, will have a deeper analysis of these issues.

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