Editorial

Economic activity in Latin America is proving more buoyant than expected some months ago, although the pace of growth has, as usual, been highly uneven across the different countries in the region, with GDP growth in 2022 ranging from 2.5% in Chile to 7.5% in Colombia.

Despite its relative resilience, economic activity is clearly moving on a slowing path. Average growth in the region's main economies was below 0.5% in 2022 H2, significantly lower than in 2022 H1 (1.1%).

Going forward, the outlook regarding the duration and intensity of the slowdown in activity is highly uncertain. Among other aspects, it will depend on the macroeconomic impact of the tighter global and domestic financial conditions, the resilience of household consumption to the loss of purchasing power resulting from the persistent inflationary episode, and the strength of external demand, particularly from China, whose reopening could boost economic activity in the region given their close trade links and the important role China plays in commodity price dynamics worldwide.

As regards price developments, in recent months, inflation in Latin America has gradually lost momentum, as in other parts of the world, although year-on-year price growth rates remain relatively high. For example, in January, the region's main economies whose central banks have set inflation targets had a year-on-year inflation rate of 7.9%. In any event, as the region's central banks have pointed out in their latest inflation reports, the upward pressure on prices in recent months appears to be essentially due to demand factors, as opposed to the greater weight of supply factors in the early phases of the current inflationary episode.

The analysts continue to forecast a gradual decline in inflation over the current year, although how sharply it does so will depend, among other factors, on developments in services prices (which have not yet shown clear signs of deceleration in any of the region's main economies) and food prices (which make up a relatively large share of the consumption basket of Latin American households). Although long-term inflation expectations remain anchored to the target, short-term expectations are above the target levels set by the region's central banks and increasingly influenced by past inflation.

Overall, the monetary policy stance in Latin America is clearly restrictive. Policy interest rates are relatively high, compared with those of other emerging and advanced areas and with those observed in the region during previous monetary tightening cycles. To some degree, this appears to have helped mitigate the high inflationary pressures, for instance, by easing currency depreciation pressures, but also by keeping medium and long-term inflation expectations anchored to the inflation targets set by the region's central banks.

Looking ahead, the analysts' consensus suggests that policy interest rates could already have peaked (or be close to peaking) in the region's main economies and that they could fall in some countries in the second half of the year. However, these expectations are subject to considerable uncertainty and will be strongly influenced by the also uncertain monetary policy developments in the main advanced economies, particularly the United States.

On the evidence provided by this report, the policy rate increases in Latin America since the start of the region's monetary tightening phase in the 2021 H1 appear to have gradually passed through to bank lending rates, attesting to the functioning of the bank lending channel in the transmission of monetary policy. However, during this period the rates of growth in lending have remained relatively high owing to different counterbalancing factors, such as the continuation – until a few months ago – of the credit support programmes launched in the most acute phase of the pandemic, and the buoyancy of activity and employment. In this regard, it should be noted that economic activity, lending and capital inflows appear to have been buttressed by the fact that several countries in the region are net commodity exporters and that geopolitical risks in Latin America are relatively contained, especially compared with the risks associated with the war in Ukraine or the trade tensions between the United States and China.

For the region as a whole, fiscal policy currently maintains a neutral or slightly restrictive stance. Although this is helping to somewhat reduce the public debt-to-GDP ratio, in historical terms and compared with other emerging market economies, the ratio remains high. The region's main vulnerabilities continue to lie in the fiscal realm. Thus, for example, the probability of the public debt-to-GDP ratio in ten years' time being higher than the pre-pandemic figure has increased notably for some countries such as Chile and, especially, Colombia.

The vulnerability indicators of the banking industry and the external sector remain at relatively low levels, with some exceptions, although Latin America could witness significant capital outflows in particularly adverse global and domestic scenarios. Also worth noting is the fact that, despite the across-the-board improvement in the region's terms of trade in 2022, trade balances deteriorated as a result of the sharp rise in imports driven by the buoyancy of domestic demand.

Moreover, the region has recently seen a fresh upsurge in economic policy uncertainty and in social and political unrest which could have a negative impact on economic activity. Also, at the global level, the risk of further fragmentation of world trade has increased. Should this risk materialise, it would affect the economies of Latin America and the Caribbean unevenly, as documented in this report.

This report includes two boxes. Box 1 analyses, for the first time, in collaboration with the SECMCA,[1] key developments in economic activity, prices, financial conditions and economic policy in the Central American region. Box 2 sets out in detail the recent changes that have taken place in the banking systems of Latin American countries that are of material significance for Spanish banks, including a description of the main risks to financial stability in those countries according to the reports published by the region's central banks.

1 Secretaría Ejecutiva del Consejo Monetario Centroamericano.