BANCO DE ESPAÑA
Eurosistema

ECONOMIC BULLETIN 2/2019
ANALYTICAL ARTICLES

14 May 2019

Report on the Latin American economy. First half of 2019

Abstract

This article reviews the recent performance of the main Latin American economies, in a difficult external environment, owing to the slowdown in the world economy and the uncertainty associated with trade tensions. Growth in 2018 was lower than in 2017 and lower than projected at the start of the year, primarily on account of the severe recession in Argentina and a slower than expected recovery in Brazil. Activity is expected to be more positive in these countries in 2019, but a slowdown is forecast in Mexico. In addition, the risks remain predominantly on the downside. Among the internal risks, the uncertainty surrounding the economic policies to be implemented in Brazil and Mexico stands out. This issue is analysed in detail in this article.

Two other articles on specific aspects of the performance of the Latin American economies will be published together with this one: “Capital flows to emerging economies: recent developments and drivers”, and “The impact of China on Latin America: trade and foreign direct investment channels”.

Keywords: political uncertainty, low growth, fiscal space.

JEL codes: F01, F21, F30, F41.

Introduction

Since the publication of the last half-yearly report on the Latin American economy, in November 2018, the world economy has continued to slow, leading the central banks of the main developed economies, and the US Federal Reserve in particular, to put a brake on the normalisation of their monetary policy stance. This shift has caused the financial conditions facing emerging economies to return, generally, to more favourable levels, following the turbulence seen in the second half of 2018. Against this background, growth in the main Latin American economies[1] in 2018 stood at 1.4%, 0.3 percentage points (pp) lower than in 2017 and significantly below the 3% expected at the beginning of the year. This poor performance stems, above all, from the severe recession in Argentina and the notably slow recovery in Brazil. Both these economies, as well as Mexico, were subdued at the turn of the year.

The forecasts for 2019 have been revised downwards and growth in the region as a whole is expected to stand slightly below 2% (see Chart 1). Argentina is projected to emerge from recession, although its growth rate for the year as a whole is still expected to be negative, while the Brazilian economy is projected to grow by somewhat less than 2% in 2019, a higher rate than in Mexico (slightly over 1.5%), for the first time since 2013.

The risks for the region originate in the external environment (arising from lower global growth and its possible effect on commodity prices, a possible tightening of international financial conditions and trade tensions) and in specific problems in certain countries. Notable among the latter is the risk that monetary and fiscal adjustment in Argentina will not succeed in anchoring inflation expectations and will have to be intensified, exacerbating the recession and compromising the success of the IMF programme.[2] The uncertainty surrounding the reform of the pension system in Brazil and the doubts raised by the policies of the new Government in Mexico, which have in some cases reversed previous structural reforms, are also elements of concern and are addressed specifically in the box in this article (see Box 1). The limited scope available for monetary policy and, especially, fiscal policy to address these risks should be noted.

Recent developments in the Latin American economy

THE EXTERNAL ENVIRONMENT AND DEVELOPMENTS IN FINANCIAL MARKETS

Against a background of deteriorating confidence and elevated uncertainty, driven by the persistent trade tensions and other risks of a political nature, the global economy has been decelerating. World GDP grew by 3.6% in 2018, 0.2 pp less than in 2017, with a declining trend during the year that extended into early 2019. This has been reflected in a downward revision in the growth outlook virtually across the board. Signs of weakness were also seen in the emerging economies as a result of the deterioration in confidence and world trade, albeit with differences from one area to another. The economic indicators of the Chinese economy have improved in recent months, following the stimulus measures implemented by the authorities. However, this improvement has not been passed through to other Asian economies, which have continued to slow, although they still have more momentum than other regions.

1 Argentina, Brazil, Chile, Colombia, Mexico and Peru, which the article refers to, in aggregate terms, as "the region". No data are available for Venezuela.

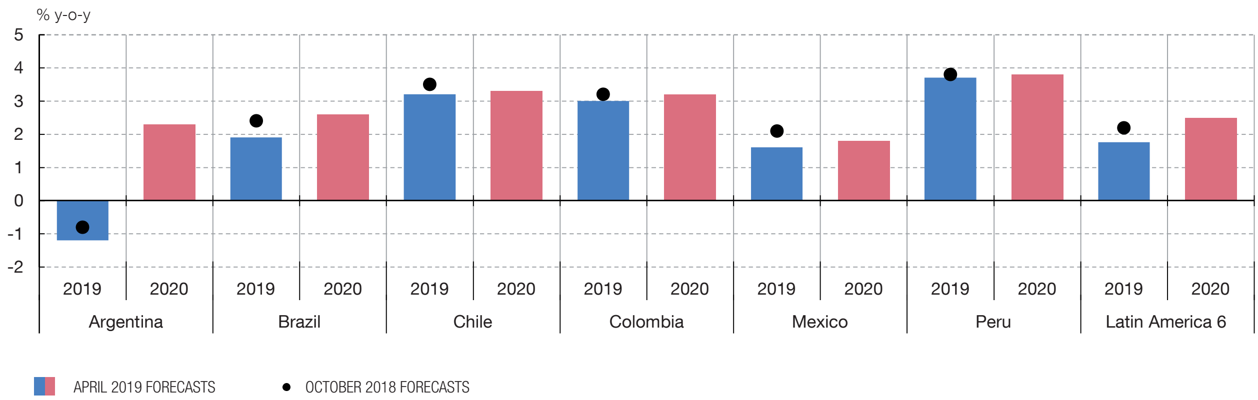
2 See the analytical article "Argentina: economic challenges in an adverse international setting" (https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/ArticulosAnaliticos/2018/T4/descargar/Files/beaa1804-art31e.pdf).

THE REGION'S GROWTH FORECAST IS REDUCED AGAIN, MAINLY DUE TO THE DOWNWARD REVISION FOR MEXICO AND, TO A LESSER EXTENT, FOR BRAZIL AND ARGENTINA

CHART 1

Following the sharp deterioration in forecasts described in the October 2018 report, the growth forecast for the region for 2019 has been reduced by a further 0.4 percentage points (pp) to 1.8%, due to global environment risks and especially the uncertainty surrounding the economic programmes in Brazil and Mexico, their slowdown in the last quarter of 2018 and the effects of the monetary and fiscal adjustment in Argentina. The growth forecasts for the other economies remained stable, or decreased slightly.

GROWTH FORECASTS FOR LATIN AMERICA FOR 2019 AND 2020



SOURCE: Latin American Consensus Forecasts.

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The general deterioration in the growth outlook led to an adjustment in the financial markets (especially in the developed ones) at the end of 2018, and the central banks of the main advanced economies revised their plans to normalise their monetary policy stances. In particular, the Federal Reserve has toned down its projected interest rate rises, at the same time as announcing that the process of balance sheet downsizing will end in September. The European Central Bank (ECB) has extended the period during which it expects official rates to remain at their current levels and has announced full reinvestment of the securities acquired within the framework of the asset purchase programme, as well as a new round of long-term refinancing operations, in order to maintain favourable credit access conditions.

Towards the end of 2018, emerging financial markets, sustained largely by idiosyncratic factors, performed better than developed ones. Following the change in the Federal Reserve's monetary policy stance, at the very start of 2019, there was a substantial improvement (see Chart 2.1). The stimulus measures adopted in China and the prospects of a trade agreement with the United States also contributed to this improvement, although such prospects have recently been perceived more negatively again (see Chart 2.2). However, episodes of adjustment occurred again in markets with major external vulnerabilities (Argentina and Turkey).

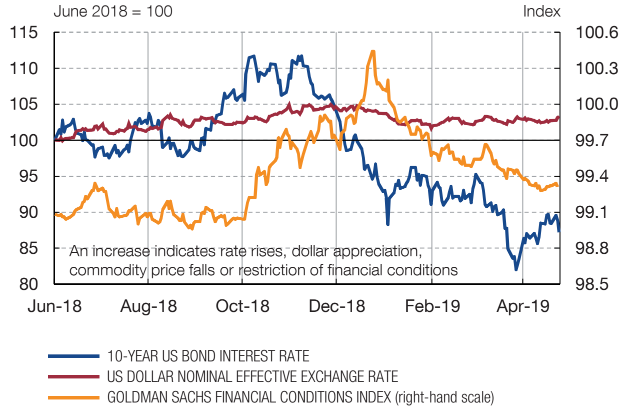
Developments on emerging financial markets were somewhat more favourable in Latin America than in the rest of the world, owing to the region's weaker links with global value chains, which are more exposed to the protectionist tensions, the recovery in the oil price and the initially favourable reaction to the measures announced by the new Governments of Brazil and Mexico, which led to currency appreciation and rising stock markets, especially in the first case (see Charts 2.3 and 2.4). Argentina, however, was hit by a new wave of turbulence from mid-March, reflected in further depreciation of the peso and rises in the risk premium (see Chart 2.5), related mainly to the deterioration in the inflation indicators and the increase in political risk associated with the uncertainty surrounding the results of the presidential elections to be held in the autumn. The problems of the state oil company

FINANCIAL INDICATORS

CHART 2

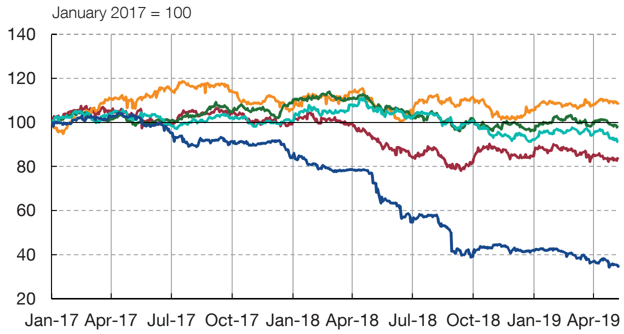
Advanced and emerging markets were influenced by the outlook for protectionism, world growth and monetary policy in the advanced economies, so that a sustained improvement was observed from the beginning of the year, following the trade truce and the change in tone of Federal Reserve communication. The Latin American markets benefited, moreover, from the increase in commodities prices and the initial favourable reaction to the new policies of the Brazilian Government. Financial conditions initially tightened and subsequently eased to their previous levels. They remain very loose, especially in Brazil.

1 FINANCIAL CONDITIONS IN THE UNITED STATES



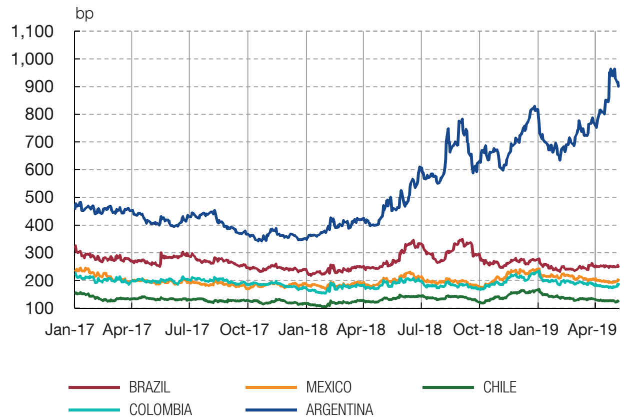
2 EMERGING MARKETS. MAIN INDICATORS

3 NOMINAL EXCHANGE RATE AGAINST THE US DOLLAR

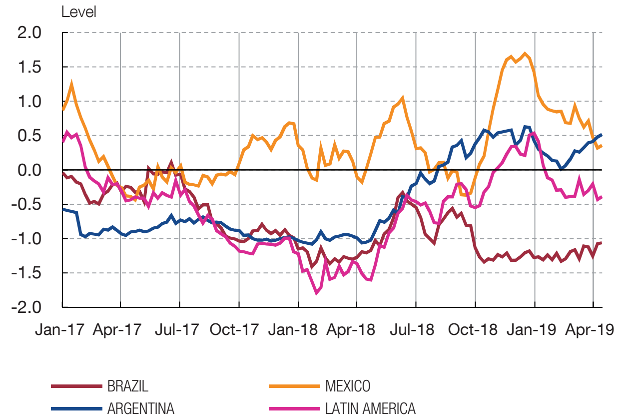


4 STOCK EXCHANGE INDICES

5 SOVEREIGN SPREADS



6 FINANCIAL CONDITIONS INDICES



SOURCES: Banco de España, Thomson Reuters and JP Morgan.

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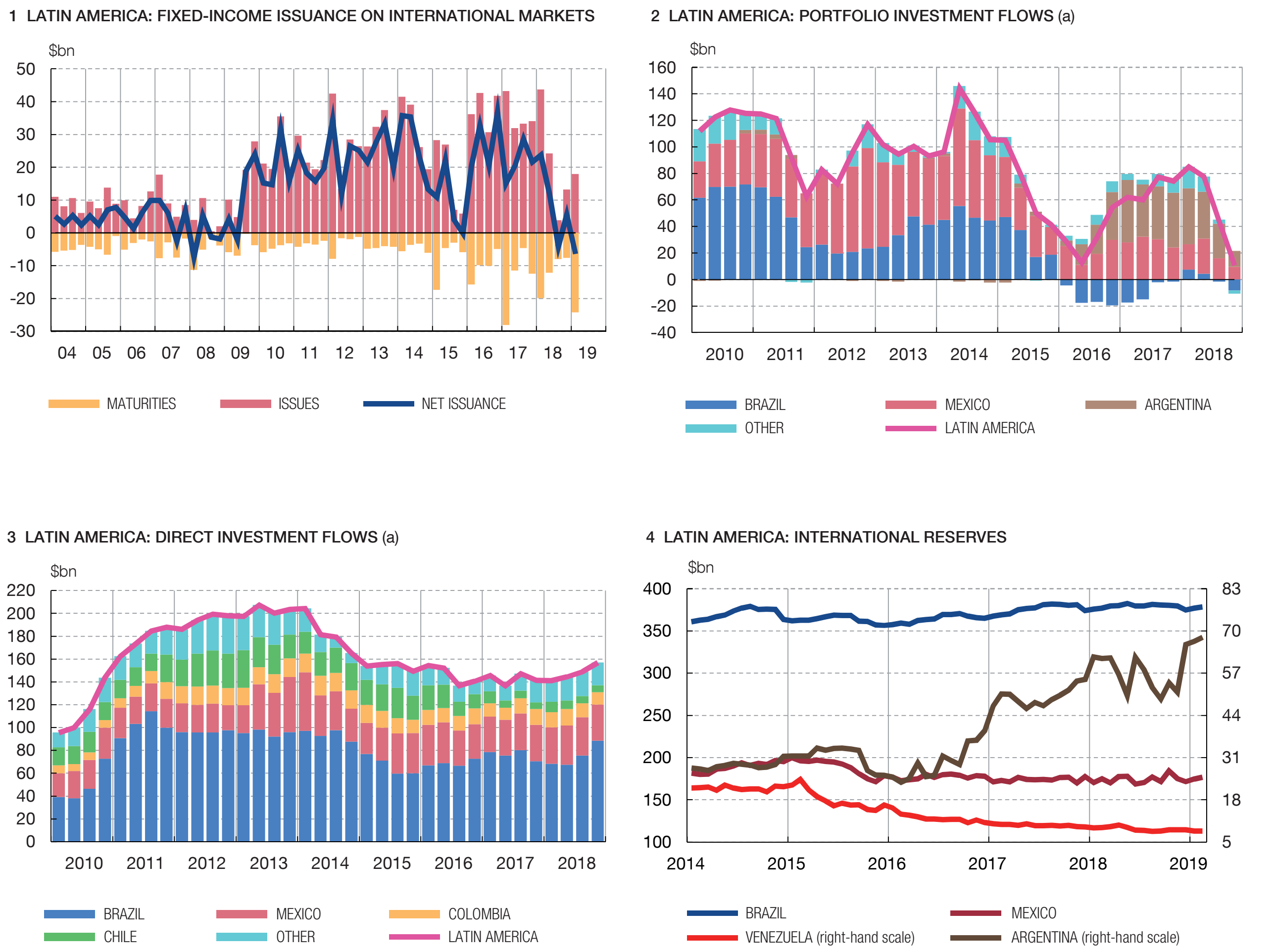
EXTERNAL DELEVERAGING CONTINUED APACE

CHART 3

The region's external deleveraging continued, with negative net issuance of fixed income on international markets. There was an increase in the most stable financing (FDI) and a decline in portfolio investment inflows. Reserves barely changed during the six-month period, except in Argentina.



SOURCES: Datastream, Dealogic, Institute of International Finance, JPMorgan, IMF and national statistics.:

a Four-quarter cumulated data.

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PEMEX caused Mexican markets to deteriorate towards the end of the period examined. All told, financial conditions since the beginning of the year have been easier (see Chart 2.6).

The net issuance of bonds on international markets was negative in the second half of 2018, for the first time since 2007 (see Chart 3.1), while gross inflows of portfolio investment fell to their lowest levels since the start of 2016, basically due to the outflows recorded by Brazil (see Chart 3.2). By contrast, the most stable form of external financing, foreign direct investment, rose during the second half, especially in Brazil (see Chart 3.3). International reserves stood at historically high levels (see Chart 3.4).

ACTIVITY AND DEMAND

Activity in the main Latin American economies as a whole continued to grow slowly in the second half of 2018 with quarter-on-quarter growth rates of 0.4% and 0.3% in the third and fourth quarters, respectively (see Table 1 and Chart 4).[3] However, these rates mask uneven

3 In Venezuela, where official figures continue to be unavailable, the indicators show that the economy remains in a deep recession and beset by hyperinflation, in accordance with the customary definitions.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2017	2018	2017	2017	2017	2017	2018	2018	2018	2018	
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	April
GDP (quarter-on-quarter rate) (a)											
Latin America 6 (b)			0.7	0.5	0.3	0.7	0.6	-0.3	0.4	0.3	
Argentina			0.4	1.3	1.5	1.0	-0.2	-4.7	-0.5	-1.2	
Brazil			1.5	0.3	0.1	0.3	0.4	0.0	0.5	0.1	
Mexico			0.4	0.4	-0.4	1.1	1.0	-0.2	0.6	0.2	
Chile			-0.9	0.9	2.3	0.8	1.1	0.6	0.2	1.3	
Colombia			-0.6	0.5	0.5	0.6	0.6	1.0	0.8	0.6	
Peru			-0.1	0.6	1.4	0.4	1.2	1.6	-0.5	2.5	
GDP (year-on-year rate)											
Latin America 6 (b)	1.7	1.4	1.2	1.7	1.8	2.2	2.2	1.2	1.4	1.0	
Argentina	2.7	-2.5	0.3	2.1	3.8	4.5	4.1	-3.8	-3.7	-6.2	
Brazil	1.1	1.1	0.1	0.6	1.4	2.2	1.2	0.9	1.3	1.1	
Mexico (a)	2.3	2.0	3.2	3.1	1.6	1.5	2.1	1.5	2.6	1.7	
Chile	1.3	4.0	-0.4	0.4	2.0	3.0	4.7	5.3	2.6	3.6	
Colombia (a)	1.4	2.7	1.1	1.9	1.4	1.0	2.2	2.6	2.9	2.9	
Peru	2.5	4.0	2.3	2.6	2.7	2.3	3.2	5.5	2.4	4.8	
CPI (year-on-year rate)											
Latin America 5 (b)	4.3	3.8	4.7	4.4	4.0	4.1	3.6	3.5	4.2	4.1	4.3
Brazil	3.5	3.7	4.9	3.6	2.6	2.8	2.8	3.3	4.4	4.1	4.9
Mexico	6.0	4.9	5.0	6.1	6.5	6.6	5.3	4.6	4.9	4.8	4.4
Chile	2.2	2.7	2.8	2.3	1.7	2.0	2.5	2.6	3.1	2.9	2.0
Colombia	4.3	3.2	5.1	4.3	3.7	4.1	3.4	3.2	3.1	3.3	3.2
Peru	2.8	1.3	3.4	3.2	3.0	1.7	0.9	1.0	1.3	2.1	2.6
Budget balance (% of GDP) (c)											
Latin America 6 (b)	-4.7	—	-5.2	-5.5	-5.0	-4.7	-5.0	-4.8	-4.8	-4.5	
Argentina	-5.9	-5.0	-4.6	-5.2	-5.5	-5.9	-5.7	-5.1	-4.8	-5.0	
Brazil	-7.8	-7.1	-9.1	-9.5	-8.8	-7.8	-7.4	-7.3	-7.2	-7.1	
Mexico	-1.0	-2.1	-1.3	-1.9	-1.1	-1.0	-2.8	-2.7	-2.5	-2.1	
Chile	-2.7	-1.7	-3.3	-2.9	-2.7	-2.7	-2.7	-2.6	-2.1	-1.7	
Colombia	-3.3	—	-4.2	-4.2	-3.2	-3.3	-3.0	-3.8	-4.6	-3.1	
Peru	-3.2	-2.0	-2.2	-2.6	-3.0	-3.2	-3.4	-2.4	-2.1	-2.0	
Public debt (% of GDP)											
Latin America 6 (b)	56.0	60.4	53.7	53.8	54.8	55.4	56.0	58.4	60.1	59.2	
Argentina	56.8	85.9	47.6	46.0	48.0	51.6	54.3	66.3	83.8	74.6	
Brazil	74.0	76.7	71.3	72.8	73.8	74.0	75.3	77.4	77.2	76.7	
Mexico	46.9	46.8	47.2	45.9	46.7	46.9	46.7	47.4	46.5	46.8	
Chile	23.6	24.0	21.9	22.5	23.0	23.6	24.6	23.5	23.9	24.0	
Colombia	43.4	47.1	42.8	43.0	43.5	43.4	43.5	45.0	45.9	47.1	
Peru	24.9	25.7	23.0	24.2	24.3	24.9	23.8	23.7	23.9	25.7	
Current account balance (% of GDP) (c)											
Latin America 6 (b)	-1.7	-2.0	-2.0	-1.8	-1.7	-1.7	-1.7	-1.9	-2.1	-2.0	
Argentina	-4.9	-5.4	-3.0	-3.6	-4.3	-4.9	-5.5	-6.2	-6.4	-5.4	
Brazil	-0.4	-0.8	-1.0	-0.7	-0.5	-0.4	-0.6	-0.8	-0.9	-0.8	
Mexico	-1.7	-1.8	-2.4	-1.9	-1.8	-1.7	-1.6	-1.7	-1.7	-1.8	
Chile	-2.1	-3.1	-2.2	-2.4	-2.0	-2.1	-1.6	-1.8	-2.2	-3.1	
Colombia	-3.3	-3.8	-4.1	-4.0	-3.7	-3.3	-3.0	-3.1	-3.2	-3.8	
Peru	-1.2	-1.5	-2.0	-1.2	-0.7	-1.2	-1.2	-1.4	-1.7	-1.5	
External debt (% of GDP)											
Latin America 6 (b)	34.4	—	35.4	34.7	35.0	34.4	35.3	34.7	35.2	37.0	
Argentina	36.5	53.6	34.5	34.4	35.2	36.5	41.2	45.0	46.8	53.6	
Brazil	32.5	35.6	35.2	33.5	33.6	32.5	33.3	32.2	33.3	35.5	
Mexico	28.7	27.9	28.7	28.5	28.9	28.7	29.1	28.5	28.2	27.9	
Chile	65.4	—	64.4	65.3	65.3	65.3	63.6	59.4	60.1	61.8	
Colombia	40.0	39.9	40.9	40.0	40.6	40.0	39.9	38.9	38.6	39.9	
Peru	35.9	34.7	37.7	38.6	38.0	35.9	34.8	33.6	33.6	34.8	

SOURCES: Thomson Reuters and national statistics.

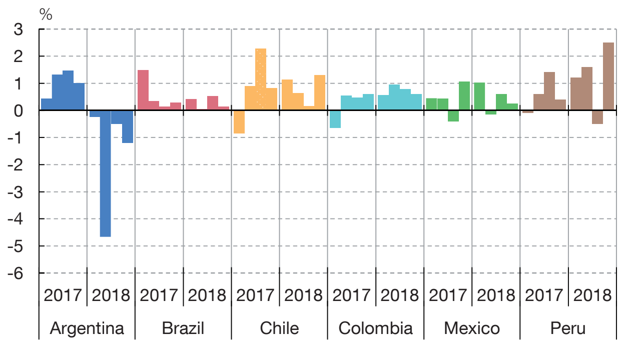
a Seasonally adjusted.
b Latin America 6: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Latin America 5: Brazil, Chile, Colombia, Mexico and Peru.
c Four-quarter moving average.

DECELERATION OF THE REGION'S GROWTH IN Q2 AND IN THE YEAR AS A WHOLE, WITH UNEVEN BEHAVIOUR ACROSS COUNTRIES

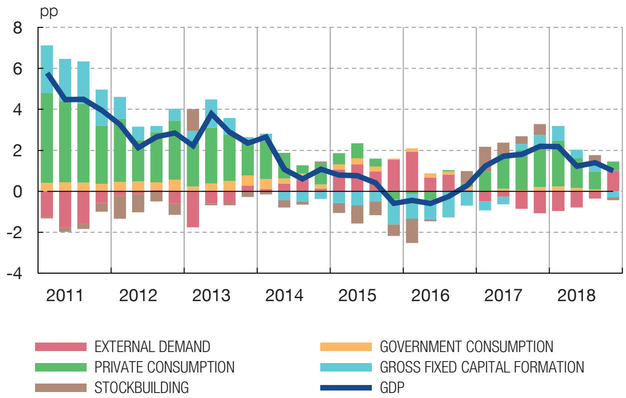
CHART 4

The growth of the region decreased to 1.4% in 2018 from 1.7% in 2017. Argentina posted four consecutive quarters of falls in GDP and Brazil and Mexico decelerated sharply in Q4. By contrast, the growth of Chile and Peru picked up in Q4 after decelerating in Q3, and that of Colombia held steady. By component, the most notable developments were the turnaround in external demand (Argentina), the contribution of which turned positive in Q4, and the gradual decrease in the contribution from the components of domestic demand (mainly private consumption and investment), despite the favourable behaviour of these factors in the Andean economies.

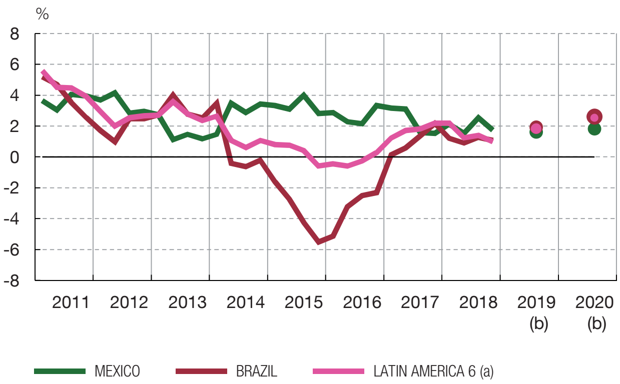
1 GROSS DOMESTIC PRODUCT
Quarter-on-quarter rate



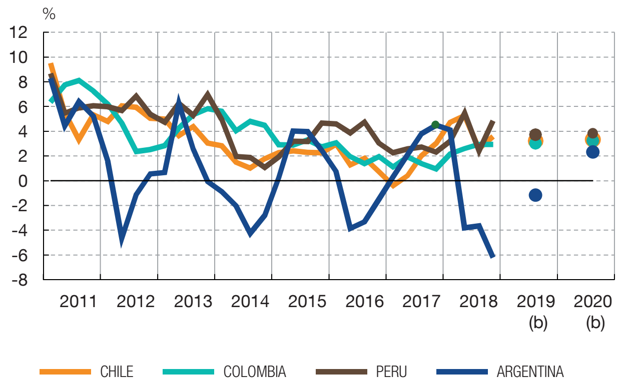
2 CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH. LATIN AMERICA 6 (a)



3 GROSS DOMESTIC PRODUCT
Year-on-year rate



4 GROSS DOMESTIC PRODUCT
Year-on-year rate



SOURCES: Thomsom Reuters and national statistics.

a Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b The dots represent the April 2019 forecasts for 2019 and 2020 by Latin American Consensus Forecasts.

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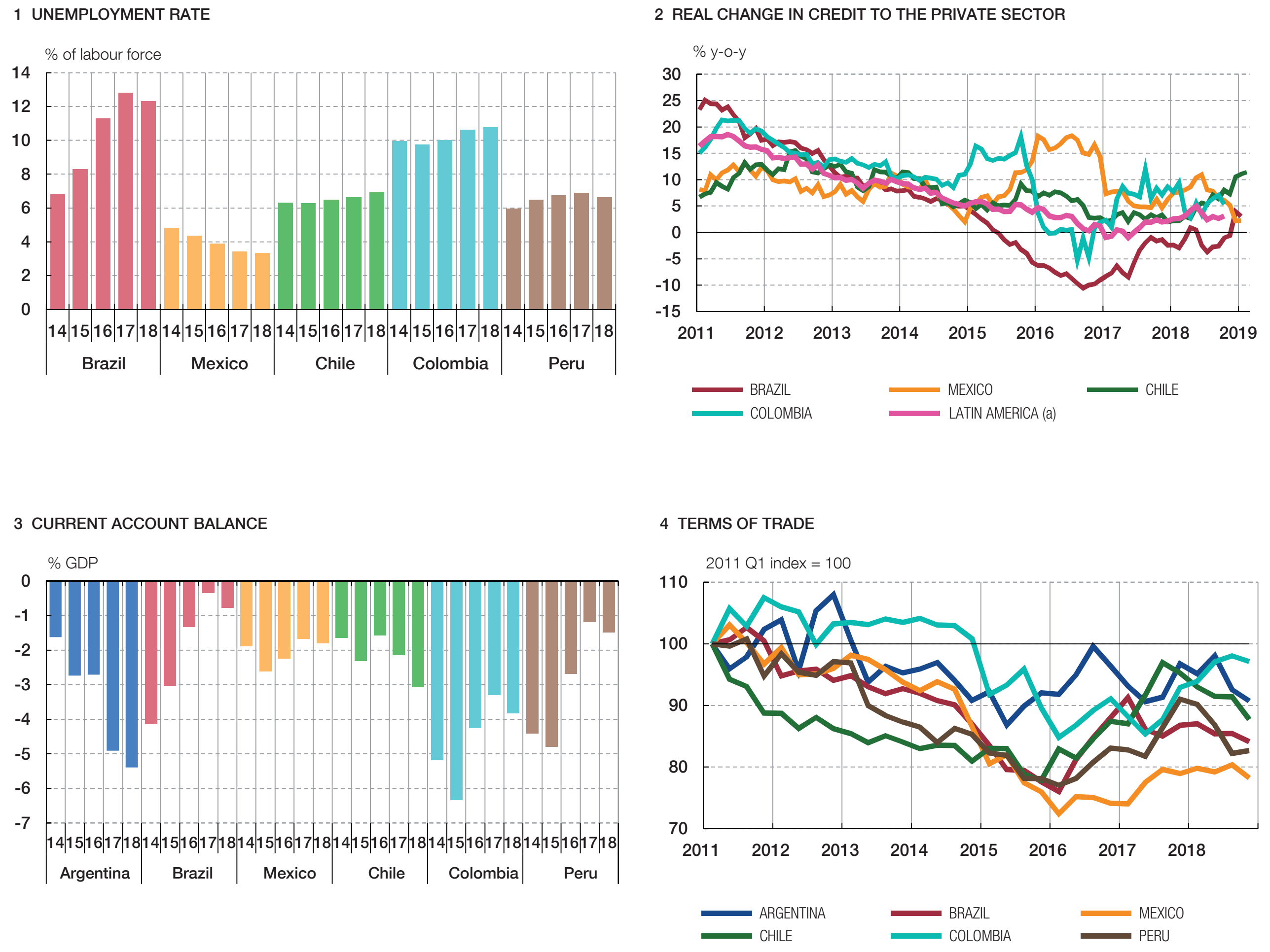
behaviour across countries. Activity continued to contract in Argentina in the second half of the year (four consecutive quarters), albeit less sharply than in the second quarter. In Brazil and Mexico, following a fairly dynamic third quarter, GDP again decelerated notably at the end of the year; by contrast, GDP in Chile and Peru picked up in the fourth quarter, following a slump in the third one. Activity was more stable in Colombia, holding around its potential growth rate. As a result, in 2018 as a whole the aggregate GDP of the region grew by 1.4%, below the rate recorded in the previous year (1.7%) and lower than the projection at the beginning of the year: Brazil grew at the same rate as in 2017 (1.1%), Mexico 0.3 pp less (2%) and the greater dynamism of the Andean economies was more than offset by the fall of 2.5% in Argentina. The data for the first quarter of the year suggest that activity continued to be weak.[4]

4 For example, the preliminary GDP estimate of Mexico in 2019 Q1 was a quarter-on-quarter growth rate of –0.2%.

UNEMPLOYMENT, CREDIT TO THE PRIVATE SECTOR AND THE EXTERNAL SECTOR — CHART 5

Unemployment rates generally held steady in 2018, with a slight decrease in the high rate of Brazil. Real credit to the private sector recovered in year-on-year terms in Chile and Brazil, and decreased in Mexico. The current account deficit increased across the board in 2018, although Argentina showed a notable decrease in Q4. The terms of trade worsened in the second half of the year.



SOURCE: Thomson Reuters.

a Brazil, Chile, Colombia, Mexico and Peru.

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By component, the notable vitality of domestic demand in the Andean economies, where investment also recouped a certain dynamism, was not sufficient to offset the deceleration in Mexico, the weakness in Brazil (particularly in the fourth quarter) and the fall in Argentina; in particular these economies did not shake off their investment sluggishness. Credit to the private sector in real terms reflected the behaviour of demand, which was most notable for the weakness in Mexico and the negative growth rates in Brazil, albeit on an improving trend (see Chart 5.2).

Net external demand contributed positively to GDP growth in Q4 (after seven consecutive quarters of negative contribution) due to its strong improvement in Argentina (+10.3 pp), largely explained by the collapse of imports. In fact, the current account deficit contracted notably in Argentina in 2018 Q4[5] due to shifts in the trade balance, while Brazil, Mexico

5 In Table 1 and Chart 4 this adjustment is not perceptible because it is presented in the usual manner using a four-quarter moving average.

and Peru continued to post small deficits, in historical terms, owing to the favourable performance of their trade balances. In Colombia, the external deficit remained high, although easily financed by the net inflow of foreign direct investment, while in Chile it increased in the second half of 2018 as a result of a fall in the goods surplus and an increase in the income deficit, owing to the profits transferred to foreign firms (see Chart 5.3). The terms of trade, defined as the ratio of a country's export prices to its import prices, a key variable in these economies which are mostly commodity exporters, showed a certain worsening trend (see Chart 5.4).

The labour markets of the region did not show significant changes in unemployment rates; the high unemployment in Brazil continued to be notable (see Chart 5.1).

INFLATION AND ECONOMIC POLICIES

Inflation has continued to fall in the last few months (see Chart 6.1) as a result of the favourable performance of the non-core component, while core inflation has held steady (see Chart 6.2). In those countries with an inflation target, inflation was in the target ranges, except for Mexico. This country's failure to meet its inflation target explains its tight monetary policy stance, with two rises of 25 basis points (bp) in the official interest rate in November and December last year, and the restrictive bias of the announcements by the Banco de México. The central bank of Chile also raised its official interest rate by 25 bp in January, after a similar increase in October, although no new rises are expected in the near future in view of the behaviour of inflation (partly due to methodological changes in its calculation) and of the change in the US Federal Reserve's monetary policy stance. Also, the central banks of Brazil, Colombia and Peru have held their interest rates unchanged for the past year. It should be noted that the inflation expectations for the end of 2019 are consistent with the achievement of the targets of this group of countries (see Table 2).

In Argentina, inflation continued rising to stand at 54.7% in March. This was a result of the depreciation of the peso, which rapidly passed through to prices, the reduction of transport subsidies and the continued worsening of expectations. In view of this, the central bank announced additional monetary policy tightening measures, reducing by 10% its year-end monetary base target with respect to the original goal, which was already very restrictive.[6] Additionally, to reaffirm its commitment to the price stability target, the central bank undertook to sustain a minimum interest rate of 62.5% in April, by absorbing the necessary liquidity to do so. And since the end of April it may sell dollars, even if the peso-dollar exchange rate stands within what was previously known as the "non-intervention zone" and the amount of pesos resulting from these sales will be subtracted from the monetary base target. Finally, to counter the depreciation pressure on the peso, the Government proceeded to auction dollars, for a sum of nearly US $9,600 million, with a limit of US $60 million daily, until the end of the year.[7]

In the fiscal policy arena (see Chart 7), at the end of 2018 Brazil's government deficit was still high (7.1% of GDP, with an interest burden of 5.5 pp), despite the correction in the last three years, and its government debt ratio exceeded 77% of GDP, after having increased more than 25 pp in the last five years. The approval of the pension reform submitted to Parliament by the new Government (see Box 1) is essential in order to be able to comply

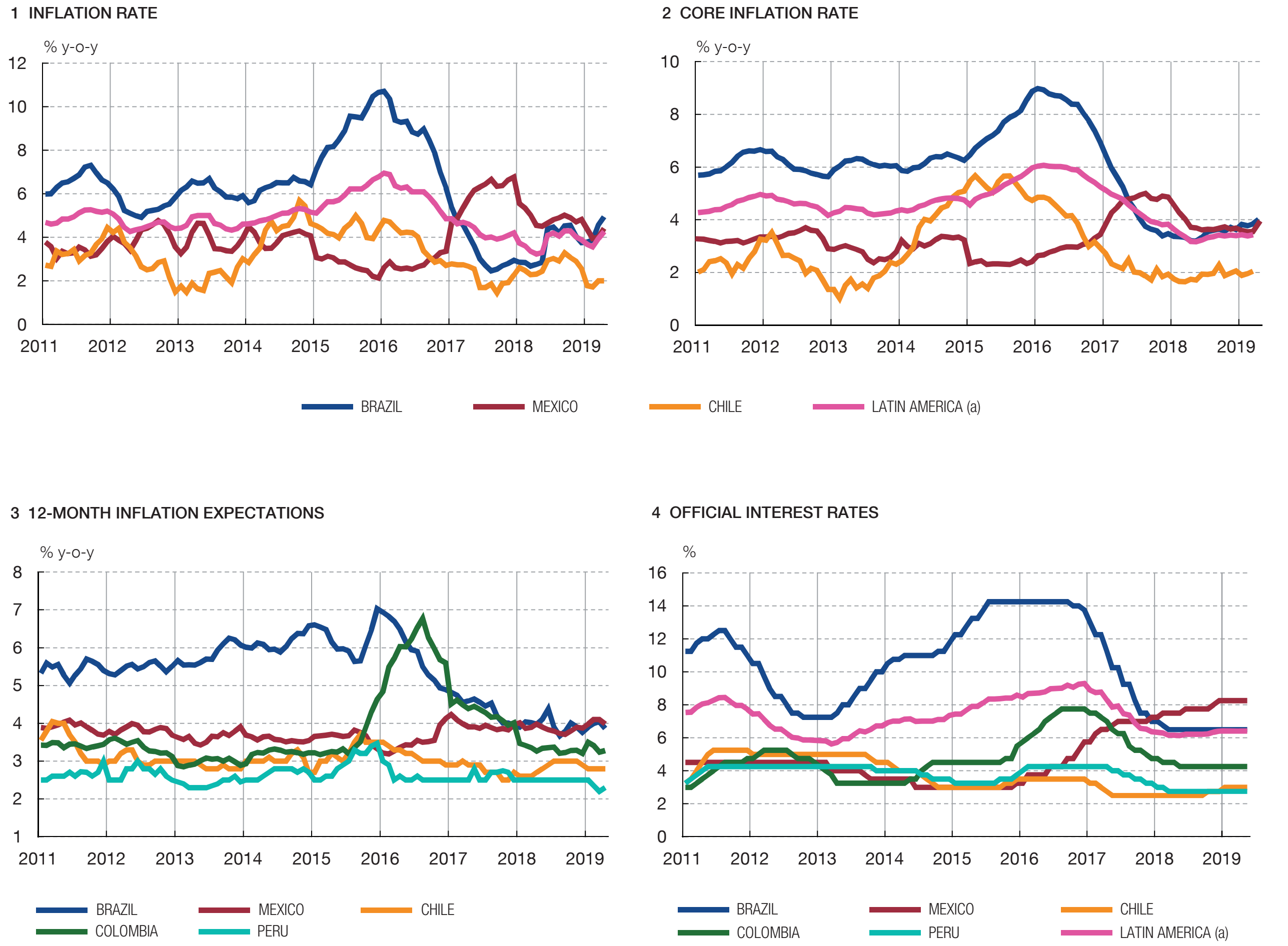
6 The measures announced by the central bank include: i) extension of the zero growth target for the monetary base to the end of 2019 (previously there was a commitment until June 2019); ii) continued over-achievement of the zero growth target for the monetary base in February (the monthly growth was negative), and iii) elimination of the seasonality adjustment (increase) of the monetary base scheduled for June.

7 A portion of these dollars comes from disbursements by the IMF following entry into the agreement and a portion comes from short-term government debt issues in dollars (known as "LETES", the Spanish acronym of *Letras del Tesoro de la Nación* – treasury bills of the nation).

ACROSS-THE-BOARD DECREASE IN INFLATION IN RECENT MONTHS, WITH A FRESH RISE IN MARCH AND APRIL. IN ARGENTINA IT HAS CONTINUED INCREASING PERSISTENTLY. MODERATE RISES IN INTEREST RATES IN MEXICO AND CHILE AND NO CHANGE IN BRAZIL, COLOMBIA AND PERU

CHART 6

Inflation in the region decreased until March and April, when the non-core component rose across the board. In Argentina the ongoing rise persists. Core inflation held steady in the five countries with inflation targets, where it stood within the target ranges. Official interest rates have held unchanged in Brazil, Colombia and Peru for the past year, and those of Mexico and Chile have been increasing moderately. Inflation expectations for 2019 are compatible with the targets set by the central banks.



SOURCE: Thomson Reuters.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

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INFLATION
Year-on-year rates of change

TABLE 2

	2018			2019		2020
Country	Target	December	Fulfilment	April	Expectations (a)	Expectations (a)
Argentina	- (b)	47.6	No	—	36.6	24.0
Brazil (c)	4.5 ± 1.5	3.8	Yes	4.9	4.0	4.1
Mexico	3 ± 1	4.8	No	4.4	3.6	3.6
Chile	3 ± 1	2.6	Yes	2.0	2.7	2.9
Colombia	3 ± 1	3.2	Yes	3.2	3.3	3.2
Peru	1 - 3	2.2	Yes	2.6	2.3	2.4

SOURCES: Thomson Reuters, national statistics and Consensus Forecasts.

a April 2019 Consensus Forecasts for the end of the year.
b Argentina suspended its monetary policy framework based on inflation targeting and temporarily adopted a monetary policy based on monetary base growth limits (ceiling of 0% m-o-m for the monetary base until December 2019, in which month it changed to a certain positive growth for seasonal reasons).
c Brazil's inflation target for 2019 is 4.25% ± 1.5, and for 2020 it is 4.00% ±1.5.

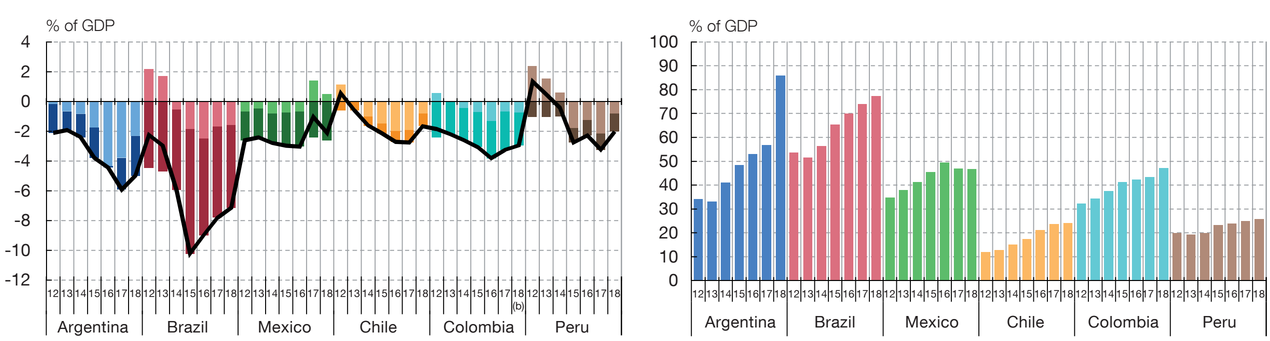
THE GOVERNMENT DEFICIT DECREASED IN ALL COUNTRIES IN 2018 EXCEPT IN MEXICO, ALTHOUGH THE MARKED FISCAL IMBALANCES REMAINED IN ARGENTINA AND BRAZIL

CHART 7

Brazil ended 2018 with a very high government deficit (7.1% of GDP) despite the decrease of nearly 3 pp of GDP in the past three years, and with a government debt of 77% of GDP. Argentina continued its fiscal adjustment. The high increase in its government debt is due to the sharp depreciation of the peso arising from the high percentage of its government debt denominated in foreign currency. Mexico again posted a primary surplus in 2018.

1 GOVERNMENT SURPLUS OR DEFICIT (a)

2 GOVERNMENT DEBT



SOURCE: Thomson Reuters.

a Light shading, primary deficit; dark shading, interest burden.
b 2018 Q3.

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with the limit on government expenditure set for the coming years, although doubts remain as to the reform which may finally be approved by Parliament.

There seem to be fiscal risks in Mexico related basically to the situation of the government-owned oil company PEMEX, because of the perception that the Mexican government would provide it with financial support if necessary. In any event, Mexico posted a primary surplus in 2018 and the budget envisages maintaining it in 2019 (at 1% of GDP) and 2020 (at 1.3%), albeit with optimistic assumptions as to GDP growth and oil production,[8] and government debt remains unchanged. PEMEX's problems, which have led various rating agencies to downgrade its rating, are of a structural nature and arise from its high debt (debt to asset ratio of nearly 100%), its tax burden (more than 80% of its profits are transferred to the government in the form of taxes and other obligations) and its low productivity. In this respect, the decisions taken by the new Government, which temporarily suspend the overall investment of PEMEX with the private sector and refocus the business on refining rather than extraction, aggravate the problem.

Argentina is proceeding with the sharp fiscal adjustment for the period 2018-2020 included in the IMF programme. However, it seems that the zero primary balance target for 2019 will be achieved with lower revenue and expenditure than previously anticipated. The government debt was near to 80% of GDP at the end of 2018, an increase of more than 20 pp in the year, due to the effect of the depreciation of the peso, since more than 75% of the government debt is denominated in foreign currency. In the other countries of the region there were no major changes in the fiscal balances, although the fiscal leeway for providing stimuli, should they be necessary, is small. In Chile, discussion continues on the proposed fiscal reform, and that approved in Colombia has a lower impact than originally

8 At the beginning of April, the Mexican Government announced it would reduce public spending by 0.5% of GDP in 2019, in consonance with the similar decrease in expected revenue.

proposed, which poses doubts as to whether the fiscal rule will be complied with in the coming years,[9] all the more so considering that the increase in government expenditure associated with the admission of Venezuelan immigrants is nearly 0.5 pp of GDP.

OUTLOOK

The growth projections for the region in 2019 were revised downwards with respect to the previous half-yearly report by 0.4 pp to 1.8% (see Chart 1). The revisions affect all countries and partly reflect the lower buoyancy at the end of 2018. The decrease of 0.5 pp in Mexico's expected growth is linked partly to the uncertainty surrounding the policies of the new Government and partly to tighter monetary conditions since the beginning of 2018. For the first time since 2013, the Brazilian economy is forecast to grow faster than that of Mexico (slightly below 2%). In Argentina, the carryover effect from 2018 will give rise to negative average growth for 2019, even though positive year-on-year rates are recorded in all quarters this year. The region's growth forecast for 2020 is 2.5%, owing to the expected upturn in Argentina and Brazil. This growth will be close to the region's potential growth rate, although it will still be insufficient to drive convergence towards higher income levels.

The balance of risks is tilted downwards. In the external environment, since the previous half-yearly report was published, the growth expectations of the main economies have been adjusted downwards and tensions have reappeared in the financial markets, rekindling fears over the performance of some emerging economies with weaker fundamentals, including some Latin American economies. On the trade front, the preliminary agreement between the United States, Canada and Mexico has still not been approved in the respective legislative chambers, a process which may turn out to be more difficult than expected in view of the change in the party holding a majority in the US House of Representatives. Moreover, a heightening of trade tensions between the United States and China or a sharper-than-expected slowdown in the latter economy may have adverse effects on global growth[10] and commodity prices, and unleash an adjustment of global financial conditions. Such a tightening of global financial conditions, particularly if accompanied by commodity price falls, might lead to capital outflows[11] and downward pressure on currencies, and hence to procyclical fiscal and monetary policies.

The internal risks inherent in implementation of the agreements between the IMF and the Argentinian government persist, particularly in view of the lack of anchorage of inflation expectations and the increasingly uncertain electoral environment. In Brazil and Mexico, now that the electoral uncertainty has passed, it remains to be seen what course the policies of the new governments will take. In Brazil there are difficulties in implementing a reform agenda and a fiscal adjustment, including principally the Social Security reform. In Mexico, against a background of a fall in agents' confidence and economic downturn, the risks are associated with the possibility of an about-face in some structural reforms and the future performance of PEMEX.

Data cut-off date: 10.5.2019.
Date of publication: 14.5.2019.

9 Corporate income tax will be progressively reduced from 2020.

10 See "The impact of China on Latin America: trade and foreign direct investment channels", Analytical Articles, *Economic Bulletin*, 2/2019, Banco de España, which analyses some transmission channels through which the slowdown in the Chinese economy passes through to the Latin American economies.

11 See "Capital flows to emerging economies: recent developments and drivers", Analytical Articles, *Economic Bulletin*, 2/2019, Banco de España.

The results of the 2018 presidential elections in Brazil and Mexico brought major changes with respect to previous Governments. The weight of these two economies[1] is such that the new Governments' actions, and the success or failure of their policies, potentially affect the whole region.

In Brazil, Jair Bolsonaro appointed an economic team favourable to deregulating the economy (including privatising some state-owned companies), rationalising and simplifying the federal tax system, granting greater independence to the central bank and reforming the pension system. Brazil's greatest vulnerability lies in the fiscal realm where it has been running a very high budget deficit since 2014 which, coupled with low growth, prompted debt to rise by 26 pp in five years, to 77% by end-2018 (Chart 1). The cost of servicing the debt, mostly denominated in reais, is linked to the policy interest rate which bottomed out in 2018, after falling by almost 8 pp since end-2016. The debt was placed in domestic markets, where investment funds and pension funds hold 52% of the total amount outstanding, at the same time as the proportion held by foreign investors has dropped to its lowest level since 2012. The primary balance component which deteriorated most was Social Security (Chart 1) due to demographic factors, the easing of eligibility criteria and higher funding for certain social programmes and the linking of some of them to the minimum wage (pensions) or to income (education and health).[2]

The central planks of the proposed pension system reform presented by the new Brazilian Government are as follows: i) an increase in the retirement age and in the compulsory pension contribution period; ii) a decrease in disability and widow(er)s' pensions; iii) limits on the accumulation of benefits among core family members; iv) limits on Social Security programmes in states and municipalities, rules for improved monitoring of fraud and more effective action against the Social Security System's largest debtors; v) elimination of the link between the minimum wage and certain social benefits; vi) an increase in public-sector employees' contributions and a decrease in those of employees earning the equivalent to the minimum wage; and vii) the creation of a funded system, with a guaranteed minimum income (financed by the public sector, if necessary), freedom of choice, transferability and public or private ownership of the pension funds.

The reform is estimated to produce savings of 15% of GDP in ten years. According to the Government's calculations, the reform would stabilise the government debt ratio at 75% of GDP in 2030 and lead to GDP growth of 1 pp higher than in the baseline scenario in 2030 (3.3%). The Government also aimed to debate a constitutional amendment in the Senate to eliminate the compulsory nature of some budgetary expenditure items, which restrict its room for manoeuvre to make fiscal adjustments but Congress approved the compulsory nature of many investment expenditure items, making the budget even more rigid.

Bolsonaro's victory was welcomed by the markets and the cost of domestic and external debt dropped sharply (Chart 2). However, the Government is encountering difficulties in approving the reforms since it is supported by pressure groups whose interests might conflict with those of its own, especially as regards privatisations[3] and external liberalisation;[4] these tensions were reflected in the geopolitical risk indicators (Chart 2). Accordingly, the pension system reform has to be approved by a qualified majority of 3/5 of the members (since it is a constitutional reform), in a highly fragmented Congress. This could lead to a diluted version of the original reform proposal and, therefore, a reduction in the saving envisaged.

On 1 July 2018, Andrés Manuel López Obrador was elected President of Mexico,[5] backed by a coalition of parties which support a programme of government comprising three main pillars. First, to foster "inclusive and sustainable" economic growth through the modernisation of transport and urban infrastructures, the increase in oil production with the reform of PEMEX's governance and of its investment plan, as well as to promote other sectors such as tourism. Second, "to improve well-being and reduce inequality" by raising pensions, the minimum wage and certain subsidies and by increasing the coverage of the health and education systems. Third, to focus on institutions and reduce crime and corruption.

With these objectives in mind, the Government approved a raft of reforms in different areas, which in some cases reverse those approved by the previous Administration, with possible consequences for Mexico's potential growth. For example, in the energy sector, the Government's efforts have focused on achieving a surplus on the oil trade balance (which is currently showing a deficit as Mexico imports most of its by-products, such as petrol, to satisfy domestic market demand) through a "national plan to boost refining" and aid for PEMEX. However, this action does not address the company's structural problems which may ultimately impact the sustainability of the fiscal situation and, possibly, macroeconomic stability (Charts 3 and 4). Furthermore, the Government suspended indefinitely the tenders for oil and gas exploration and exploitation projects on the grounds of checking the transparency of the contracts which had already been granted. This may place further restrictions on foreign direct investment and hinder its positive effects on oil production.

1 In 2018, Brazil's GDP at purchasing power parity was equivalent to 39% of the aggregate of the six economies included in this report, in comparison with Mexico which represented 30%.

2 For a more detailed analysis, including a description of the reform proposed by the previous Government and an estimate of the fiscal multiplier in Brazil, see the "Report on the Latin American economy. Second half of 2018" (https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/ArticulosAnaliticos/2018/T4/descargar/Files/beaa1804-art30e.pdf).

3 There was talk of privatising Petrobras, Electrobras and the large public banks, whereas now the privatisations refer to the sale of holdings in 24 essentially infrastructure companies.

4 The Government aimed to open up the economy by entering into bilateral trade agreements but this seems to have been delayed until after the pension reform has been approved.

5 He took up his position on 1 December 2018.

A measure with a broader reach is that to reduce the funds available for independent sectoral regulatory and oversight bodies, which includes setting a ceiling on wages. Other reforms which have been implemented or are under debate affect aspects of taxation, the legal system and security, and social policies. These include, most notably, an increase of 16% in the minimum wage in 2019 (to approximately $5 per day) and by 100% (to approximately $9 per day) in areas bordering on the United States. The governing party[6] put forward a proposal in the financial sector to increase the population's rate of financial inclusion by limiting bank charges which prompted the Mexican stock market to shed 6% in November. However, following certain modifications, a consensus was reached in respect of the reform by the parties involved (regulators and anti-trust bodies, the central bank and most commercial banks).

The use of public consultations by the Government has increased financial uncertainty. In particular, the cancellation of the new Mexico City Airport project due to the result of a public vote with a turnout of less that 1% of the population, led to higher volatility on financial markets, although this was curtailed when an agreement was reached with the creditors affected.

6 The National Regeneration Movement (Morena by its Spanish abbreviation).

THE REFORM OF PENSIONS AND OF PEMEX, RESPECTIVELY, ARE THE MAIN CONCERNS OF THE NEW GOVERNMENTS OF BRAZIL AND MEXICO

Fiscal vulnerability in Brazil stems from the situation of the Social Security System, which the new Government proposes to reform with savings of almost 15% of GDP. However, gaining approval from Congress will be an arduous task. In Mexico, PEMEX's delicate situation (declining production and high debt) may ultimately affect the sustainability of fiscal policy and, possibly, macroeconomic stability, considering the close link between PEMEX and sovereign bonds, and the importance of oil-related tax revenue (4% of GDP).

Chart 1
BRAZIL: PRIMARY BALANCE AND PUBLIC DEBT (% OF GDP)

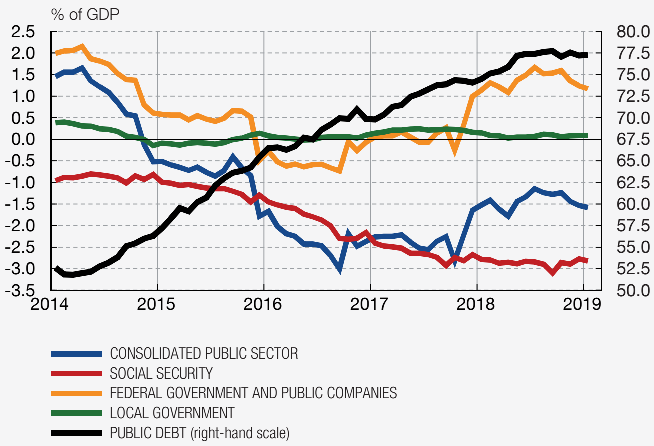

Chart 2
BRAZIL: INTEREST RATES AND POLITICAL RISK

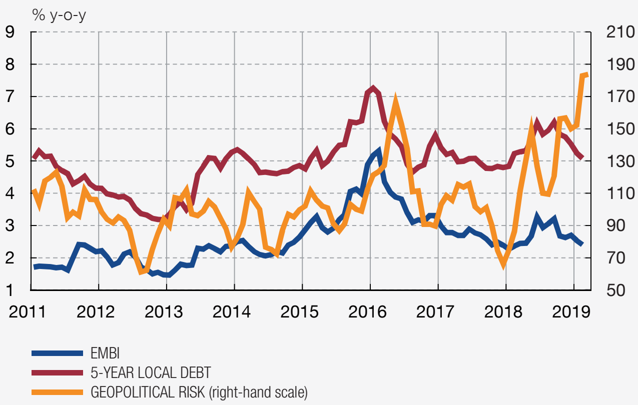

Chart 3
GOVERNMENT REVENUE

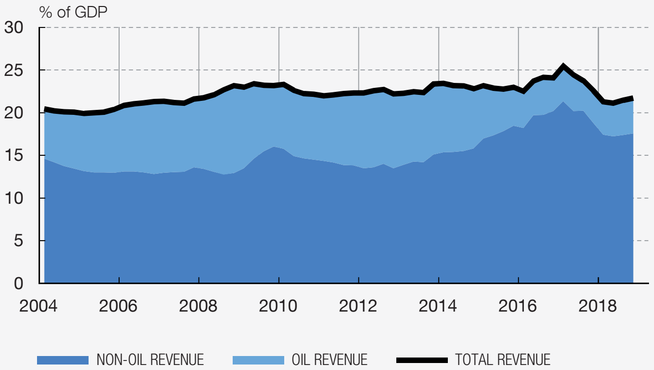

Chart 4
PEMEX: CREDIT DEFAULT SWAPS

SOURCES: Banco Central do Brasil and Thomsom Reuters Datastream.

In short, after the uncertainty surrounding the elections in Brazil and Mexico has been dispelled, doubts persist about the policies that will be implemented by the new Governments. In Brazil, this is due to the difficulty of approving reforms that are necessary, but have a high political cost. In Mexico, this is owing to subsequent changes in the policies that were initially announced and because some of them involve reversing structural reforms implemented by the previous Government, which could have negative effects on potential growth.