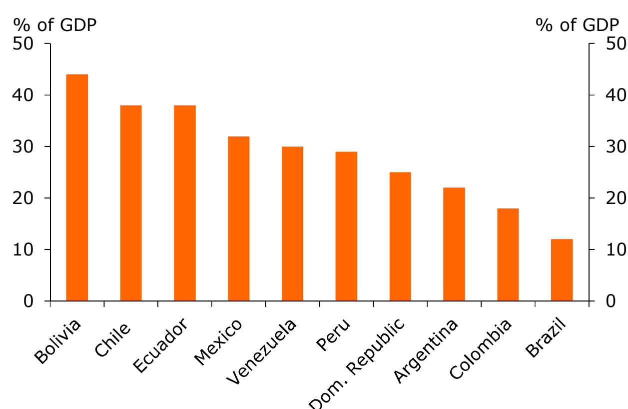
Latin America and Caribbean

While a more challenging external environment has contributed to somewhat slower economic growth in Latin America and the Caribbean in 2012, earlier overheating and inflation pressures have abated in most countries. Notwithstanding the worsened external backdrop, financing conditions and foreign direct investment inflows remained favorable, which supported domestic demand. The region's exposure to major external risks we identify in our outlook on 2013 - a failure to sufficiently address the US fiscal cliff, a further deterioration of the euro area crisis, or a marked slowdown in Chinese economic growth – tends to vary per country.

Figure 1: Goods and services exports (% of GDP)



Source: EIU

Introduction

While relatively limited European financial and trade links should reduce the direct impact of a deterioration of the euro area crisis, the region will surely not be isolated if an escalation of the sovereign debt crisis in the euro area would result in a global economic crisis. Similarly, the region remains exposed to a general increase in global risk aversion vis-à-vis emerging and developing economies, that could result in a fall in external financing. Strong trade and remittances links of Central American and Caribbean countries with the US expose that part of the region to a further US growth slowdown on the back of a sizeable forced fiscal consolidation. In contrast, as most South American countries rely relatively more heavily on commodity exports to Asia, a larger-than-expected slowdown in Chinese investment growth could weaken growth in the southern part of the region, particularly in countries with relatively undiversified export baskets.

Domestic policy space to address the spillovers from the materialization of these external risks, though in some cases limited, is still present. Given generally moderate public debt levels and limited budget deficits, regional governments still have some room for stimulus. As recent increases in inflation have mainly been driven by temporary food price increases, a further relaxation of monetary policy is possible. However, owing to either weak degrees of bank penetration, e.g. in Mexico and Central America, or already high debt servicing levels, e.g. in Brazil, the impact of monetary stimulus measures could be limited. Therefore, overall, the risks to the growth outlook are generally tilted to the downside, while limited (effectiveness of) local fiscal and monetary policy space may not sufficiently enable local policymakers to dampen the effects of a major deterioration of the external environment.

Exports and remittances remain a major growth driver in large parts of the region

With the exception of Brazil, which has a relatively large domestic market, many Latin American and Caribbean economies are highly depend on export demand from the US and China. Mexico's and Central America's economies remain heavily reliant on exports to the US market, where this trend has strengthened in recent years, as rising Chinese labor costs have boosted investments into those countries' textiles and manufacturing industries. Provided that the US manages to limit the size of the fiscal cliff and thereby avoids dipping back into recession, growth in Central America (including Mexico) and the Caribbean region is expected to come in at about 3.5% to 4% next year. Reflecting the weak performance of US and European labor markets, economic growth in tourism-dependent Caribbean economies will likely reach a level of 1% to 1.5%. This is in line with the average economic growth achieved during the period 2004-2011, but given the deep and protracted recessions that occurred during these years, next year's expected growth is rather weak.

Meanwhile, various South American countries continue to benefit from high commodity prices for their exports. Furthermore, an expected recovery of the Brazilian economy is likely to boost growth in the region. Amid ongoing loose monetary policy in the euro area and the US, as well as continuous Chinese efforts to keep economic growth above 7%, the risks of a major fall in commodity prices in 2013 should be limited (barring a major escalation of the eurozone crisis). Notwithstanding the tail-risk of a pronounced fall in commodity prices, economic growth in 2013 should come in at about 4% to 5%.

Current account deficits largely financed by foreign direct investments

Although commodity prices are still relatively high by historical standards, most major countries in the region have, at times sizeable, current account deficits, which are not expected to decline substantially in 2013. The expected current account deficits range from a limited 1% of GDP in Mexico to a moderate 3% of GDP in Brazil, Chile, Colombia and Peru. Meanwhile, large current account

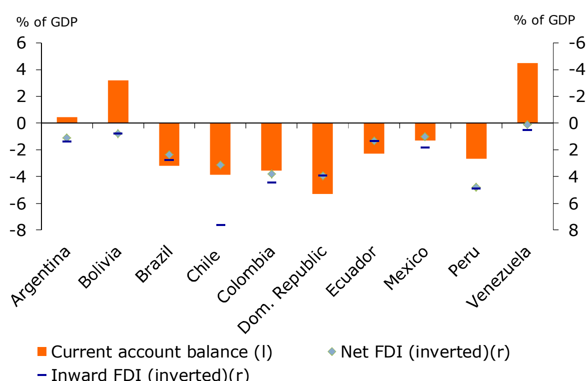
Figure 2: Main export products

	Main export products	Major export partners
Argentina	Soybeans and other agricultural produce, manufactured products, vehicles	Brazil, China, Chile
Bolivia	Natural gas, soybeans and soy products, crude oil	Brazil, US, South Korea
Brazil	Agricultural produce, iron ore, (semi)manufactured products	China, US, Argentina
Chile	Copper, fresh fruit, cellulose	China, Japan, US
Colombia	Crude oil, coal, nickel	US, Netherlands, China
Dominican Republic	Textiles, pharmaceuticals, agricultural produce	US, Haiti, Belgium
Ecuador	Crude oil, bananas, cut flowers	US, Panama, Peru
Mexico	Manufactured goods, crude oil, agricultural produce	US, Canada, Germany
Peru	Copper, gold, fishmeal	US, China, Canada
Venezuela	Crude oil, bauxite and aluminium, minerals	US, China, India

Source: CIA World Factbook, EIU

deficits of up to 25% of GDP are expected in several Caribbean countries. In the case of Brazil, Mexico and most other Central and South American countries, these deficits are largely financed by foreign direct investments. Most of these investments are directed at the mining, textiles, automotive, and telecommunications sectors, which reflect both local and foreign demand for the related products. Financing risks related to financial links with developed countries, mainly through the presence of US and Spanish banks, should be limited. The local subsidiaries are generally deposit-funded and profitable, while small local capital markets should be able to provide alternative short-term funding, if intra-bank funding were to dry up. Additionally, local regulations oftentimes limits the extent of fund repatriations to support ailing parent banks.

Figure 3: Current account deficits and foreign direct investment flows



Source: EIU

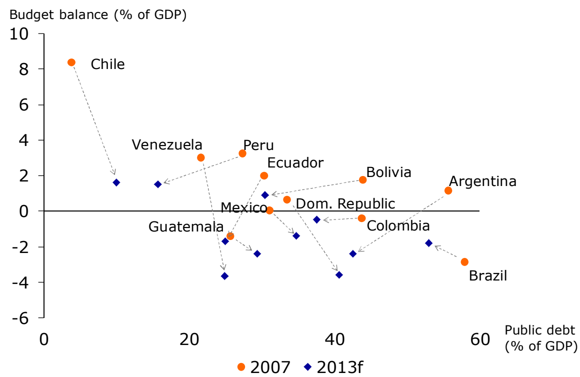
The overall composition of net private capital inflows seems to have changed in recent years. Net portfolio inflows have fallen strongly in recent years, while foreign direct investment has remained very strong. As a result, net foreign direct investment inflows are expected to account for 94% of net private capital inflows in 2012. The IMF expects their share to rise to 97% in 2013. This trend may be related to the introduction of capital controls in a number of countries. This seems to be the case in particular in Brazil, which demonstrated its willingness to use capital controls and foreign exchange interventions to protect the competitiveness of its (industrial) producers.

In the Caribbean, however, large current account deficits contribute to already elevated private and public debt levels, as FDI inflows remain weak and debt financing dominates. Rising food and oil prices remain a major driver of current account deficits in the Caribbean region (as in various Central American countries), as most island economies are heavily dependent on imports of both goods. While falling oil prices on the back of a global slowdown might contribute to an improvement in current account deficits in that part of the region, a possible end of the Venezuelan PetroCaribe oil trading scheme[1] could lead to a

[1] PetroCaribe is an oil trading scheme that supplies several Caribbean and Central American economies with Venezuelan oil at heavily subsidized prices. It allows for the postponement of full payment for oil deliveries by providing very generous (if needed non-pecuniary) repayment terms involving tenors of up to 25 years against 1% interest. According to Venezuelan opposition estimates, the scheme costs about USD 6.7bn (2% of Venezuela's GDP) per year. Since PetroCaribe is mainly supported by President Hugo Chávez, his possibly still frail health poses a risk to the continuation of the scheme. The abrupt end of the program would confront participating countries with significant costs.

major deterioration of participating countries' current account balances and it could thereby put considerable downward pressure on foreign exchange reserves holdings.

Figure 4: Fiscal performance



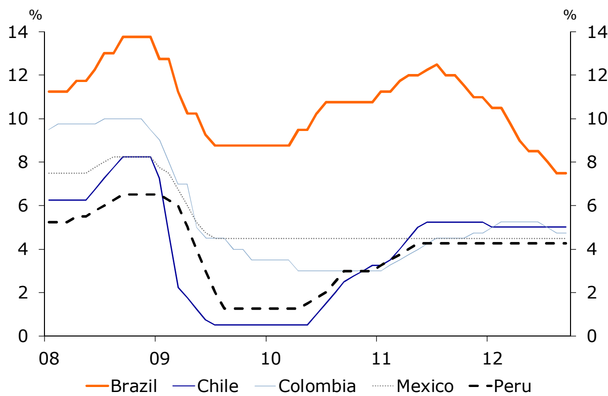
Source: EIU, S&P

Fiscal and monetary policy space present, but limited

While the Latin American and Caribbean region remains exposed to a continued growth slow-down in the US and Asia, relatively conservative fiscal policies in recent years in combination with moderate public debt levels provide some room for fiscal stimulus if needed. Although most countries are expected to have higher fiscal deficits/ lower fiscal surpluses in 2013 than in 2007, in many cases the public debt to GDP ratio has improved (see figure 4). Still, it should be noted that administrative weaknesses and oftentimes narrow tax bases limit the size, scope and effectiveness of fiscal stimulus measures. Furthermore, the available fiscal space varies per country.

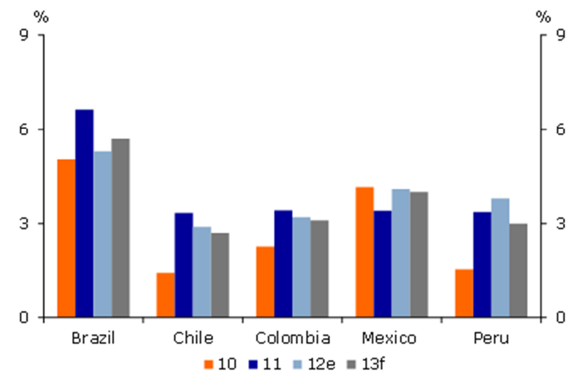
Many countries in the region have used the commodity windfall of recent years to improve their fiscal position, which gives them some fiscal policy space in the short-term. However, given their dependency on global commodity prices, the scope for sizeable stimulus is limited, as these countries need to retain acceptable buffers. Meanwhile, fiscal policy space in most Central American countries is quite limited, however, as public debt ratios remain above pre-crisis levels and

Figure 5: Regional benchmark policy rates



Source: Bloomberg

Figure 6: Consumer price inflation rates



Source: EIU

a recent resolve to rein in budget deficits appears to wane amid an increasingly uncertain external environment.

While Mexico still has some limited fiscal policy space, its ongoing commitment to fiscal prudence renders a major increase in public spending rather unlikely. Amid a region-wide public-debt ratio of almost 100% of GDP and large current account deficits, there is no fiscal space for most Caribbean economies.

Generally, monetary policy space in Latin America is remains positive, but, unsurprisingly, its availability and size varies per country. Since a recent upside deviation from Mexico's inflation target was mainly driven by a temporary increase in food prices, while core inflation remained low, limited monetary policy space is still available. In Central America, elevated inflation rates compared to Mexico, as well as concerns about second-round effects should leave very limited space for additional monetary stimulus.In most South American economies, there is still some room for interest rate cuts, as expected inflation rates are generally moderate and real interest rates remain in positive territory.

Brazil

After two years in which growth has been very disappointing, we expect the Brazilian economy to recover in 2013. The sharp slowdown in growth experienced in the past 2 years, when growth fell from 7.6% in 2010 to 2.7% in 2011 and an expected 1.5% in 2012, was primarily caused by two factors. The first was a strong monetary tightening in early 2011, when inflation was threatening to increase above the target range, which indeed happened in the course of the year. Inflationary pressures were partially the result of structural constraints, as the strong boom of 2010 led to labor and infrastructure. Part of the slowdown in growth was also related to the increase in global economic uncertainty, which resulted in lower commodity prices. Especially investment growth has fallen sharply and investment is likely to grow hardly at all in 2012. The industrial sector has performed poorly in particular. In response, the government has tried to lower the exchange rate of the *real*. Partially thanks to central bank intervention and capital controls the *real* depreciated strongly until May and has remained close to the 2 *real* per USD exchange rate the government wanted to maintain afterwards. Even more than before, Brazil thus now has a strongly managed floating exchange rate.

Looking forward, we now expect the tide to turn. Growth in Brazil is likely to be stimulated by an unprecedented monetary stimulus implemented in the past year. Between August 2011 and October 2012 Brazil's central bank lowered its main policy rates by 525 basis points from 12.5% to 7.25%. This has resulted in a strong reduction of Brazil's real interest rate from 5.6% in July 2011 to 2.2% in September 2012. Furthermore, the government tried to make borrowing cheaper by lowering the spread between the lending and borrowing rates of

public banks. As these banks account for almost half of Brazil's banking market, private sector banks afterwards also lowered their rates. The government has also implemented fiscal policy to stimulate growth, particular in the industrial sector, with some fiscal stimulus measures, although the total size of these measures is below 0.5% of GDP. We expect that the economy will recover in the final part of 2012 and 2013, resulting in growth in 2013 of 3-5%. In fact, the first signs of the recovery are already visible, as industrial production has started to recover.

However, the high growth seen in 2010 is not likely to return soon. Despite a year of extremely low growth, Brazil's labor market has remained very tight. Increasing labor costs are a risk to the inflation outlook. In fact, inflation has already increased somewhat in the past months. It seems that the central bank in practice wants inflation to be between 4.5% and 6.5%, although it officially maintains the 2.5-6.5% target range. This increases the risk of an overshooting of the target range. Foreign reserves are expected to grow to USD 391bn in 2012 and USD 410bn and thus almost fully cover Brazil's foreign debt, which greatly reduces balance of payments risk.

Chile, Colombia and Peru

Although growth slowed somewhat in Chile, Colombia and Peru in 2012, the slowdown was much less pronounced than in Brazil. With an expected growth ranging from 4.4% in Colombia to 6% in Peru, all three economies continued to perform relatively well. This trend is likely to continue in 2013. In 2011 all three countries faced high inflation, with inflation both in Chile and in Peru exceeding the target range. Afterwards, inflation in all three countries has fallen back to within the target range and is expected to stay there during 2013. In Peru and Chile, the current account deficit is likely to deteriorate to roughly 3% of GDP, while Colombia continues to post a deficit of roughly 3% of GDP. However, all three countries manage to attract large inflows of foreign direct investment, which are expected to more than fully cover the current account deficit. The budget position of the countries looks strong, especially in the case of Chile en Peru, as these countries have small budget surpluses and low debt ratios. The prudent fiscal stance seems justified, as all three countries remain dependent on a narrow range of commodities. Commodity prices are therefore an important determinant of near term economic fortunes of these countries.

Argentina and Venezuela

Meanwhile, Argentina and Venezuela continue to maintain extremely loose fiscal and monetary policies, resulting in above 20% inflation. Economic growth slowed strongly in 2012 in Argentina, as in particular investment suffered strongly from the tight import and other foreign exchange restrictions the government has implemented. This has resulted in recession-like conditions. The economic outlook is uncertain. Argentina is likely to benefit from a good crop

after the early 2012 drought and an economic recovery in Brazil. However, the underlying macroeconomic imbalances remain big. Although the government has increased the nominal depreciation of the Argentine peso somewhat recently, the rate of depreciation does not match high inflation, which means that balance of payments pressures are likely to increase once again in the future. Meanwhile, growth in Venezuela is likely to fall in 2013, after a strong increase in public spending in presidential election year 2012 boosted growth recently. Both countries remain very vulnerable to a strong fall in commodity prices, agricultural commodities in the case of Argentina and oil in the case of Venezuela.

Mexico

Benefiting from the close integration of its manufacturing sector into US supply chains, Mexico's economy has recovered solidly from its deep recession in 2009. While economic growth is expected to remain relatively constant at about 4% next year, prudent macro-economic policies, improved foreign exchanges reserves levels, and the absence of major imbalances should strengthen the country's resilience to a deterioration in its external environment. Nonetheless, a failure to sufficiently address the US fiscal cliff poses a particular risk to the Mexican economy if the US economy were to lapse back into recession. Meanwhile, in spite of the presence of Spanish banks in the Mexican banking sector, the direct consequences of a further deterioration of the sovereign debt crisis in the euro area should be limited. While local regulations restrict sizeable fund repatriations to support ailing parent banks, the sector's profitability and local funding sources augur well for its stability.

Following the inauguration of Mexico's newly-elected president Enrique Peña Nieto on December 1st 2012, Mexico's economy will be heading for a series of structural reforms in 2013 and beyond that could strengthen the country's growth potential over the medium-term. However, given the absence of a parliamentary majority, meaningful progress on the reform front will crucially depend on the new president's ability to reach across the aisle and co-operate with the opposition. Irrespective of the next president's ability to break recent years' congressional gridlock, a continuation of Mexico's prudent fiscal policies is expected. Even though a limited temporary relaxation of fiscal policy is possible if US growth were to weaken substantially, general awareness of Mexico's fiscal weaknesses – the dependency on oil revenues and the very narrow size of the non-oil tax base – will likely prevent the government from major spending increases. Mexico's monetary policy could be relaxed for the first time since September 2009, if economic growth were to disappoint in 2013, as recent upside deviations from the inflation target were primarily due to temporary food price increases.

Since Mexico's current account deficit is expected to remain small and ompletely financed by foreign direct investment and portfolio inflows, its foreign exchange reserves, which currently amount to about USD 160bn (compared to a pre-crisis level of USD 87bn in 2007), will likely continue to increase next year.

This should provide the central bank with sufficient firepower to meet possible outflows and stabilize the exchange rate if a major deterioration in global risk aversion were to occur.

Central America
Central America's small economies are expected to perform relatively well in 2013, as elevated prices for their agricultural and mineral exports support exports and rising Chinese wages boost foreign direct investments into local industrial sectors. In line with an ongoing recovery in exports to the US and resilient remittances inflows from migrant workers located there, the Central American economies are expected to grow by about 4% next year. Once more, Panama will rank among the fastest-growing Latin American economies, as the expansion of the Panama Canal and the implementation of a sizeable public infrastructure investment program boosts growth. Fiscal and monetary space to address external shocks remains rather limited in the region. While public debt levels tend to remain above their pre-crisis levels, earlier efforts aimed at fiscal consolidation appear to weaken amid an increasingly challenging external environment. Consequently, several Central American countries lack the fiscal space that helped them weather the 2009 global economic storm. Meanwhile, monetary policy space is limited, as recent food price-driven inflation hikes might feed into core inflation.

Mainly driven by elevated food and oil prices, the current account deficits of all Central American countries are expected to remain in deficit in 2013, but, with the notable exception of Nicaragua, they will generally be financed by foreign direct investment inflows. While most current account deficits are expected to remain moderate in 2013, Nicaragua's very large current account deficit (about 20% of GDP) renders the country highly dependent on politically motivated financial support from Venezuela.

Caribbean
Owing to its strong focus on tourism catering to US and European visitors, the Caribbean region's economic fate remains tied to the developments on US and European labor markets and changes in respective purchasing powers in particular. While tourist arrivals improved in 2012, partly due to rising arrivals from Latin America, the economic outlook remains rather bleak. For 2013, the tourism-dependent economies are expected to grow by about 1.5%, while Caribbean commodity exporters will likely see their economies expand by about 4%. Amid very high public debt levels, oftentimes pegged exchange rates

limiting monetary policy autonomy, weak productivity and limited scope for economic diversification, local policymakers' scope to address a deterioration of the external environment remain severely restricted. In combination with an expected further deterioration of already elevated current account deficits, ranging from about 5% of GDP in the Dominican Republic to about 25% of GDP in St. Vincent and the Grenadines, a further deterioration of already weak foreign exchange reserves levels can be expected.

Against this background, an abrupt end to Venezuela's generous subsidies under the PetroCaribe oil trading scheme (see footnote 1 above) represents a significant tail risk for various Caribbean economies. If PetroCaribe support were to end, its beneficiaries would face significantly higher oil import bills, larger fiscal deficits and a major deterioration in their debt repayment profile as the current extremely lenient repayment conditions would likely be adjusted.

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Data tables

Economic growth (Real GDP % change pa)							
	2007	2008	2009	2010	2011	2012e	2013f
Argentina	8.7	6.8	0.9	9.2	8.9	2.1	3.7
Bolivia	4.6	6.1	3.4	4.1	5.2	5.0	4.8
Brazil	6.1	5.2	-0.3	7.6	2.7	1.5	4.2
Chile	5.2	3.3	-1.0	6.1	6.0	5.0	4.6
Colombia	6.9	3.5	1.7	4.0	5.9	4.4	4.6
Dominican Republic	8.5	5.3	3.5	7.8	4.5	3.8	3.6
Ecuador	2.0	7.2	0.4	3.6	7.8	4.4	4.0
Mexico	3.2	1.2	-6.0	5.6	3.9	3.9	3.7
Peru	8.9	9.8	0.9	8.8	6.9	5.8	6.0
Venezuela	8.8	5.3	-3.2	-1.5	4.2	5.0	0.4

Budget balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Argentina	1.1	1.4	-0.6	0.2	-1.7	-3.1	-2.4
Bolivia	1.7	3.2	0.1	1.7	0.8	2.0	0.9
Brazil	-2.9	-1.9	-3.2	-2.3	-2.6	-2.5	-1.8
Chile	8.4	5.0	-4.2	-0.3	1.5	1.4	1.6
Colombia	-0.4	0.5	-2.2	-2.7	-0.7	-0.5	-0.5
Dominican Republic	0.6	-3.8	-3.2	-2.7	-2.6	-6.8	-3.6
Ecuador	2.0	0.6	-4.3	-1.6	-1.0	-1.9	-1.7
Mexico	0.0	-0.1	-2.3	-2.9	-2.5	-2.4	-1.4
Peru	3.2	2.4	-1.8	-0.4	1.9	0.9	1.5
Venezuela	3.0	-1.2	-5.0	-3.6	-4.0	-3.8	-3.7

Public debt (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Argentina	55.7	48.6	48.6	45.1	41.7	41.6	42.6
Bolivia	44.0	45.2	42.6	38.6	34.2	30.9	30.5
Brazil	58.0	57.4	60.9	53.4	54.2	54.8	53.0
Chile	3.9	4.9	5.8	8.6	11.2	10.1	10.0
Colombia	43.8	42.7	45.1	46.2	43.4	40.2	37.6
Dominican Republic	33.6	33.9	36.8	37.5	38.6	39.8	40.7
Ecuador	30.4	25.2	19.6	22.9	21.9	23.6	25.0
Mexico	31.1	35.6	36.7	36.8	35.4	35.4	34.8
Peru	27.4	22.9	25.0	21.9	19.9	18.3	15.7
Venezuela	21.7	16.4	18.8	19.1	25.1	25.1	24.9

Consumer prices (% change pa, average)							
	2007	2008	2009	2010	2011	2012e	2013f
Argentina (official rate)	8.8	8.6	6.3	10.5	9.8	9.9	9.2
Argentina (unofficial rate)	20.1	21.4	14.8	26.8	24.2	25.0	
Bolivia	8.7	14.0	3.4	2.5	9.9		
Brazil	3.6	5.7	4.9	5.0	6.6	5.3	5.7
Chile	4.4	8.7	1.5	1.4	3.3	2.9	2.7
Colombia	5.5	7.0	4.2	2.3	3.4	3.2	3.1
Dominican Republic	6.1	10.6	1.4	6.3	8.5	3.7	5.6
Ecuador	2.3	8.4	5.2	3.6	4.5		
Mexico	4.0	5.1	5.3	4.2	3.4	4.1	4.0
Peru	1.8	5.8	2.9	1.5	3.4	3.8	3.0
Venezuela	18.7	30.3	27.2	28.2	26.1		

Current account balance (% of GDP)							
	2007	2008	2009	2010	2011	2012e	2013f
Argentina	2.8	2.1	3.6	0.8	0.0	0.4	0.4
Bolivia	12.1	12.0	4.7	4.5	2.3	4.2	3.2
Brazil	0.1	-1.7	-1.5	-2.2	-2.1	-2.8	-3.2
Chile	4.3	-1.8	1.5	1.8	-1.4	-3.7	-3.9
Colombia	-2.9	-2.8	-2.1	-3.1	-3.0	-3.6	-3.5
Dominican Republic	-5.3	-10.0	-5.0	-8.7	-8.1	-6.6	-5.3
Ecuador	4.3	3.0	0.3	-2.8	-0.3	-2.0	-2.3
Mexico	-1.1	-1.6	-0.6	-0.4	-1.0	-0.7	-1.3
Peru	1.4	-4.2	-0.6	-2.5	-1.9	-2.4	-2.6
Venezuela	7.5	10.8	1.8	3.1	8.6	4.3	4.5

Sources: EIU & S&P