The Outlook for Latin American Economies

Growth slows down in Brazil and Mexico, Argentina grapples with stagflation

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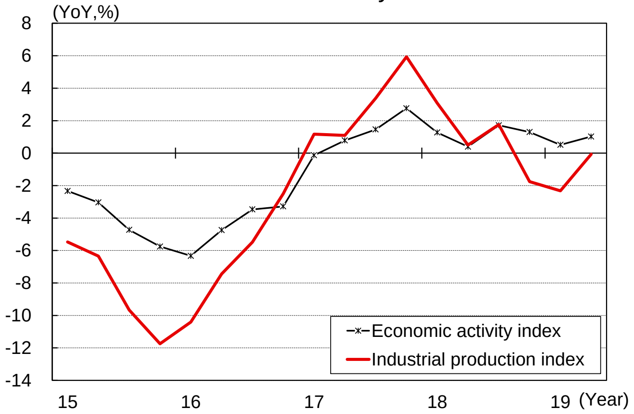
1. Brazil

The Brazilian economy has been taking time to recover. The country's real gross domestic product (GDP) growth slowed significantly to a 0.5% YoY increase in the January-March quarter of 2019 from 1.1% YoY growth in the October-December quarter of 2018. No clear signs of improvement have since been observed. The industrial production index has languished, declining 0.1% YoY in the April-June quarter (Chart 1). The economic activity index, which covers the broader economy including the service sector, has also lacked momentum, rising just 1.0% YoY in the April-June quarter.

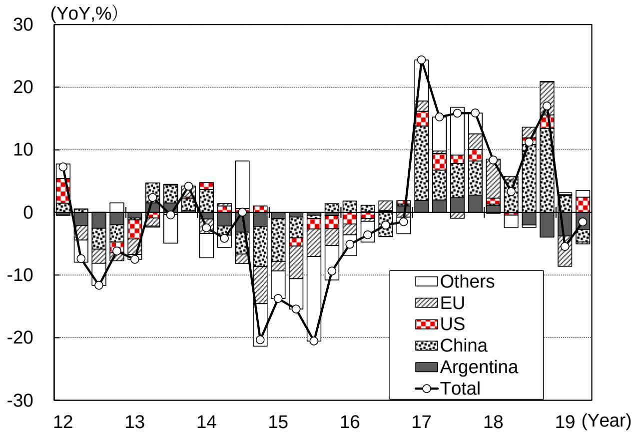
One factor behind the slowdown in economic activity is a temporary decline in mining activity due to a dam collapse accident in January. A bigger factor, however, is a decrease in exports. Brazil's exports to its neighbor Argentina, which is suffering stagflation, have been down YoY since the April-June quarter of 2018 (Chart 2). Exports to the Eurozone have also declined YoY this year, and exports to China declined YoY in the April-June quarter. The Brazilian economy appears to be taking a hit from a slowdown in the global economy as well as turmoil in Argentina.

Chart 1: Brazil Industrial Production Index and Economic Activity Index



Source: Brazilian Institute of Geography and Statistics (IBGE), Institute for International Monetary Affairs

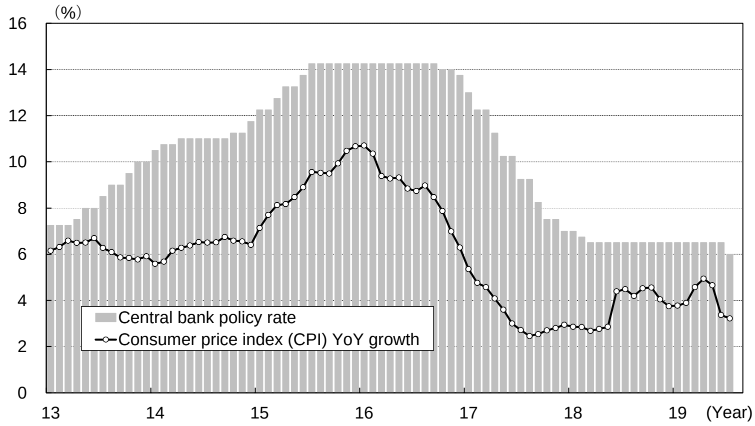
Chart 2: Brazil Export Value by Destination



Source:Brazilian Institute of Geography and Statistics (IBGE), Institute for International Monetary Affairs

Reflecting the sluggish economy, indicators for labor force and capital utilization have been lackluster. The unemployment rate stood high at 12.3% in the April-June quarter, and manufacturing capacity utilization rate was low at 77.6%. The International Monetary Fund (IMF) estimates an output gap of -3.7% of potential GDP in Brazil. As a result of the output gap, inflation rate has stabilized at a low level, with the consumer price index (CPI) increase staying below 4% YoY since June (Chart 3). The Central Bank of Brazil lowered its policy rate for the first time in 16 months at the end of July to 6.00%, the lowest on record.

Chart 3: Brazil CPI and Central Bank Policy Rate



Source: Central Bank of Brazil, Institute for International Monetary Affairs

As for the outlook going forward, Brazil's real GDP growth is expected to slow down from 1.1% YoY in 2018 to 0.7% YoY in 2019, due to the sluggish first half of the year. The external environment for the Brazilian economy appears harsh, with turmoil in Argentina likely to persist for some time (more on this later). The outlook for the Chinese economy is also an area of concern due to the escalating trade war between the US and China. And recently, Brazil's clash with major western economies over its rejection of an aid offered to respond to wildfires in the Amazon rainforests has prompted US and European companies to suspend material orders from Brazil. The rate cut and small-scale stimulus measures to shore up consumption will support the economy, but few factors are seen accelerating domestic demand growth. We therefore project a subdued recovery in the Brazilian economy, with real GDP rising by around 0.5% YoY in 2020.

One positive factor for the medium- to long-term outlook is progress in structural reforms. Owing to labor reform under the former President Michel Temer's administration, labor lawsuits decreased by around 20% in 2018 from 4 million in 2017. Robust worker protection and frequent labor lawsuits have been a cost burden for companies in Brazil, but these costs are expected to be reined in going forward. Progress on pension reform is another positive development to highlight. The lower house has passed a reform bill, and the upper house is expected to do the same by the end of September. Pension reform has long been an issue for Brazil, and it is finally taking shape this year. According to government estimates, the reform would save roughly 930 billion reais ($224 billion) over 10 years. For the short term, the reform could reduce household income and put the brake on the economy. But for the long term, the reform is expected to support the economy by boosting business investments, for instance.

2. Mexico

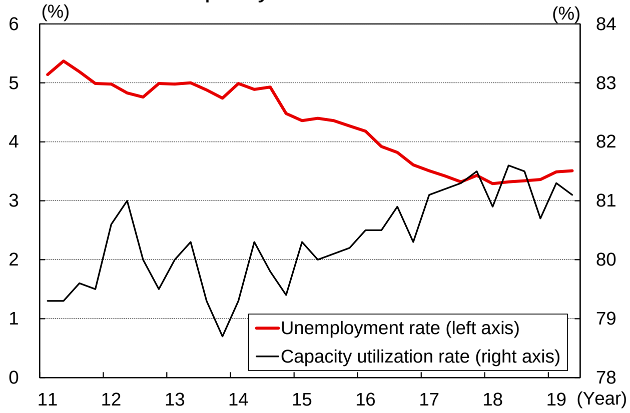
The Mexican economy has stagnated noticeably. The unemployment rate for the April-June quarter came to 3.5%, and capacity utilization rate was 81.1% -- still at relatively healthy levels seen in recent years (Chart 4 next page). Yet the economy is softening, with real GDP contracting 0.8% YoY in the April-June quarter, the first contraction since the October-December quarter of 2009 (Chart 5 next page). In quarter-over-quarter (QoQ) comparison, the GDP growth was flat, at 0.0%. Mexico's exports to the US – its biggest export destination – grew just 5.6% YoY in the first half of 2019, compared with 9.6% YoY growth for all of 2018. A slowdown in US manufacturing output growth appears to have taken a toll. Exports to the Eurozone and other Latin American countries have declined YoY. The impact of a slowing global economy seems to be surfacing in the Mexican economy as well.

Inflation trends in Mexico reflect the slowing economy. The CPI, which climbed 4.9% YoY in 2018, has risen just 3.8% YoY as of July this year. The inflation rate is now within the target range set by Mexico's central bank (3% plus or minus 1% point). After the US Federal Reserve cut its policy rate in July, Mexico's central bank cut its policy rate on August 15 by 0.25% point to 8.00%. The rate had been kept at 8.25% since December 2018.

With the unemployment rate still low and income and consumer sentiment resilient, the rate cut is expected to have an intended effect to stimulate the economy. Domestic private demand therefore is projected to show some resilience. In addition, Mexico's primary balance was a surplus equivalent to 0.6% of the nominal GDP in 2018, affording the country an opportunity to implement fiscal stimulus. President Andres Manuel Lopez Obrador's administration announced on July 29 a stimulus package worth 485 billion pesos, equivalent to 2% of the GDP. As for trade, Mexico's exports are thus projected to gradually return to a mild uptrend because US manufacturing adjustments have been mild thus far and the sector is expected to revert to an uptrend starting next year. Based on these considerations, the Mexican economy likely will steer clear of a further decline. We project that Mexico's real GDP will grow by 0.5% YoY in 2019 and 0.7% YoY in 2020.

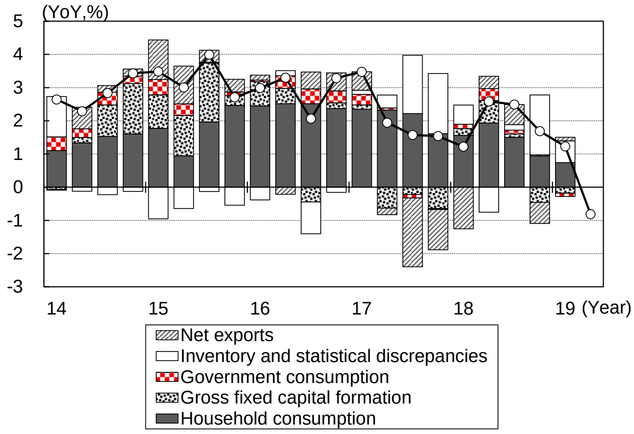
US President Trump's remarks and actions have caused many stirrups for Mexico in the past. This year on May 30, the Trump administration threatened to impose tariffs on imports from Mexico over illegal immigration. But Mexico has responded with countermeasures to address the issue, and the US has suspended the tariffs indefinitely. While President Trump's policy moves remain difficult to predict, the US-Mexico-Canada Agreement (USMCA) has been signed (pending ratifications in the US and Canada), and the US and Mexico have reached an agreement on the immigration issue. So Mexico is unlikely to be targeted by President Trump for the time being.

Chart 4: Mexico Unemployment Rate and Capacity Utilization Rate



Source: National Institute of Statistics and Geography (INEGI), Institute for International Monetary Affairs

Chart 5: Mexico Real GDP Growth



Source: National Institute of Statistics and Geography (INEGI), Institute for International Monetary Affairs

3. Argentina

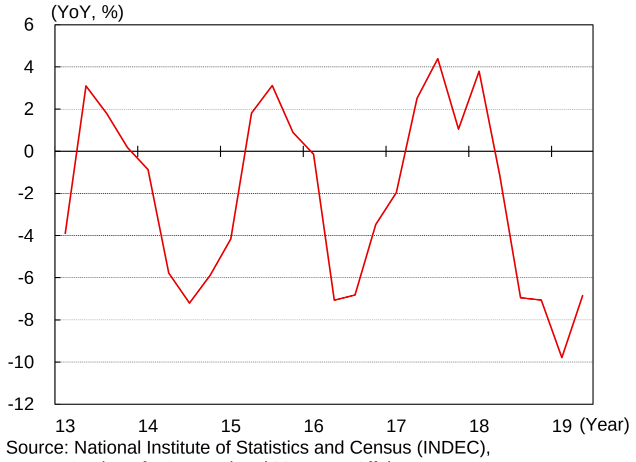
Argentina is in a serious economic downturn amid soaring inflation following last year's currency crisis. With the government carrying out austerity measures, discontent is growing among the Argentine people. Argentina's real GDP contracted 2.5% YoY in 2018, and 5.8% YoY in the January-March quarter of this year. In the April-June quarter, exports fared well thanks to abundant harvest of grains, but industrial production tumbled 6.8% YoY (Chart 6 next page). As for inflation, the CPI shot up 56.3% YoY in the April-June quarter, and the increase is still accelerating (Chart 7 next page).

The upcoming presidential election is a key consideration for the outlook of the Argentina's economy. Argentinians are taking their frustration over the economic decline on the current administration led by President Mauricio Macri. In the primary vote on August 11, center-left candidate Alberto Fernandez -- backed by left-wing Peronists -- polled 47.5% with a lead of more than 15% points to Macri. The Macri administration is now reexamining its austerity measures to boost support ahead of the October election, but time is running out.

Macri's exit from office is looming as an increasingly realistic possibility. Businesses likely will hold off investments and until after the election to gauge economic policies under a new government. If Fernandez takes office, his administration would fundamentally reexamine Macri's austerity measures and renegotiate with the IMF (Argentina had promised to carry out austerity measures for an IMF bailout). If this scenario plays out, the Argentine peso would weaken again, fueling inflation further and exacerbating economic conditions.

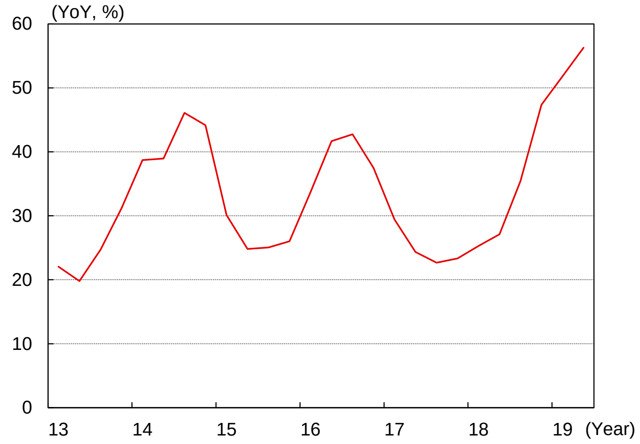
With these considerations in mind, we project Argentina's real GDP will decline by 2.0% YoY this year, marking a second consecutive annual contraction. The downtrend is expected to persist for a while if a new government overhauls economic policies. For 2020, we project that Argentina's real GDP will contract 2.0% YoY.

Chart 6: Argentina Industrial Production Index



Source: National Institute of Statistics and Census (INDEC), Institute for International Monetary Affairs

Chart 7: Argentina Consumer Price Index



Source: Central Bank of Argentina, Institute for International Monetary Affairs

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