The Outlook for Latin American Economies

Brazil stuck in low growth, Mexico in sharp deceleration, and Argentina inches closer to default possibility

HIROSHI MORIKAWA
ATSUSHI TOMATSU
The Institute for International Monetary Affairs

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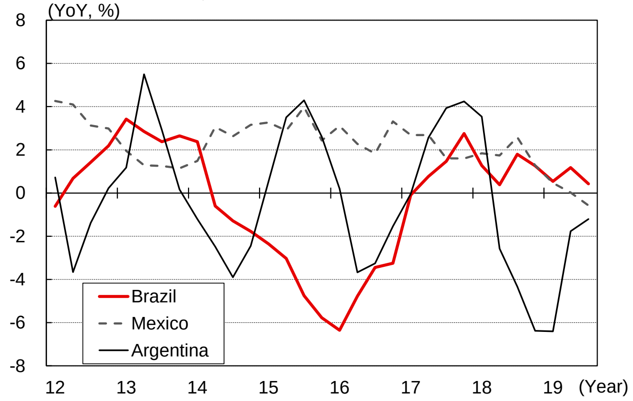
The three major Latin American economies have all been on a downtrend this year. In Brazil, where growth has been slow for some time, the Economic Activity Index has been generally decelerating. The index for Argentina, struggling with severe stagflation, fell sharply YoY in late 2018 and early 2019, and still remains in the negative territory. The index for Mexico had hovered steadily around 2% YoY for some time, but began declining in the second half of 2018 and has entered the negative territory this year (Chart 1).

1. Brazil

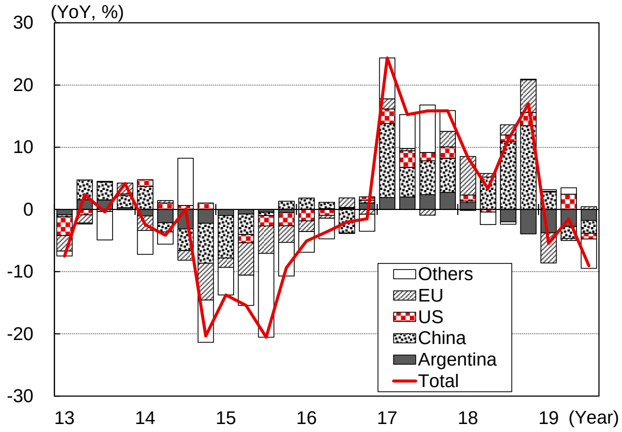
Brazil's real GDP grew by a muted 0.7% YoY in the first half of this year. Growth rate had slowed to 0.5% YoY in the January-March quarter and picked up slightly to 1.0% YoY in the April-June quarter. As for foreign demand, exports to Argentina have been down YoY since the second half of 2018 as the neighboring country suffers an economic crisis. Exports to China have sharply declined YoY this year. In the July-September quarter, exports to most destinations except the EU decreased YoY, and the total exports fell 9.0% YoY, sharper than the declines of the two preceding quarters (Chart 2). As for domestic demand, the retail sales index rose 3.6% YoY in the July-August period following a 4.1% YoY increase in the April-June quarter, pointing to continued growth in consumer spending. Meanwhile, capital investment appears to be weakening. Machinery and equipment shipments declined 7.3% YoY in the July-September quarter, following a 2.0% YoY drop in the April-June quarter.

Chart 1: Economic Activity Indices of Three Major Latin American Economies



Note: Brazil and Mexico indices for latest quarter are July-Aug averages.
Source: Statistics from each country, MUFG Bank Economic Research Office

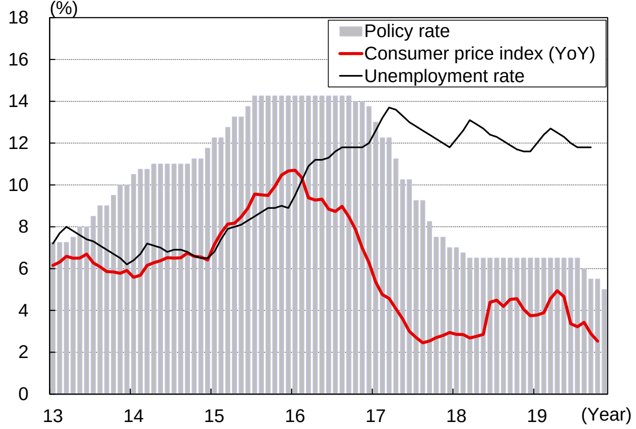
Chart 2: Brazil Export Value by Destination



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

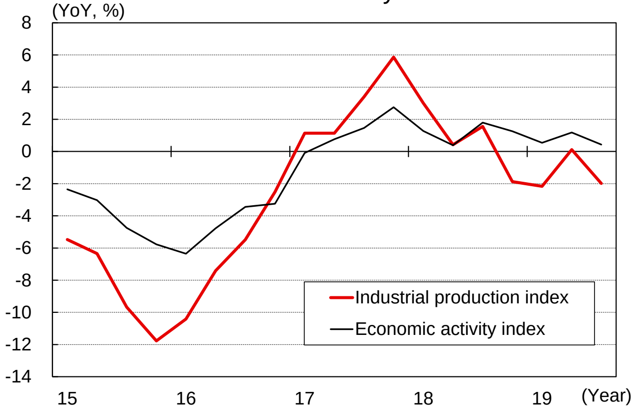
As for inflation, consumer price growth rate has been slowing and was 2.9% YoY in September (Chart 3). One reason is a labor market slack, which is easing upward pressure on wages. The unemployment rate currently stands around 12%, significantly higher than the 9.7% average of the past seven years for which comparable data is available. In view of muted inflation, the Central Bank of Brazil has cut its policy rate by 0.5% point three times in a row since July. The rate, which had been kept at 6.5% since March of 2018, has been slashed to 5.0%. The rate is already at a record low level, but the central bank has suggested it may carry out another rate cut at its December meeting.

Chart 3: Brazil Consumer Price Index, Unemployment Rate and Policy Rate



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

Chart 4: Brazil Industrial Production Index and Economic Activity Index



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

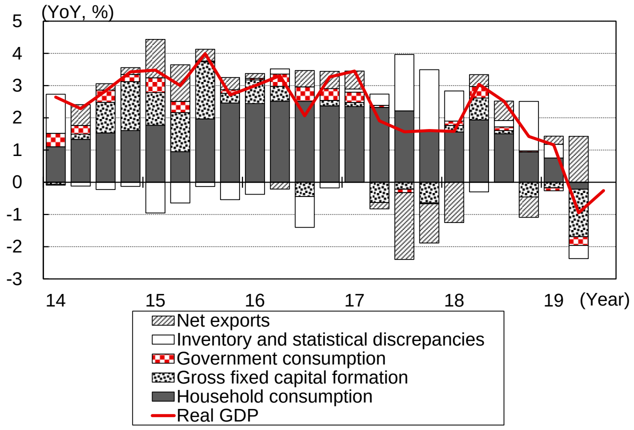
As for the outlook of the Brazilian economy, the real GDP growth rate is projected to slow to 0.9% YoY in 2019 from 1.1% YoY in 2018, mainly due to low growth in the first half of this year. In the October-December quarter, a program that allows early withdrawals from a workers' severance fund, called the "FGTS" (Portuguese acronym for Guarantee Fund for Length of Service), is expected to shore up consumption. Yet the effect will likely be short-lived. For 2020, Brazil's real GDP growth rate is projected at 1.5% YoY, significantly undershooting the potential growth rate. Both external and domestic factors are expected to dampen growth. As for external factors, economic struggles of neighboring country Argentina will likely hamper a significant uptick in Brazil's economic activity, as will the uncertainty surrounding the US-China trade friction (Chart 4). As for domestic factors, while major interest rate cuts are expected to support domestic demand to an extent, the effect of the FGTS early withdrawal program will likely run its course in the second half of 2020. The government is unlikely to carry out large-scale fiscal stimulus measures due to a 2016 legislation that limits increases in federal government spending (excluding interest payments) to no more than the previous year's inflation rate through 2036.

As for pension reform, the Senate passed on October 22nd a bill to implement a series of changes including raising the minimum retirement age. The government estimates savings of around 800 billion reais (11.7% of nominal GDP in 2018) from the reform over 10 years starting in 2020. While the reform would ease the fiscal burden of the government, the effect is not scheduled to manifest until 2023 at the earliest, so over the short term, no economic impact is expected.

2. Mexico

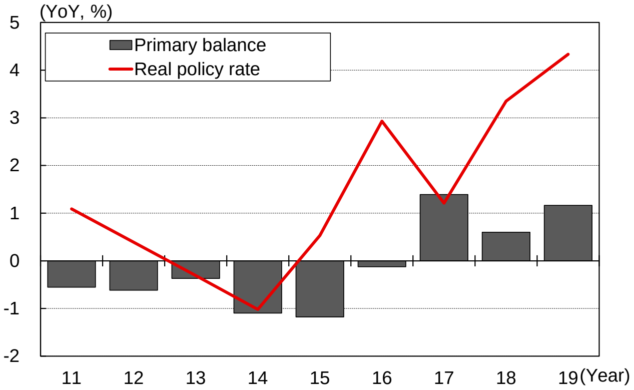
Mexico’s real GDP growth rate had been slowing since the second half of 2018 due to a sharp deceleration in consumer spending and lackluster gross fixed capital formation. In the April-June quarter of 2019, the real GDP contracted 0.8% YoY as consumer spending declined YoY and gross fixed capital formation decreased more sharply than in the previous quarter. As a result, the real GDP grew a mere 0.2% YoY in the January-June half of this year, significantly slowing from an annual 2.0% YoY increase in 2018. The downtrend has continued into the July-September quarter, when the decline narrowed slightly to 0.3% YoY (Chart 5). Three main reasons have been observed for Mexico’s economic stagnation. The first reason is a slowdown of US manufacturing production since the second half of last year, which has put the brakes on Mexico’s exports to the US, its largest export destination. In the July-September quarter of this year, US manufacturing production contracted 0.5% YoY, and Mexico’s manufacturing production rose just 0.2% YoY. The second reason is high interest rates, which are beginning to negatively impact investment. The real policy interest rate has averaged more than 4% for the January-September period following a series of rate hikes that began in late 2015 (Chart 6). The third reason is contractionary fiscal policy that the previous administration introduced in 2017. Mexico’s primary balance turned to a surplus in 2017 and has since remained in the positive territory.

Chart 5: Mexico Real GDP



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

Chart 6: Mexico Fiscal Condition and Monetary Policy



Note: 2019 primary balance is Jan-Sept total. Real policy rate is calculated based on consumer price index

Source: Mexico Ministry of Finance, Bank of Mexico, MUFG Bank Economic Resarch Office

The effect of slowing economic activity is becoming evident in inflation rate as well. The consumer price growth in September was 3.0% YoY, down from the 2018 average of 4.9% YoY. The inflation rate now stands at the midpoint of the central bank target range of 3.0% plus or minus 1.0% point. The Bank of Mexico has lowered its policy rate by 0.25% point three times starting in August, after the US Federal Reserve began its rate cuts in July. Mexico’s policy rate now stands at 7.50%.

As for the outlook, 2019 full-year real GDP growth rate is expected to be muted at around 0.1% YoY, due to weak results in the January-September period. In 2020, however, the economy is projected to revert to an uptrend, with full-year growth rate forecast at 1.5% YoY. The US manufacturing activity is expected to remain slow through the beginning of 2020, yet a cumulative effect of Mexico’s rate cuts this year and a 485 billion peso fiscal stimulus package announced by the Andres Manuel Lopez Obrador administration in July are expected to support a gradual recovery of domestic demand (485 billion pesos are equivalent to 2% of Mexico's nominal GDP). A recovery of US manufacturing activity toward the second half of 2020 would also support a mild recovery of Mexico's exports and manufacturing activity. As for the contractionary fiscal policy that has limited economic growth, not much change is expected. Mexico's primary balance is projected to come to a surplus equivalent to 0.8% of GDP this year, according to the IMF. For 2020, even with the stimulus measures put into effect, the primary balance is forecast at a surplus equivalent to 0.9% of GDP. The government still has room to increase fiscal spending.

One lingering concern on the outlook for the Mexican economy is whether the US Congress will ratify the United States-Mexico-Canada Agreement (USMCA). Influential Senate Democrats are opposing the agreement, and lawmakers facing reelection next year may shy away from a revamp in the North American trade pact. A delay in US ratification would increase uncertainty for the Mexican economy.

3. Argentina

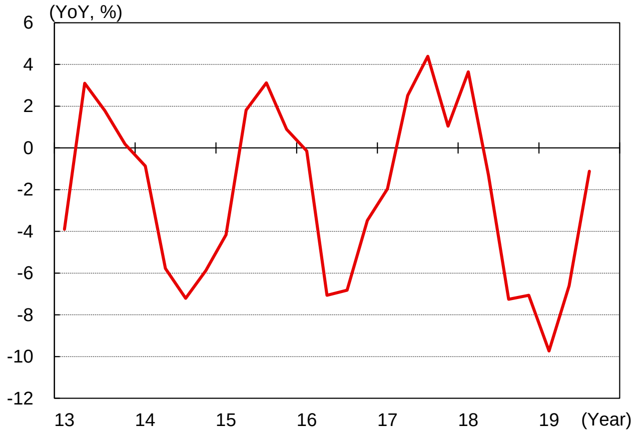
Argentina continues to grapple with soaring inflation and economic declines resulting from the currency crisis last year. One positive development this year, however, is that agricultural exports have fared well thanks to abundant grain harvests. Argentina's trade surplus for the January-September period marks a $16.0 billion improvement from a deficit of $6.4 billion a year earlier. In addition, industrial production's decline narrowed from 6.6% YoY in the April-June quarter to 1.1% YoY in the July-September quarter, signaling that the worst may be over (Chart 7). Nevertheless, economic conditions are still far from reassuring, with the country's real GDP contracting 4.1% YoY in the first half of 2019, worsening from an annual contraction of 2.5% YoY in 2018.

As for the outlook, political uncertainty surrounding a change of government calls for caution. In the August primary vote for the presidential election, Alberto Fernandez of the main opposition party beat President Mauricio Macri by a significant margin. This fueled speculation about a return of a leftist government and accelerated capital flight from Argentina. As a result, Argentina's foreign currency reserves have decreased sharply after the primary vote, even though its trade surplus has grown (Chart 8). Macri has failed to gain traction after the primary, and Fernandez declared victory after the first round of the main vote in October (his lead was wide enough to skip a runoff in the second round of vote in November). Fernandez, who is scheduled to take office as President in December, is considered more of a centrist compared with former President Cristina Fernandez de Kirchner, who will serve as vice president. Yet the new administration is certain to overhaul the economic policy of Macri's administration, which had to carry out a series of spending cuts. The new administration is likely to resort to fiscal policy to bolster the economy and combat high inflation through price control.

Negotiation with the IMF is one key issue for the new administration. During his election campaign, Fernandez repeatedly said his administration would not ask for more sacrifices from the people of Argentina. The new government is thus likely to reject or scale back the austerity measures that have been demanded by the IMF, and seek to renegotiate repayment terms for IMF loans. Furthermore, in order to address foreign currency-related concerns, the Fernandez administration is expected to attempt renegotiations of repayment terms with private-sector investors who hold Argentine government bonds denominated in foreign currencies. However, renegotiations under time constraints will be no easy task, with many stakeholders involved. Thus, the possibility of a default, perhaps next year, may be emerging for Argentina. This would be its ninth default since the nation's founding in the 19th century. The last default was roughly six years ago, in 2014.

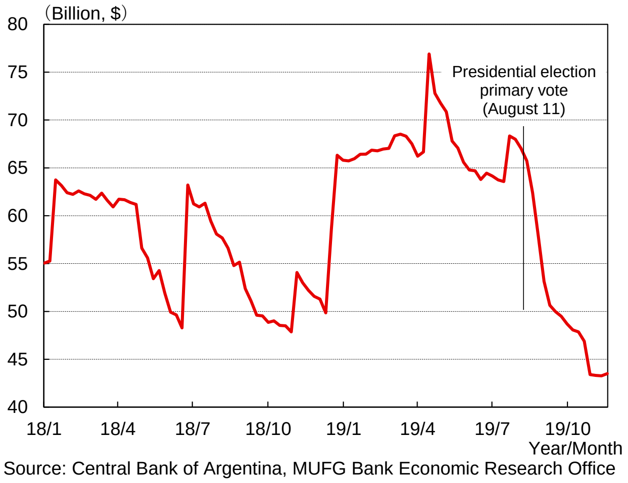
Based on the above considerations, Argentina's real GDP is projected to contract by 3.0% YoY in 2019, marking a second year of decline. In 2020, its real GDP is forecast to decline 2.0% YoY, a third annual contraction.

Chart 7: Argentina Industrial Production Index



Source: National Institute of Statistics and Census (INDEC), MUFG Bank Economic Research Office

Chart 8: Argentina Foreign Currency Reserves



Source: Central Bank of Argentina, MUFG Bank Economic Research Office

Translated by Chie Okada-Wighe

For further details, please contact the Institute for International Monetary Affairs

Written by Hiroshi Morikawa morikawa@iima.or.jp

Atsushi Tomatsu atsushi_tomatsu@iima.or.jp

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