Economic Research:

Latin America's Pre-COVID-19 Growth Challenges Won't Go Away Post-Pandemic

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LATIN AMERICA SENIOR ECONOMIST

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Key Takeaways

- Our macroeconomic narrative for Latin America has not changed materially since last quarter. The recovery from the worst of the pandemic is underway across the major economies in the region, and our GDP forecast adjustments this round mostly reflect unexpected performance in the second quarter.
- The Brazilian economy performed better than we anticipated. Argentina, Colombia, Mexico, and Peru fared worse than we expected. Chile's was broadly in line with what we envisioned. Our new forecasts account for this, and we now see the region contracting a touch more this year, but also a bit faster next year (down 8.5% for 2020 and up 4.5% in 2021).
- Most major Latin American economies will not return to prepandemic levels of GDP until 2022, and some beyond, and the permanent income losses will average about 6% of GDP--among the highest in emerging markets due to severe damage to labor and investment dynamics.
- We expect the post-COVID-19 Latin American countries to face the same structural economic challenges as before the pandemic, especially regarding weak investment and low productivity. This means the region will likely converge to its traditionally low GDP growth rates as it reaches its post-pandemic "new normal."

Our macroeconomic narrative for Latin America has not changed materially since last quarter. The recovery from the worst of the COVID-19 pandemic is underway across the major economies in the region, albeit at different speeds, largely influenced by the extent and status of lockdowns, as well as by the magnitude and effectiveness of government stimulus. Our GDP forecast adjustments this time mostly reflect different performance than we expected in the second quarter. Latin America's aggregate second-quarter GDP contracted 45% quarter-over-quarter (q/q) in annualized terms--slightly worse than we expected and 4.5x more severe than during the height of the global financial recession. This means we now see the region contracting 8.5% this year and expanding 4.5% in 2021 versus down 7.7% and up 3.9%, respectively, in our previous quarterly update. An important downside risk to growth across the region will be the potential for bouts of social instability with implications to investment due to the outsized impact of the pandemic downturn on lower-income households in an already polarized political environment in most Latin American countries.

Table 1

Latin America: GDP Growth And S&P Global's Forecasts

(%)	2018	2019	2020	2021	2022	2023
Argentina	(2.6)	(2.1)	(12.5)	4.8	3.3	2.9
Brazil	1.2	1.1	(5.8)	3.5	3.0	2.9
Chile	4.0	1.0	(6.5)	5.5	3.6	3.3
Colombia	2.5	3.3	(8.0)	5.5	4.6	3.8
Mexico	2.2	(0.3)	(10.4)	3.7	2.6	2.1
Peru	4.0	2.2	(13.5)	12.5	5.5	4.0
LatAm 5	1.4	0.5	(8.3)	4.0	3.1	2.7
LatAm 6	1.5	0.6	(8.5)	4.5	3.2	2.8

Note: The LatAm GDP aggregate forecasts are based on PPP GDP weights. LatAm 5 excludes Peru. Source: S&P Global Ratings.

Table 2

Changes In Base Forecasts From Q1 2020

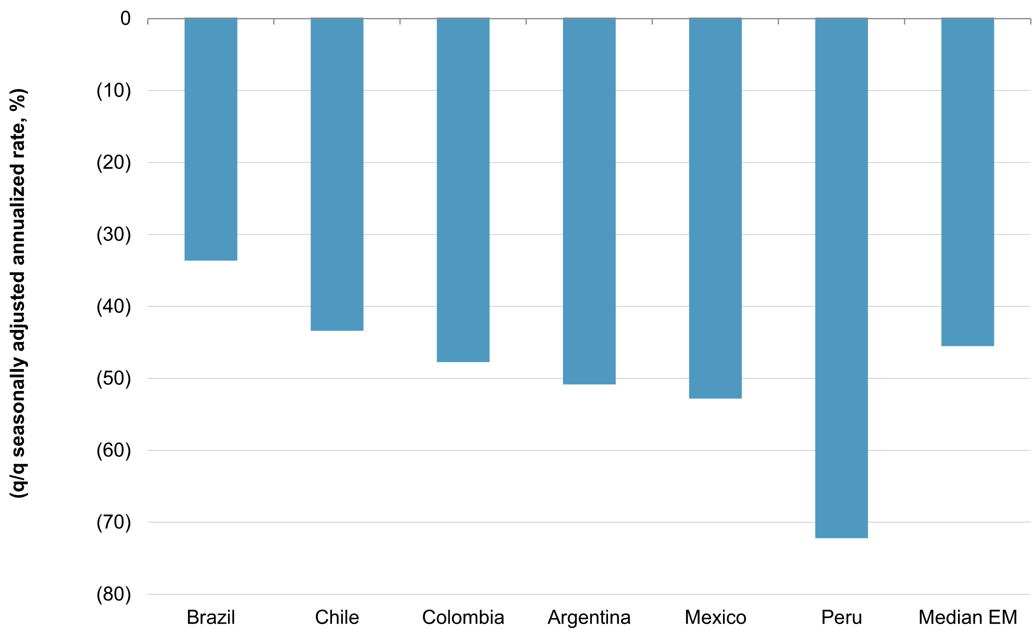
(%)	2020	2021
Argentina	(4.0)	1.9
Brazil	1.2	(0.0)
Chile	(0.0)	0.0
Colombia	(3.1)	1.0
Mexico	(1.9)	0.7
Peru	(1.5)	2.0
LatAm 5	(0.8)	0.5
LatAm 6	(0.9)	0.6

From a country-specific perspective, Brazil's economy, despite having one of the highest number of COVID-19 cases, performed better than we expected in the second quarter--one of the mildest contractions in emerging markets outside of Asia--declining 33.5% q/q in annualized terms. Less-stringent lockdown measures, significant government stimulus to households, and strong exports to China helped explain the second-quarter GDP result. In response, we have revised our 2020 GDP forecast to a 5.8% contraction, better than the 7% decline previously expected, but kept our 2021 forecast unchanged at 3.5%.

Conversely, Argentina, Colombia, Mexico, and Peru performed worse than we expected in the quarter due to relatively stringent and lengthy lockdowns in the case of Argentina, Colombia, and Peru, and to limited government stimulus for Mexico. In Argentina, Mexico, and Peru we now see GDP falling by more than 10% this year, and 8% in Colombia. In Chile, the economy is performing broadly as we expected, and we have kept our 2020 and 2021 GDP forecasts unchanged at negative 6.5% and positive 5.5%, respectively.

Chart 1

Second-Quarter 2020 GDP Growth



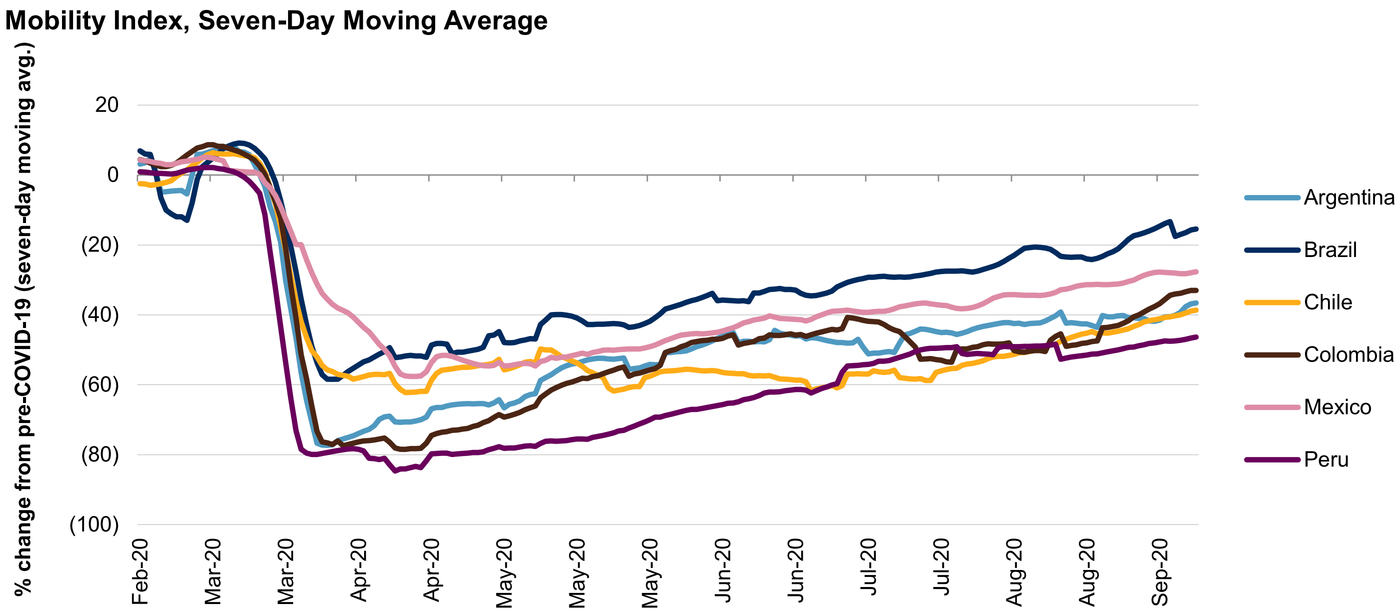
Notes: Median EM refers to the median of 14 major emerging markets excluding China. At the time of writing, Argentina has not published Q2 GDP, so our estimate is based on the monthly economic activity index, which is available for the entirety of Q2. Sources: Haver Analytics and S&P Global Ratings.

Recovery Phase Will Take Different Shapes Across The Region

We still work with the assumption that a vaccine for COVID-19 will not be widely available until sometime near the middle of next year, with a plausible scenario of that occurring a bit sooner. However, as economies continue to gradually reopen and populations become comfortable with living more "normal" lives with the virus amid the availability of better medical treatment, the ongoing recovery is likely to continue in the coming quarters despite the absence of a vaccine. An improvement in global demand and low borrowing costs are certainly helping this.

High-frequency data, such as the daily mobility data published by Google, suggests that the recovery in Latin America started roughly in the middle of the second quarter and has so far continued throughout the third quarter (see chart 2). If we take into account the improvement in mobility as a proxy for GDP, this would suggest output grew at q/q pace of 30%-40% in the third quarter on average in Latin America after falling 45% in the second.

Chart 2



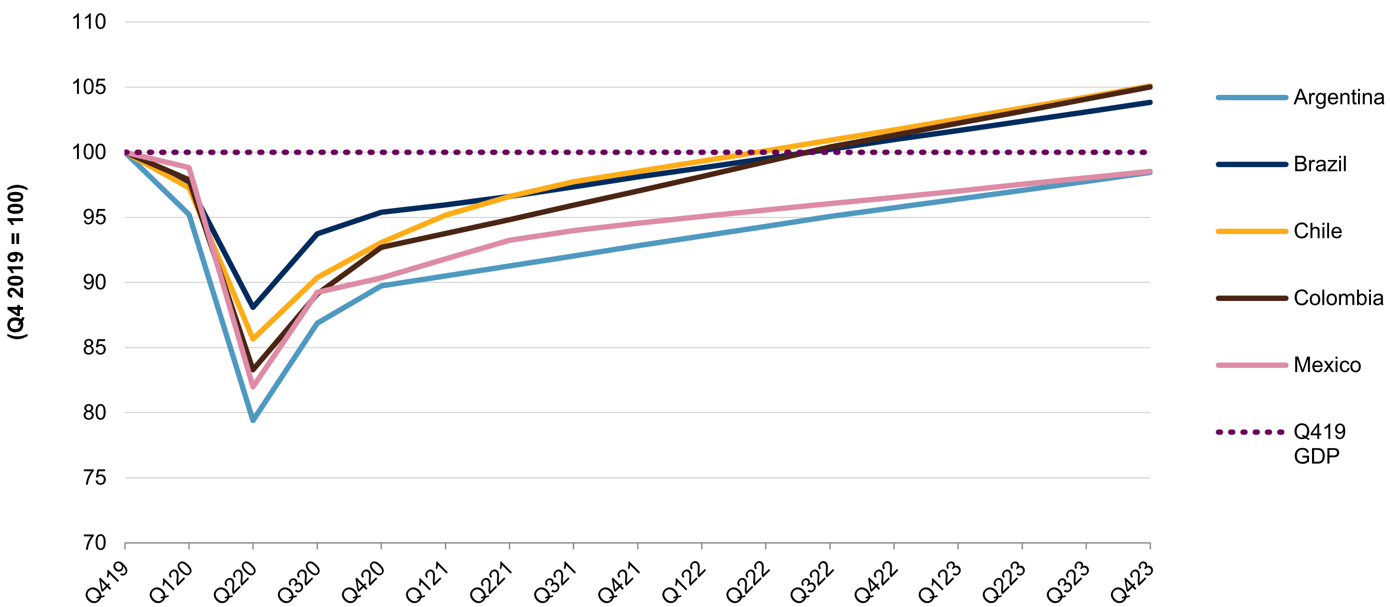
Notes: The index is an equally weighted index of retail and recreation, transit, and workplaces. The baseline is the median value, for the corresponding day of the week, during the five-week period Jan. 3–Feb. 6, 2020.
Sources: Google LLC "Google COVID-19 Community Mobility Reports" and S&P Global Ratings.

The recovery is far from even across the region, however, and could be prone to setbacks depending on how quickly and smoothly consumption and investment pick up, as well as on the development of global demand. Looking at mobility data and available hard data, such as retail sales, it's clear that Brazil is leading the pack in terms of speed of recovery in Latin America, helped by a monthly stimulus check that has reached about 66 million informal and low-income workers. That said, stimulus in Brazil is already being unwound, with the stimulus check being cut in half starting in September, and the program scheduled to end in December--this means consumption momentum is likely to moderate in the rest of the year and into 2021.

Other countries with strong stimulus measures, such as Chile and Peru, are not recovering as quickly as Brazil mostly due to more-stringent and lengthier lockdowns, but as social distancing measures are relaxed, the recovery is likely to pick up steam; these countries may see relatively strong fourth quarters. In Mexico, on the other hand, stimulus to households was very limited, which means consumption is likely to lag most of the region, but the good news is that strong U.S. demand for autos is boosting Mexico's key manufacturing sector.

Chart 3

Projected GDP Level Versus Pre-Pandemic Level



Note: For Chile, we use Q319 as a starting point, given the sizable impact of protests on Q419 GDP. We then averaged out Q419 and Q120, and used that as Q120 to smooth out the volatility. We excluded Peru from the chart because the outsize drop in Q2 moved the axis too low, making it hard to see details on the other countries. Under our projections, Peru returns to its pre-COVID-19 GDP level in Q322. Sources: Oxford Economics and S&P Global Ratings.

Ultimately, we believe that, beyond the initial recovery period that's largely driven by the easing of lockdowns, countries with stronger and longer-lasting support for consumption and investment dynamics will return to prepandemic GDP levels more quickly, and will have smaller permanent GDP losses. Under our projections, most economies return to their prepandemic (fourth-quarter 2019) GDP levels in 2022, except for Argentina and Mexico. Those two countries are likely to return to their prepandemic GDP levels beyond our 2023 forecast horizon--in 2024--assuming a constant growth rate; they have the highest permanent income losses in the region.

In both Argentina and Mexico, we estimate permanent income losses of about 8% of GDP due to structural economic weakness that preceded COVID-19, which amplified the impact of the pandemic, as well as limited support to the labor market and businesses; this means investment and consumption will not fully recover. We see the lowest permanent income losses in Chile and Peru (about 5% of GDP). These economies have implemented ample stimulus, and have some room to continue doing so. Brazil and Colombia are somewhere in the middle, at about 6% and 7%, respectively, in permanent GDP losses since both economies are constrained by the amount of government stimulus that can still be implemented due to strict fiscal rules that limit spending.

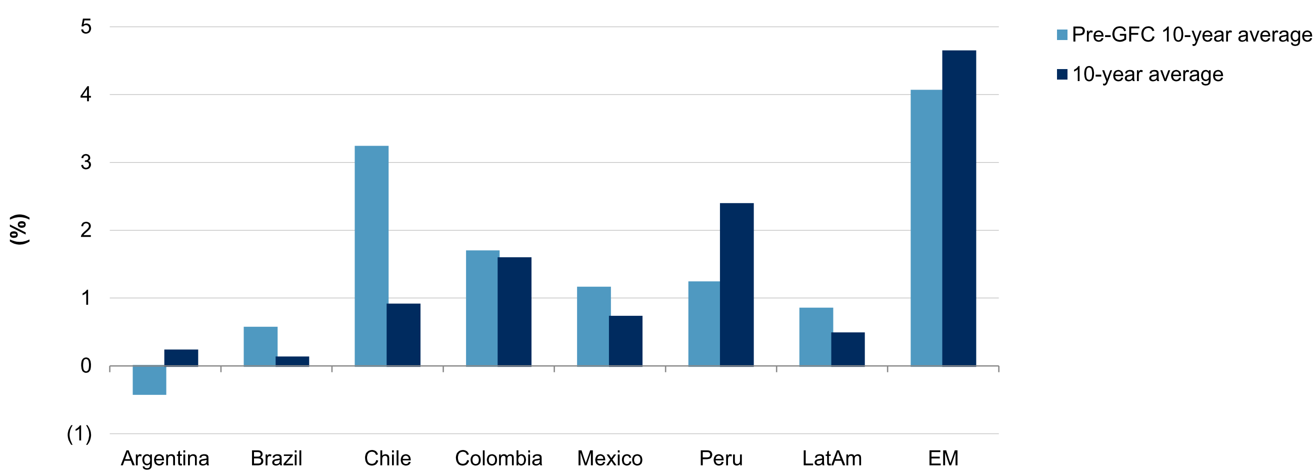
Latin America Will Continue To Face Low Productivity Challenges In The Post-COVID "New Normal"

Once a vaccine is widely available, and economies gradually transition into a post-COVID "new normal," we believe Latin America will continue to face the same structural economic weaknesses that preceded the pandemic, ultimately keeping the region in a low-growth environment. These structural weaknesses are largely related to both low levels of investment and weak growth returns on investment. More specifically, real fixed investment in Latin America has averaged less than 2% over the past 10 years, while across major emerging markets, it has averaged nearly 6%.

Furthermore, investment in Latin America tends to return less GDP growth than in other emerging markets, as shown by investment efficiency indicators such as the incremental capital output ratio (ICOR). In Latin America, the ICOR has averaged above 15 over the past decade, compared with an average of roughly 10 in major emerging market--in other words, in Latin America on average you need about 50% more units of investment to produce the same one unit of GDP than in other emerging markets. The reasons for this weakness are well-known: high unpredictability in government policies, heavy regulatory burdens, and large informal sectors, among others. Unless those issues improve materially in the coming years, investment is likely to remain low and inefficient in a post-COVID world.

Chart 4

Average Productivity Growth



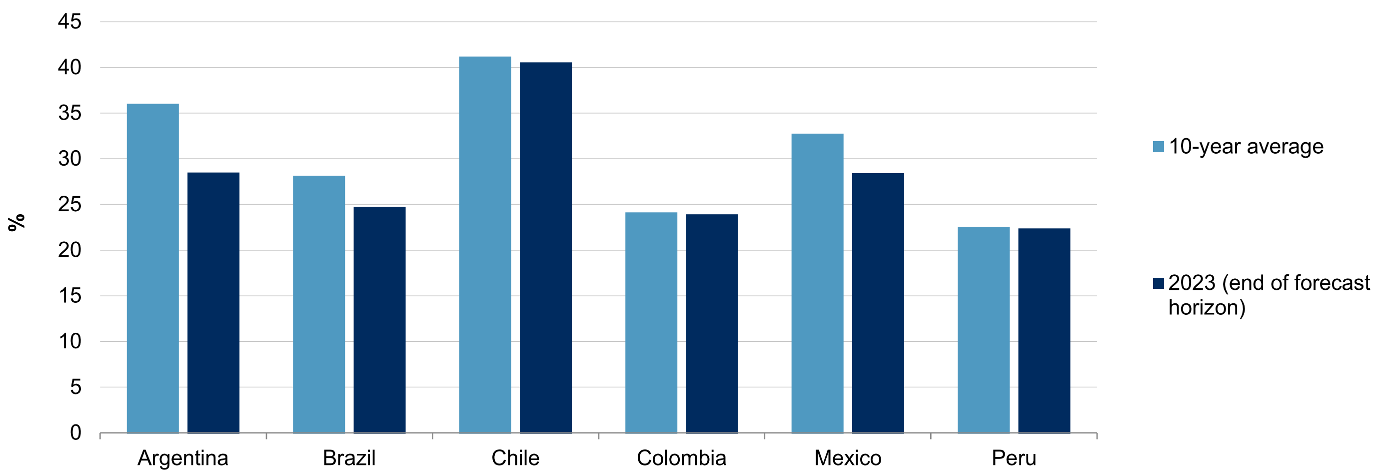
Note: Pre-GFC 10-year average refers to 1999-2007. EM refers to an aggregate of 16 of the largest economies, weighed by GDPP in purchasing power parity terms. Sources: Oxford Economics and S&P Global Ratings.

Weak and inefficient investment has kept productivity growth low in Latin America, averaging just 0.5% in the past decade, much lower than the 4.5% average in emerging markets. In fact, most of the recent GDP growth in the region has stemmed from the expansion of employment thanks to favorable demographic dynamics rather than an improvement in productivity. Indeed, the formula for the roughly 2% average GDP growth Latin America in the past decade has been 0.5%

productivity growth plus 1.5% growth in employment. But productivity improvements will become more important as populations age in the region and employment growth slows. Low productivity has also meant that income per capita convergence with advanced economies hasn't really progressed, and is unlikely to improve unless Latin America grows sustainably faster than it has in recent years (see chart 5). Potential disillusionment over incomes not catching up with the rest of the world could lead to further social unrest and political volatility, further complicating the investment picture.

Chart 5

Ratio Of GDP Per Capita To The U.S. In Purchasing Power Parity Terms



Sources: Oxford Economics and S&P Global Ratings.

Our GDP Forecasts:

Argentina

We lowered our 2020 GDP forecast to negative 12.5% from negative 8.5% previously, mostly due to the worse-than-expected second-quarter GDP reading of roughly 50% q/q decline. This led us to raise our 2021 GDP projection to 4.8% growth, from 2.9%, as our assumptions did not change materially. The government underwent relatively smooth debt restructuring process last month, but the economy continue to faces severe economic constrains, such as persistently high inflation, a heavy foreign currency debt burden, and low foreign exchange reserves, resulting in a scarcity of U.S. dollars in the economy. In light of these dynamics, economic growth will remain susceptible to large swings, which will keep investment weak and the recovery from the pandemic downturn slow in the coming years.

Brazil

The performance of the economy has been better than we anticipated, with second-quarter GDP having one of the mildest contractions in emerging markets outside of Asia, at 33.5% q/q in annualized terms. This has prompted us to improve our 2020 GDP projection to negative 5.8% from negative 7% previously. The surprise upside to growth has arisen from three factors: large government transfers to informal and low income workers; less-stringent lockdown measures than many other nations in the region; and strong exports to China, especially of soybeans. Amid a challenging fiscal scenario, including a constitutional requirement to keep primary spending flat in real terms, stimulus measures will likely have to be unwound rapidly next year, which will be a significant headwind to growth, therefore, our 2021 GDP growth will likely remain unchanged at 3.5%.

Chile

We kept our 2020 and 2021 GDP projections unchanged at negative 6.5% and positive 5.5%, respectively. Second-quarter GDP growth declined broadly as we expected, contracting 43% q/q in annualized terms, close to the 45% median decline in major emerging markets outside of China. Chile has had one of the most-stringent and longest lockdowns in the region, so the recovery has been slower than most others in the region. But strong government support for labor markets and business, as well as a new program that allows individuals to withdraw funds from their pension accounts, means that, as the economy opens up, growth will likely pick up very quickly. So, we think Chile will likely have one of the strongest Q4 GDP growth rates in the region. However, the country is still undergoing significant political changes, including an upcoming plebiscite on a new constitution, which poses downside risk to our longer-term growth outlook.

Colombia

GDP growth contracted nearly 50% q/q annualized in the second quarter--worse than we anticipated. As a result, we lowered our 2020 GDP projection to negative 8% from negative 5% previously, but increased our 2021 growth forecast to positive 5.5% from 4.5%. The collapse in exports in the second quarter was among the most severe in the region, declining nearly 70% q/q due to the sharp drop in demand for oil, Colombia's largest export. The recovery in the third quarter has not been as smooth as in other regional economies, especially given a retightening of lockdowns in August in major cities as the usage of intensive care units surpassed thresholds that mandated shutting down certain parts of the country, including Bogota. But lockdowns were relaxed nationwide in September, and we expect a recovery will firm up into the fourth quarter. Consumption will be slow to recover due to severe job destruction, which has pushed unemployment to 20%. Complying with Colombia's fiscal regime will imply a pullback in government spending next year, which will also likely reduce public capital expenditures.

Mexico

We lowered our 2020 GDP forecast to negative 10.4% from negative 8.5% previously, and boosted our 2021 growth projection to 3.7% from 3%. The revision results mostly from the weaker-than-expected contraction in the second quarter (over 50% q/q annualized), and the rest of our assumptions have not changed significantly. We still expect Mexico to have among the weakest economic recoveries in emerging markets from the COVID-19 pandemic. The economy had structural weaknesses before the pandemic, with a mild contraction in 2019 due to unfavorable investment dynamics. Furthermore, the policy response has been relatively small, with fiscal stimulus so far amounting to about 1% of GDP, mostly focused on direct transfers, and with limited support to small and medium enterprises.

Peru

We now see the economy contracting 13.5% this year, and then growing 12.5% in 2021 versus our previous expectation of a 12% decline in 2020 and 10.5% growth in 2022. The Peruvian economy has been among the hardest hit this year globally by the fallout of the pandemic, with second-quarter GDP falling more than 70% q/q. This resulted from the temporary halt in metals production, the stalling in the country's key fishing season, as well as one of the lengthiest and most-harsh lockdowns. We think Peru will still have the highest GDP growth rate in 2021 as the economy reopens, helped by the strong stimulus measures put in place (roughly 12% of GDP) and an expected strong recovery in Chinese demand--Peru's top destination for exports.

Appendix

Table 3

Latin America: CPI Inflation And S&P Global Ratings' Forecasts (Year-End), % Change Year Over Year

	2019	2020	2021	2022	2023
Argentina	53.8	38.0	42.0	35.0	30.0
Brazil	4.3	1.9	3.5	3.5	3.5
Chile	3.0	2.2	3.0	3.0	3.0
Colombia	3.8	1.9	2.7	3.0	3.0
Mexico	2.8	3.8	3.5	3.3	3.0
Peru	1.9	1.7	2.4	2.0	2.0

Source: Oxford Economics, S&P Global Ratings

Table 4

Latin America: CPI Inflation And S&P Global Ratings' Forecasts (Average)

(%)	2019	2020	2021	2022	2023
Argentina	53.5	43.0	40.0	38.5	32.5
Brazil	3.7	2.7	3.0	3.5	3.5
Chile	2.3	2.8	2.6	3.0	3.0
Colombia	3.5	2.6	2.3	3.0	3.0
Mexico	3.6	3.5	3.7	3.4	3.1
Peru	2.1	1.8	2.0	2.2	2.0

Sources: Oxford Economics and S&P Global Ratings.

Table 5

Latin America: Central Bank Policy Interest Rates And S&P Global Ratings' Forecasts (Year-End)

	2019	2020	2021	2022	2023
Argentina	55.00	33.00	30.00	25.00	25.00
Brazil	4.50	2.00	3.00	4.50	5.50
Chile	1.75	0.50	1.00	2.00	2.50
Colombia	4.25	1.75	2.75	4.00	4.50
Mexico	7.25	4.25	4.25	5.00	5.50
Peru	2.25	0.25	1.00	2.00	2.50

Sources: Oxford Economics and S&P Global Ratings.

Table 6

Latin America: Year-End Exchange Rates And S&P Global Ratings' Forecasts (Versus U.S. Dollar)

	2019	2020	2021	2022	2023
Argentina	59.89	85.00	115.00	125.00	135.00
Brazil	4.03	5.25	5.05	5.00	5.00
Chile	745	765	760	755	755
Colombia	3,277	3,700	3,675	3,650	3,650
Mexico	18.93	21.50	21.25	21.00	21.00
Peru	3.31	3.45	3.40	3.35	3.35

Sources: Oxford Economics and S&P Global Ratings

Table 7

Latin America: Average Exchange Rates And S&P Global Ratings' Forecasts (Versus U.S. Dollar)

	2019	2020	2021	2022	2023
Argentina	47.97	72.00	100.00	120.00	130.00
Brazil	3.94	5.12	5.10	5.02	5.00
Chile	703	790	762	758	755
Colombia	3,281	3,700	3,690	3,660	3,650
Mexico	19.25	21.70	21.30	21.15	21.00
Peru	3.34	3.45	3.42	3.38	3.35

Sources: Oxford Economics and S&P Global Ratings

Table 8

Latin America: Average Unemployment Rate

(%)	2019	2020	2021	2022	2023
Argentina	9.8	12.7	11.5	10.1	9.9
Brazil	11.9	13.4	12.9	12.2	11.6
Chile	7.2	11.1	10.4	9.2	8.7
Colombia	10.5	15.4	14.5	13.6	12.7
Mexico	3.5	5.1	4.8	4.4	4.2
Peru	6.6	9.4	8.7	7.8	7.3

Sources: Oxford Economics and S&P Global Ratings.

A Note On Our COVID-19 Assumptions

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the in the middle of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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