SPECIAL REPORT

TD Economics

July 29, 2014

LATIN AMERICAN OUTLOOK: SEEING THE RAIN FOREST THROUGH THE TREES

Highlights

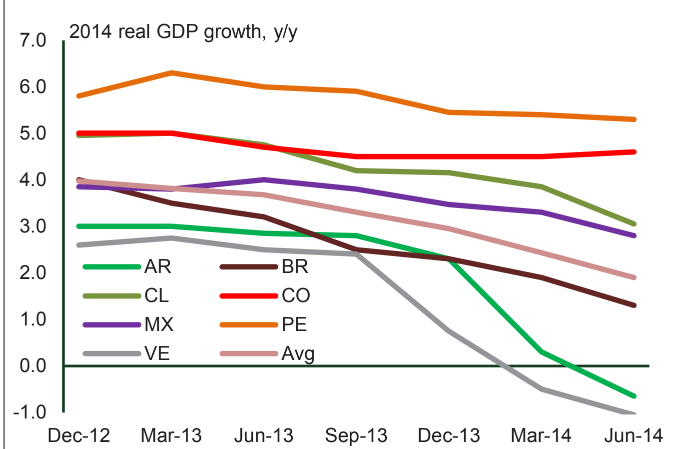
- From a 4.5% average pace of real GDP growth over the 2004 to 2011 period, growth in Latin America slowed to 3.1% in 2012 and further to 2.7% in 2013.
- Economic growth in Latin America should hit a trough at 2.3% in 2014, before rebounding to a still subdued 2.9% in 2015. Many of the conditions that underpinned growth during the boom years – high commodity prices, commodity-driven investment, a ramp-up in credit (both public and private) – are unlikely to be repeated, and in some cases may act as a drag on the economy.
- For 2014-2015, the performance across economies will be uneven, and this report will examine the divergence in growth across major Latin American economies. Peru and Colombia are set to lead, growing by 4.5%-5.5%. Chile and Mexico will follow with growth averaging between 3%-4% annually. Finally, growth in Brazil, Argentina and Venezuela will lag, likely falling short of 2%.
- Beyond the next two years, economic growth in Latin America should gradually rise to an annual average of 3.2% over the 2016 to 2020 period. Growth will remain lower than over the 2004 to 2011 period, but will be faster than in most advanced economies.

Latin American financial markets have been ebullient so far this year. Currencies in most major countries with floating exchange rates have risen, ten-year bond yields have fallen, and local stock markets are up. In contrast to the bullish tone in financial markets, economic growth has been tepid in Central and South America. Growth forecasts for the seven largest Latin American economies (LAC-7), Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela, have been trending downwards (chart 1). Relative to the boom years of 2004-2011, when real GDP growth averaged 4.5%, growth slowed to 2.7% in 2013 and 2014 looks no better.

Economic growth in Latin America[1] should hit a trough this year at 2.3%, before rebounding next year to a still subdued 2.9%. Some of the conditions that underpinned growth during the boom years – high commodity prices, commodity-driven investment, a ramp-up in credit (both public and private) – are unlikely to be repeated and in some cases may act as a drag on growth.

Nonetheless, the regional growth forecast hides a crevice that has formed between major Latin American countries. Economic growth within Peru and Colombia will have little similarities to its neighbors. These two economies are expected to lead the region, growing at a 4.5%-5.5% pace. At the other end of the spectrum will be clear laggards, noted by Argentina, Brazil and Venezuela. Underperformance in

CHART 1. CONSENSUS FORECASTS FOR MAJOR LATIN AMERICAN ECONOMIES HAVE TUMBLED



Source: Bloomberg. Ar=Argentina, BR=Brazil, CL=Chile, CO=Colombia, MX=Mexico, PE=Peru, VE=Venezuela.

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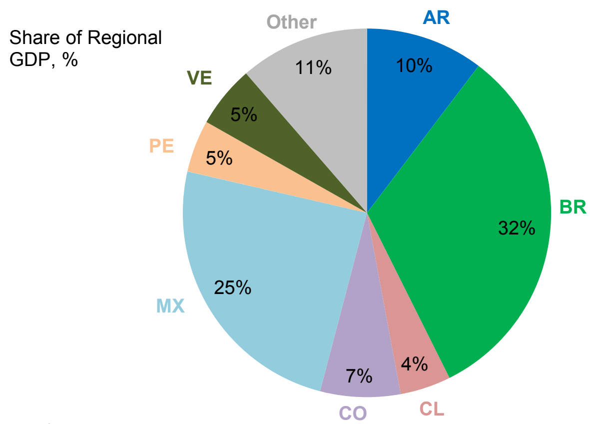
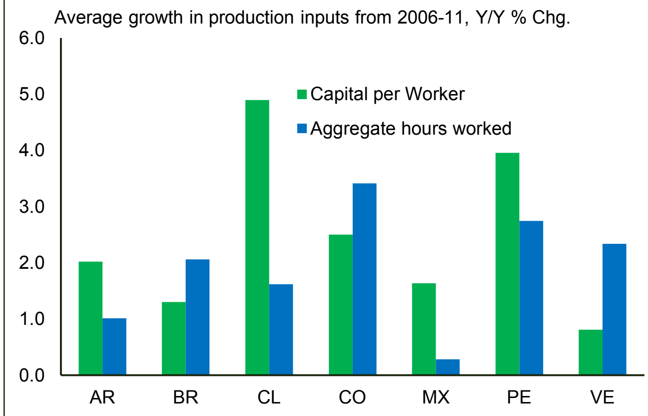
CHART 2. WEAKNESS IN ECONOMIC HEAVYWEIGHTS BRAZIL, ARGENTINA AND VENEZUELA WILL WEIGH ON GROWTH IN THE REGION



Source: IMF.

CHART 3. PERU AND COLOMBIA HAVE SEEN SOME OF THE FASTEST PRODUCTION FACTOR GROWTH



Source: PWT 8.0.

this trio of economic heavyweights is one of the primary reasons that the LAC-7 aggregate will be depressed relative to earlier years (chart 2). Plagued with high government deficits, weak investment and, in some cases, political issues, these countries will be hard-pressed to squeak by with 2.0% growth over the next two to three years. By comparison, Mexico and Chile fall in the middle of the LAC-7 pack with growth of 3.0%-4.0% expected. With the exception of the laggard group, economic growth prospects for the region remain promising and will exceed that of most advanced economies, but this distinction may be lost if investors don't sift through the data.

The Growth Leaders

In general, when people think of emerging markets, they will often think of fast growing populations, particularly compared to the slower rates seen in advanced economies. This, in turn, boosts economic growth through more labor hours worked, often in tandem with rising productivity. However, relatively faster employment growth has only been part of the success of Latin American leaders, Columbia and Peru. Even more important is their economies' ability to equip these workers with machinery, equipment and infrastructure through greater investment. Indeed, one of the main factors that has set Peru and Colombia apart from the pack in recent years is their high level of investment as a share of GDP. As a result, physical capital per worker has grown faster here than in other LAC-7 countries, with the exception of Chile (chart 3). This is an important distinction, because higher levels of investment are critical to boosting the running speed of an economy (i.e. potential GDP growth).

A high level of investment in both economies is further enhanced by relatively low levels of debt and little or no government deficits. Both economies are politically stable with a free-market macroeconomic framework. Therefore, unlike some other Latin American countries, fiscal drag is far less likely to be an impediment to growth, and the business climate remains friendly.

TABLE 1: COUNTRY STATISTICS

Country	GDP per capita 2012*	Exchange Rate/Monetary Regime	Inflation, Y/Y % Chg. June 2014	Real GDP Growth, Avg Y/Y % chg. 2004-11	Real GDP Growth, Avg Y/Y % chg. 2012-13
Argentina	17,917	Crawling Currency, Monetary Aggregate Targeting	16.7**	7.6	1.9
Brazil	11,876	Floating, Inflation-targeting	6.5	4.3	1.8
Chile	18,182	Floating, Inflation-targeting	4.3	4.7	4.7
Colombia	10,697	Floating, Inflation-targeting	2.8	4.9	4.4
Mexico	15,344	Floating, Inflation-targeting	3.8	2.7	2.5
Peru	10,596	Floating, Inflation-targeting	3.4	6.8	5.7
Venezuela	13,480	Currency Peg	60.9	6.5	3.5
Latin America & Carribean	12,295	N/A	N/A	4.5	2.9

Source: IMF, Haver. *Current International Dollar, PPP. **Annualized, not Y/Y.

CHART 4. WEAKNESS IN COMMODITY PRICES IS WEIGHING ON TERMS OF TRADE

Source: Nat'l Statistical Agencies. *2012-13 refers to 2012 only as 2013 data is N/A.

Colombia

For Colombia, economic growth in the first quarter of the year came in at a resounding 9.7% (annualized), amidst strong agricultural and construction output. Growth is not expected to remain at such a lofty level. With inflation below target, but rising, the central bank has raised interest rates by a total of 75 basis points (bps) over three consecutive meetings. One factor that likely provided confidence to the central bank is that downside risks to the economy are fairly limited. Oil is by far the country's primary export, with petroleum exports representing 9% of GDP last year. As such, it is less vulnerable to a broader commodity slowdown. Generally higher global growth (and reduced supply from the Middle East), should keep oil prices elevated over the near future.

Less exposure to base metal commodities also explains why Colombia was one of the few major Latin American economies to see a rise in foreign direct investment last year, and could conceivably see a further rise this year. With Juan Manuel Santos recently reelected as president, the odds of a peace deal being signed with the FARC rebels are now higher than ever, a development that will surely be well received by foreign investors. Near and medium-term prospects remain bright and while the pace of economic growth seen in the first quarter is unlikely to be sustained, growth is expected to exceed 4.5% over the next two years.

Peru

From 2006 to 2011, Peru registered strong increases in aggregate hours worked and in capital stock per worker. Since 2011, strong investment has continued, with gross fixed capital formation rising almost 12% annually, nearly double the investment growth in the second closest country in the LAC-7, Chile.

So far in 2014, economic growth has disappointed relative to consensus forecasts of less than a year ago, which called for growth of 6% in 2014. Weakness in copper prices, Peru's main export, has been weighing on foreign direct investment, and terms of trade have turned negative in recent years.

On the other hand, Peru's exports are relatively diversified, with both gold and oil comprising a significant share of exports. This should help it weather some of the weakness seen in base metal prices. Moreover, several new public infrastructure projects are slated to begin later this year, which will prop up overall investment. While economic growth is unlikely to meet prior glowing forecasts of 5.5%-6.0%, it is likely to remain at roughly 5% or higher over the near future.

Middle Tier Growth Countries

The middle tier of countries is composed of Chile and Mexico, for whom economic growth is expected come in slightly below 3% this year before rebounding to just short of 4% next year. Both countries have higher-than-Latin-American-average levels of investment. This is particularly true for Chile, which in recent years has seen the strongest growth in capital stock per worker among the LAC-7.

Chile and Mexico both find themselves in the middle tier, but Chile is entering from its former perch among the growth leaders, while Mexico is rising from the lower ranks. Slower growth in Chile and faster growth in Mexico is partly a result of differences in the products that each country exports. Chile's economy is dependent on copper exports, whereas Mexico exports manufactured goods, mainly to the U.S.

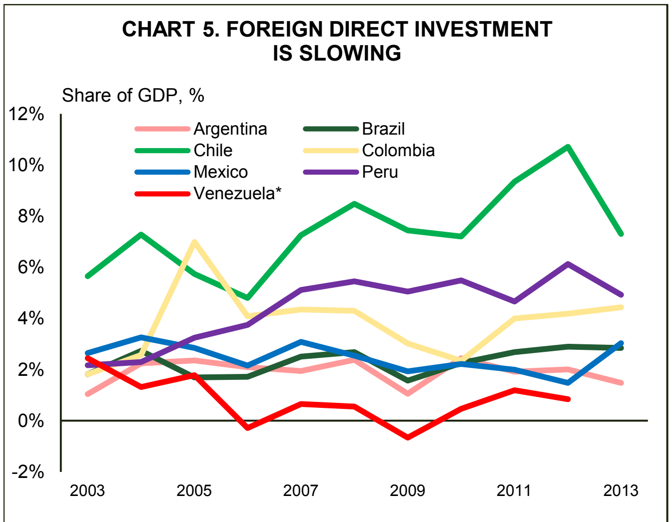
Chile

Chile's economy remains reliant on copper exports,

TABLE 2. PRIMARY EXPORT PRODUCT STATISTICS

Country	Primary Export	Price chg. since Jan. 2011	% of Exports	% of GDP
Argentina	Soyabeans and derivatives	9.2	22.3*	3.0
Brazil	Iron ore & simple derivatives	-44.3	14.8	1.6
Chile	Copper ore & simple derivatives	-26.6	51.2	20.6
Colombia	Petroleum products	11.0	55.2	8.6
Mexico	Motor Vehicle & Parts	N/A	20.0*	6.2
Peru	Copper ore & simple derivatives	-26.6	24.3*	5.6
Venezuela	Petroleum products	11.0	96.0**	27.8

Source: International Trade Center. 2013 data. *2012 data. **2011 data. Note: Oil prices are brent . Iron ore price is Brazil export price to China. Soybean price is for Argentina soyabean meal. Copper price is LME Grade A price.



Source: National Central Banks, INDEC (Argentina), Haver. *2013 data not available.

which represent over 20% of its economy, and for whom prices have fallen fairly precipitously since 2011 (table 2). The fall in prices is tied to worries over the slowdown in China, which accounts for almost 40% of global demand for the mineral[2]. Although a number of other Latin American countries also export base metals to China, Chile's massive exposure explains why Chile's terms of trade have turned more negative than most of its peers in recent years (chart 4).

In addition to lowering export income, subdued copper prices appear to have tarnished interest from foreign investors, with foreign direct investment (FDI) to Chile tumbling last year (chart 5). Meanwhile, the recently elected president, Bachelet, has a plan to raise corporate taxes from 20% to 25%, in order to increase funding for education. Investment in education should lead to eventual gains in human capital and so a rise in potential GDP growth. However, in the short term, the increase in corporate taxes is likely to be another factor weighing on investment.

Another potential headwind lies in the fact that Chile has the highest level of private sector indebtedness among the LAC-7. With higher interest rates likely to materialize in the U.S. in 2015, financial conditions could also tighten in Chile and weigh on domestic demand.

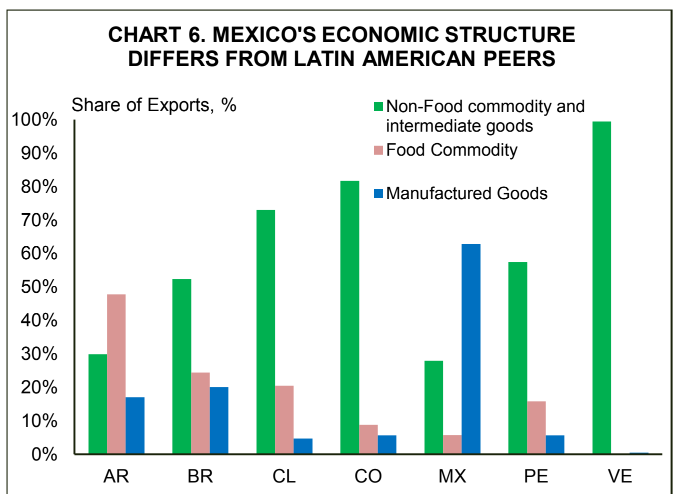
At the same time, Chile's strengths should not be discounted. It enjoys a stable political situation, a business-friendly climate, and arguably the most developed financial markets in the region. It is no wonder that the proportion of FDI it receives as a share of its economy is much larger than that of its peers. It also has an admirable fiscal situation, composed of extremely low debt, virtually no deficit and a sizable sovereign wealth fund. The bottom line is that while economic growth is slowing and is unlikely to return to previous highs, it has the tools to deal with most headwinds. Provided copper prices do not collapse, (which is not expected), real GDP should grow by between 3%-4% over the near and medium term.

Mexico

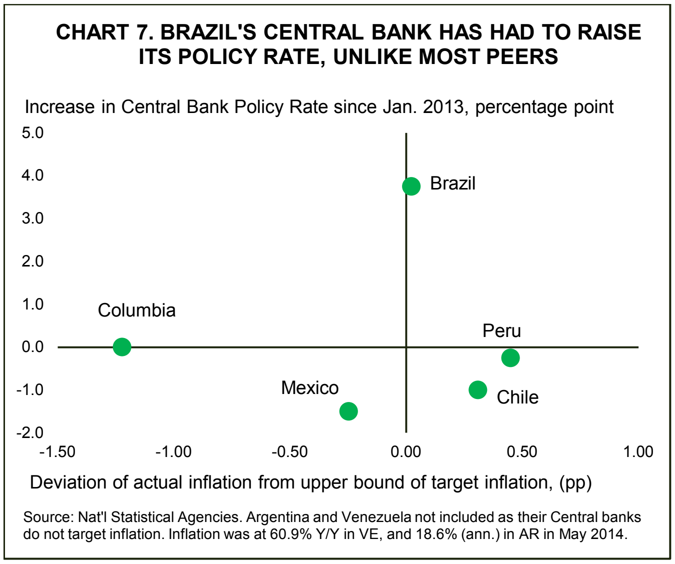
Mexico's economic structure differs somewhat from some of its Latin American peers (chart 6). The U.S. is by far its largest trading partner. A sluggish recovery in America has been weighing on Mexican economic growth. Moreover, its main exports are manufactured goods. As a result, it did not benefit from as large a gain in its terms of trade as its peers during the commodity price boom of the late 2000's. Economic growth over the 2004 to 2011 period was a subdued 2.7%, relative to the greater-than 4.0% growth seen in all other LAC-7 economies.

So far this year, economic growth has been disappointing. A slow first quarter and weak handoff from 2013 suggests that economic growth is likely to come in at 2.7% this year, with some downside risk.

However, unlike Chile, which enjoys a higher trend rate of growth but is dealing with several headwinds, several factors point to a cyclical upturn in growth in Mexico in the quarters and years ahead. Firstly, an improvement in the U.S. economy is likely to trickle down to Mexico's export sector, as its manufacturing sector remains very competitive. Secondly, reforms undertaken by Enrico Pena are likely to significantly boost investment in the energy sector, which will eventually result in greater oil production over the medium term. Mexico was one of only two countries in the LAC-7 to raise FDI last year , and continues to attract strong



Source: UN Comtrade. Sums do not add up to 100%, as an "other" category, largely comprising coin and non-ore gold, is excluded. This category represents 5% or less of exports for all countries with the exception of Peru.



investment flows, particularly in its auto sector. Recent announcements by BMW, Daimler and Renault-Nissan add up to $2.3bn in new plant investment, with more announcements from automakers and suppliers likely to follow in coming months and years. Finally, the slump in construction, which weighed on the economy last year, will not last forever, with some evidence that recent months have been more favorable. While the annual rate of growth in 2014 is expected to come in at trend-like rate of 2.7%, Mexico's economy is expected to accelerate to 3.8% in 2015.

The lagging countries

Brazil, Argentina and Venezuela are expected to be the economic laggards among the LAC-7 over the next two years. However, the impediments to growth generally differ across all three countries, and the factors weighing on Brazil are significantly less than those weighing on Argentina and Venezuela. Argentina, and especially Venezuela, are dealing with political challenges and have wayward monetary policies in place. These have resulted in significantly elevated inflation and currency controls, with a negative impact on private business. In contrast, Brazil enjoys a relatively sturdy political situation and stable macroeconomic framework through an inflation-targeting monetary regime. Nonetheless, low investment and several near-term headwinds will weigh on Brazilian economy output over 2014-15.

Brazil

As recently as 2010, Brazil's economy grew by a robust 7.5%. However, over the past three years, growth has averaged 2.1% – not the typical performance expected from the "B" in BRIC. As mentioned, investment remains low relative to peers, suggesting a lower trend rate of growth in the economy. Had Brazil's capital per worker increased at the same pace as the LAC-7 from 2004-2011, this would have implied a 0.4 percentage point higher potential growth rate[3]. An increase in investment could also help raise productivity, and therefore competitiveness relative to peers. Brazil's competitive difficulties are an issue we've previously visited.

Several near-term headwinds are also contributing to a cyclical deceleration in economic growth. The price of iron ore, Brazil's main export, has fallen by roughly 44% since January 2011, thus lowering export income. The decline in iron ore prices has been fuelled by rising global supply, which suggests that investment in this mining sector is likely to remain subdued going forward. Thankfully, Brazil is a fairly diversified exporter, with significant exports of soybeans and oil, for whom prices are rising and relatively stable.

Higher interest rates are another factor weighing on the economy. Following last's years "taper tantrum," when the Federal Reserve first began to talk about tapering its asset purchase program, a number of emerging market currencies fell in value. Brazil, with its sizable current account and fiscal deficit, was considered one of the "Fragile Five", and was one of the worst impacted. As a result, Brazil's central bank had to raise interest rates in order to defend the real and limit the rise in inflation. Since early 2013, the central bank's policy target rate has been raised by 375bps (chart 7). The currency has since stabilized, but inflation remains slightly above the top of its target range, suggesting little room for extensive interest rate cuts. As such, whereas most

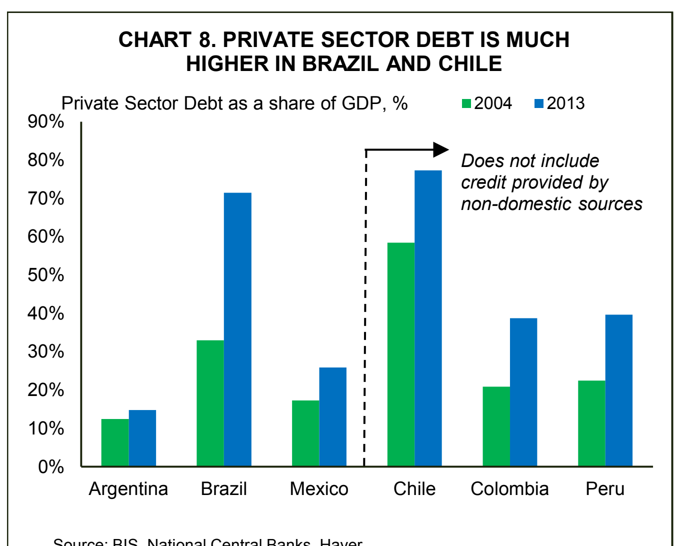
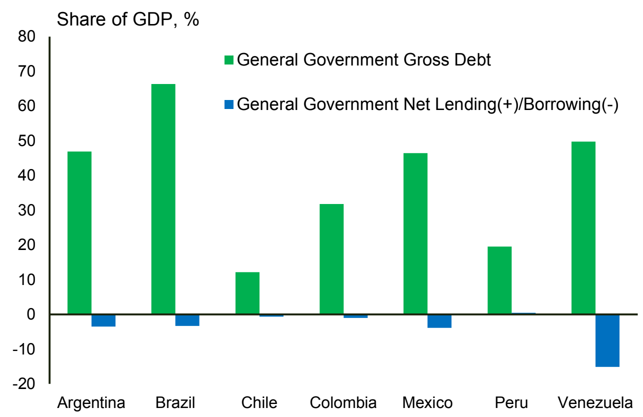


CHART 9. FISCAL TIGHTENING WILL BE NECESSARY IN A NUMBER OF LATIN AMERICAN COUNTRIES



Source: IMF. Data is 2013 IMF estimates.

major Latin American economies have lowered interest rates in recent years in order to support flagging growth, Brazil has had to raise them. The recent announcement by Brazil's central bank to lower required reserves at banks could help increase credit and therefore economic growth in the short term, however it could also maintain upward pressure on inflation, ensuring that interest rates will remain elevated for a time to come.

Meanwhile, private sector debt alone has already risen by roughly 30% of GDP since early 2008 (chart 8). Higher rates are likely to result in less discretionary spending, and, therefore, weaker consumer and business expenditures. Additionally, fiscal policy is unlikely to be supportive of the economy, with some tightening anticipated. General government gross debt is the highest among the LAC-7, and it also has a significant fiscal deficit (chart 9). Earlier this year, S&P cuts its debt rating to one notch above junk

Overall, the economy is expected to eke out very tepid growth of 1.5% and 1.7% in 2014-15. Beyond this, growth should gradually rise, however there is little impetus for a return to 4%+ real GDP growth.

Argentina

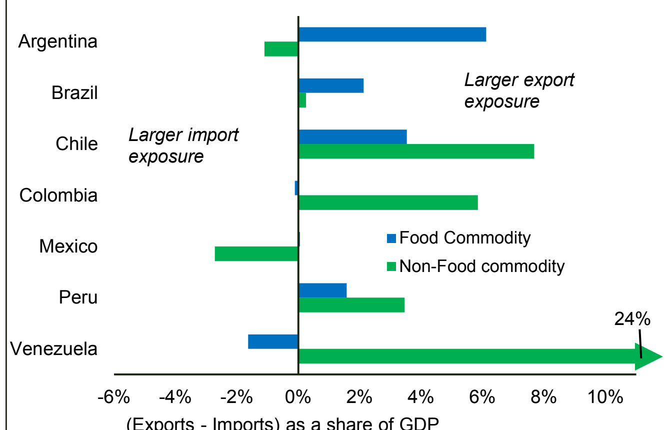
Growth prospects for Argentina in the near term remain weak, with a number of severe headwinds weighing on the outlook.

Similar to Brazil, investment as a share of GDP is low. Raising investment would require greater access to credit markets, as well as a relaxation in currency controls. Access to credit markets remains limited, as the government is currently negotiating a resolution with outstanding holdout investors from its 2002 default. A failure to find agreement by the end of July would result in another outright default and lead to prolonged uncertainty. Meanwhile, currency controls introduced in 2011 have severely reduced capital inflows. As a result, foreign exchange reserves have fallen from $52.6bn (USD) in January 2011 to $29.3bn today. In a bid to stem the outflow of hard currency, Argentina devalued its official exchange rate earlier this year, in order to bring it closer in line with the black market rate. This appears to have worked, with forex reserves stabilizing and rising slightly in recent months.

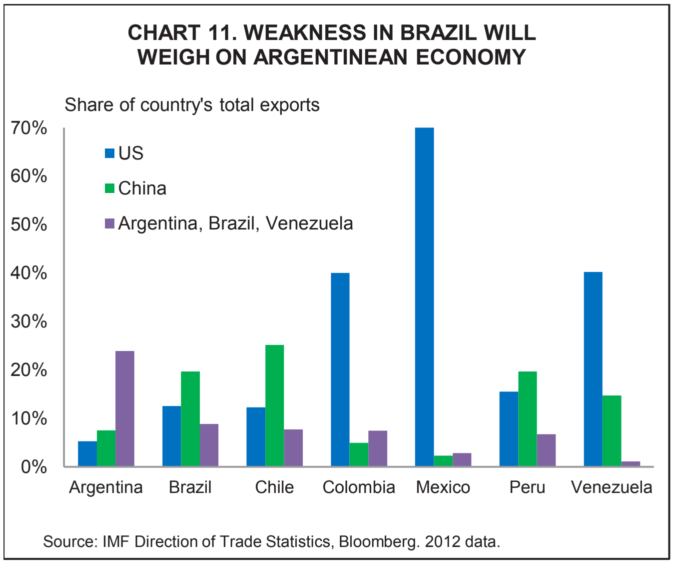
There is some evidence that the country is very slowly adopting more orthodox macroeconomic policies. It finally introduced a new methodology for calculating inflation earlier this year, after manipulating the previous measure for years. Nonetheless, even the new measure remains susceptible to manipulation. Meanwhile, the government's fiscal deficit remains large and has been financed in recent years by the Central Bank. As a result, monetization of the debt has led to galloping inflation, with even the official measure of consumer prices showing a rise of 16.7% annualized in June. Lowering inflation will likely require a reduction in fiscal expenditures, with negative implications for economic growth.

Not everything in the economic landscape is bleak for Argentina. One of its advantages relative to Latin American peers is that it is not as reliant on exports of base metal commodities, but rather on food commodities (chart 10). As a result, the decline in its terms of trade has been milder than peers in recent years. Going forward, the ongoing deceleration in China, and the rebalancing of its economy

CHART 10. ECONOMY'S EXPOSURE TO FOOD AND NON-FOOD COMMODITIES



Source: UN Comtrade.



away from fixed investment and towards consumption, will likely continue to weigh on the prices of some base metals. On the other hand, a rising middle class with an evolving diet will mean greater demand for food products. Therefore, one could expect that countries, such as Argentina, with a large share of food commodity exports are likely to benefit more over the coming years, relative to those with more exposure to non-food commodities.

Nonetheless, the Argentinian economy has shrunk for two consecutive quarters and industrial production is down so far in 2014. Over 20% of exports go to Brazil, and the slowdown there is likely to weigh on activity in the short term (chart 11). If Argentina can settle its issues with its international creditors and solve its currency situation, there is potential for greater growth in the medium term, particularly if it can attract foreign investors and raise investments. Until then, political challenges, weakness in trade partners and necessary fiscal consolidation suggest that near-term prospects remain dim.

Venezuela

Similarly to Argentina, Venezuela is dealing with a number of political and economic challenges, albeit of a more severe nature.

Currency controls have resulted in several "official" exchange rates, as well as a black market exchange rate, and a shortage of U.S. dollars in the economy. The inability to easily access U.S. dollars, as well as extensive price controls, have led to a shortage of various goods within the country and an interruption in operations at a number of companies. A relaxation in price and currency controls would reduce distortions within the economy and allow businesses to better operate. This could occur through a devaluation which would help bring its different exchange rates in line. However, inflation in May was already a massive 61% year-on-year, and would be further exacerbated by devaluation.

Textbox: Medium Term Prospects

Beyond the next two years, economic growth in Latin America should gradually rise to an annual average rate of 3.2% over the 2016 to 2020 period. In other words, growth is likely to be higher than over the 2012-2015 period, but lower than over the boom years of 2004-2011. Some of the conditions that underpinned growth during the boom years, such as the drastic rise in the terms of trade of many Latin American economies, are unlikely to be repeated. In addition, growth in the working-age population is also decelerating, suggesting that the contribution to growth from the labor force will also decelerate over time(see chart 12).

The slowdown in working-age population will be sharper in Brazil and Chile. However, increasing the share of individuals in formal employment, which remains low in a number of Latin American countries, as well as raising participation rates could be important tools in mitigating a slowdown in overall population growth. Moreover, shifting individuals into more productive industries would also result in higher overall growth. Demographics will remain more favorable than in advanced economies, however even in certain emerging markets, slowing demographics are likely to eventually mean slower overall growth.

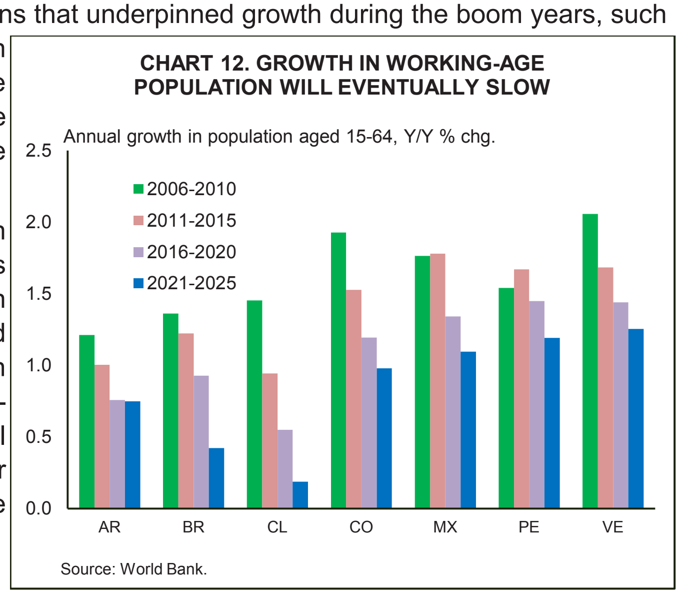


TABLE 3. AVERAGE ANNUAL REAL GDP GROWTH FORECASTS		
Range	**Near Term (2014-2015)**	**Medium Term* (2016-2020)**
4%+	Colombia, Peru	Colombia, Peru
3-4%	Mexico, Chile	Latin America, Chile, Argentina
2-3%	Latin America	Brazil, Mexico
1-2%	Brazil	Venezuela
0-1%	Argentina, Venezuela	

Source: TD Economics. *Estimated using trend growth, by HP-filtering annual growth through 2016 forecast, and adjusting for labor force changes based on World Bank estimates for working-age population.

Reducing inflation would require a sharp cut in fiscal expenditures. The IMF estimates that general government expenditures exceeded revenues by over 15% of GDP in 2013, funded in large part by central bank monetization. The obvious solution would be for the government to reduce subsidies (to petrol among other things). However, these cuts would prove highly unpopular in the short run, with street riots already erupting earlier this year over poor economic mismanagement.

Fortunately for Venezuela, the price of oil, exports of which represented 96% of all exports and 28% of GDP in 2011, has remained resilient. However, with production stable or declining, revenues from oil sales will be not be sufficient to solve the government's predicament.

There have been some signs of late that the government has begun to show pragmatism, signaling that a convergence in official exchange rates may soon occur. However, even if more pragmatic, economic reforms are unlikely to occur rapidly enough to support the economy over 2014-15. Therefore, the economic outlook for Venezuela in the near-term remains dim, with growth only likely to occur once significant reforms have been undertaken.

Bottom Line

Taking it all in, economic growth is expected to be modest in Latin America over the next two years (Table 3). Lower prices and demand for commodities, a slowdown in FDI, some fiscal tightening, an eventual tightening in financial conditions, as well as political challenges in several countries will weigh on economic growth. However, 2014 should represent the trough, with economic growth expected to gradually rise thereafter.

The contrast in economic performance across countries will be stark, with Peru and Colombia expected to lead the way, followed by Chile and Mexico. Economic growth will be sluggish in Brazil and extremely weak in Argentina and Venezuela, with the latter at risk of seeing no growth whatsoever over the 2014-15 period. Afterwards, economic growth in the region should gradually pick up, but it is unlikely to return to that of the 2004-11 boom years.

End Notes

1) In this report, Latin America refers to Latin America and the Carribean, and comprises the same countries as the IMF Country Group of the same name.

2) Refers to consumption of refined copper. 40% is 2011 data. Source: U.S. International Trade Commission.

3) Assuming a standard Cobb-Douglas production function with a capital share of 40%. Source for capital stock data: Penn World Table 8.0.