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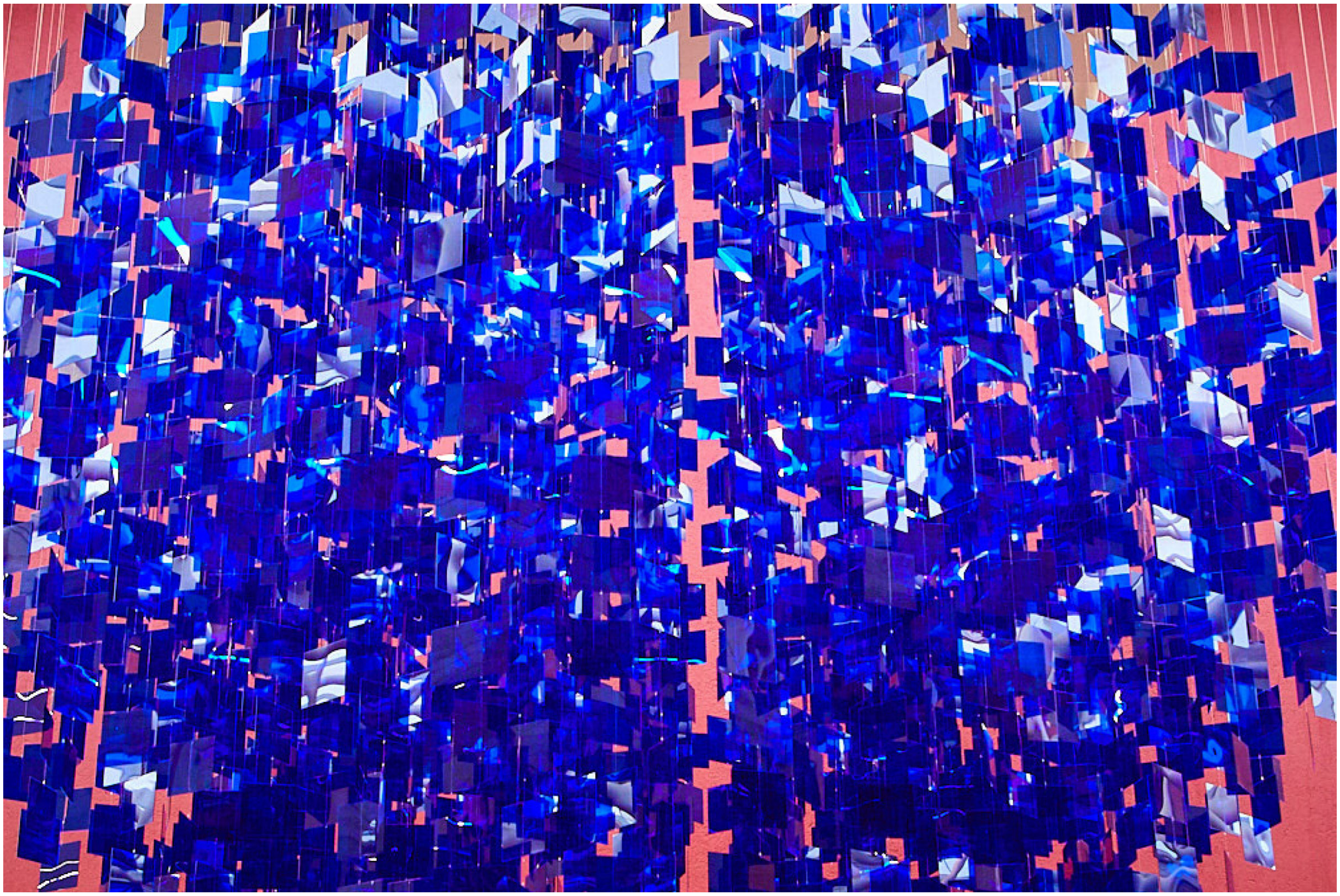
The COVID-19 crisis: Will Latin America endure a lost decade (2015–25)?

Latin America's eventual recovery from the COVID-19 crisis is likely to be gradual and uneven.



OVERVIEW

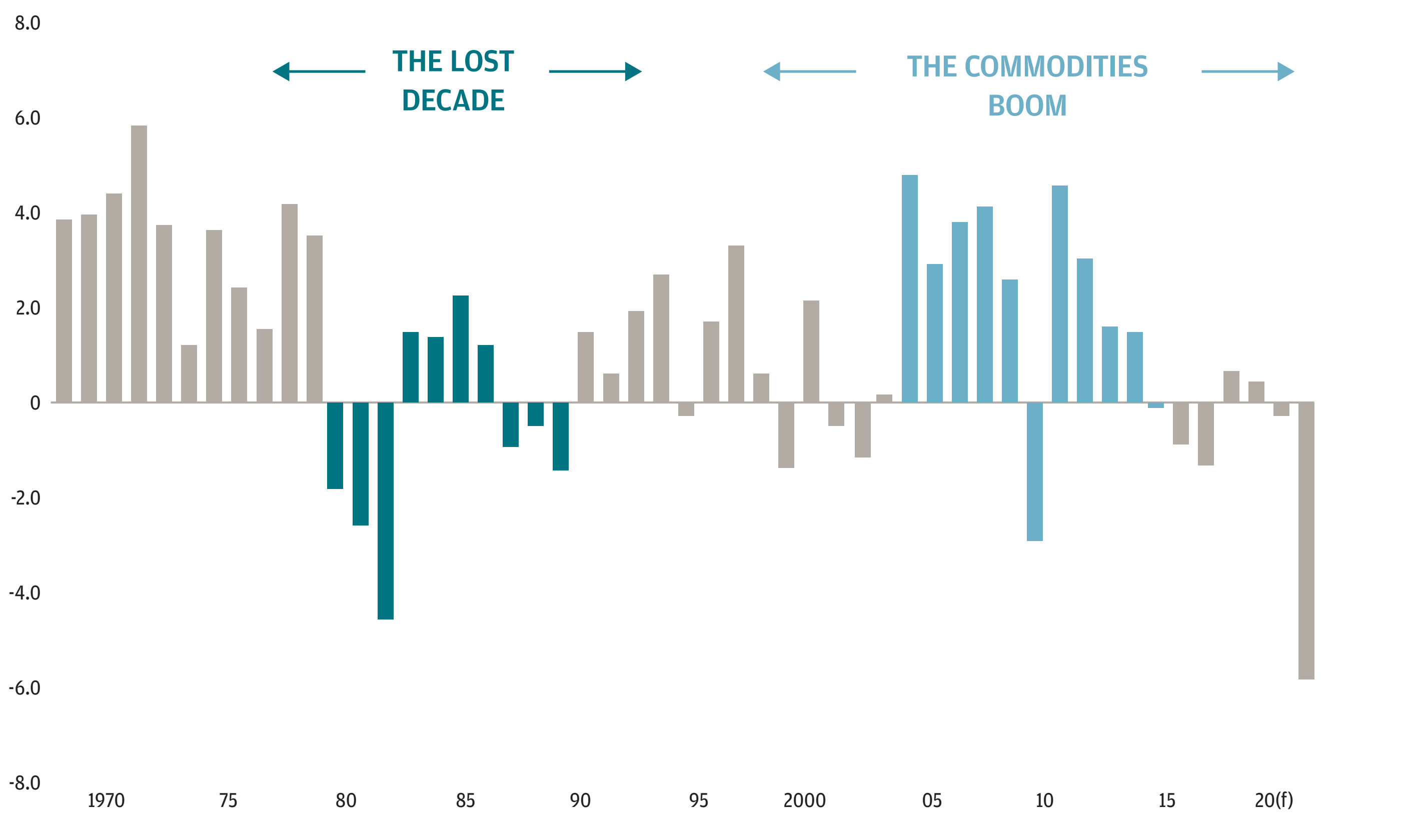
“The Great Lockdown of 2020,” as it has been dubbed by the International Monetary Fund (IMF), is set to overshadow virtually all other crises in modern history, plunging Latin America and the Caribbean (LAC) into its deepest recession since the 1930s. The crisis has also left economic forecasters scrambling to keep up, and plunged the region’s long-term economic outlook into doubt. COVID-19 comes as much of the region was struggling to recover from the end of the commodities cycle. And so the IMF’s Western Hemisphere Director, Alejandro Werner, now warns of a possibility of another lost decade (2015-25)—of nil GDP per capita growth—for the region.

Some basic trends are already evident. Latin American economies are extremely vulnerable, relying heavily on the external sector and commodities, and characterized by a significant—and largely unprotected—informal sector. The economic policy response, although not quite “whatever it takes,” is likely in many cases to be firm, notwithstanding already high debt burdens and the likelihood of a long-term debt hangover for the region that could complicate the longer-term prospects for some economies. The containment response has, in most countries (with the notable exceptions of Brazil and Mexico), been rapid and robust, reflecting health system weaknesses that would amplify the effects of an unchecked escalation of the virus.

To examine these trends in more detail, The Economist Intelligence Unit has developed a “heatmap,” which compares how the LAC-6 major economies are positioned to face the impacts of COVID-19. Ultimately, it seeks to help determine which countries are best placed to maneuver through the crisis and recover more quickly.

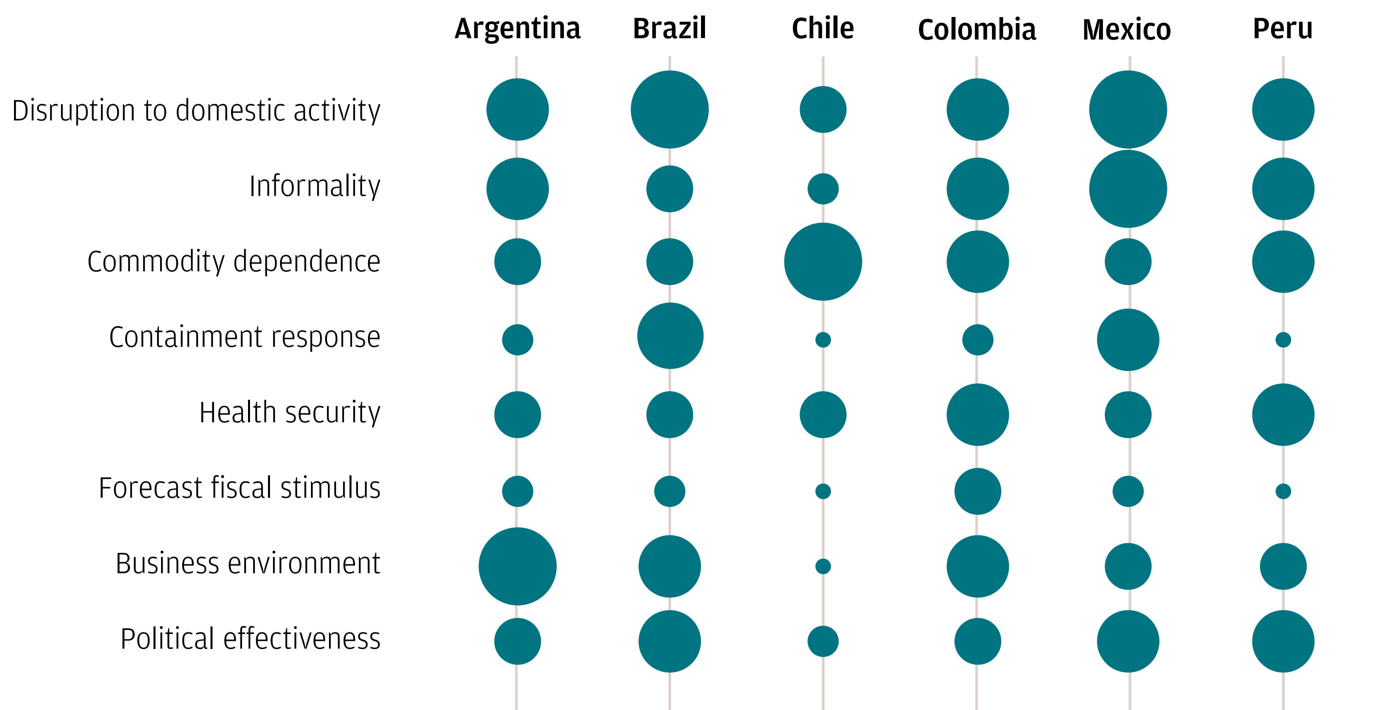
REAL GDP PER CAPITA: LAC

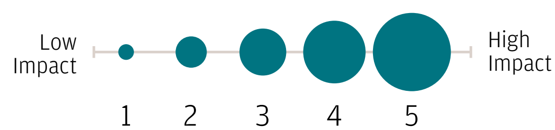
% change, year-on-year



Sources: World Bank; The Economist Intelligence Unit.

COVID-19 IMPACT ASSESSMENT





Disruption to domestic activity: Uses the contribution of Services to GDP to assess the extent to which quarantine measures affect aggregate output.

Informality: Uses proportion of informal employment to assess labor market vulnerability to economic shocks.

Commodity dependence: Uses the commodity exports-to-GDP ratio to assess countries' exposure to external demand shocks.

Containment response: A qualitative assessment by EIU analysts of the strictness of social distancing protocols, enforcement of border controls and measures taken to increase the testing rate.

Health security: Considers countries' capabilities to respond to epidemics and pandemics, as measured by the EIU's Global Health Security Index.

Forecast fiscal stimulus: Considers the magnitude of fiscal stimulus, as a percentage of GDP, deployed to minimize economic damage.

Business environment: Considers the quality and attractiveness of the environment for doing business, as measured by the EIU's global Business Environment Ranking.

Political effectiveness: A qualitative assessment of the effectiveness of public instiutions in enacting policy, as measured by the EIU's Operational Risk Briefing.

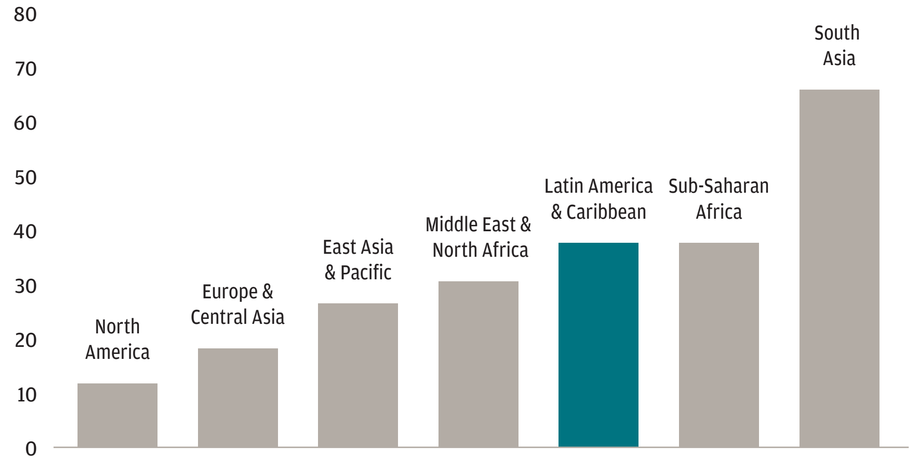
Source: The Economist Intelligence Unit.

KEY AREAS TO WATCH

While there is undoubtedly a high level of uncertainty surrounding potential outcomes, we believe there are several key areas to watch to see how the crisis—and recovery from crisis—play out in the region: firstly, healthcare-related factors, including health system capacity and government containment policy; secondly, the economic policy response, including fiscal and monetary policy; thirdly, structural economic factors; and fourthly, institutional factors that will ultimately be crucial in determining which of Latin America's big economies perform best over the coming quarters, emerge less weakened by the crisis, and manage to post higher growth rates over the medium term.

OUT-OF-POCKET HEALTH EXPENDITURE

% of total current health expenditure



Source: Out-of-pocket health expenditure.

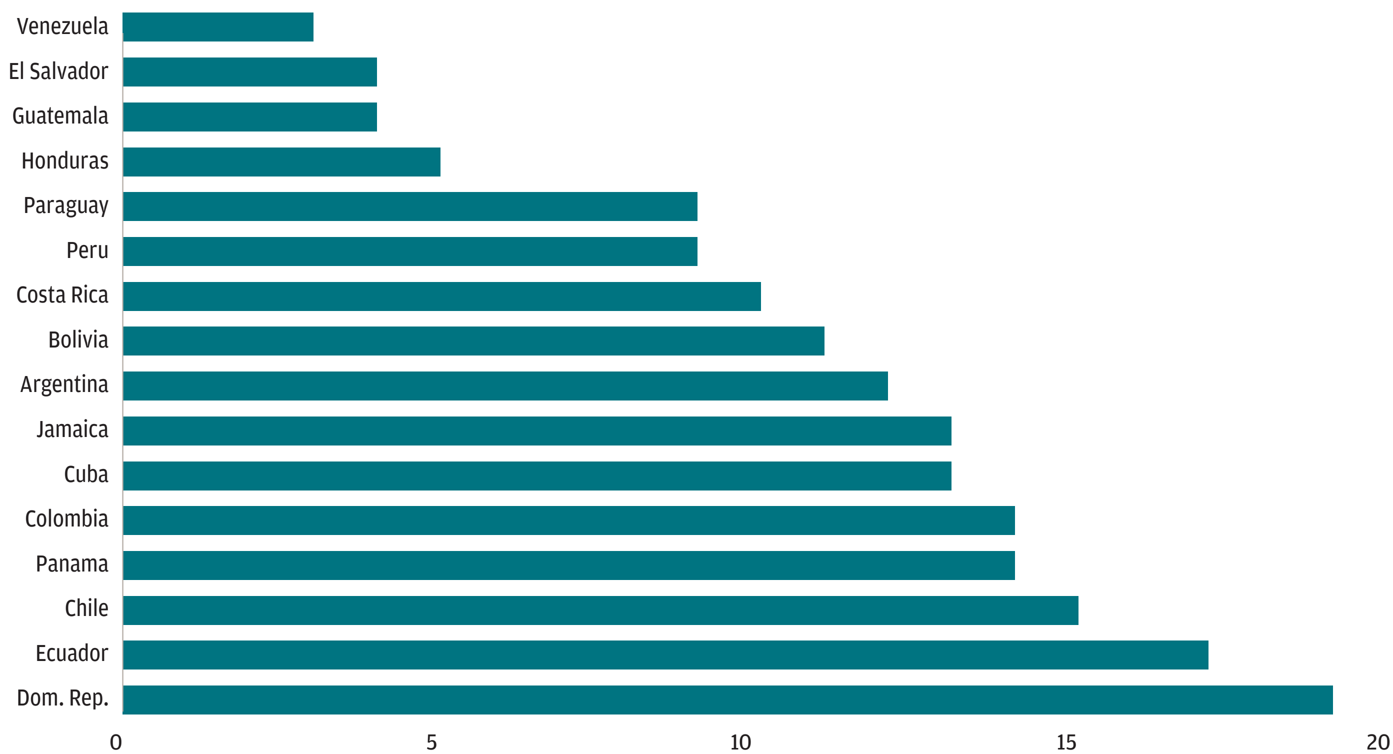
1. HEALTH SECTOR CAPACITY VARIES REGIONALLY

The quality and coverage of health systems varies across the region. The 2019 Global Health Security Index (GHSI), prepared by The Economist Intelligence Unit with support from the Nuclear Threat Initiative and Johns Hopkins Center for Health Security, concluded that "no country is fully prepared for epidemics or pandemics," but also noted that gaps in some countries were significantly larger than in others. In Latin America, the region's largest economies—Argentina, Brazil and Mexico—all perform relatively well on the GHSI. By contrast, the Andean nations (with the exception of Chile) have big deficiencies in their healthcare systems that reflect years of underinvestment. But with all that said, as a whole, it is clear that Latin America spends less and has fewer hospital beds, doctors and nurses per capita than the OECD average. Healthcare system deficiencies are especially clear in the high level of out-of-pocket health spending in the region—which points to a lack of access to public healthcare, and which poses a major challenge in a context of plummeting disposable incomes.

But even robust healthcare systems can only mitigate the overall economic blow from necessary containment measures, not prevent it altogether, as has been made all too clear by the European and North American experiences of dealing with COVID-19. In this context, governments across Latin America and the Caribbean (LAC) have, for the most part, recognized the need to act decisively; for the median LAC country, there were just nine days between the confirmation of the first coronavirus case locally and the complete lockdown of the country. Central American and Andean nations have been the fastest to respond, most likely in recognition of the extremely limited capacity of their healthcare systems to deal with a protracted public health crisis. By contrast, governments in Brazil and Mexico, countries which boast better healthcare systems, were slow to implement even the most basic non-pharmaceutical interventions, reflecting political leadership issues in response to the crisis in both countries.

TIMELINESS OF GOVERNMENT RESPONSE IN LAC, SELECT ECONOMIES

Number of days from first confirmed COVID-19 case in country to announcement of national lockdown by the federal government

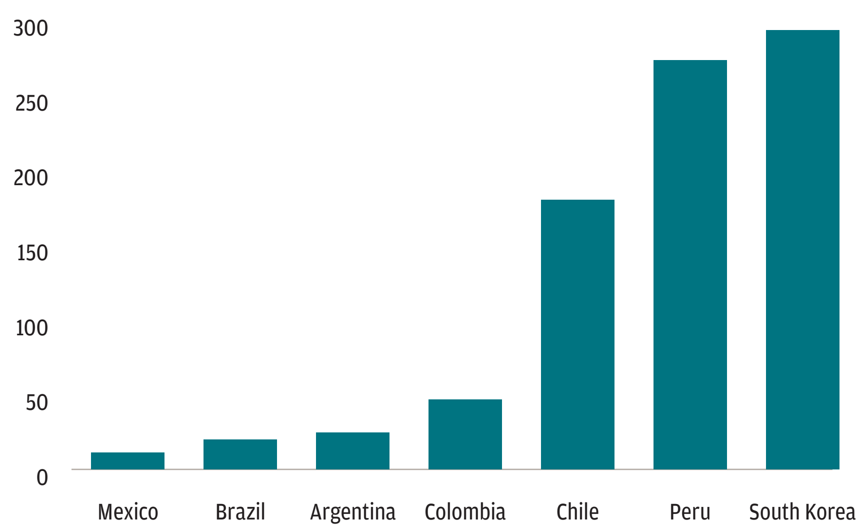


Source: The Economist Intelligence Unit.

The containment measures, however, are only a means to an end. As the South Korean experience suggests, in order to exit lockdown and gradually reopen the economy, governments will need to implement an aggressive "test and trace" strategy. Governments in Chile and Peru have acted expeditiously to purchase testing equipment and expand laboratory capacity, giving those countries an early-mover advantage. However, in most of the region, testing remains inadequate. A spike in global demand for testing equipment and chemical reagents has meant that LAC's low- and middle-income countries have had to compete against wealthier economies, in many cases putting them to the back of the line.

COVID-19 TESTING RATE, SELECT ECONOMIES

Tests per million people per day



Source: The Economist Intelligence Unit.

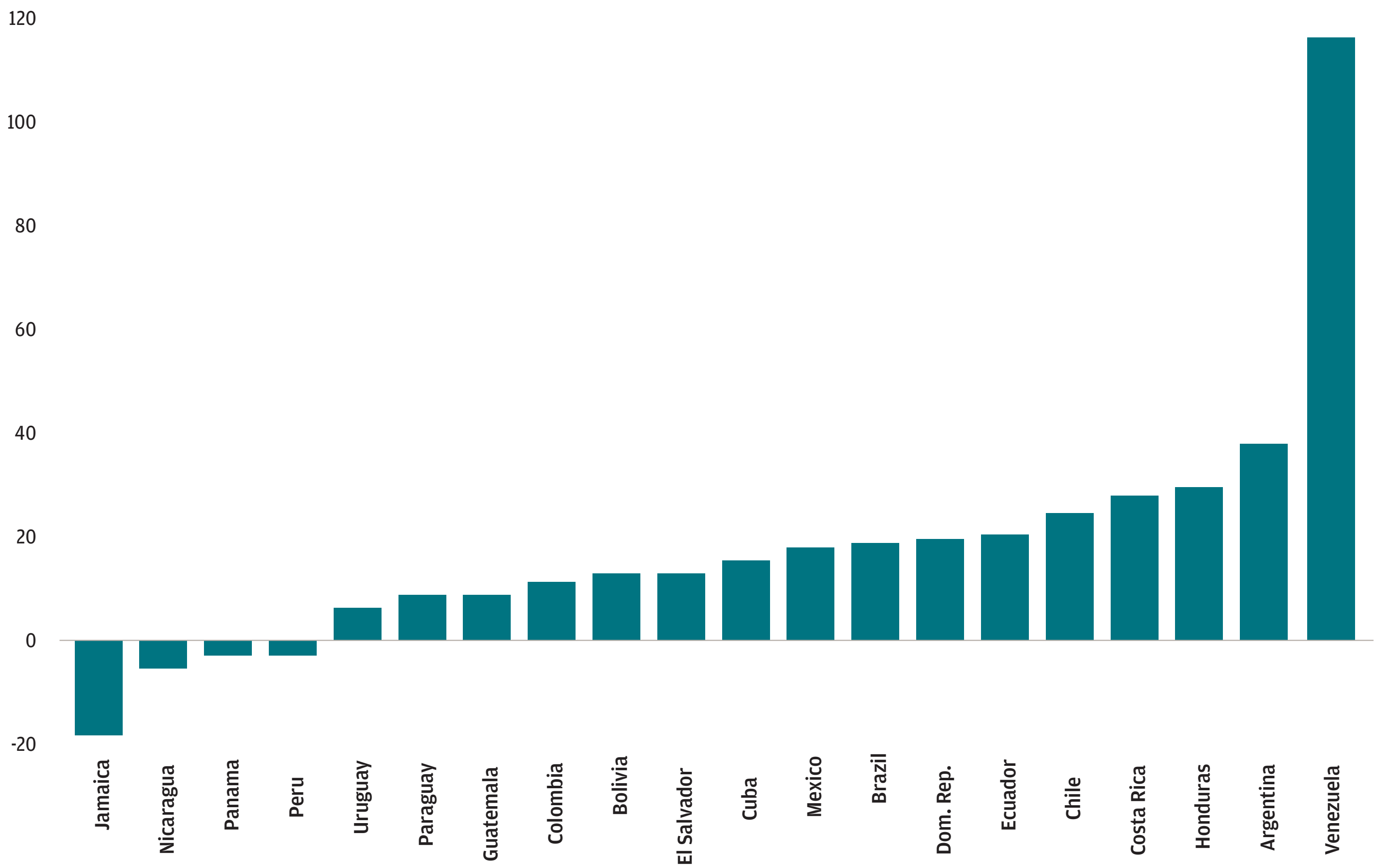
2. ASSESSING CAPACITY FOR ECONOMIC STIMULUS

Unquestionably, the public health capacity of countries in the region will influence their response to the crisis. However, insofar as the pandemic generates a sudden stop to activity, governments are having to step in to minimize the economic damage. The severity of the downturn and the strength of the subsequent recovery in a given country will depend in large part on the space available to the government to deploy countercyclical policy, public confidence in the effectiveness of state policy and the economy's resilience in the face of external shocks.

With the economy in an induced comatose state, governments are using the levers of policy as much as they are able to provide households and businesses with much-needed support. Central banks across the region have been increasingly loosening monetary policy by cutting interest rates and deploying unconventional tools to unclog the financial system and ease liquidity constraints. However, the effectiveness of monetary policy will be somewhat limited in a context of plummeting demand. As a result, much of the burden will fall on fiscal policy to restart economic activity. In some key respects, the region as a whole is less prepared to weather the unfolding crisis than it was when the global financial crisis struck in 2008-09, with the fiscal and debt dynamics in most countries now significantly weaker than in 2007. The chart below shows how countries have taken on more public debt.

PUBLIC DEBT, 2007 VS. 2019

% change in the public debt-to-GDP ratio between 2007 and 2019



Source: The Economist Intelligence Unit.

But despite budgetary constraints, many LAC governments have already begun rolling out sizeable fiscal programs. Plans to support consumption include direct cash transfers, increased social insurance benefits, higher pension payouts and payroll cost subsidies. On the investment side, governments have increased budgets for public works (particularly in health infrastructure), provided tax relief or tax deferrals for businesses and instituted low-cost credit lines to help small and medium-sized enterprises (SMEs) to stay afloat. Countries like Chile and Peru have responded with the most ambitious fiscal programs so far (equivalent to 7% of GDP and 12% of GDP, respectively), and they should be able to finance their spending with relative ease owing to a history of prudent fiscal management and economic orthodoxy. More developed local capital markets than in the past will help, as will a reasonable reserves cushion in many countries. Even countries with high debt levels, like Argentina and Brazil, have committed significant resources (of over 3% of GDP) to combat the COVID-19 crisis. However, financing these packages will prove difficult, and the challenge of working off the resulting debt overhang will weigh on economic recovery on the other side of COVID-19.

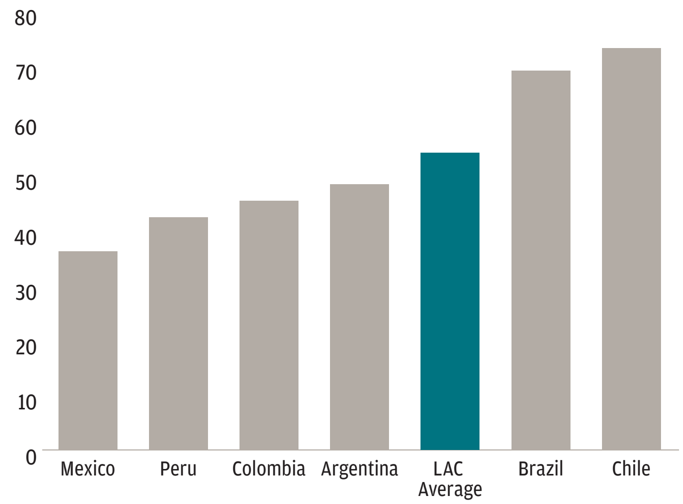
3. LAC ECONOMIES SHARE COMMON STRUCTURAL DEFICIENCIES

Even for countries that pull out all the stops on the fiscal front, a number of formidable challenges lie ahead. Many governments in the region face large administrative costs and low technical capacity, which will constrain the effectiveness of fiscal policy in stimulating demand. Implementing targeted fiscal policy is complicated even further by high levels of informality. In the median LAC country, over half of the workforce is informally employed, leaving a large share of laborers outside the sphere of traditional safety nets. Although some countries have policies in place aimed specifically at protecting informal workers, there are big implementation problems arising from a lack of financial inclusion. According to the World Bank's Global Financial Inclusion Database and the EIU's Global Microscope, only 55% of adults in LAC have an account with a formal financial institution. This is below the comparable level for South Asia (70%), East Asia and the Pacific (74%), and the overall global average (69%).

Another major structural vulnerability, which fiscal policy can do little to address, is the region's dependence on the external sector. Having made only moderate progress on economic diversification in recent decades, many regional economies still rely heavily on commodity exports to drive economic growth. The region's commodity exporters are now faced with the double whammy of collapsing commodity prices (which reduce economic rents) and lower export volumes. Finally, for all of LAC, business disruption

ACCOUNT PENETRATION

% of adults with an account at a formal financial institution



Sources: World Bank; The Economist Intelligence Unit.

and uncertainty will cause inward foreign direct investment (FDI) to fall sharply this year. This will be severely damaging in a region where domestic savings are weak and FDI accounts for 3% of GDP and 15% of total fixed investment.

4. INSTITUTIONAL FACTORS WILL ALSO PLAY A ROLE

Going beyond these shared vulnerabilities, however, there is significant variation in the performance of LAC economies on other indicators of institutional strength. In our view, the investment climate fostered by governments over the years will play a determinative role in the strength of an eventual economic recovery. In this regard, countries like Chile, Peru and Mexico are fairly well positioned, having made strides in strengthening their business environments by deregulating trade, strengthening investor protections and deepening domestic capital markets. By contrast, in Argentina and Brazil, several years of left-wing rule in the 2000s helped produce large regulatory states and inflexible labor markets, and increased investor concerns over contract rights.

All that said, policies and regulations are only as effective as the governments implementing them. Chile, once again, stands out in this regard: Anti-corruption laws are duly enforced, public procurement systems are transparent, and judicial proceedings are both speedy and independent. Among the region's major economies, Argentina and Colombia have also made progress in reducing regulatory capture in recent years. However, in most of the region, political efficacy risk remains extremely high owing to a poorly trained bureaucracy and a rampant culture of corruption and political impunity.

LOOKING AHEAD

Faced with pressures from many sides, Latin America's eventual recovery from the COVID-19 crisis is likely to be gradual and uneven. Countries like Chile, Peru and Colombia stand the best chance of emerging faster and more sustainably from the Great Lockdown. This owes not only to decisive action by the political leadership in the face of the pandemic, but more broadly to economic and regulatory frameworks that are conducive to medium- and long-term growth. By contrast, LAC's three biggest economies (Argentina, Brazil and Mexico) will face many more obstacles in restoring consumer and business confidence, weighing on their economic prospects well into the medium term, meaning that they face more of a risk of suffering a 2015-25 "lost decade."

Looking ahead, investors are beginning to position for the recovery phase to identify investment opportunities and see which sectors will be likely to perform better. Production and export of soft and hard commodities (and the logistics that they rely on) are unlikely to be significantly affected by continued social distancing measures, given that these sectors are less labor-intensive and are carried out mostly away from urban centers. With oil demand collapsing in the short term, and demand for metals soft in the meantime, the commodities outlook will hinge on a recovery in export demand from the main markets—China, the United States and the rest of the world. Our forecasts suggest that after a recovery from this year's contraction, global GDP growth (at market exchange rates) will average just under 3% in 2022-25, providing a reasonable outlook for Latin American commodity exports.

Most large LAC manufacturing companies will fairly adequately manage to restart operations with social-distancing norms in plants. Despite official financial assistance, even some of the larger companies may struggle, potentially revealing M&A opportunities for local and foreign investors. SMEs will be hit hardest, and larger companies currently using them for inputs may well have to reassess and source their supplies from overseas providers, shifting supply chains. The crisis may well lead company executives to adapt AI and robotics technologies in their operations.

Services, which is by the far largest sector in the economy, will face the greatest challenges as people adapt to the new circumstances, and this will most affect restaurants, travel, tourism and other hospitality sectors. E-commerce activities, including retail, are likely to grow. Financial services are likely to be affected the least, as more operations move online, although demand for their services will hinge on an adequate recovery of household and business expenditures.

The Economist INTELLIGENCE UNIT

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