Swiss Re Institute

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Economic insights

Latin America: existing growth headwinds to prevail over rising commodity prices

Key takeaways

- We have lowered our 2022 growth forecast for Latin America from 2.6% to 2.1% for 2022, while raising our inflation projections.
- Above-target inflation and rising interest rates will outweigh the positive growth impacts of favorable terms of trade resulting from high global commodity prices.
- Slowing global growth, capital flight to safety, and local political uncertainty will further weigh on growth.
- Brazil is most as risk of slipping into a stagflation scenario.
- Mitigating policies such as tax cuts and subsidies in some countries will not fully offset inflation pressures.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

High commodity prices typically boost growth momentum in Latin America. This time round, however, a backdrop of high inflation, tighter financial conditions and elevated political uncertainty will likely outweigh positive effects and we expect 2022 to be a year of just lackluster economic growth. With little buffer, fiscal action will be limited to mitigating the impact of price rises for staples.

The consequences of the conflict in Ukraine will add to an already-weakening economic growth outlook for Latin America. The anticipated 1) slowdown in global growth; 2) additional inflationary pressures from higher commodity prices; 3) flight to safety from investors; and 4) increased geopolitical and trade tensions, are headwinds piling on top of already-adverse inflation and interest rate developments, a legacy of the monetary policy responses to the COVID-19 pandemic. Inflation in all major economies is above target and interest rates will likely continue to rise as the US Federal Reserve (Fed) continues to tighten monetary conditions. Mexico is likely to be the most reactive to changes in Fed policy given its closely intertwined financial cycle.

Considering that 1) the geopolitical ramifications of Russia's invasion of Ukraine can potentially have long-lasting effects on energy and food markets; and that 2) the reshaping of the supply chain networks post-COVID is yet to play out,[1] the global economy may be entering a new prolonged period of high commodity prices. In themselves, high commodity prices globally typically generate favorable growth momentum in Latin America. As net exporters of commodities (see Figure 1), the economies of the region benefit from more favorable terms of trade and windfall gains for fiscal revenues. Chile and Peru rely heavily on metals; Mexico, Colombia and Brazil have large exposure to oil, and the region as a whole is a net exporter of agricultural goods.[2]

This time around, however, we believe the underlying economic conditions and political uncertainties stated above will outweigh the positive growth effects of the current high commodity prices. Today's growth outlook is very different from the commodity supercycle of the 2000s, which was fueled by strong Chinese demand to support infrastructure and manufacturing growth.. With today's backdrop, we do not see the current high commodity prices as outweighing the slowing growth effects of the Ukraine crisis. Hence, we have raised our inflation projections for the major economies in the region while at the same time revised down our 2022 aggregate GDP growth forecast for Latin America to 2.1% from 2.6%. The risk of recession outcomes has increased, most notably in Brazil, which is slipping towards stagflation

[1] *sigma* 6/2020: De-risking global supply chains. Swiss Re Institute.
[2] In the case of Mexico, its terms of trade have not improved as much as regional peers as it predominately exports manufactured goods to the US.

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territory. We forecast that inflation in Brazil will average around 9% this year and that growth will remain flat.

In view of current inflationary developments, we expect to see policy responses such as tax cuts and subsidies in some countries (eg, Brazil, Mexico and Argentina) as a means to limit price rises of key CPI items (eg, gasoline and food staples). However, such fiscal support actions would come in a time of already stressed public finances. In addition, the inflationary environment of the past 12 months has pushed central banks to exit what had been a long period of accommodative monetary policy quicker than expected, and tightening is set to be the broad theme for the next year. While high interest rates may help anchor local currency strength and tame inflation, they will also hinder economic growth. Slower growth, in turn, means less fiscal revenue.

Table 1

Economic forecasts and revisions for 2022 (LHS), and FX changes (RHS), both % yoy

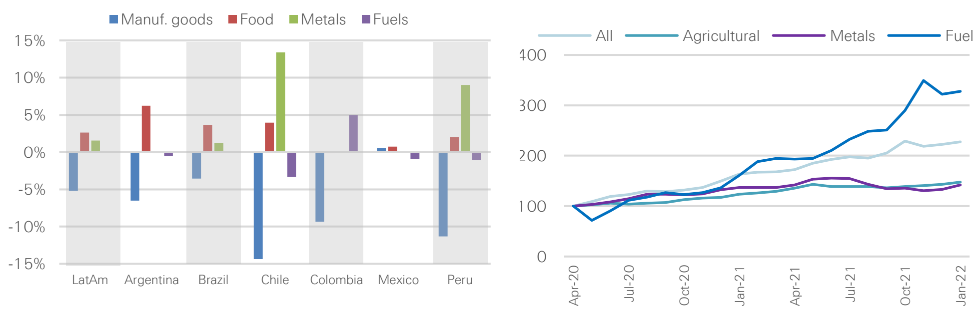
	Real GDP		Inflation (average)		Policy rate		FX change	
	Current	Revision	Current	Revision	Current	Revision	Year to date	Since 24-Feb
Brazil	0.0	-0.4	9.2	1.3	12.75	1.00	-8.1	2.2
Mexico	2.1	-0.4	6.5	0.8	7.25	1.00	2.0	3.3
Colombia	3.2	-0.4	6.5	2.4	7.00	1.25	-6.7	-2.9
Chile	1.7	-0.4	7.6	3.0	7.50	1.50	-4.5	2.8
Peru	3.2	-0.5	5.2	1.6	5.00	1.00	-6.8	-0.4

Source: Thomon Reuters and Swiss Re Institute

In the 2000s, the extraordinary revenues from commodity price boom were pumped into Latin American economies via generous social programs and large-scale public investments. This time around, the region has very limited fiscal space and pushing spending policies would add to already-elevated inflation pressures. A prudent course of action would be to use excess revenues, if any, to service the elevated debt levels prompted by the pandemic. This would be a step in the right direction but will do little to fully resolve existing fiscal woes caused by high economic informality, tax evasion and inefficient public spending. Addressing fiscal sustainability issues would help generate greater macroeconomic resilience and ensure affordable credit to cope with a next recession.

Figure 1

Commodity net exports as a share of GDP (LHS), and Commodity price index, (April 2020 = 100, RHS)



Source: UNCTAD and Swiss Re Institute

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