

LATIN AMERICA FOCUS

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Editors: Roger Bootle and Julian Jessop

Heading for the worst recession since the 1930s

- **We expect Latin America's GDP to contract by 4% this year, the biggest decline since the Great Depression of the 1930s.** What's more, the region's recovery will be much slower than those from previous crises, with GDP growth unlikely to return to its historic average of around 4% until 2012. **At a country level, Brazil will be less affected but GDP is still likely to contract by 2%. Meanwhile, the Mexican economy is on course to shrink by 5% this year and Argentine GDP could fall by 6%.**
- **While several domestic factors will weigh on the region over the coming year (notably weaker bank lending), the recession in Latin America will be primarily driven by three external factors. First, weaker global demand will lead to an outright fall in exports of at least 5% this year, reducing GDP by 1%.** Mexico will be hit hardest, given that exports to the US are equivalent to 25% of GDP. By contrast, Brazil is a relatively closed economy – total exports account for less than 15% of GDP.
- **Second, the sharp drop of commodity prices will cause a drastic deterioration in the region's terms of trade.** This will significantly reduce the region's ability to purchase foreign goods and services. Indeed, we expect domestic demand to contract by 4% this year.
- Ecuador and Venezuela will be hardest hit, primarily as a result of lower oil prices. Mexico and Chile are also heavily dependent on commodities, but have been partly insulated from a fall in prices through a combination of stabilisation funds and, in Mexico's case, a decision to hedge oil prices at \$70pb for the bulk of this year. Contrary to popular belief, Brazil is much less dependent on commodity exports - another reason to expect the country to outperform this year.
- **Finally, Latin America will suffer a withdrawal of foreign capital over the next year or so.** While this has already hit the financial markets, the impact on the real economy has yet to be fully felt. Inflows of foreign direct investment could dry up altogether. As firms find it harder to access working capital, we expect fixed investment in the region to contract by 10%.
- **The upshot is that the outlook is pretty grim. In the context of emerging economies, Latin America is likely to fare slightly better than Emerging Europe, since the region has been less dependent on foreign capital to fund its development.** But Latin America is likely to underperform Western Europe, the US, China and India. What's more, **with the world economy likely to stagnate at best in 2010, the recession will extend well into next year.**

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Heading for the worst recession since the 1930s

This *Focus* looks at how the current world recession will affect Latin America. We start with a short overview of how the region has fared in previous economic crises and how it has performed in the past five years. We then look at the factors that will weigh on the region over the next year or so. In particular, we will focus on the degree to which weaker export growth, lower commodity prices and capital withdrawals will hit growth. Finally, we will present our forecasts for Latin America for 2009 and 2010.

TABLE 1: LATIN AMERICA'S GDP AND POPULATION IN 2007

	Pop. (Mil.)	GDP (\$ Bn.)	Share World GDP*	GDP (PPP \$ Bn.)
Brazil	189	1,313	2.70	1,835
Mexico	105	893	1.89	1,346
Argentina	39	260	0.48	523
Venezuela	27	236	0.42	334
Colombia	47	171	0.38	319
Chile	16	163	0.32	231
Peru	28	109	0.20	219
Ecuador	13	44	0.08	98
Guatemala	13	33	0.06	62
Costa Rica	4	26	0.05	45
Uruguay	3	23	0.04	37
El Salvador	7	20	0.04	41
Panama	3	19	0.04	34
Bolivia	9	13	0.02	39
Honduras	7	12	0.02	30
Paraguay	6	10	0.02	27
Nicaragua	6	5	0.01	15
Suriname	0.5	2	0.00	4
Belize	0.3	1	0.00	2
Guyana	0.8	1	0.00	2
Latin America	530	3,361	6.80	5,252
Emerging Asia	3,497	7,454	13.80	15,524
Emerging Europe	469	3,586	6.60	5,650

* At market exchange rates
Source – IMF

An overview of Latin America

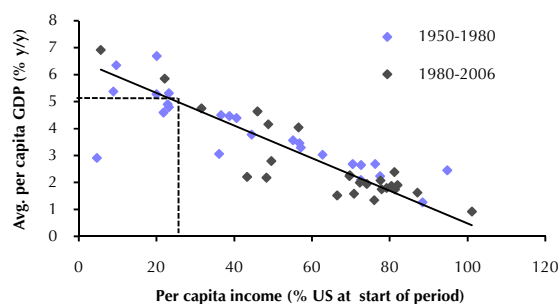
Latin America had a GDP of more than \$3.3trn in 2007. (See Table 1.) This was equivalent to nearly

7% of the world's GDP, which is roughly the same share as Emerging Europe. Yet Latin America is much poorer. At purchasing power parity (PPP) exchange rates, per capita GDP was around \$10,000 in 2007. This was less than 25% of the equivalent figure in the US and some \$5,000 lower than in Emerging Europe. But it was roughly twice as high as in China.

Latin America's real GDP growth has averaged around 4% since 1950. This sounds relatively good, but the region's potential growth rate is probably somewhat higher, based on what other countries at a similar stage of development have been able to achieve.

To illustrate this, Chart 1 plots the average growth rates of per capita GDP achieved by a selection of countries against their per capita GDP relative to the level in the US at the start of the period. The Chart shows that there is a pretty reliable relationship between the two – the lower relative per capita GDP is at the starting point, the faster the growth rate that has achieved. The data are shown over two periods (1950-80 and 1980-2006) to confirm that the relationship has held up both before and after the leap forward in globalisation symbolised by the opening up of China. The dotted line marks the growth rate of per capita GDP that a country with an income of 25% of the US level should be able to achieve, based on past form.

CHART 1: GDP GROWTH RATES & INCOME LEVELS FOR ASIAN AND WESTERN ECONOMIES

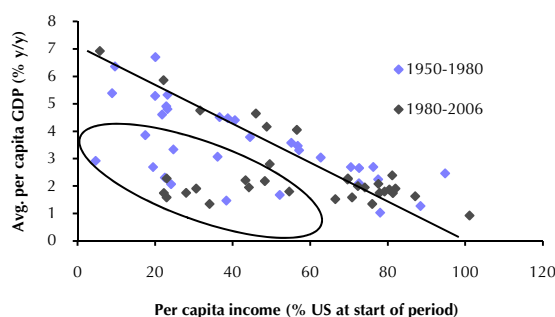


Sources – A. Madison, Capital Economics

The relationship shown in Chart 1 therefore suggests that Latin America should be able to achieve a per capita GDP growth rate of around 5% per year. Since Latin America's workforce has been expanding by between 1% and 2% per year, we estimate that Latin America's potential GDP growth rate is at least 6%.

Latin America's historic GDP growth rate of 4% (since 1950) therefore indicates that the region is a chronic underperformer. This point is illustrated in Chart 2, which replicates the previous chart but includes the major economies in Latin America (shown in the oval). From this, it is clear that the region's per capita GDP growth (and thus real GDP growth) has been well below the potential rates signalled by other economies.

CHART 2: RELATIVE GROWTH RATES & INCOME LEVEL FOR ASIA, WESTERN ECONOMIES AND LATIN AMERICA

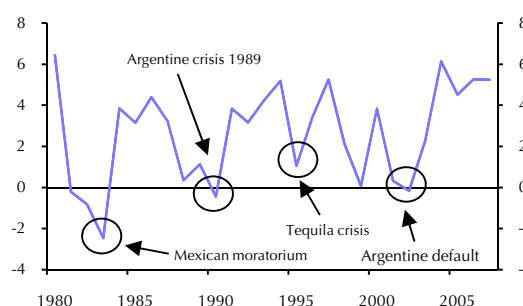


Source – A. Madison, Capital Economics

Economic and financial crises in Latin America

Latin America is no stranger to economic and financial turmoil. In the last 30 years, four major crises have beset the region: the Mexican debt moratorium of 1982, the Argentine crisis of 1989, the Mexico currency crisis of 1994 (the so-called Tequila crisis) and the Argentine default of 2001. (See Chart 3.)

CHART 3: LATIN AMERICA REAL GDP (%Y/Y)



Source – Economic Commission for Latin America and the Caribbean (ECLAC)

Of these, the Mexican crisis of 1982 was the worst. Regional GDP contracted by more than 2% and only a few countries were able to avoid outright recession. The most recent economic crisis was the 2001 default in Argentina, which sent shock waves to other Latin American countries. Investment and consumption shrank across the region and regional GDP growth stagnated for two years.

TABLE 2: LATIN AMERICA'S PERFORMANCE IN PAST CRISES

	Real GDP % y/y before crisis	Real GDP % y/y after crisis	Change in GDP Level (%) ¹	Fall in local currency v Dollar (%) ²	Inflation Rate ²	Commodity prices (%) ^{3*}
Great Depression 1929+	7.8	-5.0	-12.4	N/A	N/A	-9.5
Oil crisis 1973	6.8	3.5	19.1	-14	N/A	48.0
Mexican moratorium 1982	0.7	-2.5	-3.3	-40	104	-0.1
Argentine crisis 1989	0.6	0.3	0.9	-57	402	12.4
Mexican crisis 1994	3.9	0.4	5.2	-21	38	10.5
Asian crisis 1997- 98	3.6	0.7	8.4	-11	9	-21.3
Dot-com crisis 2000	0.7	0.2	4.3	-7	6	26.9
Argentine default 2001	0.2	-0.1	-0.1	-26	9	3.8

Source – IMF, ECLAC and Madison.

¹ Values indicate change in level of GDP between year before the crises and year when crises ended

² Values at the end of the year of crisis

³ Values are the average annual change during the crisis

*Commodities prices based on Dow Jones commodity index except for Great Depression, which only used prices of oil, gold, silver, iron and cotton.

+Latin America's GDP only includes data from Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela

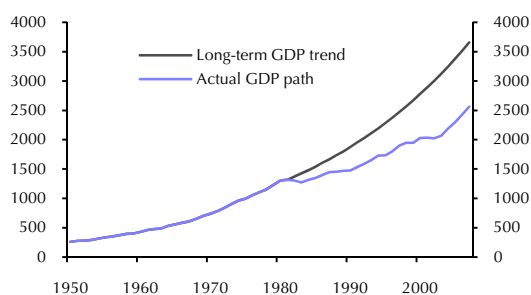
Latin America has also been hit hard by crises which originated in other regions. (See Table 2 on the previous page.) **During the Great Depression of the 1930s, Latin America's economy shrank by more than 10%**, by far the largest collapse in the region's economic activity in the last 80 years. **This contraction was accompanied by a fall in commodity prices that averaged 10% per year during the crisis.** During the Asian crisis of 1997-98, Latin American GDP growth slowed to 1%. This crisis was also accompanied by a drop in commodity prices, which fell by more than 20%.

Perhaps the only occasion when the region was not severely damaged by a major international crisis was during the 1970s oil shocks. Indeed, while industrialised economies grew at an average rate of 3% during this decade, Latin America's GDP increased at an average rate of almost 6%. This was because the region was less integrated with the rest of the global economy in terms of non-oil trade or financial flows, but benefited from the fact that commodity prices remained high.

Some progress but no immunity

Over the past five years, Latin America's GDP has grown on average by more than 4.5%. This has been hailed as a success by its leaders. Admittedly, this is nearly two percentage points above its historic average from 1980. But it is barely above its average rate since 1950. Indeed as Chart 4 shows, Latin America is still significantly poorer than had GDP continued to grow at its long-term rate of 4% from 1980 onwards.

CHART 4: LATIN AMERICAN REAL GDP (\$Bn. 2000 PRICES)

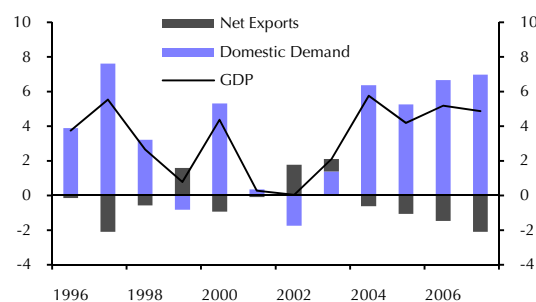


Sources – ECLAC, Capital Economics

What's more, over the past five years the region's GDP has expanded at a slower pace than that of Emerging Europe and Asia, which have grown on average by 5.5% and 7% respectively.

Recent growth in Latin America has been partially driven by an expansion of exports as the region continues to integrate with the world economy. However, net trade has actually subtracted from GDP. **Instead, the main driver has been domestic demand, which has increased on average by 5.5% over the past five years.** (See Chart 5.) **In turn, this has been fuelled by an average improvement of 4% in the terms of trade,** that is the ratio of export to import prices.

CHART 5: CONTRIBUTIONS TO LATIN AMERICAN GDP GROWTH (ANNUAL, % POINTS)



Sources – ECLAC, Capital Economics

The recent strong economic growth enabled Latin American governments to strengthen their fiscal positions and reduce external debt to less than 25% of GDP. (In the 1980s the external burden stood on average at 50% of GDP.) Also, since 2001 inflation has been lowered to single digits despite the rise of commodity prices in the past few years.

Moreover, following the commodity boom, Latin America's current account balance went from a deficit of 3% of GDP at the turn of the century, to a surplus of half a percentage point in 2007. This is a significant improvement, not only in the context of Latin America's own history, but also compared to Emerging Europe, where some countries have been running deficits in excess of 20%.

Accordingly, Latin American leaders argue that their economies have come a long way over the past five years, and the region is in a much stronger position to weather the current economic turmoil. But are they right?

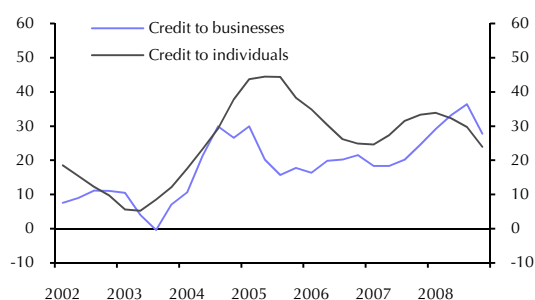
We're not convinced. While it is true that Latin America has made significant progress since the Argentine crisis, we still think that the region is heading for **its most severe recession since the Great Depression**.

Banks less vulnerable, but credit set to slow

The factors that will drag on Latin America's economy over the next year or so can be split into two camps: those that are home-grown and those that come from abroad. On the whole, we are most concerned about the latter.

Admittedly, domestic bank lending will slow across the region. We will look in more detail at the position of Latin American banks in a subsequent *Focus*. But the short point is that on the whole they are in much better shape than their counterparts elsewhere in the world, partly because regulation has been tightened following the crises of the 1990s. While the recent pace of credit growth has been strong, lending has largely been funded out of domestic deposits. (See Chart 6.) As a result, banks in the region have been less reliant on external financing than, in particular, their counterparts in Emerging Europe. This is reflected in the region's relatively low levels of short-term external debt.

CHART 6: BRAZIL – CREDIT GROWTH (% Y/Y)



Sources – Thomson Datastream, Capital Economics

What's more, aside from a few hot spots, the region has avoided the global housing bubble, largely because mortgage finance is relatively undeveloped and home ownership is low. Accordingly, banks have not suffered the same huge losses on sub-prime mortgages, or associated financial instruments, that have blighted the US and European banking systems.

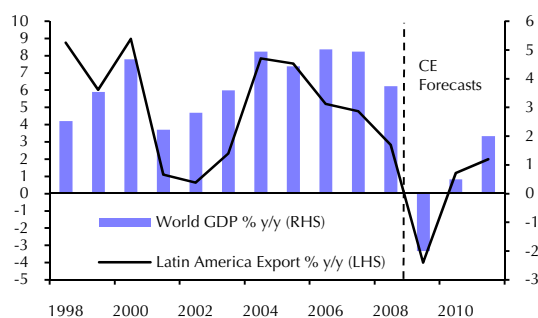
The upshot is that while the latest data suggest that credit conditions have tightened following the collapse of Lehmans last autumn, there is no need for Latin America to undergo a painful period of deleveraging. Credit growth is almost certain to fall from recent rates of 30% y/y but we think credit could still increase by 5-10% this year in the region's major economies. What's more, given that domestic credit markets remain relatively underdeveloped, the impact of a slowdown in lending on economic activity is likely to be negligible. All other things being equal, we estimate that domestic demand growth would fall from 7% last year to around 6% this year.

Of course, all things are not equal. In particular, consumer and business confidence has been battered in recent months. This is obviously not just a domestic phenomenon – weaker confidence has been driven in part by global developments. Yet even if we assume that weaker confidence is purely a 'domestic' phenomenon, headwinds from the domestic economy would still not be enough to tip Latin America into recession. Instead, the recession will be driven by global developments, and three factors in particular: weaker export demand, lower commodity prices and a reversal of international capital flows driven by an increase in risk aversion.

Export demand set to collapse

Based on past experience, our forecast for the world economy to contract by more than 2% this year is consistent with an outright fall in Latin America's exports by at least 5%. (See Chart 7, overleaf.) What's more, there is little prospect of any meaningful recovery in exports until 2011.

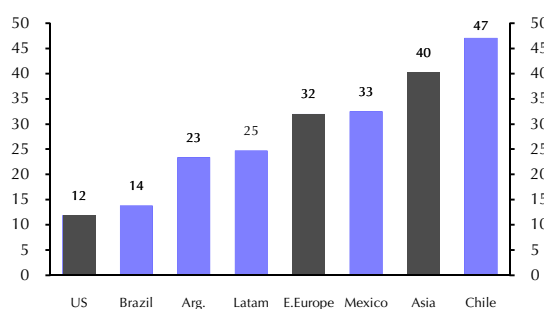
CHART 7: WORLD GDP & LATIN AMERICA EXPORTS



Sources – IMF, Capital Economics

Of course, the impact on individual countries will depend on both how open their economies are and how diversified their export base is. While the region as a whole is less open than Emerging Europe and Asia, some countries remain extremely export dependent. For instance, Chile and Mexico's exports account for around 50% and 30% of their GDP respectively. (See Chart 8.) The impact of weaker global demand is therefore likely to be much stronger in these economies than elsewhere in the region, notably Brazil.

CHART 8: EXPORTS (% OF GDP, 2007)



Sources – ECLAC, IMF, Capital Economics

To make matters worse, Chile's exports are concentrated on just one good: copper. As fixed investment in the West collapses, Chile's export volumes could fall by 5% or more. Likewise, Mexico is likely to pay a heavy price for its ties to the US, which buys 70% of its exports.

The impact of lower commodity prices

What's more, while export *volumes* are set to fall sharply, export *prices* have also collapsed following the recent bursting of the commodities

bubble. Latin America is one of the world's leading producers of commodities. More than half of world production of coffee and soybeans comes from the region. The region is also a major producer of sugar, copper and nickel. (See Table 3.)

TABLE 3: LATIN AMERICAN COMMODITY PRODUCTION 2007

Commodity	Latin America's % of world production	Key producers
Coffee	57	Brazil, Colombia, Mexico
Soybeans	51	Argentina, Brazil, Paraguay
Copper	48	Chile, Peru
Sugar	46	Brazil, Colombia, Mexico
Nickel	18	Brazil, Colombia
Corn	14	Argentina, Mexico
Oil	8	Brazil, Mexico, Venezuela
Gold	7	Peru
Wheat	4	Argentina
Coal	2	Colombia

Sources – Thomson Datastream, US Geological Survey, FAO

Accordingly, commodity exports account for around 25% of GDP in the eight main economies in the region. (See Table 4.) Of course, the importance of commodities varies from country to country. Commodity exports account for nearly 40% of GDP in Chile compared to just over 10% of GDP in Brazil.

TABLE 4: COMMODITY EXPORTS (% GDP)

	2004	2005	2006	2007	Average
Brazil	15	13	13	12	13
Mexico	27	28	30	30	29
Argentina	23	22	22	21	22
Venezuela	35	38	35	29	34
Colombia	17	17	18	18	17
Chile	34	35	40	41	37
Peru	18	22	26	26	23
Ecuador	24	27	31	32	28

Sources – Thomson Datastream, Capital Economics

Nonetheless, the region as a whole will be hit hard by the collapse of commodity prices. The channels through which this will take place are complex and manifold. In order to explain why, it is necessary to understand how the region was made better off as a result of the commodity price *boom*.

The problem with conventional GDP measures

Crucially, the true effect of a rise in commodity prices on the region's economy is not properly captured by real GDP. This is because real GDP is supposed to be a measure of *real* output, that is to say output at unchanged prices. Accordingly, when working out real GDP, the increase in the value of exports triggered by the commodity price boom is offset in the GDP deflator. **As a result, a rise in commodity prices will have no direct impact on measurements of real GDP.**

It will, though, undoubtedly make the region better off. After all, it is now earning far more for its exports than was previously the case. **We estimate that the commodity price bubble generated more than \$300bn in extra export income for the eight largest economies in Latin America during the period 2004-08.** (See Table 5.) This is just under 10% of their GDP in 2008. Unsurprisingly, those countries that are most reliant on commodity exports have experienced the largest rise in incomes from commodities over the past five year (Ecuador, Venezuela and Chile). Brazil has seen a much smaller rise in income.

A better measure of economic welfare

To avoid the shortcomings of traditional GDP measures, we have constructed an alternative measure of 'real income' - nominal GDP deflated by the domestic demand deflator. In doing so, fluctuations in the terms of trade are not lost in the export deflator.

On this basis, we estimate that as a result of the commodity price boom, the growth of Latin American 'real income' has been at least two percentage points higher than the average growth

rate of real GDP since 2004. (See Table 6.) More generally, by comparing real income growth against a scenario in which commodity prices remain flat, it becomes clear that **Ecuador, Venezuela, Chile, Mexico and Peru have benefited most from the commodities boom. By contrast, Brazil has benefited the least.**

TABLE 6: COMMODITY PRICE BOOM EFFECT ON REAL INCOME
(AVG. % Y/Y 2004-08)

	Real GDP	Real Income* (1)	Real Income* using flat comm. prices (2)	Diff. (1-2)
Brazil	4.3	4.5	4.3	0.2
Mexico	3.2	6.4	5.3	1.1
Argentina	7.8	8.1	7.5	0.6
Venezuela	8.3	11.8	8.6	3.2
Colombia	6.0	7.2	6.3	0.9
Chile	4.6	10.1	8.1	2.0
Peru	7.0	8.2	7.1	1.1
Ecuador	4.4	5.3	1.0	4.3

Sources – Thomson Datastream, Capital Economics

* Real Income was obtained by deflating nominal GDP by the domestic demand deflator

An indirect effect on real GDP?

An increase in commodity prices can, however, have an *indirect* effect on real GDP as the resulting boost to incomes may lead to extra spending, thus increasing domestic demand and causing output to rise. But, in order for this to happen three conditions must hold. First, the extra income must be spent rather than saved. The extent to which this has been the case is difficult to ascertain, since it requires that we can quantify just who has benefited from the rise in commodity prices and what they have done with the extra income.

In some countries this is relatively straightforward. For instance, **in the case of Chile, most of the extra revenue from the run-up in copper prices**

TABLE 5: LATIN AMERICA'S EXTRA EARNINGS FROM COMMODITY NET EXPORTS

	Brazil		Mexico		Argentina		Venezuela		Colombia		Chile		Peru		Ecuador	
	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP	\$Bn.	% GDP
2005	2	0.3	12	1.4	1	0.4	10	6.6	2	1.2	1	0.8	0	0.3	2	5.4
2006	8	0.9	26	2.7	2	0.9	21	11.3	4	2.4	7	4.5	2	2.3	5	11.3
2007	6	0.6	19	1.9	2	0.9	16	7.1	5	2.6	9	5.3	3	2.8	4	8.1
2008	13	1.1	44	5.0	7	2.5	34	10.7	8	3.5	13	8.4	5	4.3	8	15.5
Total*	30	2.6	101	11.5	12	4.3	81	25.6	19	8.6	30	19.2	10	8.7	18	35.5

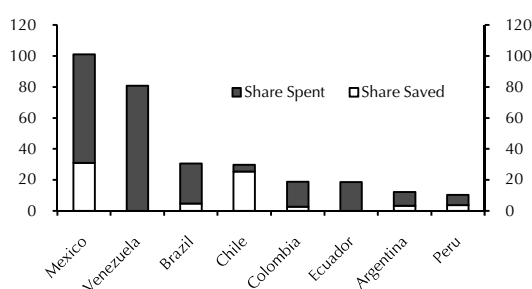
Sources – Thomson Datastream, US Geological survey, Bloomberg, FAO and Capital Economics.

* Total extra earnings are shown as a share of GDP in 2008.

has accrued to the state, which in turn has saved around 85% in a sovereign wealth fund. In Venezuela all of the extra income from oil exports has also accrued to the state, but in contrast to Chile, this has largely been spent.

Elsewhere, we have had to rely on national savings rates to estimate just how much of increase in revenues has been spent and how much has been saved. On this basis, we think that around \$230bn of the extra \$300bn of income from higher commodity prices has been spent. (See Chart 9.)

CHART 9: CE ESTIMATES OF EXTRA INCOME FROM COMMODITY BOOM (\$BN, 2004-08)



Source – Capital Economics

However, in order for this additional spending to have driven an increase in domestic demand, it must be spent on domestically produced goods (our second condition) and crucially, the economy must be operating below full capacity (our third condition). If the latter does not hold, the extra increase in demand would simply result in a rise in prices.

On the whole, we estimate that Latin America spends around 60 cents of every additional \$1 of income on domestic production. Accordingly, around \$150bn of the boost to income from higher commodity prices has been spent on domestic production. What's more, most estimates of the 'natural rate' of unemployment suggest that a significant amount of spare capacity existed in the region's economy at the start of the commodities boom in 2004.

Accordingly, it is possible that the extra income from commodity exports generated a rise in domestic demand. But on the face of it, the numbers involved are surprisingly small. **Over the period 2004-08, domestic demand in the region increased by a cumulative \$1.9tn in nominal terms, or \$1.2tn in real terms. That's enormous compared with the extra \$150bn of nominal spending (\$90bn in real terms) that might have been generated by higher commodity prices.**

But this is due in part to the fact that the regional numbers are distorted by Brazil, which is a large economy and a relatively small net exporter of commodities. If we exclude Brazil, higher commodity prices have accounted for around 20% of the rise in real domestic demand in the region between 2004 and 2008. And in some of the more profligate commodity producers such as Ecuador and Venezuela the boom in prices has accounted for a much larger share of the rise in domestic demand. (See Table 7.)

TABLE 7: SHARE OF RISE IN DOMESTIC DEMAND ACCOUNTED FOR BY HIGHER COMMODITY PRICES (% , 2004-08)

Country	%
Ecuador	60
Venezuela	25
Mexico	15
Peru	10
Colombia	10
Chile	5
Argentina	5
Brazil	2.5

Source – Capital Economics

What next?

Having established just how the region benefited from the improvement in the terms of trade, we can now assess how it will be affected by the recent collapse of commodity prices.

It goes without saying that the region will be worse off. That said, just as the boom in commodity prices had no direct impact on conventional measures of real GDP, the collapse of these will have no direct effect either. But domestic demand

could be hit as the region's terms of trade deteriorate. Indeed, we expect domestic demand to contract by an average of 4% across Latin America this year.

The true impact of falling commodity prices can only be seen in our 'real income' measure. (See Table 8.) Ecuador and Venezuela will be hardest hit. This is unsurprising as they benefited most from the commodity boom.

By contrast, Brazil, which was a much small beneficiary of the boom in prices, will escape relatively unscathed following the crash. Finally, it is worth noting that Mexico's decision to hedge 70% of its 2009 oil production at \$70 per barrel will mean that its terms of trade, and consequently its 'real income' will continue to fall over the course of 2010 (assuming that market prices are lower than \$70pb next year too).

TABLE 8: CE FORECAST OF REAL GDP AND REAL INCOME (% Y/Y 2009-10)

	Real GDP		Real Income	
	2009	2010	2009	2010
Brazil	-2.0	0.0	-3.0	0.0
Mexico	-5.0	-1.5	-6.0	-2.5
Argentina	-6.0	-2.0	-8.0	-3.0
Venezuela	-7.0	-3.0	-13.5	-4.0
Colombia	-4.0	-1.0	-5.0	-1.0
Chile	-3.0	0.0	-7.0	-0.5
Peru	-3.5	-1.0	-6.0	-2.0
Ecuador	-10.0	-5.0	-12.0	-5.5

Source – Capital Economics

The impact of withdrawal of capital

The third and final external factor which will weigh on the region is the withdrawal of international investment. The financial element of the current economic crisis has of course caused severe damage in equity markets across developed and emerging economies alike. But the full impact of the withdrawal of capital and the broader financial crisis have yet to be felt.

For a start, net flows of foreign direct investment (FDI) to the region, which stood at \$60bn in 2008,

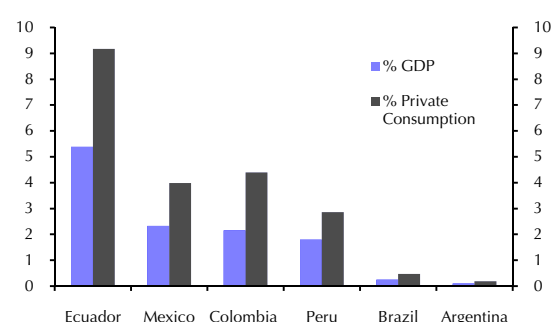
could dry up altogether this year as a result of a rise in investor risk aversion and the collapse of output in commodity-export industries. (The latter is more relevant in countries where production of commodities is capital-intensive.) This is equivalent to a fall in total investment of about 8%.

What's more, by the time we account for a withdrawal of non-FDI capital of around \$5bn plus the effects of the collapse in commodity prices, discussed above, fixed investment is likely to contract by closer to 15%. Admittedly, an increase in public works spending will cushion the blow, but we still expect fixed investment in the region to drop by 10% this year.

Mexico & Ecuador hit by collapse in remittances

As we noted earlier, the recent boom in consumer credit has been largely financed by domestic deposits and so is less likely to be hit by weaker global capital flows. That said, households will be hit by weaker inflows of remittances from nationals living abroad. While this is officially accounted for on the current account (rather than the capital account) side of the balance of payments, the result is the same – as household income falls, private consumption will drop.

CHART 10: REMITTANCES AS A SHARE OF GDP & PRIVATE CONSUMPTION



Sources– Thomson Datastream, Capital Economics

The numbers involved are surprisingly large in some cases. **Remittances currently account for around 5% of GDP in Ecuador and 2% of GDP in Mexico.** In both cases, the vast majority comes from workers in US. Once again, Brazil is less exposed. Remittances currently account for barely

0.25% of GDP. (See Chart 10.) We estimate that on the basis of our forecast for US GDP and employment growth, remittances to the region could shrink by 20%. That would be enough to cut overall private consumption in the region by 1%.

What's more, once the effects of a drop in the terms of trade and a rise in unemployment are accounted for, private consumption in Latin America is on course to contract by 3% this year. Of the major economies, consumers in Mexico will be hit the hardest - we think that private consumption here could contract by over 5% this year.

Meanwhile, private consumption in Brazil is likely to shrink at a much slower pace: the deterioration in the terms of trade will be less severe, households are less dependent on remittances from abroad and jobs in the economy more generally are less dependent on a buoyant export sector. We have pencilled in a drop in consumption of 2% this year.

Latin America: Outlook for 2009

Summing this all up, Latin America is facing its first recession since the Argentine crisis of 2001. In fact, **we expect the region's GDP to contract by 4%, the biggest decline since the Great Depression.** The outlook for the region is not quite as negative as that of Emerging Europe (expected to contract by at least 5%), since Latin America has been less dependent on foreign capital to fund its development. However, the region will underperform both India and China, where we expect growth of 4% and 5% respectively.

Brazil: Recession all but inevitable

Brazil is in a better position to withstand external shocks than it was during the last Latin American crisis, partly due to its reduced dependence on overseas finance. The country's foreign debt as a share of GDP has been cut from 45% of GDP in 2001 to 14% in 2008. In addition, international reserves grew from \$27 billion by the end of 2002 to \$130 billion as of September 2008.

What's more, as outlined above, Brazil is less exposed to the turmoil in the global economy than other countries in the region. **But despite the claims of President Lula to the contrary, Brazil will not avoid a recession.** For a start, exports are likely to shrink by 4%, while the terms of trade are set to deteriorate by 6.5%. Accordingly, domestic demand could contract by 2%.

In addition, Brazil's current account balance will tip into a deficit of close to 2% of GDP. Only fiscal spending is set to expand in 2009. Indeed, the government's stimulus package is of extreme importance not only because of its implications for the economy, but also because general elections will be held in Brazil in 2010.

TABLE 9: BRAZIL'S FORECAST

	Aver. 00-07	2008	2009	2010
GDP	3.4	5.1	-2.0	0.0
Private cons'ptn	3.1	5.5	-2.0	0.0
Gross fixed invest.	3.9	15.0	-10.0	2.0
Gov't cons'ptn	2.6	5.0	5.5	3.0
Domestic Demand	2.2	6.9	-2.0	1.0
Exports	9.6	2.0	-4.0	0.0
Imports	7.4	20.0	-4.0	1.0
Current Account*	-0.5	-1.8	-2.0	-2.0
Fiscal Balance *	-2.5	-2.0	-4.5	-5.0
Inflation	8.4	5.7	3.0	3.5

% Change on a year earlier (unless indicated otherwise) * As % of GDP
Source – Capital Economics

Mexico: The price of the ties with the US

By contrast, Mexico will be one of the hardest hit economies in the region, with GDP on course to shrink by 5%. As the US economy contracts by around 2% this year, we anticipate that Mexican exports will shrink by over 5%. In addition, we expect domestic demand to shrink at a similar pace, fuelled by a drop in remittances, a rise in unemployment and a deterioration in Mexico's terms of trade.

The sharp fall in exports to the United States will worsen the current account position, even though imports are also expected to decrease in response to the drop in domestic demand. In addition,

remittances from Mexicans living abroad are set to fall by more than \$2bn as unemployment increases in the US. The pressure of these factors is likely to cause Mexico's current account to tip into deficit of more than 3% of GDP in 2009. Finally, **the prospect of only a slow recovery in the United States will cause Mexico's real GDP to continue contracting in 2010.**

TABLE 10: MEXICO'S FORECAST

	Aver. 04-07	2008	2009	2010
GDP	3.8	2.1	-5.0	-1.0
Private cons'ptn	5.0	2.5	-5.0	-1.0
Gross fixed invest.	7.4	7.0	-10.0	-3.0
Gov't cons'ptn	0.5	1.0	2.0	3.0
Domestic Demand	5.0	3.3	-5.5	-2.0
Exports	8.8	3.0	-5.5	0.5
Imports	9.7	4.0	-6.0	1.5
Current Account*	-0.6	-1.0	-1.5	-3.0
Fiscal Balance *	-0.2	-2.5	-5.0	-5.5
Inflation	4.1	5.0	2.0	3.0

% Change on a year earlier (unless indicated otherwise) * As % of GDP
Source – Capital Economics

Argentina: The weakest link

Argentina remains one of the most vulnerable economies in Latin America. Admittedly, the country has improved its financial accounts by building a current account surplus of more than 2% of GDP and reducing the external debt to less than 40% of GDP by mid-2008, down from 161% of GDP in 2002. Also, foreign exchange reserves have more than trebled since 2003.

That said, **we think that the international economic turmoil will cause Argentina's GDP to shrink by 6% in 2009.** The collapse of the economy will be driven by a deterioration in the terms of trade, which we expect to fall by close to 10%. This, combined with continued high levels of risk aversion, is likely to cause investment in Argentina to contract by 15%. In addition, private consumption may shrink by 5% this year and 2.5% in 2010.

The crisis will also take its toll on Argentina's exports, which we expect to contract by 4% this

year. As export revenues fall (and consequently the flow of foreign exchange reserves), the country's currency will come under increased pressure.

As shown in Table 10, the combination of factors described above is worse than the condition of Argentina's economy the year before it defaulted in 2001. Thus, the risk that this country will go down that path again in the next year or so has increased significantly.

TABLE 11: ARGENTINA'S FORECAST

	2000	2008	2009	2010
GDP	-0.8	7.2	-6.0	-2.0
Private cons'ptn	-0.7	7.0	-5.0	-2.5
Gross fixed invest.	-6.8	12.0	-15.0	-2.0
Gov't cons'ptn	0.5	8.0	5.0	2.0
Domestic Demand	-1.7	8.2	-5.0	-1.5
Exports	2.7	5.0	-4.0	-0.5
Imports	-0.2	18.0	-4.5	-1.0
Current Account*	-3.2	2.0	-0.5	-1.0
Fiscal Bal.*	-2.1	-0.3	-4.0	-4.0
Inflation	-0.9	15.0	10.0	11.0

% Change on a year earlier (unless indicated otherwise) * As % of GDP
Source – Capital Economics

Others: Poor performances

The rest of the region is likely also to perform poorly. **The case of Venezuela is perhaps as worrying as that of Argentina.** The leftist agenda of the government does little to promote investment and we do not anticipate any recovery before 2011. **Venezuela's fixed exchange rate system, its strong dependence on oil exports, and pro-cyclical fiscal policies, are a lethal cocktail that is likely to lead GDP to contract by 7% in 2009 and by 3% in 2010.**

The woes in Venezuela could spread to other countries in the region. Indeed, a collapse of domestic demand in Venezuela will have a direct effect on Colombian exports, compounding the impact of the recession in the US - Venezuela is Colombia's second largest trading partner after the United States. Accordingly, **Colombia's GDP is likely to contract by 4% in 2009.**

In Chile, the country's terms of trade have been hit hard by the collapse of copper prices, with obvious consequences for domestic consumption and investment. But **in contrast to most of the region, previous sound policies will allow the government to loosen the purse strings and cushion the downturn.** Recently, the government announced an ambitious fiscal package, which will see the budget swing from a surplus of 8% of GDP in 2007 to a deficit of 3% of GDP this year. This will be partly funded by a transfer of funds from the \$24bn sovereign wealth fund. **Nevertheless, a recession still seems likely and we have pencilled in a fall of 3% in GDP this year.**

Like Chile, Peru's sound macroeconomic management of recent years will allow the authorities to increase spending to counter-balance the collapse in domestic demand triggered by the terms of trade and exports. That said, we expect

Peru's real GDP to contract by 3.5% in 2009.

In Ecuador, the collapse of oil prices is set to hit domestic demand. In addition, the government's default in late 2008 will exacerbate the effects of the crisis on fixed investment. Consequently, GDP looks set to shrink by 10% in 2009. This is likely to be the worst GDP contraction in the region.

In contrast, Panama could be the only country to avoid outright recession in 2009. In addition Panama's GDP growth rate in 2010 is set to be the largest in Latin America on the back of the expansion of the Panama Canal, which is due to be completed in 2014.

Conclusions

We expect Latin America's GDP to contract by 4% this year (see Table 12), marking the biggest decline since the Great Depression. Latin American leaders claim that their countries have come a long way since the last economic turmoil and that the region is now in good shape to face the current international economic crisis. We disagree. Although the region has made significant progress in terms of debt reduction, Latin America is far from becoming immune to economic crisis.

On the contrary, **most Latin American countries have missed the window of opportunity given by five years of uninterrupted growth to alleviate the factors that make the region so vulnerable to external shocks.** Indeed, many countries in the region continue to suffer a chronic dependence on commodity production and its industrial sector (with the exception of Brazil and Mexico, perhaps) remains unable to compete with the industries of other emerging economies.

A crisis of this magnitude has not been seen in Latin America in several generations. With limited support from the IMF or the World Bank, Latin America's road to recovery will be steep and difficult. We expect that it will probably take the region two to three years (if not more) to return to its long term growth path.

TABLE 12: LATIN AMERICA'S REAL GDP GROWTH

	FORECAST (%)		
	2008	2009	2010
Brazil	5.1	-2.0	0.0
Mexico	2.1	-5.0	-1.0
Argentina	7.2	-6.0	-2.0
Venezuela	4.8	-7.0	-3.0
Colombia	3.4	-4.0	-1.0
Chile	3.9	-3.0	0.0
Peru	6.3	-3.5	-1.0
Ecuador	4.8	-10.0	-5.0
Guatemala	3.4	-7.0	-3.5
Costa Rica	2.9	-4.5	-2.5
Uruguay	4.2	-3.0	-0.5
El Salvador	2.1	-6.0	-4.0
Panama	5.4	0.0	2.0
Bolivia	3.3	-5.5	-3.0
Honduras	3.4	-6.5	-3.0
Paraguay	2.8	-4.5	-2.0
Nicaragua	2.8	-7.0	-3.0
Suriname	4.7	-5.0	-3.0
Belize	2.1	-6.0	-3.5
Guyana	3.2	-8.0	-6.0
Latin America	4.5	-4.0	-1.0
Emerging Europe	5.0	-5.0	1.0
Emerging Asia	6.3	1.8	-0.5
United States	1.2	-2.0	-0.5
World	2.0	-2.0	-2.5

Source – Capital Economics