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REPORT ON THE LATIN AMERICAN ECONOMY. FIRST HALF OF 2021. OUTLOOK, VULNERABILITIES AND POLICY SPACE

ABSTRACT

The economic recovery in Latin America continued into the first part of this year, but lost momentum owing to the adverse course of the pandemic. Against this macro-financial backdrop, the region's banking systems remain healthy, although some indicators, such as bank profitability, have started to feel the effects of the persistence of the crisis. The strength of the recovery will be chiefly determined by the course of the pandemic, in particular by how fast the vaccine is rolled out and its effectiveness. It will also hinge on the momentum of foreign demand and commodity prices, the resolution of potential social tensions in the region, global financial conditions, the degree of support from economic policies, whose headroom has narrowed, and regional and global economic safety nets. Given the high level of uncertainty surrounding the economic outlook, the report presents alternative scenarios relating to a series of epidemiological, economic and financial variables. However, it should be noted that, broadly speaking, the region has fewer structural vulnerabilities now than in previous episodes of turmoil. In any event, the complex economic situation reinforces the need for institutional and economic reform agendas that address the region's structural problems.

Keywords: health crisis, mobility, commodities, financing conditions, capital flows, household savings, economic policies, public debt sustainability, global and regional safety net.

JEL classification: C11, E52, E58, E62, F01, F30, F47.

REPORT ON THE LATIN AMERICAN ECONOMY. FIRST HALF OF 2021.
OUTLOOK, VULNERABILITIES AND POLICY SPACE

Executive summary

The economic recovery in Latin America continued into the first part of this year, but lost momentum owing to the adverse course of the pandemic. The recovery shows some similar characteristics to those observed in other regions, although it is proving less dynamic than in other emerging areas. This could stem from the impact of structural elements, such as the higher relative rate of informal employment. The improvement in activity is being underpinned by the resolute economic policy measures, the encouraging trajectory of foreign demand and commodity prices, and satisfactory financing conditions, although these have tightened somewhat recently.

Against this macro-financial backdrop, the region’s banking systems remain healthy. However, some indicators, such as bank profitability, have started to feel the effects of the persistence of the crisis. Maintaining this healthy position in the future will hinge on the strength of the economic recovery and whether or not the specific public support programmes are extended as and when they reach their expiry date.

The future course and control of the pandemic continue to be the main factor conditioning the recovery. Vaccination is progressing in Latin America, albeit at a slower pace than in the advanced economies. The simulations presented in this report for the region’s six main economies show that both a slower-than-expected rate of vaccination and, especially, a potential reduction in vaccine effectiveness could have significant human and economic costs.

The strength of the recovery will also depend on whether or not certain macro-financial risks, of opposite signs, materialise, even assuming that the health crisis is gradually overcome. The report provides estimates of the economic costs under several risk scenarios for the two main economies of the region: Brazil and Mexico. These scenarios include a potential increase in financial stress, the implementation of a new fiscal stimulus plan in the United States from end-2021, and the possible adverse impact of the crisis on potential growth. The risks associated with the emergence or intensification of social unrest are also highlighted.

In general, the region has fewer structural vulnerabilities now than in previous episodes of turmoil. In addition, on the indicators presented in this report, vulnerabilities do not appear to have substantially worsened during the pandemic, except for fiscal vulnerabilities in some countries.

In order to withstand possible adverse scenarios, the role of domestic economic policies is essential, although their headroom could be decreasing. In the monetary realm, this policy space would be affected if there is a change in the global financial cycle or an increase in inflationary pressures which, for now, remain limited. As regards fiscal policy, the widespread deterioration in public finances and, in some cases, possible future public debt developments point to a narrowing of fiscal policy space. Against this backdrop, the role of the global and regional safety net and, in particular, that of the support of multilateral organisations are again of particular importance. Likewise, the complex economic situation in the region reinforces the need for institutional and economic reform agendas that address the region's structural problems.

The economic recovery in Latin America continued into the first part of this year, but lost momentum owing to the adverse course of the pandemic

Economic activity in the main Latin American economies saw a marked recovery in 2020 H2, following the abrupt fall in H1 (see Chart 1.1). This occurred in tandem with the increase in people's mobility observed up to end-2020 that accompanied the gradual improvement in the incidence of the health crisis (see Charts 1.2 to 1.4). However, the recovery lost steam in 2021 Q1, as agents' mobility decreased. This decline in mobility was attributable to the reintroduction in various countries in the region of some restriction measures to tackle rising infections, in part resulting from the emergence of new strains of the virus, and also to the population's own precautionary behaviour. Despite these developments, the economic impact has been limited, given that the correlation between mobility and activity has decreased in recent quarters, possibly reflecting economic agents adapting better to the health emergency (see Chart 1.5).

Inflation has risen in general in the region, mainly on account of the developments in the more volatile components: food and energy. These items have a significant weight in consumption baskets in emerging economies in general and in the Latin American economies in particular (see Chart 1.6).

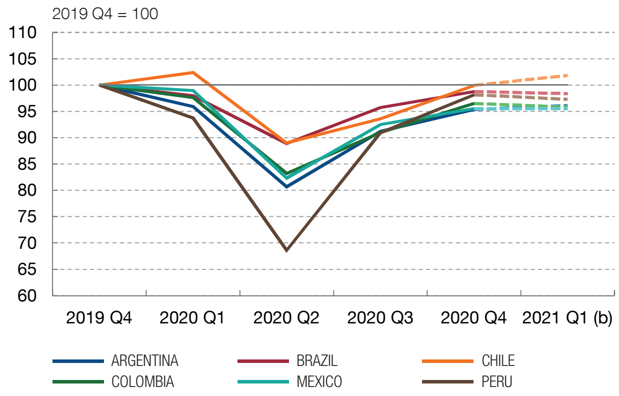
The recovery in Latin America has similar characteristics to those observed in other regions of the world, with certain distinguishing features

The recovery is being underpinned by a series of internal and external factors. Notable among the internal factors are the gradual easing of the lockdown measures and the extensive support of economic policy, which is proving essential to mitigate the economic impact of the health crisis and maintain the normal functioning of the financial markets. Broadly speaking, the authorities swiftly and decisively adopted highly expansionary fiscal, monetary and prudential policies, which were

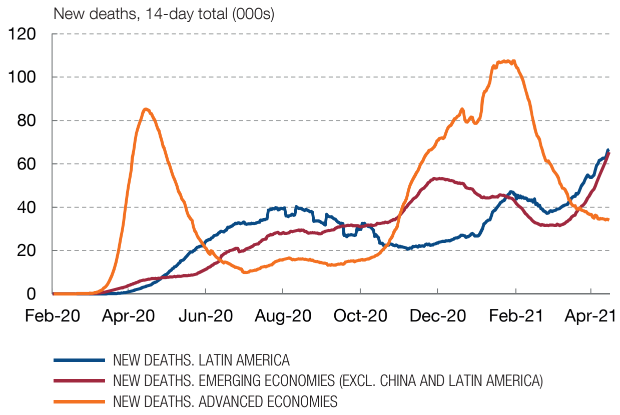
Chart 1
RECENT DEVELOPMENTS

Economic activity in the region saw a notable recovery in 2020 H2, in line with the easing of the mobility restrictions. In 2021 Q1 the recovery slowed down on account of the increase in infections, although economic agents have adapted to a greater extent to the new restrictions. After reaching all-time lows in May 2020, inflation has risen in several of the region's countries, especially in the more volatile components such as food and energy.

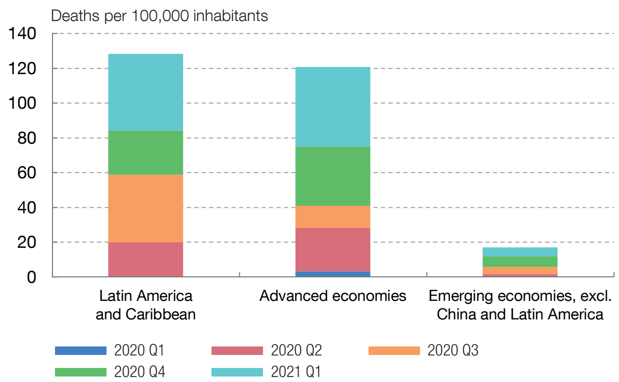
1 LATIN AMERICA-6 (a). REAL GDP



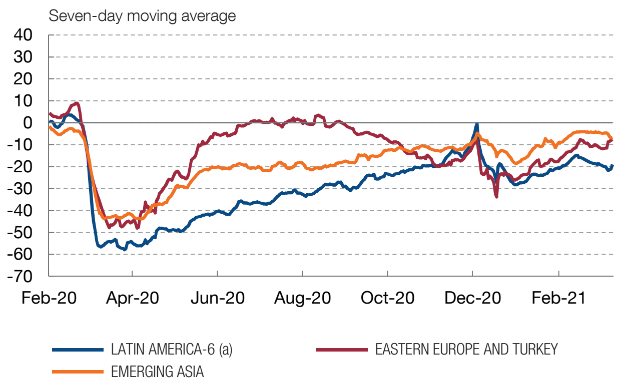
2 DEATHS SINCE THE BEGINNING OF THE PANDEMIC



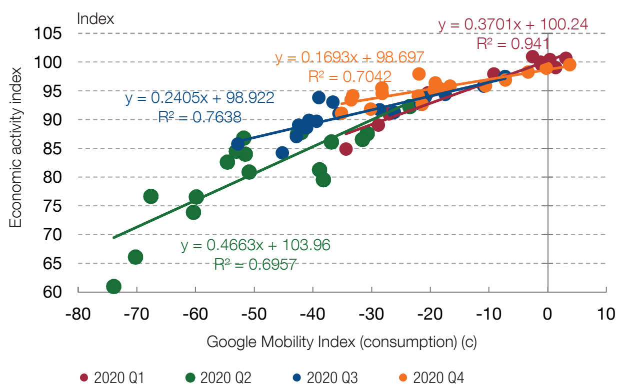
3 DEATHS IN DIFFERENT WAVES



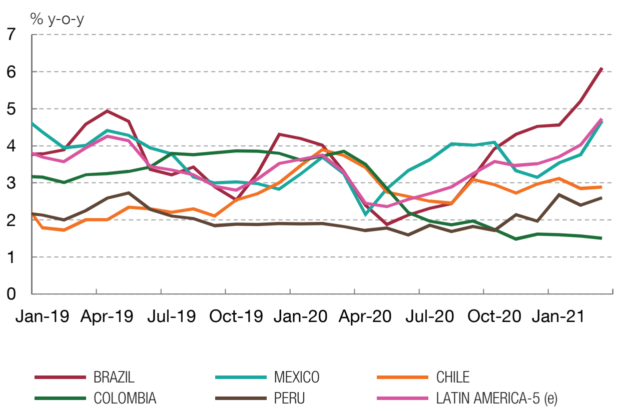
4 MOBILITY DATA. CONSUMPTION (c)



5 ECONOMIC ACTIVITY AND MOBILITY INDEX (d)



6 INFLATION. LATIN AMERICA-5 (e)



SOURCES: John Hopkins, Google Mobility Report, Refinitiv, Latinfocus and national statistics.

- a Argentina, Brazil, Chile, Colombia, Mexico and Peru.
- b Latinfocus projection (March 2021).
- c Mobility data on consumption-related activities. "Consumption" is the average of "retail and recreation" and "food and pharmaceutical products" activities. The reference value is calculated during the five-week period from 3 January to 6 February 2020.
- d The dots represent the monthly data of the six main economies of Latin America (Argentina, Brazil, Chile, Colombia, Mexico and Peru), in each of the quarters indicated.
- e Aggregate of the five countries with inflation targets (Brazil, Chile, Colombia, Mexico and Peru), weighted by purchasing power parity.

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unprecedented in terms of their size, protracted time horizon and newness. This policy response in the region was smoothed by the institutional credibility gained in recent decades (in particular by central banks), by the fact that developed economies were adopting the same type of measures (given the global nature of the shock behind the crisis), and by the support from multilateral institutions.[1]

The decisiveness of economic policy is helping maintain highly favourable financing conditions for the emerging economies, with policy interest rates at all-time lows in most countries of the region. However, there has been a notable worsening of public finances (see Table 1), which could limit additional policy space in the future, as discussed below.

Noteworthy among the external factors underpinning the region's recovery are the growth in the main trading partners, most notably in the United States and China (see Chart 2.1), the increase in commodity prices (see Chart 2.2), which represents an improvement in the terms of trade for several economies, the strong performance of remittances to the region, which are very important to Mexico and the Central American and Caribbean economies, the favourable global financing conditions, and the return of capital flows to Latin America, which is discussed below.

Against this backdrop, there were also positive surprises in the economic data observed in 2020 H2 vis-à-vis the autumn forecasts, reflecting the better performance of the fundamentals and the greater extent to which agents have adapted to the health crisis, mentioned above.[2] Thus, on the International Monetary Fund's April forecasts,[3] GDP fell by 7% for Latin America and the Caribbean as a whole in 2020, compared with the 8.1% drop projected last October.[4] This pattern was common to analysts as a whole. Nevertheless, the slump in GDP in 2020 was sharper than for the other emerging economies (see Chart 2.3). This could be explained, at least in part, by a series of differential structural characteristics of Latin America, such as the comparatively higher levels of poverty, lower institutional quality, higher rate of labour market informality, relative weakness of the health systems and higher proportion of the population living in urban areas.[5]

In addition, the recovery is heterogeneous across the different countries of the region. This is largely attributable to their uneven pre-pandemic starting point as

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1 For a description of the main economic policy measures of the countries in the region, see, inter alia, Banco de España (2020a), Banco de España (2020b) (for the asset purchase programmes), Banco de España (2020c) (for the role of international institutions) and Inter-American Development Bank (2021) (in particular for the micro and macroprudential measures). See also Banco Central de Chile (2020) for a description and assessment of the measures taken in countries such as Chile and Peru allowing private pension scheme savers to withdraw a share of their savings.

2 See Box 1 of this report for a quantitative assessment of the main determinants of this better performance of the two largest economies of the region, Brazil and Mexico, in 2020 H2.

3 See IMF (2021a).

4 See IMF (2020a).

5 See Banco de España (2020d) and Hernández de Cos (2021).

Table 1

LATIN AMERICA: MAIN ECONOMIC INDICATORS

	2007-2019 Average	IMF Projections (April 2021 WEO)			2019	2020				2021
		2020	2021	2022	Q4	Q1	Q2	Q3	Q4	Q1 (a)
GDP (year-on-year rate) (b)										
Latin America and the Caribbean	2.1	-7.0	4.6	3.1						
Argentina	1.6	-9.9	5.8	2.5	-1.1	-5.2	-19.0	-10.1	-4.3	-0.9
Brazil	1.9	-4.1	3.7	2.6	1.6	-0.3	-10.9	-3.9	-1.1	-0.6
Mexico (c)	1.9	-8.5	5.0	3.0	-0.8	-2.2	-18.7	-8.5	-4.5	-4.0
Chile	3.1	-5.8	6.2	3.8	-2.0	0.2	-14.2	-9.0	0.0	-0.8
Colombia (c)	3.7	-6.8	5.2	3.6	3.3	0.1	-15.6	-8.3	-3.5	-2.5
Peru	4.9	-11.1	8.5	5.2	1.8	-3.7	-30.0	-9.0	-1.7	2.4
CPI (year-on-year rate) (b)										
Latin America and the Caribbean	5.5	6.4	7.2	6.6						
Argentina	17.8	42.0	—	—	52.2	50.4	43.9	39.8	36.4	40.3
Brazil	5.6	3.2	4.6	4.0	3.4	3.8	2.1	2.6	4.3	4.4
Mexico	4.2	3.4	3.5	3.1	2.9	3.4	2.8	3.9	3.5	4.0
Chile	3.3	3.1	3.1	3.0	2.8	3.7	2.9	2.7	2.9	3.0
Colombia	4.2	2.5	2.1	2.6	3.8	3.7	2.9	1.9	1.6	1.6
Peru	3.0	1.8	2.0	2.0	1.9	1.9	1.7	1.8	2.0	2.6
Budget balance (% of GDP) (b) (d)										
Latin America and the Caribbean	-3.8	-8.7								
Argentina	-2.0	-8.5			-3.8	-4.4	-7.2	-8.3	-8.5	
Brazil	-4.9	-13.6			-5.8	-6.1	-11.1	-13.5	-13.7	
Mexico	-2.2	-2.6			-2.0	-1.9	-2.7	-2.1	-2.6	
Chile	-0.6	-7.3			-2.9	-2.8	-5.0	-7.5	-7.3	
Colombia	-3.1	—			-2.2	-1.7	-4.5	-6.4	—	
Peru	-0.9	-9.4			-2.1	-2.8	-4.8	-7.3	-9.4	
Public debt (% of GDP) (b)										
Latin America and the Caribbean	52.7	77.2								
Argentina	44.3	104.4			76.8	84.0	97.6	92.9	104.4	
Brazil	61.3	88.8			74.3	76.9	83.6	88.7	88.8	
Mexico	38.4	53.8			46.8	51.4	54.8	55.9	53.8	
Chile	14.6	35.7			28.2	29.1	30.8	32.0	32.5	
Colombia	47.4	—			45.6	50.3	53.3	57.0	—	
Peru	29.7	35.0			26.8	26.3	30.3	32.0	35.0	
Current account balance (% of GDP) (b) (d)										
Latin America and the Caribbean	-1.9	0.2	0.0	-0.4						
Argentina	-1.3	0.8	2.3	1.3	-0.9	0.0	1.2	1.8	0.8	0.5
Brazil	-2.3	-0.9	-0.6	-0.8	-2.7	-3.1	-2.8	-1.6	-0.9	-1.1
Mexico	-1.5	2.5	1.8	1.0	-0.3	0.0	-0.4	1.1	2.4	-0.9
Chile	-1.4	1.3	0.3	-0.6	-3.7	-3.3	-1.3	0.2	1.3	0.0
Colombia	-3.6	-3.3	-3.8	-3.9	-4.4	-4.1	-4.0	-3.3	-3.3	-3.6
Peru	-2.5	0.5	-0.4	-0.7	-1.5	-1.1	-0.7	0.1	0.5	—
External debt (% of GDP) (b)										
Latin America and the Caribbean	35.2	56.3	54.4	52.1						
Argentina	38.4	71.0			62.3	62.9	67.4	69.6	71.0	
Brazil	35.4	44.0			36.0	35.1	37.0	40.1	43.7	
Mexico	21.3	34.2			28.0	28.5	31.8	33.7	34.2	
Chile	68.3	82.3			70.8	72.3	80.8	82.8	82.1	
Colombia	38.9	57.1			42.9	44.3	49.8	52.8	56.9	
Peru	40.1	43.4			34.7	35.2	38.9	41.6	43.5	
MEMORANDUM ITEMS: Aggregate of emerging economies excluding Latin America and China (IMF, WEO April 2021)										
GDP (year-on-year rate)	4.5	-3.7	6.1	5.0						
CPI (year-on-year rate)	7.0	6.4	6.6	5.4						
Budget balance (% of GDP)	-2.4	-8.6	-6.6	-5.6						
Public debt (% of GDP)	39.6	58.1	58.0	59.2						
Current account balance (% of GDP)	0.7	-0.2	0.0	-0.3						
External debt (% of GDP)	27.6	29.2	28.3	28.0						
Weight in world GDP, in PPP (%)	31.4	32.0	31.7	31.7						

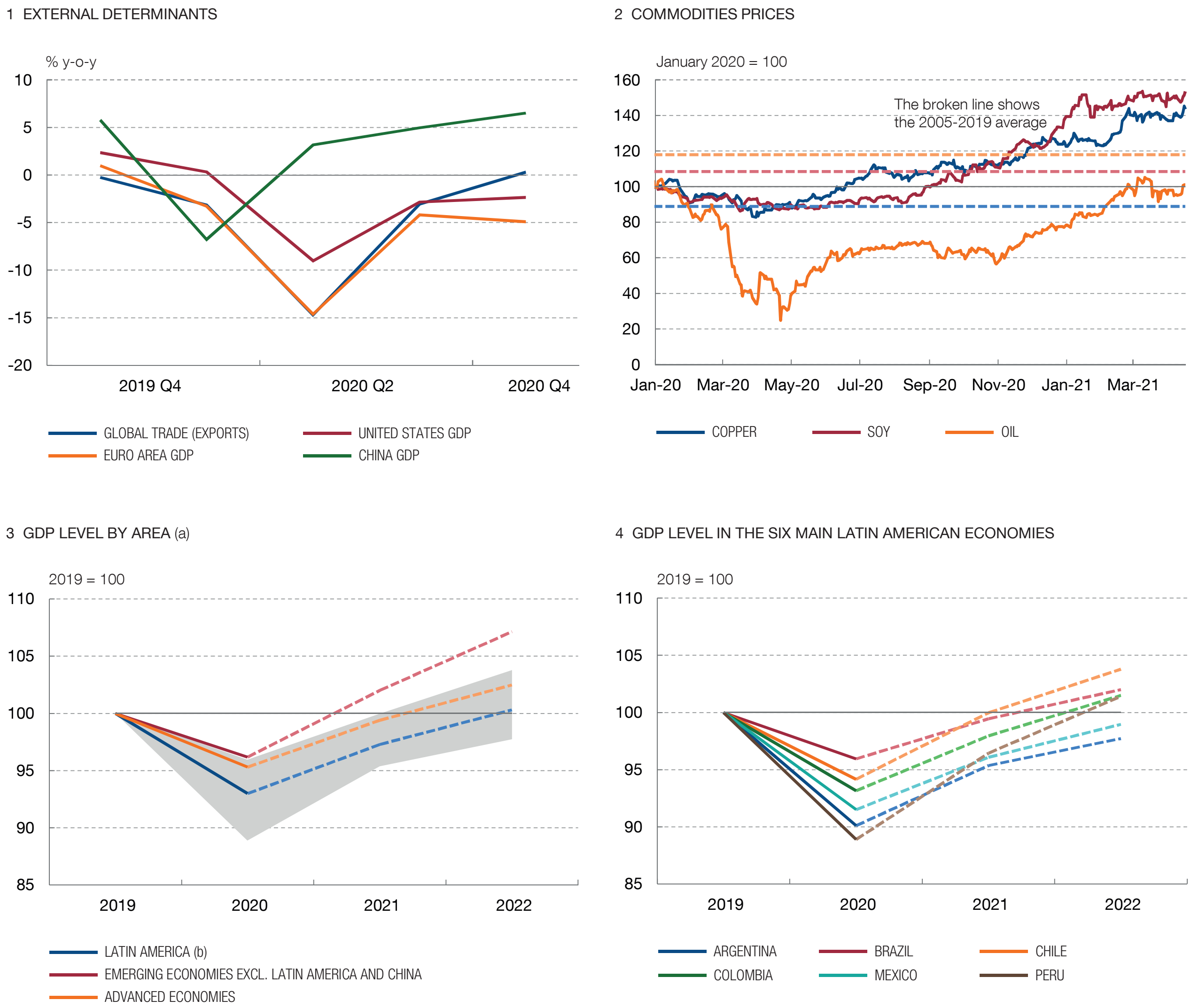
SOURCES: IMF, Thomson Reuters and national statistics.

a The inflation data for Argentina and Brazil and all the data on GDP and the current account balance correspond to the Latinfocus March 2021 projections.
b Latin America and the Caribbean account for 7.3% of world GDP, measured in PPP. The six economies shown represent 86.0% of the total of Latin America and the Caribbean (IMF).
c Seasonally adjusted.
d Four-quarter moving average.

Chart 2

THE RECOVERY IS BEING UNDERPINNED BY FAVOURABLE EXTERNAL FACTORS AND IS HETEROGENEOUS ACROSS COUNTRIES

Notable among the external factors contributing to the economic recovery in Latin America are the growth in the main trading partners, the increase in commodities prices, the improvement in global financing conditions and the return of capital flows to the region. The fall in GDP in 2020 was sharper in Latin America than in other emerging economies and fairly heterogeneous across countries, ranging from -4.1% in Brazil to -11.1% in Peru.



SOURCES: IMF, Refinitiv and CPB World Trade Monitor.

a The shaded area corresponds to the range between the maximum and minimum value for each year for the six main economies of Latin America (Argentina, Brazil, Chile, Colombia, Mexico and Peru).

b Latin America and Caribbean aggregate (IMF).

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regards economic vulnerabilities, the differing support of economic policies,[6] the trajectory of foreign demand (as regards its composition by product and trading partner, and the economies' degree of openness), and the various strategies for

6 Notable in this regard are the sizeable fiscal stimulus measures implemented in Brazil, Chile and Peru and, on a much smaller scale, in Mexico. See Banco de España (2020a), Inter-American Development Bank (2021) and the "Database of Country Fiscal Measures in Response to the COVID-19 Pandemic" in the Methodological and Statistical Appendix of IMF (2021b).

containing the disease, reflected in the significant differences in population mobility indices. Thus, the fall-off in activity in 2020 for the region's main economies ranged from -4.1% in Brazil, where the collapse in domestic demand was cushioned by the public income transfer programmes and health measures were less severe, to -11.1% in Peru, which imposed one of the most stringent lockdowns in the world in 2020 H1[7] (see Chart 2.4).

The recovery from the crisis is also proving unequal by economic sector, as in other geographical areas. The sustained growth in manufacturing contrasts with greater, persistent weakness in services, especially those requiring greater social interaction or where remote working is less feasible (see Chart 3.1). On the demand side, there was a strong recovery in investment and imports in 2020 H2 (see Chart 3.2). Private consumption has been less buoyant on account of the mobility restrictions, precautionary behaviour associated with the heightened uncertainty and the rapid deterioration of the labour market, and also a certain increase in some households' liquidity constraints. This lower buoyancy in consumption, together with the public fiscal measures to support household income, would help explain the marked increase in private-sector saving in the region (see Charts 3.3 and 3.4),[8] which exceeded the increase in dissaving by the public sector and led to an improvement in the current account balance (see Table 1). Consequently, unlike in previous episodes in the region, the current account corrections have not on this occasion been caused by external financing constraints. In any event, part of the current account corrections is expected to be temporary, meaning that the build-up in households' saving should drive the recovery in private consumption when the situation returns to normal and the mobility restrictions and precautionary behaviour associated with the heightened uncertainty disappear.

The favourable financing conditions continue to underpin the recovery, although some tightening has been observed in recent months

As mentioned above, the economic recovery in Latin America is benefiting from favourable financing conditions and the return of capital flows, after the bouts of significant turmoil in March-May 2020 were overcome. Specifically, the region's financial markets posted a strong boost from November 2020, thanks to the dissipation of the uncertainty over the US elections and the vaccine announcements. This, in general, eased financial conditions across the region to levels similar to those observed before the onset of the pandemic (see Charts 4.1 to 4.6). Moreover,

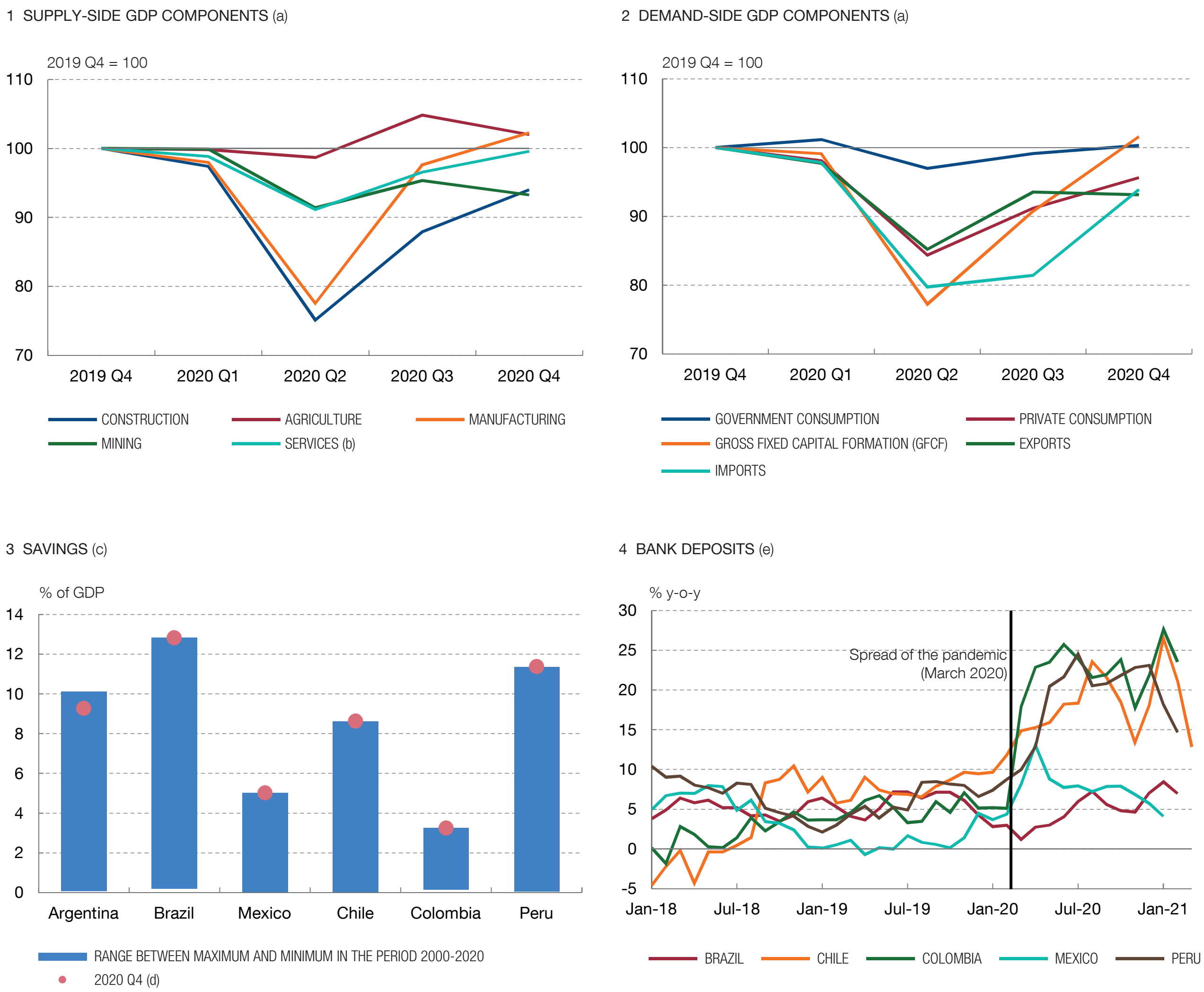
7 See Figure 1.3 in IMF (2020b).

8 In addition, in Chile and Peru, the exceptional measures allowing withdrawals of pension funds have prompted a shift from long-term savings (which can only be used under certain conditions upon retirement) to more liquid products such as deposits. In Chile, according to Banco Central de Chile (2021) (Table V.2), withdrawals from pension funds amounted to 12.2% of GDP in January 2021, of which only 15.2% had been used at that date for the consumption of goods. For more information on pension funding systems in Latin America, see Inter-American Development Bank (2019) and Berganza et al. (2020).

Chart 3

UNEVEN PERFORMANCE BY ECONOMIC SECTOR AND DEMAND COMPONENTS, WITH A SHARP INCREASE IN SAVING

The recovery from the crisis is proving unequal by economic sector: the sustained growth in manufacturing contrasts with greater, persistent weakness in services. On the demand side, there has been a strong recovery in investment. Private consumption has been less buoyant and this, together with the fiscal measures to support household income, explains the marked increase in private-sector saving in the region and the build-up of bank deposits.



SOURCES: Refinitiv and national statistics.

a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b Services sector does not include exactly the same sub-sectors in all countries.
c Net lending of domestic private sector.
d 2020 Q3 for Colombia.
e In real terms.

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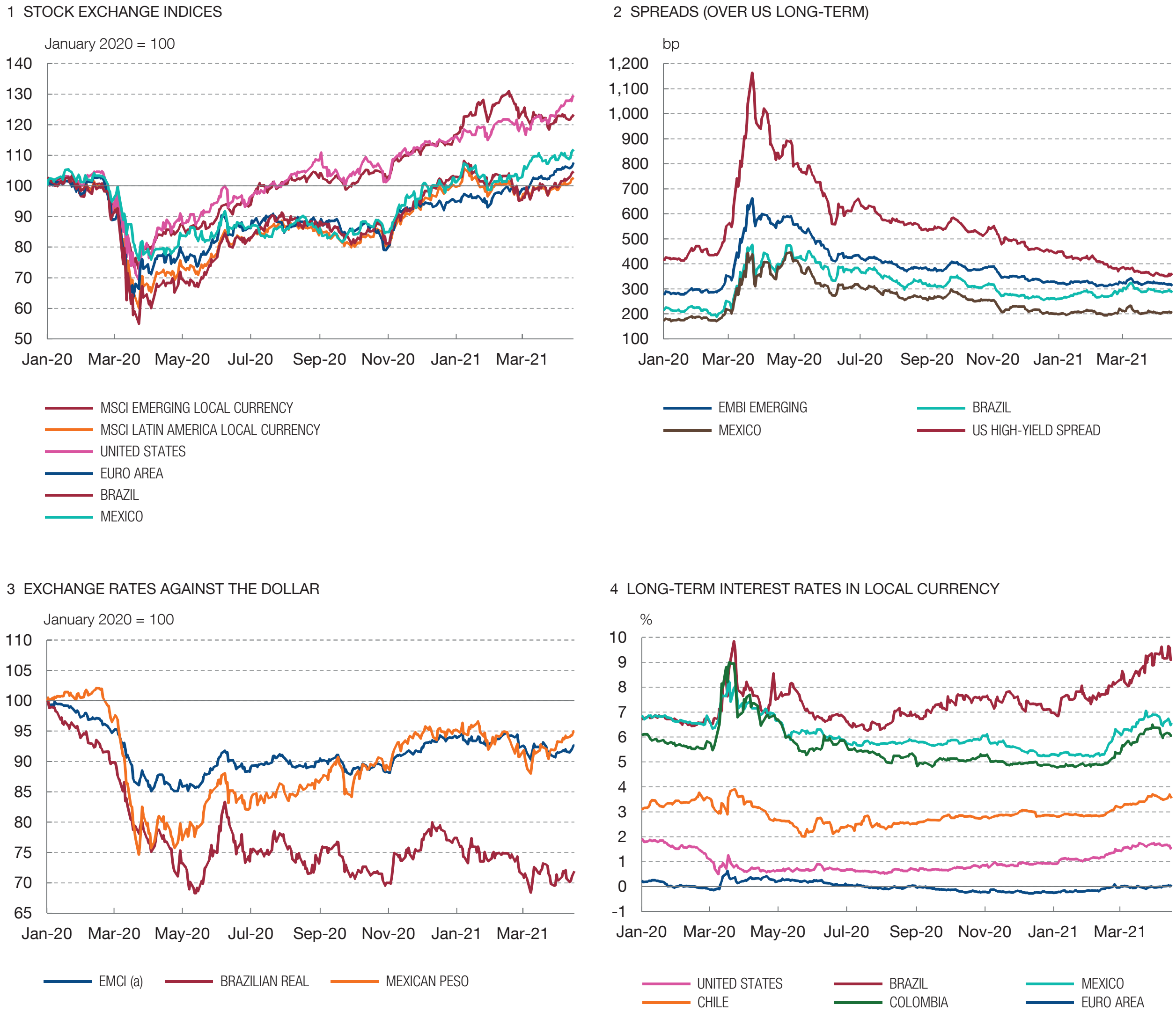
by end-2020 the recovery of portfolio capital inflows to these economies had more than offset the initial outflows (see Chart 4.7). A large part of these new capital inflows took the form of debt purchases, as exemplified by the debt securities issuances on the international markets, which increased in the emerging economies as a whole (see Chart 4.8).

Chart 4

LATIN AMERICAN FINANCIAL MARKETS

The Latin American financial markets rose sharply from November 2020, thanks to the dissipation of the uncertainty over the US elections and the positive news on vaccines. However, from February the rise in long-term interest rates in the advanced economies passed through to the emerging markets. Portfolio capital flows recovered in 2020 H2, with many taking the form of purchases of debt issued by these emerging economies.



SOURCES: Refinitiv, Dealogic and Banco de España.

a Emerging economies aggregate exchange rate.

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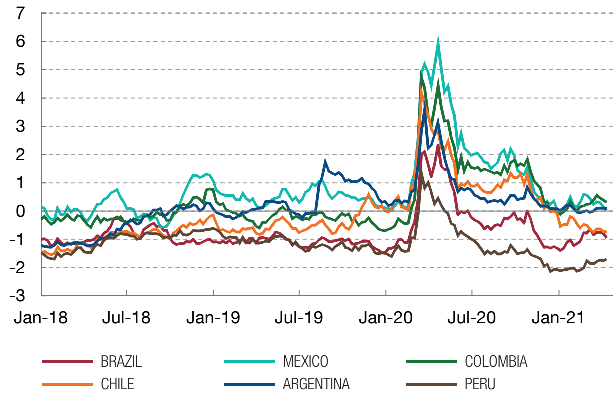
However, in 2021 to date, long-term interest rates have risen in the advanced economies, particularly in the United States, and the dollar has appreciated. These two factors have resulted in a similar increase in market yields in the region, especially in Brazil (see Chart 4.4), and in other major emerging economies such as Turkey, Russia and Indonesia. This has led to a certain tightening of financial conditions and, in some cases, heightened financial stress (see Charts 4.5 and 4.6). In addition, since end-January 2021 portfolio capital inflows have fallen and, in some countries, even appear to have reversed.

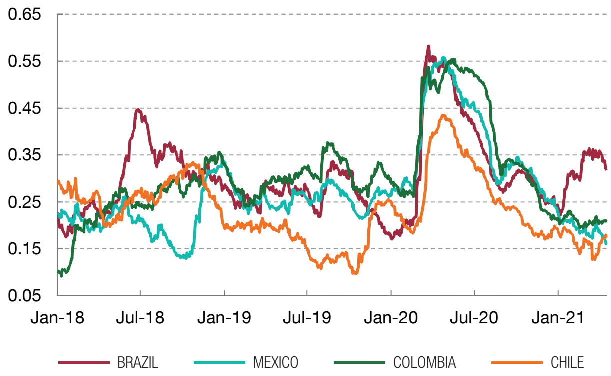
Chart 4
LATIN AMERICAN MARKETS (cont'd)

The Latin American financial markets rose sharply from November 2020, thanks to the dissipation of the uncertainty over the US elections and the positive news on vaccines. However, from February the rise in long-term interest rates in the advanced economies passed through to the emerging markets. Portfolio capital flows recovered in 2020 H2, with many taking the form of purchases of debt issued by these emerging economies.

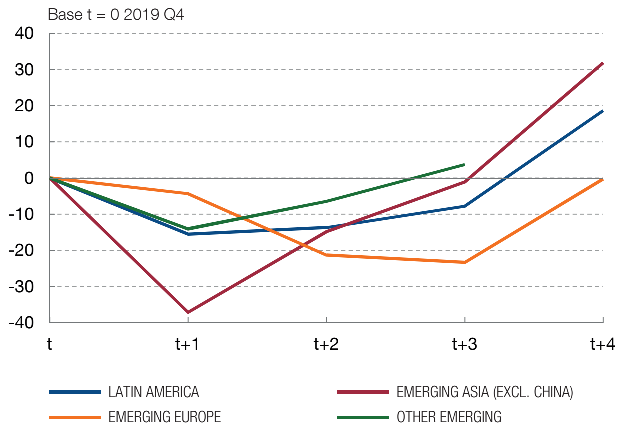
5 FINANCIAL CONDITION INDICES (b)



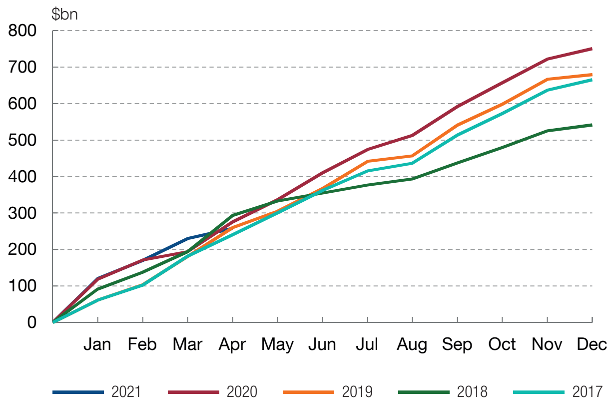
6 FINANCIAL STRESS INDICES



7 PORTFOLIO CAPITAL FLOWS TO EMERGING MARKETS DURING THE PANDEMIC ($bn)



8 EMERGING ECONOMIES' FIXED-INCOME ISSUES IN INTERNATIONAL MARKETS ($bn, cumulative)



SOURCES: Refinitiv, Dealogic and Banco de España.

b An increase denotes a tightening in financial conditions.

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Against this macro-financial backdrop, the region's banking systems remain healthy, although some indicators have started to feel the effects of the persistence of the crisis

The Banco de España has identified five Latin American countries (Mexico, Brazil, Chile, Peru and Colombia) as "material", i.e. they could represent a greater risk owing to the proportion of the Spanish banking system's exposures.[9] The policies launched to support the banking sector since the onset of the pandemic have been similar in all countries, albeit with some differences. Specifically, these measures sought three

9 See Box 2 in Banco de España (2020c).

aims: to support the flow of credit to economic agents, to provide liquidity to the system, and to mitigate the possible impact of the crisis on banks' capital ratios. In some cases, these measures either remain in force or have been renewed or replaced by similar measures.[10]

The latest data show that credit to the private sector continues to expand, albeit more moderately than in 2020 H1, except in Mexico, the only country not to launch a specific scheme to support lending and the only one where private credit is decreasing (see Chart 5.1). The general slowdown has been observed particularly in business loans. By country, lending is more buoyant in Brazil, where public-sector banks have started to contribute positively to credit growth, and in Peru, which has one of the largest state-backed loan schemes in the region. There has also been a process of loan dedollarisation across the region.[11] The increase in credit was largely financed by deposits, which were highly buoyant, as discussed above (see, again, Chart 3.4), and by debt securities issuances by banks on the international markets, which rose in all countries compared with 2019.

The system's liquidity increased, driven by asset purchases and other programmes launched by central banks. Further, capital ratios improved in 2020 Q3 and Q4, despite the increase in risk-weighted assets, again thanks to the various macroprudential measures adopted (see Chart 5.2). Financial institutions' profitability fell, chiefly on account of the decline in net interest income, historically low interest rates and an increase in provisions, in anticipation of the deterioration in loan portfolios (see Chart 5.3). Thus, as was expected given that the maturities of the deferrals for non-performance were in general concentrated in 2020 H2, non-performing loans (NPLs) began to increase in most countries of the region, although they remain at low levels in Colombia (see Chart 5.4). The notable exception is Brazil, where the NPL ratio declined in all tranches, especially in the case of those earmarked by the authorities for public and private sector bank loans. Lastly, net liabilities to the rest of the world also fell in 2020 H2, tempering the balance sheet risks of an exchange rate depreciation.

In short, although the region's banking sector seems to have withstood the initial impact of the pandemic, and its vulnerability has not deteriorated excessively, the future is not risk-free, considering that the support programmes will gradually expire and the loose internal and external financing conditions could potentially become tighter.

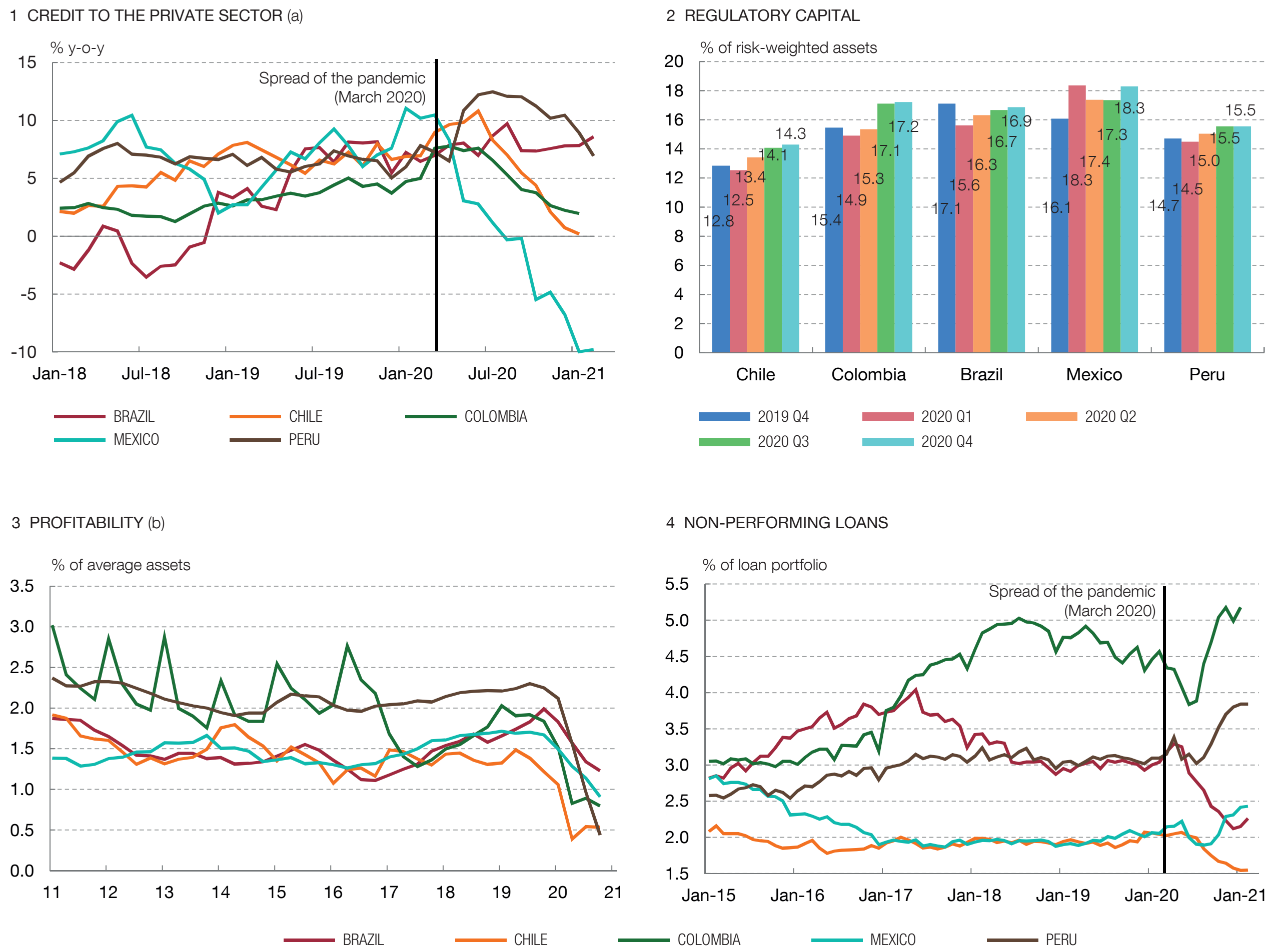
10 At the cut-off date for this report, the liquidity injection programmes continue to be in force in all countries, while loan reschedulings and guarantee schemes remain in force in some countries. For example, in Peru the *Plan Reactiva Perú* guarantee scheme expired in late November, although rescheduling of the loans granted under this plan has been permitted. In Brazil, a credit support programme has recently been renewed, and the possibility of resuming another programme, which expired in late 2020, is being debated in the Senate. In Mexico, new loan rescheduling measures have been announced, although the eligibility requirements have not yet been detailed. In addition, the Banco Central de Chile launched phase three of the financing facility conditional upon increased bank credit (FCIC 3) in January.

11 Bank credit to the private sector in foreign currency posted negative rates of growth in Chile and Mexico, while in Peru, the rate of dollarisation of such credit stood at 22% at end-2020, a decline of 4 pp on end-2019.

Chart 5

RECENT PERFORMANCE OF THE LATIN AMERICAN BANKING SYSTEMS MOST RELEVANT FOR THE SPANISH BANKING SECTOR

Real credit continues to grow in all countries, except in Mexico, although the pace of growth has slowed owing to the decline in business loans. Non-performing loans (NPLs) have increased in most countries of the region, although the levels are still low. Capital levels have remained above the regulatory minimum, and even rose in Q4, while profitability continues to decline on account of lower net interest income and higher provisioning.



SOURCES: National statistics, Refinitiv, IHS Markit and IMF.

a In real terms.
b Return on average assets (ROA).

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Going forward, the strength of the recovery will hinge on the future course and control of the pandemic and its domestic impact, foreign demand, the degree of support from economic policies and the maintenance of accommodative global financial conditions

As mentioned above, the Latin American economies have benefited from external factors that, in general, have performed better than expected. In this regard, the economic outlook for two of the region's closest trading partners (the United States and China) has been revised upwards for 2021 H2 and 2022. Commodity futures prices are higher than those factored in a few months ago, underpinned chiefly by this improved global economic outlook. In turn, if the accommodative financial conditions are to continue, the transitory nature of the recent rise in interest rates at the longer end of the curve and the dollar appreciation will have to be confirmed, and the portfolio capital flows maintained.

Turning to domestic factors, the main determinant continues to be the course of the pandemic. Overcoming the health crisis would lead to economic activity returning to normal and, potentially, the use of the liquidity buffers that have been built up by households, as mentioned above. Consequently, making progress in vaccinations is of crucial importance. At the cut-off date for this report, at least one dose of a COVID-19 vaccine had been given to nearly 40% of the population in Chile, somewhat more than 8% in Brazil and Argentina, around 6% in Mexico and less than 5% in Colombia and Peru. The average in the advanced economies was around 22% of the population, whereas in the emerging economies as a whole, it stood at 6% (see Chart 6.1). The vaccines acquired by the countries to date would be sufficient to vaccinate between 50% (Mexico) and 250% (Chile) of the population at end-year (see, again, Chart 6.1). This, together with the degree of natural immunity of those people who have recovered from the disease, could lead to major progress in controlling the health crisis this year, if the vaccines retain their effectiveness. Nevertheless, if more decisive progress is to be made, there needs to be a significant increase both in the pace of administering vaccines and in their availability across virtually the entire region, particularly in those countries that have not yet contracted enough doses to vaccinate the entire population.

As regards economic policies, and as discussed in more detail below, the possibility of adopting additional stimuli is more limited than a year earlier. Monetary policy faces some tightening in global financial conditions and an increase in inflation and inflation expectations in some countries. Indeed, the Brazilian central bank has recently raised its benchmark interest rate, while others, such as the Mexican central bank, have halted their monetary easing cycle. Moreover, central banks with inflation targets have, in general, seen that the financial markets and surveys expect the first policy rate hike to be slightly earlier. Fiscal space has also shrunk notably, doing so sharply in some countries (such as Brazil) where public debt levels have increased significantly.

Taking all of these factors into account, the IMF's latest forecasts[12] consider that Latin America will post growth of 4.6% in 2021 and 3.1% in 2022 (see, again, Chart 2.3). The noteworthy dispersion in the GDP growth rates projected for the region's various economies in 2021 (see Chart 2.4), which range from 3.7% for Brazil to 8.5% for Peru, is determined by the varying strength of the factors described above in the different countries. Specifically, these include differences in: sectoral structure (for instance, the high relevance of tourism for Mexico); dependence on

12 See IMF (2021a).

commodity prices, such as copper (Chile and Peru), oil (Colombia) and certain agricultural products (Argentina and Brazil); the monetary and fiscal policy space available (more limited in Brazil); and the degree of trade openness. Regarding the latter, those countries that are less open to trade and less integrated into global value chains (in particular Argentina and Brazil) will benefit to a lesser extent from the global recovery than other more open economies in the region (such as Chile and Peru, which would benefit mainly from the recovery in China, and Mexico, from the recovery in the United States). The robustness of the projected recovery is also linked to the differing intensity of the fall in 2020 which, as mentioned above, was highly uneven across countries.

On these forecasts, Latin American GDP would return to pre-crisis levels in 2022, even though several of its main economies, such as Argentina and Mexico, are expected to lag behind. Thus, the region would see a relative loss of GDP compared with other emerging economies (excluding China), whose GDP in 2022 is expected to be 7% higher than before the pandemic. This weaker relative performance would be added to that already posted in the previous five-year period: in 2014-2019, cumulative GDP growth for Latin America was somewhat less than 4%, compared with more than 27% for the other emerging economies (excluding China). Indeed, economies such as Argentina and Brazil had a lower GDP in 2019 than in 2013. This situation reaffirms the need to set in train a broad programme of structural reforms that enable the region to achieve higher potential growth, especially through sustained productivity gains.[13]

In any event, the uncertainty surrounding this economic outlook is very high. Accordingly, set out below is a series of risk scenarios grouped into two blocks. The first provides the hypothetical impacts on activity of the materialisation of different epidemiological scenarios. The second envisages a series of macro-financial risks, based on a scenario of gradual recovery from the disease.

The main sources of uncertainty associated with the pandemic relate to how fast the vaccine is rolled out and its effectiveness

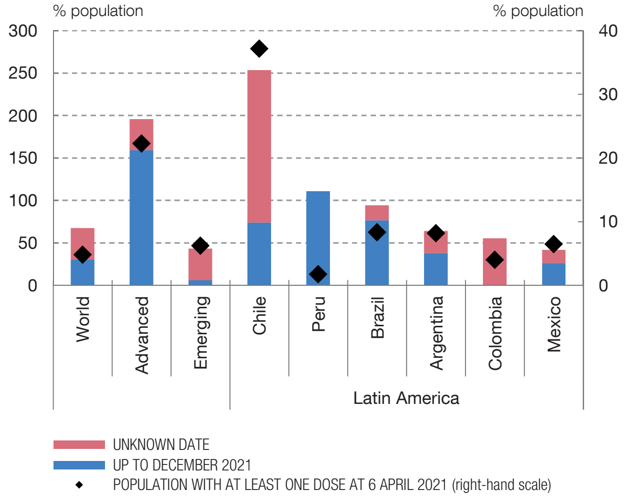
The most likely scenario at present, in which COVID-19 is brought under control in 2021, is also uncertain, given the potential delays in the medical solution at global level. Specifically, the possibility that the plans cannot be carried out within the time frames envisaged cannot be ruled out. Of particular concern is the potential loss of immunity to the virus owing to the emergence of new variants, including some that are potentially more contagious and deadly. This could reduce the effectiveness of the current vaccines and the natural immunity acquired to date, and could necessitate the introduction of new containment measures.

13 See Banco de España (2020e).

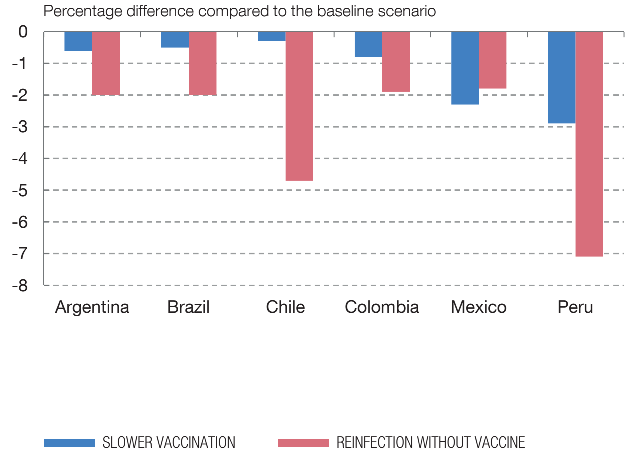
Chart 6
EPIDEMIOLOGICAL DEVELOPMENTS

The main uncertainties for the coming months in relation to the pandemic are the pace of vaccination, which has so far been uneven across the main economies of the region, and the effectiveness of vaccines against possible outbreaks of more aggressive variants that could even result in loss of immunity. The economic impacts under scenarios of a slower vaccine rollout or, particularly, of a loss of immunity could be substantial for some economies of the region.

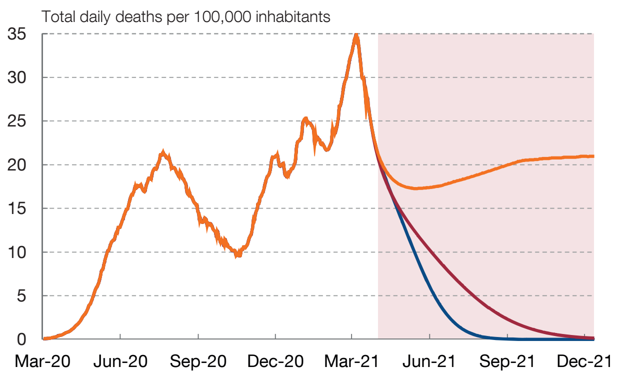
1 VACCINES AGREED WITH PHARMACEUTICAL COMPANIES AND VACCINES ADMINISTERED



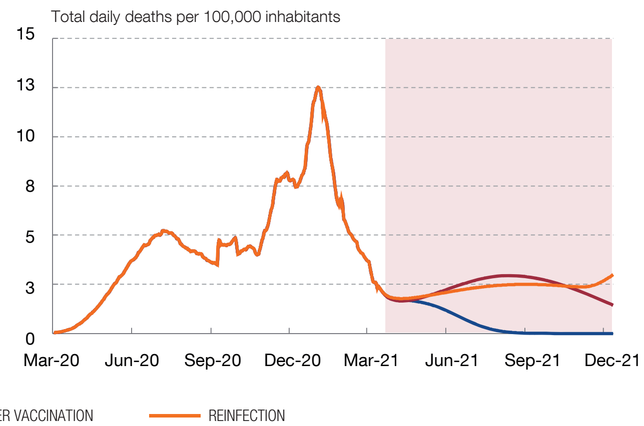
2 IMPACT OF DIFFERENT EPIDEMIOLOGICAL SCENARIOS ON GDP IN 2021 (a)



3 SCENARIOS FOR THE COURSE OF THE PANDEMIC IN BRAZIL (b)



4 SCENARIOS FOR THE COURSE OF THE PANDEMIC IN MEXICO (b)



SOURCES: Bloomberg, Duke Global Health Innovation Center, Our World in Data, COVID-19 INED and Rungcharoenkitkul (2021).

a Deviation from a baseline scenario in which the pandemic is gradually overcome.
b Scenarios considered by Rungcharoenkitkul (2021). The "baseline" scenario assumes steady vaccinations at a pace that will deplete all contracted dosages by end of 2021. The “slower vaccination” scenario considers the vaccination proceeding at a third of the baseline pace. The “reinfection” scenario assumes loss of immunity 60 days after infection or vaccination.

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To assess the hypothetical economic impact of some of these epidemiological risks, Charts 6.2 to 6.4 show alternative scenarios prepared using an epidemiological model.[14] Chart 6.2 shows the GDP losses for the six largest Latin American

14 The model of Rungcharoenkitkul (2021) is used. This is a susceptible-exposed-infectious-recovered (SEIR)-type epidemiological model that describes the pandemic evolution conditional on society’s mobility choice. The reduction in mobility is translated into losses in GDP terms using country-specific conversion factors, assuming a linear relationship between the two. The factors are the ratios of the cumulative revisions of growth forecasts

economies under two adverse scenarios compared with a baseline scenario (which assumes that the pandemic is overcome gradually).[15] Specifically, following Rungcharoenkitkul (2021), a "slower vaccination" scenario considers the vaccination proceeding at a third of the baseline pace, whereas a "reinfection" scenario assumes a loss of immunity 60 days after infection or vaccination. Under the "slower vaccination" scenario, the output losses in 2021 would range from 3% in Peru to somewhat less than 0.5% in Chile and are inversely related to the intensity of the vaccination progress observed to date and to the part of the population that has acquired natural immunity after having recovered from the virus. Under the "reinfection" scenario, the impacts would be substantially higher, from 2 pp to 7 pp of GDP, with very pronounced adverse developments on account of the share of the population susceptible to reinfection; in this case, the advantages of the vaccination processes are reduced.

Notable among the macro-financial risks are a potential increase in financial stress, a new fiscal stimulus plan in the United States, the materialisation of adverse effects on potential growth and heightened social unrest

Drawing on a baseline scenario similar to that envisaged by the analysts' consensus, several macro-financial risk scenarios are considered (see Box 1). First, temporary increased stress in the financial markets and heightened uncertainty over economic policies are simulated. Second, a scenario is considered under which approval is given to the new US fiscal package for public investment announced on 31 March. Lastly, a scenario is considered which assumes that the pandemic has permanent downside effects on the factors driving the level of long-term output (labour and capital), on the degree of efficiency in how these are combined (which determines the total productivity of these factors) and, therefore, on growth capacity. All the exercises are restricted to the two largest economies, Brazil and Mexico, where the Spanish banking system's largest exposures in the region are located.

The main results of these exercises are set out in Chart 7. A temporary increase in economic policy and financial uncertainty would lead to lower GDP growth in both 2021 and 2022, with a larger impact on Mexico, given its greater sensitivity to this variable. The cumulative output losses in Mexico and Brazil would be somewhat higher than 1.5% and 1%, respectively. If a new fiscal plan were launched in the United States from the end of the year, and assuming that monetary policy does not tighten in that country, GDP growth would be higher, especially in 2022. In addition, the positive effect on growth would be greater for Mexico because over 80% of its exports go to the United States, and its economy is much more open than Brazil's.

for 2020 (the difference between consensus GDP growth forecasts for 2020 made at the end of 2020 and those made at the start of the year) and the decline in average mobility during 2020.

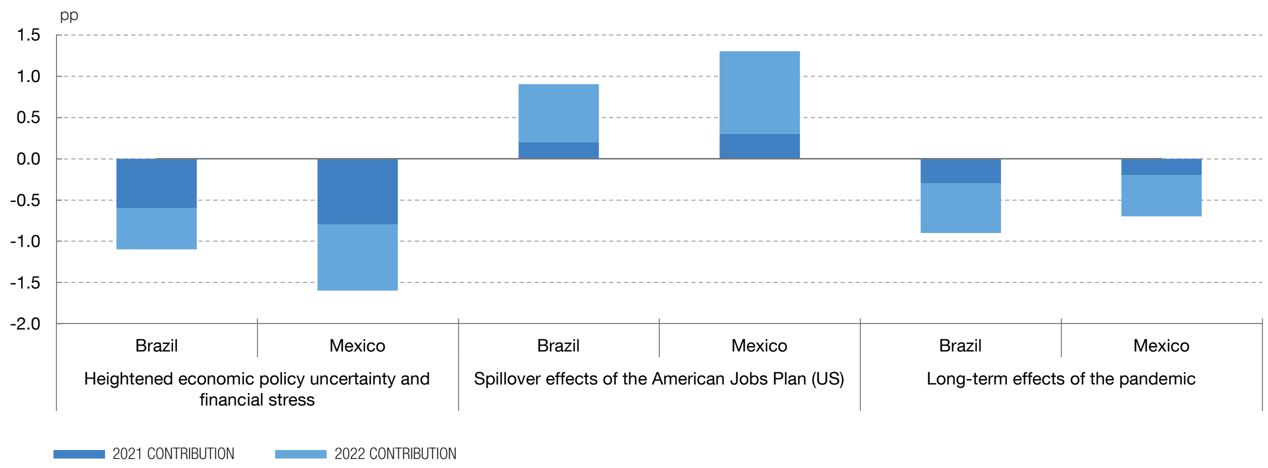
15 Specifically, in line with Rungcharoenkitkul (2021), it assumes steady vaccinations at a pace that will deplete all contracted dosages by end of 2021.

Chart 7

RISK SCENARIOS FOR MACROECONOMIC DEVELOPMENTS IN BRAZIL AND MEXICO

Under the assumption that the pandemic will be gradually overcome, three macro-financial scenarios of opposite signs (a temporary increase in financial stress and economic policy uncertainty, a new fiscal stimulus plan in the United States and the materialisation of permanent adverse effects of the pandemic on potential growth) are considered for the Brazilian and Mexican economies in 2021 and 2022.

GDP CUMULATIVE CHANGE IN 2021-2022 FOR EACH SCENARIO AND COUNTRY (a)



SOURCE: Banco de España.

a Deviation from the projections of the baseline scenario.

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Specifically, GDP would grow in cumulative terms by nearly 1.5 pp and 1 pp in Mexico and Brazil, respectively, in 2021-2022. Lastly, under the scenario that envisages permanent downside effects of the pandemic on long-term growth, the output loss in 2021-2022 would be close to 1 pp in Brazil and somewhat less in Mexico.

An added element of uncertainty for the region not considered in the foregoing exercises relates to the numerous legislative and presidential elections scheduled for this year and next. These will be held in a context of wide-ranging social unrest, as shown by the protests and demonstrations in 2019 H2, which could have been temporarily masked by the current health crisis. These social tensions could intensify on account of the notable downturn in the labour markets and the worsening of some tendencies that had been perceived before the pandemic, such as growing income and wealth inequality and increasing poverty. In this regard, in 2020 poverty rose by 3.2 pp to 33.7% of the population, while extreme poverty rose by 0.8 pp to 12.5% of the population (see Chart 8.1), causing reversals in the decline in poverty observed over the last two decades.[16] This could undermine support for institutions in the region (see Chart 8.2), against a backdrop of high political polarisation and lower stability (see Charts 8.3 and 8.4).

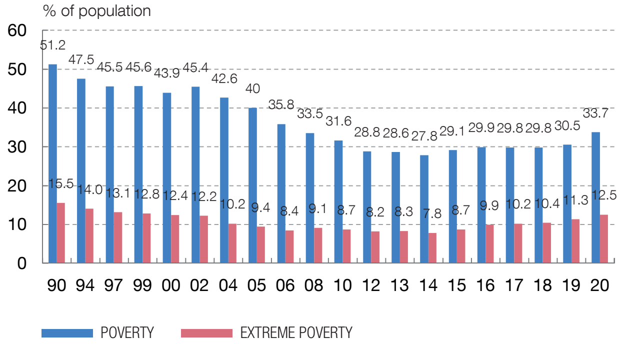
16 See Economic Commission for Latin America and the Caribbean (2021).

Chart 8

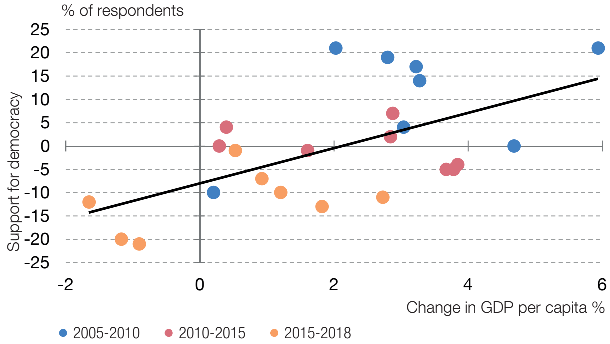
SOCIAL UNREST

In 2020, the region suffered a marked deterioration in terms of poverty. This situation, together with decline of GDP per capita, could undermine support for democratic institutions in the region, against a backdrop of high political polarisation and lower political stability. Uncertainty surrounding the future course of economic policies remains high, especially in Chile, Peru and Colombia. This could have an adverse impact on economic activity in the area.

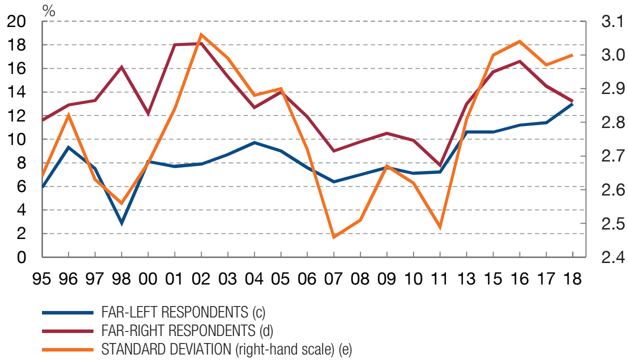
1 LATIN AMERICA. PEOPLE LIVING IN POVERTY AND EXTREME POVERTY (1990-2020)



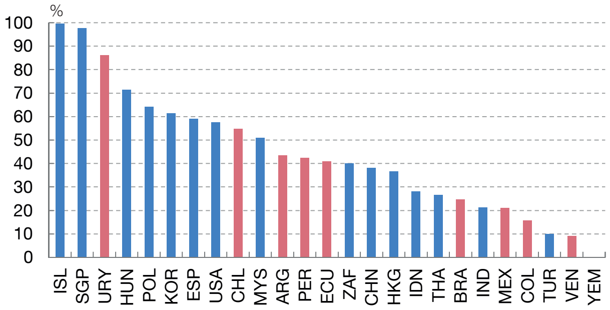
2 GROWTH IN GDP PER CAPITA (a) AND SUPPORT FOR DEMOCRACY (b)



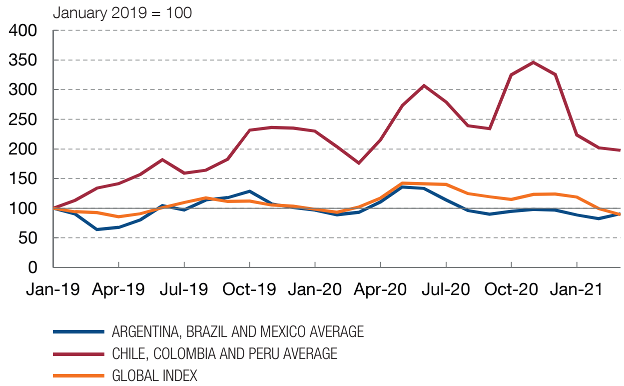
3 POLITICAL POLARISATION



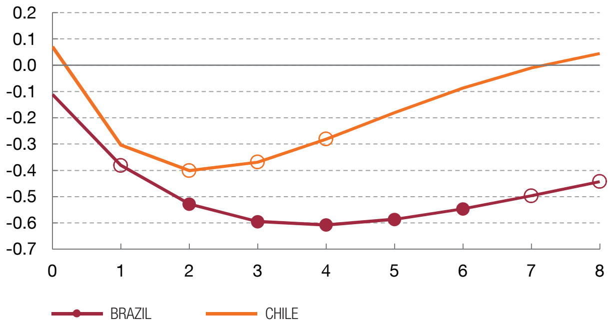
4 PERCENTILE IN THE WORLD BANK'S RANKING ON POLITICAL STABILITY AND ABSENCE OF VIOLENCE (2019) (f)



5 ECONOMIC POLICY UNCERTAINTY INDEX (g)



6 IMPULSE RESPONSE FUNCTIONS OF GDP TO CHANGES IN ECONOMIC UNCERTAINTY (h)



SOURCES: CEPAL, World Bank, 2018 Latinobarómetro and Banco de España (based on Ghirelli, Pérez and Urtasun (2020)).

a Average changes in GDP per capita in constant dollars in the five-year period. Eight largest economies, excluding Venezuela.
b Change in the share of respondents stating that "Democracy is preferable to any other form of government" between the dates indicated. The data correspond to 2018, since the 2019 survey could not be conducted due to the COVID-19 crisis.
c Respondents who place themselves at levels 0 and 1 in the question: "In politics we usually talk about left and right. On a scale where 0 is left and 10 is right, where would you place yourself?".
d Respondents who place themselves at levels 9 and 10 in the question: "In politics we usually talk about left and right. On a scale where 0 is left and 10 is right, where would you place yourself?".
e Standard deviation of all the answers to the question on the political scale.
f A higher percentile indicates a better position in the ranking.
g Quarterly moving average of the indicator that is constructed on the basis of the number of articles published in the Spanish press that contain a set of words related to the concept of economic policy uncertainty (EPU).
h GDP response to an increase in the standard deviation of economic uncertainty, measured by the EPU described in footnote g. Filled circles indicate a 5% significance, unfilled circles indicate a 10% significance and lines with no marks indicate a lack of significance at conventional levels.

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Apart from the economic costs that potential episodes of social and political tension could have in the short term, uncertainty surrounding the future course of economic policies remains high (see Chart 8.5). This could negatively influence the possibility of implementing institutional and economic reform agendas that would help provide a solution to the region's structural problems, in addition to having an adverse impact on economic activity (see Chart 8.6).

Against this backdrop of high uncertainty, however, the region has fewer structural vulnerabilities than in previous episodes of turmoil

As can be seen in Chart 9, according to a wide range of indicators, the vulnerability of the region's economies is lower in certain aspects than in past episodes of financial turmoil. Thus, for example, at end-2020, these economies had a more favourable current account balance (although, as indicated, this could have a temporary component owing to the pandemic's impact on savings), higher international reserves, lower inflation and exchange rates more in line with their historical average. However, the volume of external and domestic debt, be it public or private debt, is now significantly higher. In general, international investors' participation in local markets is lower, which would reduce the risk of portfolio capital outflows in the event of turmoil, but it could hamper the placement of new liabilities.

In a broader sense, the region's vulnerability does not appear to have worsened substantially during the health crisis (see Table 2),[17] except in the fiscal arena, particularly in the case of Brazil, which is in the upper range of risks in comparison with other emerging economies. The deterioration in macroeconomic variables has also been significant owing to the collapse of growth rates, and institutional uncertainty remains at high levels, as reflected by the political risk and institutional quality indicators across most of the region. By contrast, both the external sector and the banking sector maintain moderate levels of vulnerability, underpinned by the public support programmes and the regulatory and macroprudential measures.

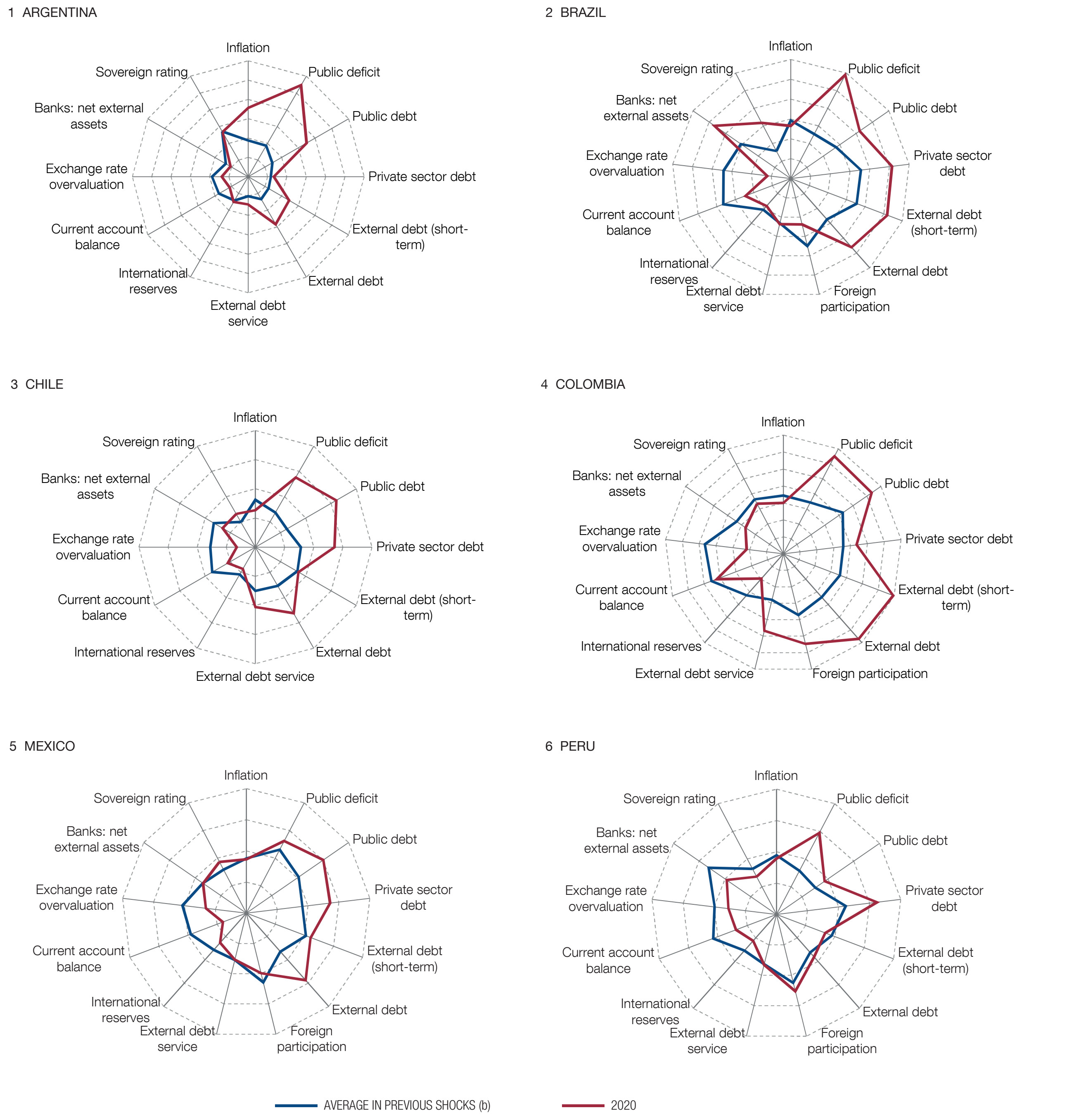
In order to withstand possible adverse scenarios, the role of domestic economic policies is essential, although both monetary and fiscal headroom could be decreasing

In the case of monetary policy, and against a backdrop of ongoing subdued inflation (see Chart 10.1) and anchored inflation expectations (see Chart 10.2), central banks

17 These heatmaps draw on the percentiles for each indicator at each moment of time in a frequency distribution of the time series (for each country from 1993 to 2020) and at cross-section level (comparing it with another 16 emerging economies at the same moment of time). Different colours are assigned, from red (the greatest risk) to green (very low risk). For more details about the methodology and the usefulness of the maps, see Alonso and Molina (2021).

Chart 9
VULNERABILITY INDICATORS (a)

Overall, the largest Latin American economies have a more deteriorated fiscal stance than in previous times of turmoil, along with higher levels of external, private and public debt. However, the region registered lower external imbalances, as measured by the current account balance, and a smaller exchange rate overvaluation, combined with higher reserves and reduced inflation.



SOURCE: Banco de España.

a Standardised series. A line closer to the origin represents less vulnerability.
b Average of 2008 Q3 data (global financial crisis), 2013 Q1 (taper tantrum) and 2015 Q2 (Chinese stock market crash).

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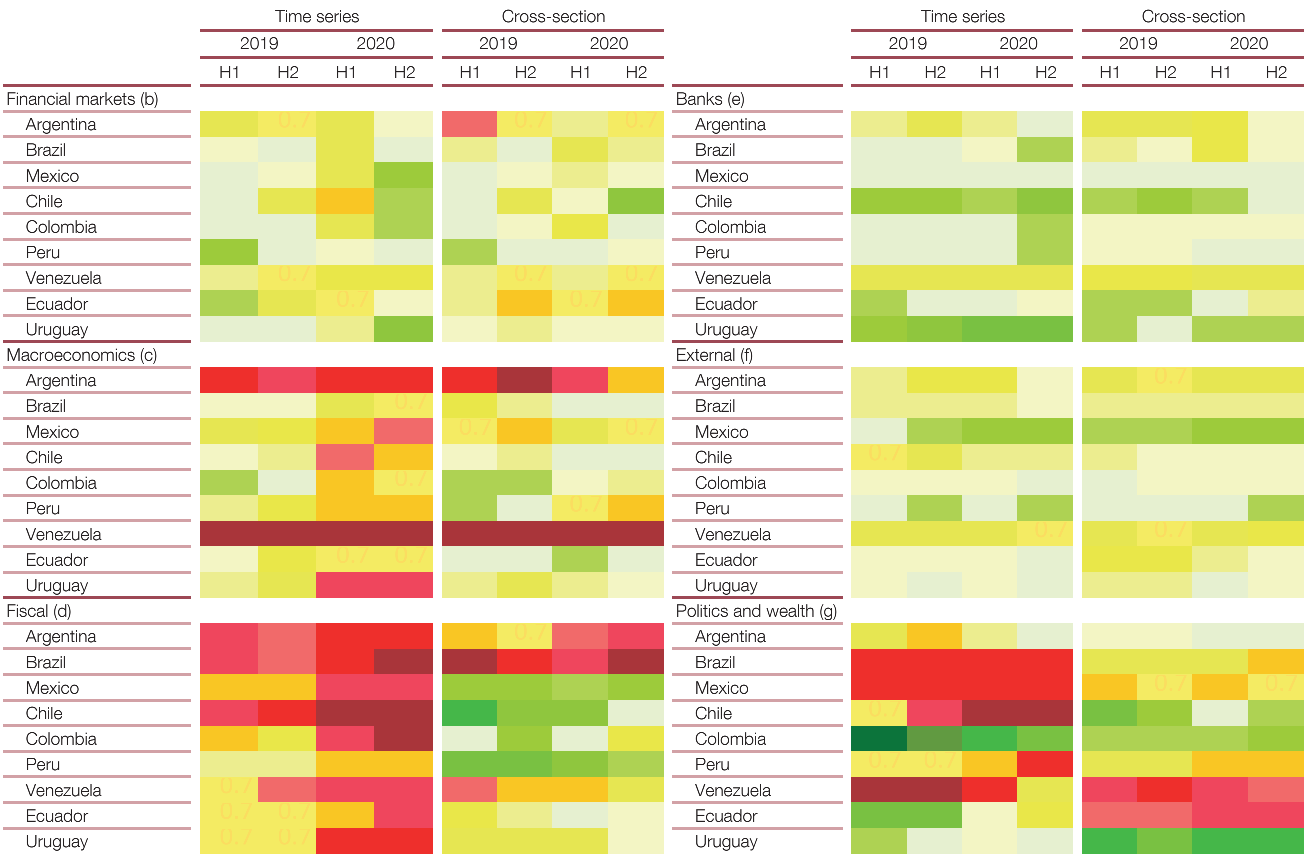
Table 2
LATIN AMERICA: VULNERABILITY SITUATION (a)



SOURCE: Alonso and Molina (2021).

- **a** The risk level is indicated with shades of green (associated with lower levels of vulnerability), yellow (medium vulnerability) and red (variables in the riskier percentiles).
- **b** Sovereign spread (level and quarterly change) and quarterly change in equity index and in exchange rate.
- **c** Change in GDP and industrial production, inflation rate and change in GDP per capita.
- **d** General government balance and gross public debt (% of GDP).
- **e** Real change in credit and deposits, loan-to-deposit ratio, non-performing loans, net foreign assets of banks, banks' equity index, interest rate on banks' external debt, qualitative indicators (BICRA / IHS Markit), short-term interbank rate and net interest income.
- **f** Current account balance, direct and portfolio investment inflows, external debt, short-term external debt and external debt service, and international reserves.
- **g** IHS Markit political risk indicator, geopolitical risk indicator and GDP per capita.

in the region implemented highly expansionary policies in 2020,[18] as mentioned above. This has reduced policy rates to all-time lows virtually across the board (see Charts 10.3 and 10.4), placing them, in real terms, in negative territory. It has also considerably increased the size of central banks' balance sheets (see Chart 10.5).

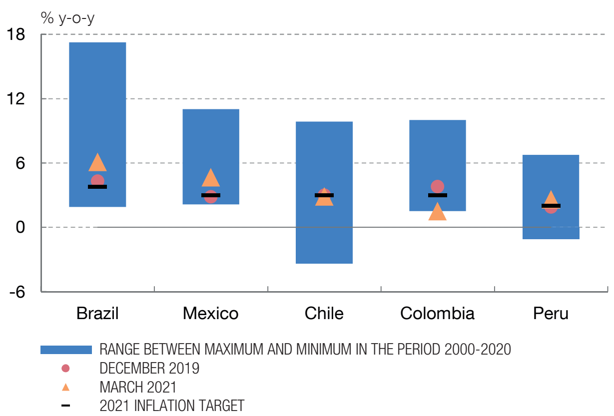
Consequently, the space for providing any necessary monetary stimulus measures in the future is narrowing. One of the variables that will have a decisive influence on the space available will be inflation. Inflationary pressures stemming from internal

18 See, for example, Banco de España (2020b), IMF (2021a), World Bank (2021a) and Inter-American Development Bank (2021).

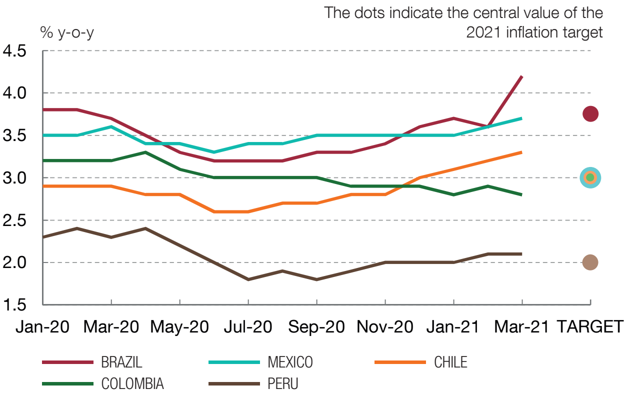
Chart 10
MONETARY POLICY

Against a backdrop of subdued inflation and anchored inflation expectations, central banks in the region implemented highly expansionary policies, with policy interest rates in many cases at all-time lows, negative real interest rates and other innovative measures for the region (asset purchases). This led to an increase in central banks' balance sheets. The recent rise in inflation and worsening expectations have led some countries to unwind (Brazil) or pause (Mexico) these expansionary policies.

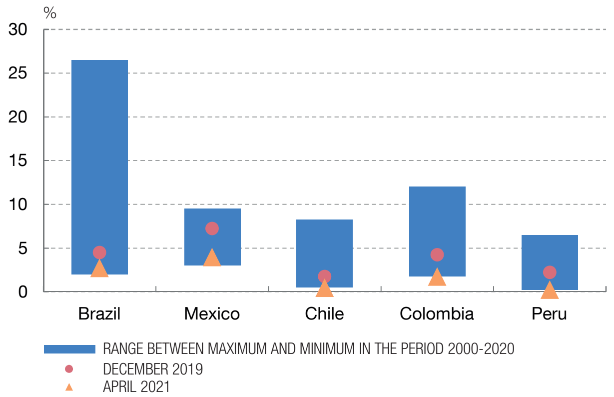
1 INFLATION (a)



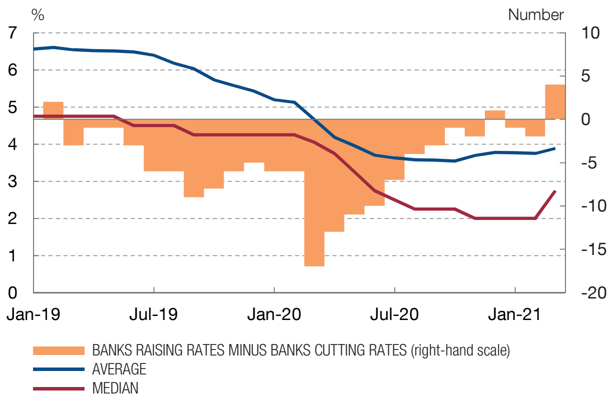
2 INFLATION EXPECTATIONS FOR DECEMBER 2021



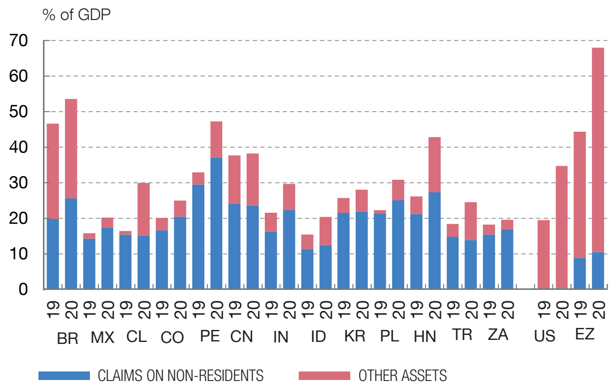
3 POLICY INTEREST RATE (a)



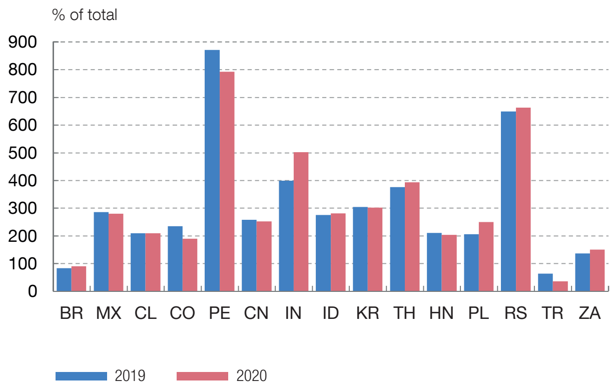
4 POLICY INTEREST RATES IN EMERGING ECONOMIES



5 CENTRAL BANKS' BALANCE SHEETS (% of GDP) (b)



6 RESERVES (% OF SHORT-TERM EXTERNAL DEBT) (b)



SOURCES: Refinitiv, Consensus Forecast and national statistics.

a The columns represent the range between the highest and lowest value in the period from 2000 to the latest available data.
b Data at the end of each year.

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conditions are low, given the economies' negative output gaps, which will foreseeably limit wage increases and corporate earnings. Nevertheless, in some of the region's countries with an inflation target, inflation increases have recently been observed in some items, especially in the more volatile ones, i.e. food and energy goods and services, which have a highly substantial weight in the economies concerned. This has led to a certain increase in inflation expectations in some countries (see Chart 10.2), which could spill over to non-core components, especially given that additional increases in the annual inflation rate are expected over the coming months. Indeed, this was the main reason given by the Brazilian central bank for initiating a cycle of policy rate hikes on 17 March 2021. The Mexican central bank halted its monetary easing cycle on 11 February 2021, as it considers there is a need to prompt an adjustment in relative prices without affecting price formation and inflation expectations. In this context, the financial markets have factored in some monetary policy tightening in the closing months of 2021 or the opening months of 2022.[19]

As shown above, external financing conditions have tightened in recent months, despite the developed economies' central banks maintaining their message that monetary policies will remain accommodative. This factor could also limit the possibility of further monetary stimulus measures being adopted in Latin America, if any were needed to cope with the materialisation of potential adverse scenarios, particularly in a context of desynchronisation of the region's economic situation from that of the main advanced economies. Moreover, if the recovery in other regions of the world were more dynamic or earlier than expected, investors could lose confidence in the resilience of Latin American economies, hampering the adoption of more accommodative monetary policies. Indeed, under such scenarios, the authorities might have to adopt more restrictive monetary policies, to meet their inflation targets and for reasons of financial stability. Nevertheless, in order to deal with a potential tightening of external financial conditions, other tools could also be used, such as foreign exchange interventions (see Chart 10.6) or greater financial asset purchases, which are new to the region and have proven to be effective.[20]

As regards fiscal policy, the significant response to the pandemic[21] and the slump in activity prompted a substantial increase in 2020 in the public deficit (up 4.8 pp, to 8.7% of GDP, see Table 1) and in public debt (up 9.2 pp, to 77.2% of GDP) across the region. The fiscal stimulus was also smoothed by the easing of fiscal rules, either by temporarily suspending them or by using escape clauses. In this regard, Brazil invoked an escape clause to exclude coronavirus-related public spending from the constitutional expenditure ceiling and lifted the obligation to comply with the primary

19 At the cut-off date for this report, the financial markets are factoring in an increase of around 250 basis points (bp) in Brazil's policy rate vis-à-vis its current level, over one year. In Chile, Colombia and Mexico, the magnitude of the policy rate hikes priced in for the same period would be around 100 bp, 125 bp and 75 bp, respectively.

20 Arslan, Drehmann and Hofmann (2020) show that bond purchases by emerging economies' central banks significantly reduced long-term government bond yields for a set of emerging economies.

21 See "Database of Country Fiscal Measures in Response to the Covid-19 Pandemic" in the Methodological and Statistical Appendix of IMF (2021b).

balance target in 2020, while Colombia and Peru temporarily suspended fiscal rules (despite, in the case of Peru, having escape clauses) and Chile and Mexico modified their fiscal targets.[22] Public finances are deteriorating across the board, albeit with notable heterogeneity (see Charts 11.1 and 11.2), as shown in a comparison between Brazil (budget deficit increase of 7.5 pp of GDP) and Mexico (3.5 pp), mainly on account of the difference in the amount of the fiscal stimuli implemented in each case.

Some countries, such as Chile and Peru, which have low public debt compared with other emerging economies, accumulated sovereign funds[23] and credit facilities available from the IMF, would have more space for adopting new fiscal stimuli in the future. Indeed, in March 2021 Chile approved a new fiscal package amounting to 2% of GDP. Nevertheless, the worsening of the main fiscal figures, which has pushed public debt positions to levels unprecedented in recent decades, together with the persistence of the crisis and some prior structural problems (such as the situation of the state-owned oil company PEMEX in Mexico), is, in some cases, increasing risk perception among investors and credit rating agencies as to the debt of some countries, such as Colombia, Brazil and Mexico. Indeed, in Colombia, for example, the Government has recently submitted draft legislation to Congress on increasing public revenue.

To illustrate the possible constraints on the fiscal space available in the region's two main economies, Brazil and Mexico, a stochastic analysis model of debt sustainability[24] is used to plot the simulated probabilities of these countries' public debt being above certain thresholds –in a range of 90% to 120% of GDP for Brazil and of 30% to 70% for Mexico – at the end of 2030 (see Charts 11.5 and 11.6). The probabilities are calculated for five scenarios. The first takes 2019 Q4 as its starting point for the simulations, to define a counterfactual scenario that reflects the analysis that would have been made just before the pandemic. The starting point taken for the other four scenarios is 2021 Q4, in accordance with the macroeconomic scenarios described in Box 1 (baseline scenario and three risk scenarios).

In the case of Brazil (see Chart 11.5), if the starting point taken is the baseline macro-financial scenario, public debt would be over 90% of GDP in 2030 (similar to the 89.2% observed in 2020) in nine out of ten simulations (probability of slightly more than 90%). This shows that there is a considerable risk that the current public debt levels, which are at all-time highs, will persist. In general, the alternative scenarios

22 See Box 1.3 in IMF (2021b).

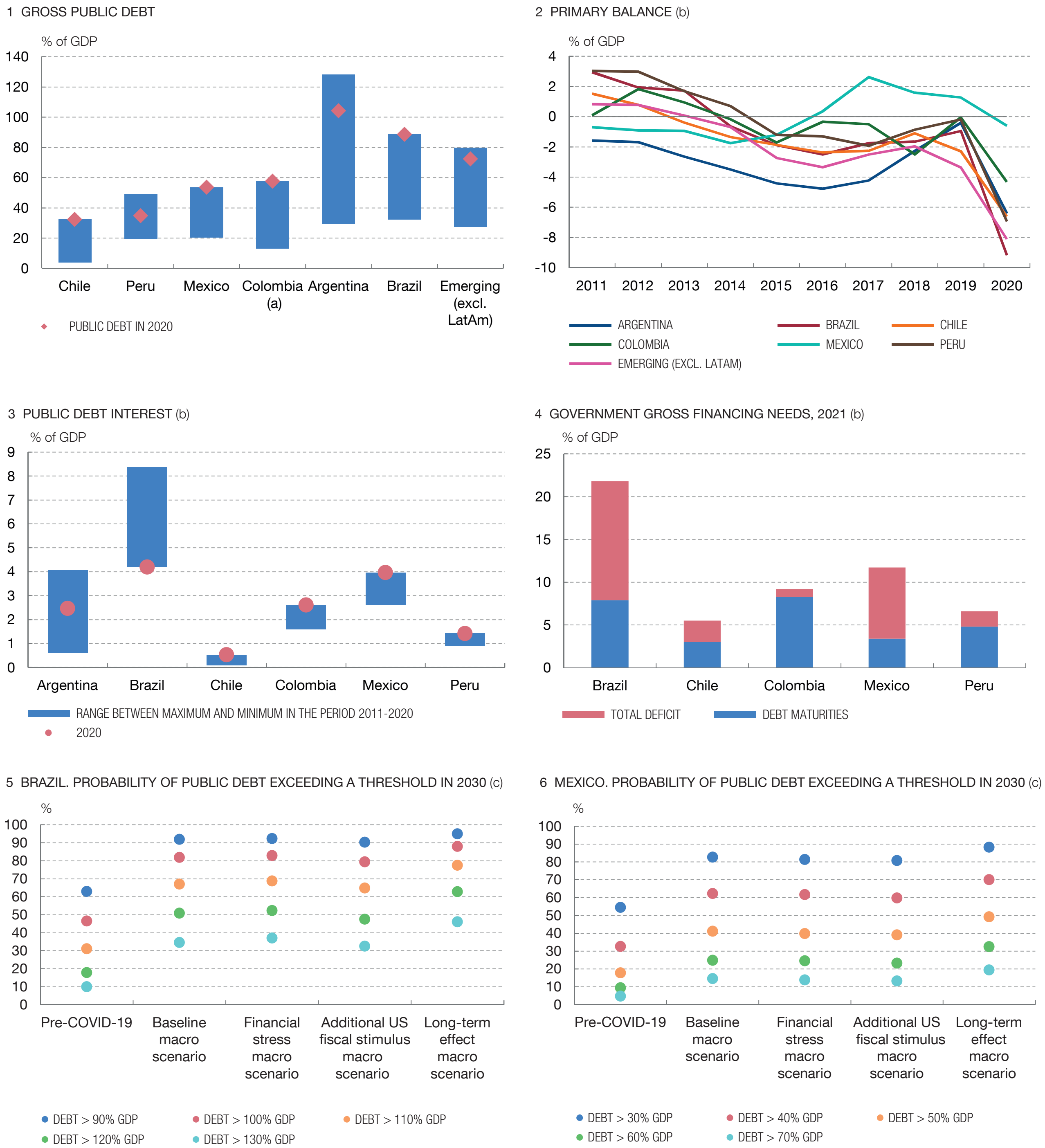
23 See Brunet, Cuadro and Pérez (2021).

24 See Alloza et al. (2020). The simulations are made using a stochastic analysis model of the sustainability of public finances. This allows for projection of future paths of both the budgetary variables (budget deficit and interest payments) and the macroeconomic variables (GDP, inflation and interest rates) that are key to calculating future public debt paths consistent with compliance with public sector budgetary constraints. In turn, the future paths projected (Montecarlo simulations) permit quantification of the range of the debt trajectories at different horizons, taking the assumptions in each scenario as the starting point.

Chart 11

FISCAL POLICY

The slump in activity and the response to the pandemic led to widespread, albeit uneven, deterioration in the region's public finances. Public debt was at all-time highs in many cases and financing needs in 2021 will be significant for Brazil. To illustrate future public debt developments in Brazil and Mexico, the simulated probabilities of debt being above certain thresholds at the end of 2030 are shown for a number of scenarios.



SOURCES: IMF, national statistics and Banco de España.

a Colombia: 2020 Q3.
b IMF data (April 2021 WEO).
c Each scenario is associated with a different initial debt-to-GDP ratio in 2021 Q4 (resulting from the simulations performed for that variable in each scenario over 2021). The dots express the probability of debt exceeding different thresholds in 2030, estimated using the methodology of Alloza et al. (2020) based on each of the scenarios.

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considered do not alter this assessment. Fiscal stress was already visible for Brazil in pre-pandemic data. In fact, on the data available up to 2019 Q4, the counterfactual probability estimated of public debt being over 90% of GDP in 2030 was around 60%, taking as a starting point the figure observed at that time of 74.2% of GDP.

In the case of Mexico (see Chart 11.6), taking the baseline macro-financial scenario, there is a 40% probability of public debt being over 50% of GDP in 2030. This indicates an expected underlying trajectory in which public debt would stabilise or decline in the medium term, given that in this scenario it is estimated that public debt would be around that level at end-2021. In general, the alternative scenarios considered do not alter this assessment. However, the probability of public debt being above the pre-pandemic level (43.8% of GDP in 2019) in the medium term has increased significantly compared with the underlying patterns at that time. In consequence, the probability of public debt being over 40% of GDP in 2030 increases from 30%, taking 2019 Q4 as a starting point for the simulations, to 60%-70% in the other scenarios.

In any event, these scenarios do not reflect various sources of uncertainty that might affect the outcome. Thus, exchange rate fluctuations could have important valuation effects, especially for Mexico.[25] Likewise, were contingent liabilities (such as possible bail-outs of state-owned companies) to materialise, this could increase public debt further than considered in this exercise.

If the national policy space is compromised, the role of the global and regional safety net once again becomes particularly important

The support available includes, first, the swap lines with the central banks of Brazil and Mexico and the FIMA Repo Facility provided by the Federal Reserve to boost the supply of dollars in the economies of the region and which has been particularly important in the last year. The Flexible Credit Lines (FCLs) granted by the IMF to Chile, Colombia, Mexico and Peru also play a fundamental role. Excluding the loan to Argentina,[26] financial aid to Latin America and the Caribbean accounts for 62% of all the credit lines. In December 2020, the Colombian government made a drawing of $5.4 billion under the FCL arrangement granted by the IMF, somewhat more than 30% of the total for Colombia. Other multilateral institutions, such as the World Bank, the CAF-Development Bank of Latin America, the Latin American Reserve Fund (FLAR) and the Inter-American Development Bank (IBD), are also playing an important

25 Some 25% of Mexican public debt is denominated in foreign currency.

26 The IMF maintains a Stand-By Arrangement with Argentina, approved before the present crisis, for a sum of $55.7 billion (almost thirteen times its quota), of which approximately $43.7 billion has been paid out (see Serra et al. (2018)).

role in easing the effects of the health crisis in Latin America. This includes a recent initiative to help the region improve its negotiating capacity for access to vaccines.[27]

Lastly, in view of the analysis presented here, it is considered that the complex economic situation and the challenges identified reinforce the need for economic and institutional reform agendas in Latin America to address the region's structural problems.

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27 https://www.iadb.org/en/news/idb-support-latin-america-and-caribbean-negotiate-faster-access-vaccines.

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Box 1

TECHNICAL ASSUMPTIONS OF THE BASELINE SCENARIO AND DESCRIPTION OF THE MACRO-FINANCIAL RISK SCENARIOS FOR BRAZIL AND MEXICO

The economic outlook for Latin America in the short and medium term, as for most countries and regions, is greatly affected by epidemiological developments. The high level of uncertainty surrounding these developments makes it advisable to treat the available projections with particular caution and to prepare alternative hypothetical scenarios on the future course of the pandemic, as in the main text of this report. Some elements of uncertainty could translate into a positive economic impact (e.g. owing to an improved vaccination process). In other cases, this impact could be negative (e.g. due to an increase in the number of infections). However, even under a scenario of gradual subsiding of the pandemic, there are other macro-financial risks that could affect the economic recovery profile of Latin America forecast by private and public institutions. This box attempts to reflect in broad terms the possible impact of some of these risks on the region's main economies (Brazil and Mexico). To this end it describes, first, a baseline scenario for the performance of these two economies in 2021 and 2022, under the assumption that the disease is gradually brought under control. Second, based on this scenario, three alternative scenarios are constructed focusing on possible transitory bouts of tension that may arise in the financial markets, the positive spillovers stemming from the approval of a new fiscal stimulus plan in the United States, and the emergence of potential permanent downward effects on long-term growth due to the impact of the pandemic.

The baseline scenario uses the available short-term economic information, referring mainly to the financial and economic activity indicators up to mid-March 2021. In Q1, a significant slowdown in activity is expected in Brazil (a 0.4% quarter-on-quarter fall, following the 3.2% rise in the previous quarter), given the adverse course of the pandemic and the signals from short-term indicators (particularly, industrial output, consumer confidence and retail sales). In Mexico, output is expected to remain unchanged in quarter-on-quarter terms (compared with 3.3% in 2020 Q4), as the positive effect of foreign demand appears to have been offset by weak domestic demand, partly associated with a tightening of restrictions in some states owing to the pandemic.

Crucially, beyond the short term, the baseline scenario is based on the assumption of gradual recovery of the epidemiological situation in the medium term. Over the three-year horizon, the forecast assumes a continued convergence towards a normal level of mobility and the complete removal of constraints on economic activity. At end-March, mobility in Brazil and Mexico was 16% and 9% below its pre-pandemic level, respectively. Thus, the scale of the impact on economic activity of a full recovery in mobility in the medium term is relatively small, in a setting in which, moreover, the correlation between the two variables (economic activity and mobility) has declined in recent quarters.

The baseline scenario is constructed on the basis of a series of technical assumptions,[1] shown in Table 1, relating to trends in oil prices, financial market volatility, policy interest rates, exchange rates, sovereign spreads and economic policy uncertainty indices.[2] Oil futures prices have risen significantly with respect to six months ago, from under $50 per barrel to prices exceeding the $60 per barrel threshold, in both 2021 and 2022. Financial market volatility increased in 2020 and the new assumptions expect some of this higher volatility to persist in 2021 and 2022. Among national financial variables, a higher-than-expected rise in Brazil's policy interest rate in March also drove up the future path of Brazilian policy interest rates. In Mexico, by contrast, the outlook for monetary policy remained stable and current forecasts envisage a modest appreciation of the currency.

Table 1 also shows the assumptions for foreign demand. In 2020 Q2 it grew faster than expected in October 2020 in both Mexico and Brazil; this is also reflected in this year's higher foreign demand growth rate. The more buoyant foreign demand is due to greater US demand, partly because of the estimated impact of the US fiscal stimulus package (the American Rescue Plan) approved

1 The baseline scenario is based on econometric models (BVAR). The basic econometric model comprises ten macro-financial variables. A distinction is drawn between global variables, such as foreign demand, oil prices, financial market uncertainty and US policy rates, and domestic variables affecting Brazil and Mexico. These are real GDP growth, core inflation, the exchange rate of the Brazilian real and the Mexican peso against the US dollar, dollar-denominated sovereign spreads of each country vis-à-vis US government debt, the economic policy uncertainty index and policy interest rates.

2 The technical assumptions are calculated following the methodology of the Eurosystem's macroeconomic projections exercises. The cut-off date used for calculating the paths of these variables is 18 March 2021.

on 11 March,[3] especially in the case of Mexico, along with the better outlook for other markets, particularly China.

The baseline scenarios obtained under these assumptions are shown in Chart 1. In Brazil, output is projected to grow by 4.2% in 2021 (after declining by 4.1% in 2020), which is in the upper range of analysts' forecasts, and by 2.2% in 2022. In the case of Mexico, the economy is expected to grow by 4.4% in 2021 (-8.5% in 2020), which is consistent with consensus forecasts, and by 2.5% in 2022. Despite the progress expected for both years, according to this scenario only Brazil would recover its pre-pandemic output level (at end-2021), while Mexico would still be almost 2% below its pre-pandemic level at the end of 2022. Compared to the previous half-yearly report,[4] annual growth forecasts have been revised down slightly for Brazil and up slightly for Mexico (see Chart 2 for a breakdown of the determinants of these revisions).

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

The baseline scenario rests on a series of technical assumptions that are based on the available short-term economic information. The projections are likewise based on the technical assumptions described here. The alternative scenarios are based on changes to one or several of the assumptions underlying the baseline scenario.

Annual rates of change, unless otherwise indicated		April 2021 projections (b) (c)		Difference between current assumptions and the October 2020 exercise assumptions (d)		
	2020	2021	2022	2020	2021	2022
International environment						
Foreign demand in Brazil (e)	-5.3	13.3	6.0	6.4	8.1	1.2
Foreign demand in Mexico (e)	-9.3	17.1	3.3	5.4	11.5	0.0
Oil price in dollars/barrel (level)	42.3	65.1	61.5	-1.2	17.6	12.4
Monetary and financial conditions						
Volatility of global financial markets (VIX) (level)	29.3	22.0	22.0	2.3	0.5	0.5
US policy interest rate (level) (f)	0.6	0.1	0.1	0.1	-0.1	-0.1
Brazil's policy interest rate (level) (f)	2.8	3.2	5.4	0.1	1.0	2.1
Mexico's policy interest rate (level) (f)	5.3	4.1	4.8	0.0	-0.1	0.4
Brazilian real/dollar exchange rate (level)	5.2	5.6	5.7	0.0	0.3	0.3
Mexican peso/dollar exchange rate (level)	21.5	20.7	20.8	-0.5	-1.7	-1.6

SOURCES: ECB, Thomson Reuters, JP Morgan, Chicago Board Options Exchange and Banco de España.

a Cut-off date for assumptions: 18 March 2021. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
b For the projection period, the figures in the table are technical assumptions based on the ECB's March projections or, in their absence, the Eurosystem's methodology for joint projection exercises. The assumptions regarding commodity or financial variables are based on futures markets prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.
c With respect to the previous exercise, the specification of the model has been updated in the following aspects: the measure of the dollar-denominated sovereign spread for Brazil and Mexico vis-à-vis the United States was changed from EMBI to EMBI+ and the economic policy uncertainty index for Brazil and Mexico (EPU) was added. For further details, see C. Ghirelli, J. J. Pérez and A. Urtasun, "Economic policy uncertainty in Latin America: measurement using Spanish newspapers and economic spillovers", Working Paper No 2024, Banco de España.
d Differences are expressed as percentage points for foreign demand and interest rates and as levels for the remaining variables.
e Foreign demand is approximated using a synthetic measure which includes the main trading partners of each country. This approximate is based on data from the ECB's March projections exercise; the impact of the higher foreign demand prompted by the American Rescue Plan in the United States has been added using a general equilibrium model (NiGEM). See Box 3 of Economic Bulletin 1/2021 for further details on the simulation of the US fiscal stimulus package.
f These variables are expressed in terms of percentages.

3 Foreign demand is taken from the ECB's March projection exercise. The impact of the higher external demand prompted by the US fiscal stimulus is then added using a general equilibrium model (NiGEM). See Box 3 of the Economic Bulletin 1/2021 for further details on the simulation of the US fiscal stimulus package.

4 See "Report on the Latin American economy. Second half of 2020", Analytical Articles, *Economic Bulletin* 4/2020, Banco de España.

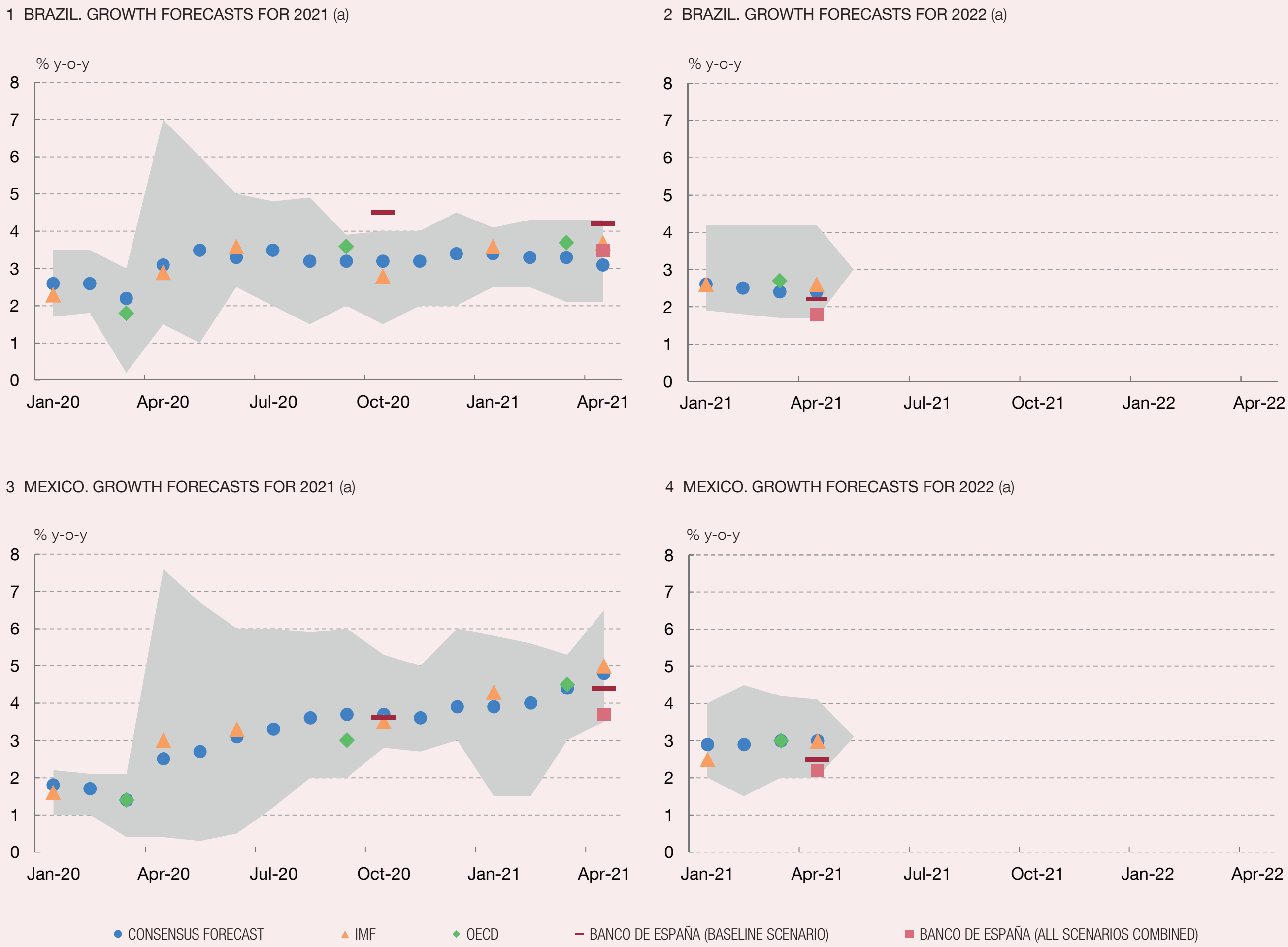
Box 1

TECHNICAL ASSUMPTIONS OF THE BASELINE SCENARIO AND DESCRIPTION OF THE MACRO-FINANCIAL RISK SCENARIOS FOR BRAZIL AND MEXICO (cont'd)

Developing a baseline scenario is essential for the construction of risk scenarios, since the latter are based on changes to one or more of the assumptions underlying the former. In a first alternative scenario, a temporary increase in both economic policy uncertainty and financial stress is assumed. Specifically, it is assumed that financial market volatility in 2021 Q2 adversely impacts the economic policy and financial uncertainty variables and temporarily increases them by one standard deviation, before gradually reverting to the technical assumptions path underlying the baseline scenario. It would therefore be a very limited financial shock, in terms both of the size assumed and of its temporary nature. In this scenario, at end-2022 there would be a cumulative loss in GDP of -1.1 pp and -1.6 pp relative to the baseline scenario for Brazil and Mexico, respectively.

Chart 1
GROWTH FORECASTS

Our baseline scenario projects a 4.2% rise in Brazil's GDP in 2021, which would then stabilise at 2.2% in 2022. GDP growth in Mexico in the same years would be 4.4% and 2.5% These projections are close to the latest forecasts of international organisations and private analysts, with the exception of Brazil's projection for 2021, which is somewhat higher although still within the consensus range. Were all the scenarios considered in this box to materialise, their cumulative combined effect in 2021-2022 would lead to growth rates that are around 1.1 pp and 1 pp lower than expected in Brazil and Mexico, respectively.



SOURCES: Consensus Forecasts, IMF, OECD and Banco de España.

a The shaded areas correspond to the range between the highest and lowest forecasts by private and public sector analysts in each month.

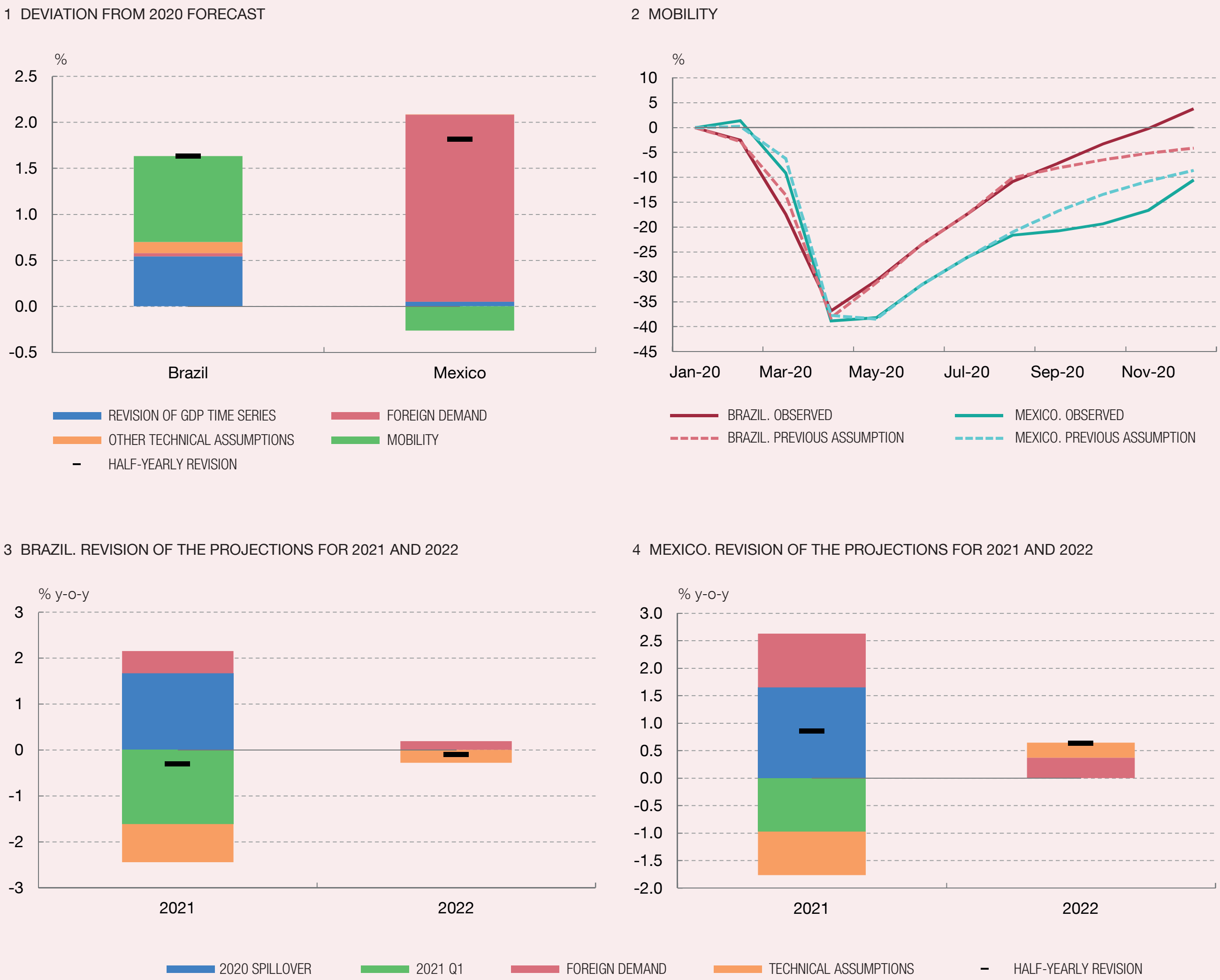
Box 1

TECHNICAL ASSUMPTIONS OF THE BASELINE SCENARIO AND DESCRIPTION OF THE MACRO-FINANCIAL RISK SCENARIOS FOR BRAZIL AND MEXICO (cont'd)

A second alternative scenario considers the effect of an additional fiscal stimulus in the United States from end-2021, in line with the announcement made on 31 March (the American Jobs Plan).[5] In this scenario, higher foreign demand positively impacts GDP growth in Brazil and Mexico, with a cumulative effect at the end of the two-year period considered (2021 and 2022) of +0.9 pp and +1.3 pp respectively.

Chart 2
DEVIATIONS AND REVISIONS OF GROWTH FORECASTS

Deviations from last year's growth forecast were due mainly to the revision of the GDP time series and higher-than-expected mobility in Brazil, and to more buoyant foreign demand in Mexico. In Brazil, the downward revision of the growth forecast for 2021 is largely explained by the slowdown in the economy in 2021 Q1. In Mexico, the revision is upwards, driven by higher foreign demand from the American Rescue Plan in the United States.



SOURCES: ECB, Google, Refinitiv and Banco de España.

5 The NiGEM macro-econometric model is used to quantify the impact. Given the lack of a clear definition of the American Jobs Plan announced on 31 March 2021, the details of this potential new plan are estimated on the assumption that it will be similar to that included in the then candidate Biden's election manifesto. For further details, see S. Párraga and M. Roth (2021), "Analysis of US fiscal policy plans", Box 3, Quarterly report on the Spanish economy, *Economic Bulletin* 1/2021, Banco de España.

Lastly, the third alternative scenario assumes permanent pandemic-induced downward effects on long-term growth. The aggregate estimates recently published by the ECB on the impact of recessions on the long-term performance of the factors of production and total factor productivity[6] are used to calculate the possible effect on the potential output of the two Latin American economies. In this scenario, cumulative growth in 2021-2022 would be 0.9 pp and 0.7 pp lower than in the baseline scenario in Brazil and Mexico, respectively. It should be noted that the adverse effects of the crisis would extend beyond the simulation horizon considered, leading to lower economic growth in the long term.

Were the risk scenarios to materialise, the simulations presented show that they would have a significant impact on both of the economies analysed. However, scenarios in which, for example, several of the shocks described occur at once cannot be ruled out. Specifically, should the three (two downward and one upward) alternative scenarios materialise simultaneously, GDP in Brazil and Mexico would grow 3.5% and 3.7% in 2021, respectively, compared with growth of 4.2% and 4.4% under the baseline scenario (see Chart 1). In cumulative terms, additional falls in GDP resulting from this circumstance in 2021-2022 would amount to -1.1 pp and -1 pp for Brazil and Mexico, respectively, relative to the baseline scenario.

In any event, it is important to bear in mind that the macro-financial scenarios presented in this box are based on the assumption that the pandemic will be gradually overcome. However, as discussed in the main text of this report and illustrated by specific simulation exercises, much uncertainty persists in this respect. In addition, the scenarios envisaged in this box do not factor in any possible economic policy response that might mitigate the impact of the shocks considered in this analysis.

6 See European Central Bank (2020), Economic Bulletin 8/2020.