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Economic impact of the COVID-19 pandemic on Latin America

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Author: Dr Katrin Ullrich, +49 69 7431-9791, katrin.ullrich@kfw.de

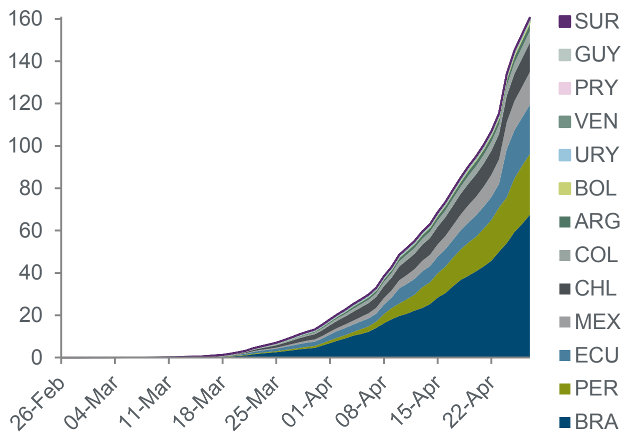
The coronavirus pandemic is spreading across Latin America. The countries' mainly difficult economic situation is making the region susceptible to all the economic consequences of the crisis. It is being hit not just by the impacts of the containment measures but by the collapse of commodity prices, disruptions in international financial markets, including currency devaluations, and the economic slump in its major trading and financing partners, the US and China. This will result in a deep recession because countries that lack monetary and fiscal policy scope have difficulty rolling out corresponding support measures.

The pandemic situation in Latin America

The region's first coronavirus infection was identified in Brazil on 26 February. That was around one month after Europe and the US, giving the countries of Latin America some – albeit short – time to prepare for the pandemic. Many countries in the region were quick to implement containment measures including border and school closures, as well as other social distancing measures. Seven of the countries reviewed here – Argentina, Bolivia, Colombia, Ecuador, Paraguay, Peru and Venezuela – introduced general restrictions on movement.

Figure 1: Case numbers in Latin America

In thousands



Source: Johns Hopkins University, as at 17 April 2020.

The other countries, including Mexico and Brazil, decided to impose partial lockdown measures from 1 April. However, the presidents of these two countries with the largest populations in the region (initially) played down the seriousness of the threat to health. In Brazil, the president's rhetoric continues to sabotage the containment measures with calls for a reopening of the economy.

Many countries of the region, including Argentina, Brazil, Colombia and Peru, are making additional funds available for healthcare. Public health expenditure was only 0.8% of GDP in Venezuela in 2016 (latest available figures), as opposed to a notable 6.5% in Uruguay, whereas the OECD average is 10%.

General economic impact

The consequences of the pandemic in Latin America, as for emerging and developing countries overall, can be expected to occur through the following channels:

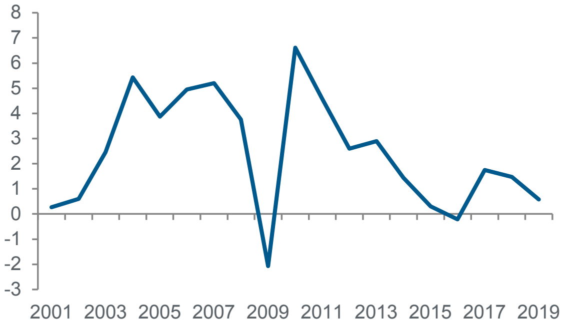
- First, the immediate consequences of the nationwide spread of the coronavirus consist in the containment response and behavioural changes. Data on traffic congestion and the use of public transport show that both have decreased significantly since the beginning of the crisis. In Peru, for example, the intensity of traffic congestion has dropped by 92% and in Mexico by 61%.[1] The resulting negative impact on consumption and production can be anticipated.
- Second, global financing conditions have deteriorated rapidly. Emerging economies' currencies have devalued sharply and risk perceptions for developing and emerging countries have increased dramatically and, above all, quickly. Substantial capital outflows have also occurred. External financing is thus becoming increasingly difficult.
- Third, commodity prices are falling, tourism is collapsing and worker remittances from abroad are drying up. The region has many commodity exporters that are being hit by the collapse in prices. This affects not just oil but other materials such as copper.
- Fourth, demand from abroad will be lacking. Some of the countries in the region are heavily dependent on the US or China for trade and finance. The economic downturn there can be expected to have corresponding repercussions.

Economic situation in the region

The crisis has hit the region in a difficult economic environment. The year 2019 was characterised by weak commodity prices, low global economic momentum and volatile capital flows, all of which created an unfavourable external economic climate for Latin America. It was compounded by the political uncertainty and social upheavals of the second half of the year and by the refugee crisis in Venezuela. As a result, aggregate growth of the countries under review – without Venezuela – was a weak 0.6%.

Figure 2: Gross domestic product growth rate

In per cent, weighted average without Venezuela.



Source: IMF, calculations by KfW Research.

The three largest economies of the region in particular entered the crisis from a weak economic position. Brazil never really recovered from the deep and long recession of 2015/2016, in Mexico the first year of the new presidency was – as always – marked by poor economic performance, and Argentina is in the midst of a recession and debt crisis.

The containment measures imposed in the form of lockdown measures, social distancing regulations and closures of non-essential businesses, as well as changes in consumer behaviour, hit the service sector particularly hard. In Brazil, the sector contributes 73% to GDP and in Paraguay it is still 52%. Furthermore, more than half the workforce in Latin America and the Caribbean is employed in the informal sector,[2] which also represents a challenge for the design of support measures aimed at limiting the social and economic impact.

Export sector heavily reliant on commodities

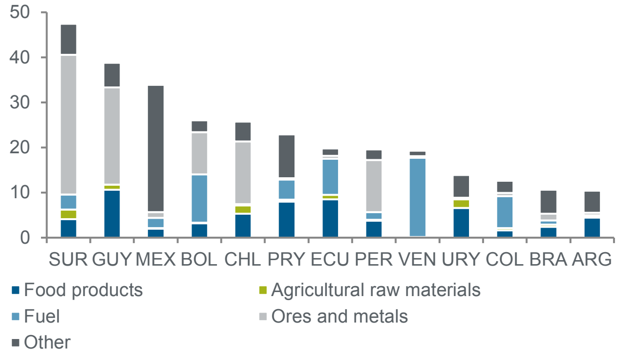
Commodity prices have plunged. The IMF Commodities Price Index (without gold) lost 25% between the end of 2019 and March 2020. Oil prices in particular are down by almost half. The drop was partly due to the initially failed talks between Russia and the OPEC on bolstering prices by cutting production. Apart from this supply-side effect on the oil price, the coronavirus pandemic is affecting demand, first in a relatively direct manner through depressed demand from the tourism and aviation sector and generally as a result of the global economic slump. The IMF sees the oil price at only USD 37 a barrel of Brent crude on average for the year 2020, below the USD 44 of the year 2016.

The price drop is not just limited to oil; the price index for metals also dropped by 8% in the first three months (copper: 15%) and for agricultural raw materials by 3%.

Ores and metals, oil and agricultural raw materials are essential export goods for many countries in the region. The Economic Commission for Latin America and the Caribbean (CEPAL) has forecast an approximately 14% drop in the value of exports of these goods for South America in 2020 (Brazil: -11%, Mexico: -7%).[3] For the affected countries, the price slump also means a decline in public revenue which will then be lacking for economic policy measures to combat the pandemic.

Figure 3: Composition of exports

In per cent of GDP, average across 2014–2018



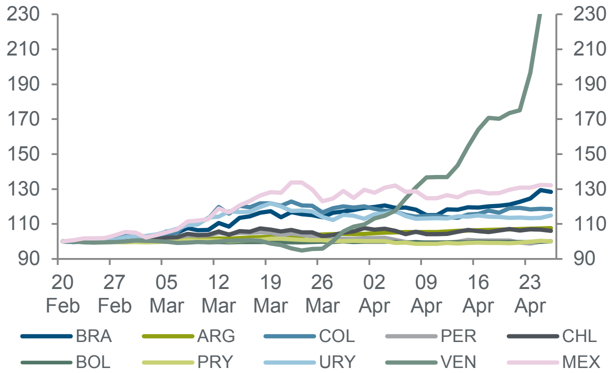
Source: UNCTAD, IMF, calculations by KfW Research.

Substantial external financing in some countries

The coronavirus pandemic comes with severe disruptions in the financial markets. The exchange rates of Latin American countries have greatly depreciated amid uncertainty about the scale and duration of the pandemic and its economic consequences. Venezuela's currency suffered the sharpest drop of around 130%, followed by Mexico with approx. 30% (since 20 February 2020). But the currencies of Brazil, Colombia and Uruguay have also depreciated significantly.

Figure 4: Exchange rate development

Index 20 February 2020=100



Source: Macrobond, calculations by KfW Research.

In some countries, however, the exchange rate has responded more moderately despite flexible arrangements. In Peru, for example, the central bank intervened, which is easily possible – at least temporarily – given its high currency reserves. In Argentina, restrictions on capital movements have been in place since August 2019 and the central bank has intervened to stabilise the exchange rate despite low currency reserves.

Given the more or less simultaneous global economic slump, the exchange rate movement is not very likely to significantly boost exports. However, China is a major export destination for Latin American countries and its economy is already on track to recover.

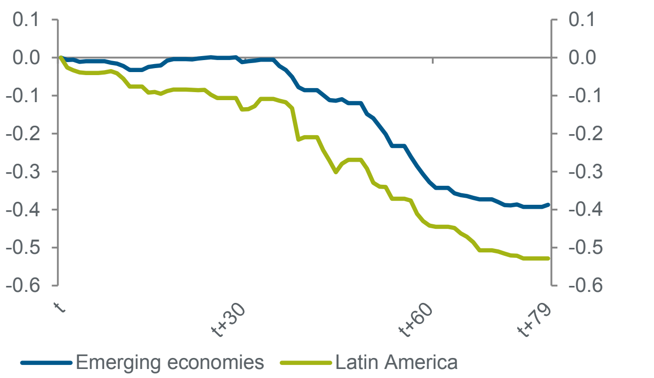
The second major aspect of currency devaluation relates to debt (see Table 2 on public and external debt levels). If a country has debt in foreign currency and its own currency depreciates, its debt level in local currency rises automatically. The dollarisation of public debt varies greatly from one country in the region to another. In Ecuador it is 100% because the US dollar is the official means of payment. It is followed by Paraguay and Argentina with 82 and 80% respectively, while the Brazilian government is indebted almost exclusively in local currency. Corporate debt also needs to be taken into account, however. The region's securities issues in the international bond market have been dominated by the private sector (including banks and supranational corporations) since 2008. In 2019, the private sector contributed 64% of the issue volume and 83% of all issues was in US dollars.[4]

In addition to exchange rate reactions and sudden surges in yields on government bonds in Mexico, Colombia and Brazil, for example, uncertainty in the financial markets and investors' risk aversion is also reflected in capital flows. This is more pronounced for emerging economies in general than during the global financial and economic crisis and in relation to gross domestic product, Latin America is even more affected than the overall group of emerging economies.

To ensure liquidity in US dollars, the US Federal Reserve has reopened the swap lines with the central banks of Mexico and Brazil that were introduced during the global financial and economic crisis. At up to USD 60 billion each, they are twice as high as before.

Figure 5: Cumulative portfolio flows of non-residents

In per cent of GDP, based on daily observations. t=21 Jan. 2020



Source: IMF.

Tourism and remittances from migrant workers will be missed

International tourism plays a lesser role for Latin American than Caribbean countries. Nevertheless, tourism expenditure is not insignificant as it involves labour-intensive services which will also grind to a halt as a result of containment measures such as border closures. Domestic tourism will also be heavily affected, however, either because of explicit restrictions on movement or as a result of consumers' more cautious behaviour.

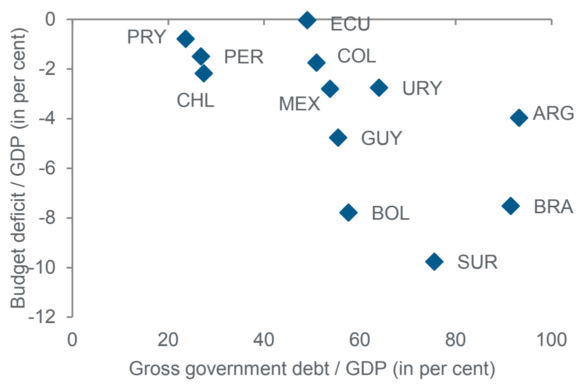
The anticipated global economic downturn will also affect remittances from migrant workers, some of which are substantial. In Bolivia they amount to 3.5% of GDP and reach just under 7% of households. Remittances are also of relevance for Mexico, accounting for 3% of GDP and involving nearly 5% of households. It will likely be more difficult for remittances to exercise the stabilising function attributed to them when both the remitting and the receiving country enter a recession more or less simultaneously. With the delayed start of the pandemic in the Latin American countries, the recovery in the US can be expected to begin sooner so that remittances to Mexico, for example, can then play a positive role.

Fiscal-policy scope was already restricted in some places before the crisis

Putting together sufficiently large fiscal packages and financing support measures will be a challenge for the countries of the region, i.a. because tax revenue is shrinking. Besides, all countries have a budget deficit and some of them are considerable. This applies to Brazil, Bolivia and Argentina in particular, which also have relatively high public debt levels. General government gross debt is generally higher and in some countries much higher than in 2007, before the global financial and economic crisis. Peru and Guyana are two exceptions. The debate in Ecuador about suspending external debt service and using the funds to finance support measures is an example that illustrates the financing problems, including their political dimension.

Peru, Chile and now also Brazil have announced extensive support measures. In Peru they amount to 12% of GDP. By contrast, Mexico has not yet announced any spending over and beyond the resources that are available and even these are relatively limited.

Figure 6: Situation of public finances



Source: IMF.

Monetary policy response is being hampered by exchange rate reactions

The countries also have limited room for monetary policy manoeuver, as the central banks of the region already embarked on a loosening cycle of monetary policy last year. The monetary policy reactions are concentrated on reducing key interest rates and providing banks with liquidity. With the exception of Argentina as an outlier (-17 percentage points), key interest rate reductions range between 2.75 percentage points in Paraguay and 0.5 percentage points in Colombia compared to the level at the start of the year. Chile already started off with a low key interest rate of 1.75% and is now close to zero, at 0.5%. The same is true of Peru, which is down to 0.25 from 2.25%. At the same time, many currencies are under depreciation pressure, which has thus far prevented more aggressive interest rate reductions. Inflationary pressure from currency depreciation is finding its counterbalance with a slump in demand and declining commodity prices.

Table 1: Policy rates

In per cent

	1 January 2020	27 April 2020
Argentina	55.0	38.0
Brazil	4.5	3.75
Chile	1.75	0.5
Colombia	4.25	3.75
Ecuador	8.68	8.4
Guyana	5.0	5.0
Mexico	7.25	6.0
Paraguay	4.0	1.25
Peru	2.25	0.25

Source: Macrobond.

In addition to key interest rate reductions, the central banks have introduced a number of further measures aimed at both securing banks' liquidity and limiting exchange-rate turbulence. Because of the possibility of capital outflows and exchange-rate fluctuations, central banks in emerging economies already combine inflation targeting with macroprudential measures and the accumulation of currency reserves as a monetary policy strategy. Now they may have to expand their catalogue of measures by taking on the role of 'dealer of last resort'. In this function they make liquidity available to market participants in a targeted manner, for example in the repo market or the domestic bond market. The central banks of Colombia and Chile have thus launched various types of asset purchase programmes in order to reduce risk premiums and provide liquidity.

Preliminary assessment of the economic impact

The countries of Latin America are expected to suffer very severely under the impact of the coronavirus pandemic. The already serious negative consequences of an outbreak within the country are compounded by unfavourable external developments to which the region is susceptible – despite all country-specific heterogeneity. Against this background and given the poor starting position, a recession in the region is inevitable.

The recession will further exacerbate inequality and poverty in the region. Inequality, which is already relatively high in a worldwide comparison, generally poses major challenges for the countries' response to the pandemic. The reason is that lower socio-economic status is usually associated with poorer health outcomes and poorer healthcare, so that poor people are in greater need of protection from the health impacts of the pandemic. At the same time, the restrictions lead to a loss of earned income and poor households have no reserves to offset this loss. As a result, they are generally in particular need of public support.

The magnitude and duration of the downturn and the speed of the ensuing recovery will depend on the specific characteristics of each individual Latin American country. They include their economic structure as well as the duration and nature of the restriction measures, their dependence on natural resources, the size of the informal sector and the effectiveness of the monetary and fiscal policy support measures. International aid, as well as regional and national development banks, will also play a role. Bolivia and Paraguay have already received emergency financing approval under the IMF's Rapid Financing Instrument.

Table 2: Overview of the present situation in Latin America

Relative starting position by country measured in quintiles.

Dark green – relatively best starting position of all countries, read – relatively poorest starting position of all countries.

	ARG	BRA	BOL	CHL	COL	ECU	MEX	PRY	PER	URY
Commodity exports / GDP (Ø 2014-2018, in per cent)	1	3	20	16	8	10	4	5	13	2
Real GDP (y-o-y. in per cent)	-3	1	4	3	3	0	0	1	3	0
Share service sector (in per cent)	66	73	57	63	64	55	65	52	59	67
Share informal workers (in per cent)	48	45	84	29	61	73	66	70	69	24
Exchange rate (Index 20.02.2020=100)	105	119	100	106	117	100	132	99	101	117
Currency reserves / ARA measurement	1	2	1	1	1	0	1	2	3	2
Current account balance / GDP (in per cent)	-1	-3	-5	-3	-4	0	-1	0	0	-2
External debt / GDP (in per cent)	62	37	43	69	43	49	37	16	30	76
General government gross debt / GDP (in per cent)	93	92	58	28	51	49	54	24	27	64
Public debt dollarisation (in per cent)	80	0	63	13	28	100	21	82	33	51
General government net lending/borrowing / GDP (in per cent)	-4	-8	-8	-2	-2	0	-3	-1	-1	-3
Internat. Tourism expenditure / GDP (in per cent)	1	0	3	2	2	2	2	1	2	5
Remittances / GDP (in per cent)	0	0	3	0	2	3	3	2	1	0
Key interest rate as at 01.01.2020 (in per cent)	55	5		2	4	9	7	4	2	

Notes: Excluding Guyana, Suriname and Venezuela due to lack of data. Unless otherwise specified, 2019 or latest available data.

Sources: UNCTAD, Weltbank, IWF, CEPAL, ILO, Macrobond, KfW Research.

[1] See https://www.iadb.org/en/topics-effectiveness-improving-lives/coronavirus-impact-dashboard

[2] ECLAC (2020): América Latina y el Caribe ante la pandemia del COVID-19. Efectos económicos y sociales, 3 April 2020.

[3] ECLAC (2020): América Latina y el Caribe ante la pandemia del COVID-19. Efectos económicos y sociales, 3 April 2020.

[4] ECLAC (2020): Capital Flows to Latin America and the Caribbean 2019 Year-in-Review.