LATIN AMERICA and THE CARIBBEAN

Economic activity in the broader Latin America and the Caribbean contracted in 2015, amid lower commodity prices, decelerations in major trading partners, and persistent domestic challenges among the region's largest economies. With commodity prices expected to stabilize, coupled with the continued recovery in the United States and Euro Area, regional growth is expected to improve over the medium term. Major downside risks include further declines in commodity prices, bouts of financial volatility, sharp falls in capital flows, and protracted economic downturns among the region's largest economies.

Recent developments

Economic activity in the broader Latin America and the Caribbean (LAC) region contracted in 2015. Following three consecutive years of slowing growth, output in the region fell 0.9 percent in 2015, partly reflecting sharp declines in economic activity of large regional economies, such as Brazil and the República Bolivariana de Venezuela (Table 2.3.1, Figure 2.3.1). This reduction in output stemmed from a combination of global and domestic factors, particularly the continued slump in commodity prices. Lower crude oil prices – down around 45 percent from 2014 levels – have reduced export earnings and fiscal revenues of regional oil exporters, such as Belize, Colombia, Ecuador, Mexico, and the República Bolivariana de Venezuela. Depressed prices of copper, iron ore, gold, and soy beans have worsened the terms-of-trade for commodity exporters, such as Brazil, Chile, the Dominican Republic, and Peru. A number of governments had to undertake pro-cyclical fiscal tightening, aggravating the economic slowdown. Several large South American economies have also been grappling with severe domestic macroeconomic challenges that have eroded consumer and investor confidence, further contributing to the regional output decline in 2015.

Output in the South American sub-region experienced a particularly marked reduction in 2015.[1] With GDP falling in Brazil, Ecuador and the República Bolivariana de Venezuela, South America saw overall economic growth turn negative, to an estimated -2.1 percent in 2015, after tepid growth in 2014. Investment in Brazil has been dropping since 2013 due to investors' loss of confidence, which was exacerbated in 2015 by the widening investigations into the Petrobras scandal. Monetary and fiscal tightening, accelerating inflation, and concerns about growing fiscal deficits also weighed on investment. The República Bolivariana de Venezuela too is in recession, with very high rates of inflation. Controls that restrict imports of vital consumer goods and intermediate inputs have curtailed private consumption and impeded manufacturing. The appreciation of the U.S. dollar has meant a loss of competitiveness for the fully dollarized Ecuadorean economy. This, together with lower oil prices, has pushed Ecuador into a recession in 2015. In contrast, Argentina saw activity rebound in 2015.[2] However, the increase in activity might not be sustainable as it was partly due to a surge in pre-election public spending, while net exports have been falling and inflation has been high. Other large economies, particularly commodity exporters, are continuing to grow at tepid rates.

Note: The author of this section is Derek H. C. Chen. Research assistance was provided by Mai Anh Bui. The discussion in this section includes both developing and high-income economies in the Latin America and the Caribbean region.

[1] The South American sub-region includes: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Uruguay, and the República Bolivariana de Venezuela.

[2] Based on official national accounts data.

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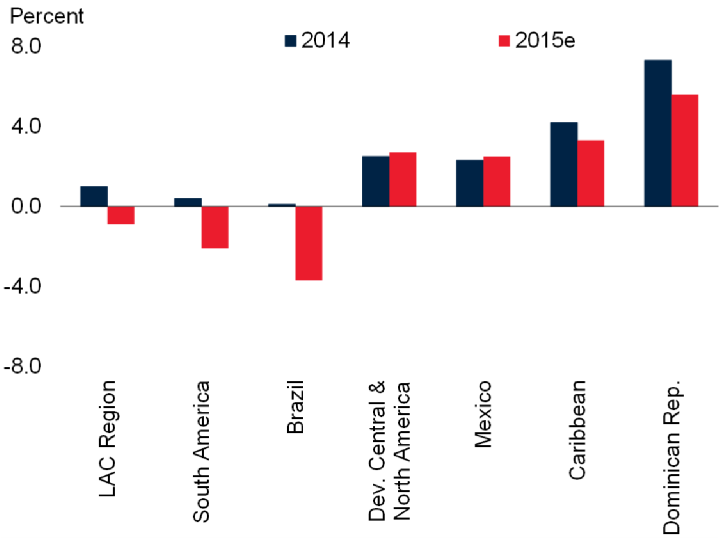
FIGURE 2.3.1 GDP growth, 2014-2015

Regional GDP contracted in 2015, because of recessions in large South American economies. Output continued to grow in developing Central and North America and the Caribbean.

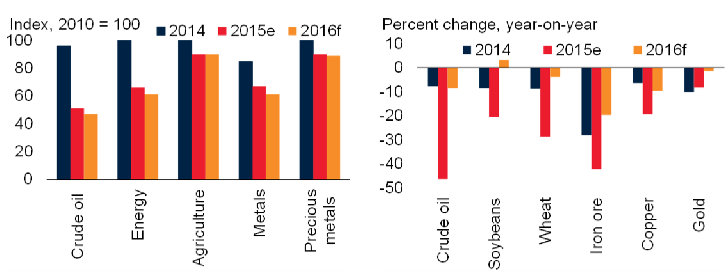


Source: World Bank.
Note: e= estimated. GDP weighted averages.

FIGURE 2.3.2 Commodity prices

Commodity prices continued to soften across the board in 2015, amidst well-supplied markets.

A. Commodity prices **B. Prices of key commodity exports**



Source: World Bank.
Note: e = estimated; f = forecast.

Despite strong economic ties to a strengthening United States, developing Central and North America saw growth rates in 2015 rise modestly from 2014.[3] The sub-region's largest economy, Mexico, saw a small pickup in growth in 2015 on the back of expanding exports to the United States. However, the Mexican economy has been weighed down by low oil prices and reduced oil production. Lower oil prices have severely curtailed government revenues, and compelled fiscal tightening.

Economic growth in the Caribbean moderated in 2015, with output expanding by 3.3 percent.[4] The Dominican Republic, the largest economy in the sub-region, experienced a contraction in mining exports, as prices fell. A surge in investment, including the construction of new public schools and two new coal-fired power plants, provided some support to output. In contrast, Jamaica saw growth pick up, amid increased business and consumer confidence, a successful IMF Extended Fund Facility program review, and stronger mining output.[5]

The sharp fall in commodity prices, predominantly due to well-supplied markets, adversely affected commodity exporters in LAC. In 2015, prices of agricultural products declined by about 13 percent, metals by 21 percent, and precious metals by 11 percent from 2014 (Figure 2.3.2). Oil prices towards the end of the year were about 45 percent below 2014 prices. This hurt tax and export revenues, and exerted pressures on fiscal balances of oil exporters (Belize, Colombia, Ecuador, Mexico, Venezuela). Similarly, the slump in copper prices, along with the continued slowdown in major trading partners, dampened investment into the mining sector, weighing on growth in Chile and Peru.

Regional currencies continued to depreciate in 2015. Commodity exporters in the region saw large depreciations on account of the continued slump in commodity prices (Figure 2.3.3). At end-October 2015, the currencies of Chile, Colombia, Mexico and Uruguay depreciated by an average of 13 percent in nominal terms and around 9 percent in real effective terms with respect to their levels at the beginning of the year. The Brazilian real saw an exceptionally large depreciation, due to investor concerns about macroeconomic imbalances and political uncertainty. The Argentine peso depreciated 27 percent on December 17, 2015 when capital controls were lifted.

[3]The developing Central and North America sub-region includes: Costa Rica, Guatemala, Honduras, Mexico, Nicaragua, Panama, and El Salvador.

[4]The Caribbean sub-region includes: Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

[5]Higher mining output was led by increased production of alumina, boosted by higher global demand.

Regional export performance improved in 2015, boosted by weak exchange rates and continued recoveries in the United States and the Euro Area. Regional export volumes of goods and services climbed around 5 percent in 2015 after remaining broadly unchanged in 2014 (Figure 2.3.4). Exports in South America expanded by about 4 percent, led by Brazil with a substantially depreciated real. Similarly, with its close ties with the United States, developing Central and North America experienced export growth of more than 8 percent. Led by strong tourism demand, the Caribbean's exports of goods and services rose almost 5 percent in 2015.

There was a large divergence in inflation performance across the region. Reduced oil prices led to lower inflation in developing Central America, North America, and the Caribbean. For example, despite seeing a 12 percent depreciation of the peso against the U.S. dollar and being an oil exporter, Mexico's consumer price inflation reached historic lows in 2015 (Figure 2.3.5). The mild inflation rates enabled the Banco de México to maintain a record low interest rate of 3 percent for most of 2015 (Figure 2.3.6).[6] Inflation pressures in Nicaragua also eased sharply following a cut in electricity prices in April. El Salvador, which imports almost all of its oil, saw annual inflation turn negative for most of 2015. Similarly, consumer prices in Costa Rica fell in the latter half of 2015, and the central bank further lowered its policy rate to 2.25 percent in October. Also with low inflation, the Dominican Republic reduced interest rates and lowered commercial bank reserve requirements in the first half of 2015.

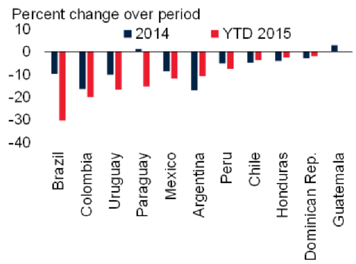
In contrast, consumer price inflation ran at very high rates in Argentina, Brazil, and especially the República Bolivariana de Venezuela. In Brazil, inflation reached a 12-year high in the second half of 2015. This was in part due to the one-off effect of a reduction in subsidies and an increase in administered prices, but the main reason was higher underlying inflation, as the core inflation accelerated to above 9 percent. In a series of upward adjustments, the Banco do Brasil raised policy interest rates to 14.25 percent, a nine-year

[6]The central bank of Mexico raised its benchmark interest rate by 25 bps to 3.25 percent at its December 17th, 2015 meeting.

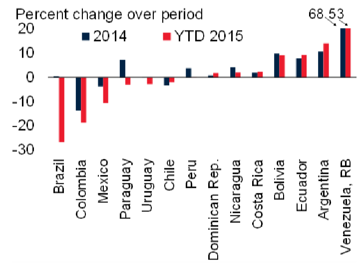
FIGURE 2.3.3 Exchange rates

LAC currencies continued to depreciate against the U.S. dollar in 2015. The depreciation of the Brazilian real was particularly steep. Because of high inflation, the real effective exchange rates of Argentina and the Republica Bolivariana de Venezuela rose, indicating a loss of cost competitiveness.

A. Exchange rates against U.S. dollar



B. Real effective exchange rates

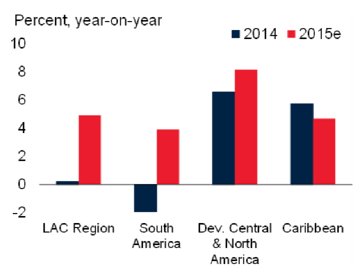


Source: Haver Analytics.
A. Last observation is November 2015.
B. Last observation is September 2015. An increase denotes real appreciation.

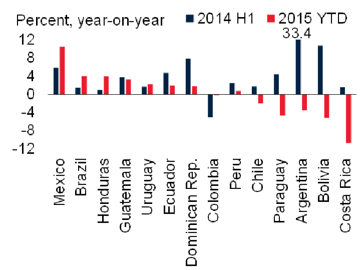
FIGURE 2.3.4 Exports

Regional export performance improved in 2015, boosted by weak exchange rates and continued recoveries in the United States and Euro Area.

A. . Regional export growth



B. Export growth in selected countries

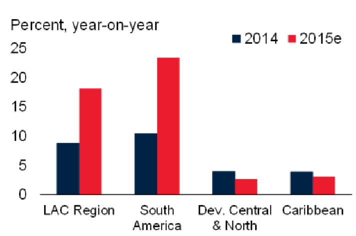


Source: IMF 2015i; Haver Analytics.
Note: e = estimated.
A. GDP weighted averages.
B. Last observation is Q2 2015, except for Brazil, Chile, Paraguay and Peru, for which the last observation is Q3 2015.

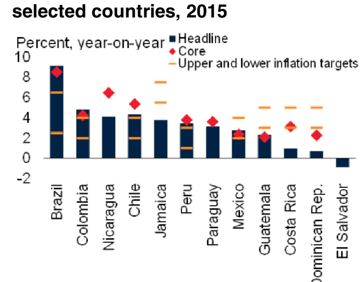
FIGURE 2.3.5 Inflation rates

Inflation rates are diverging across countries.

A. Regional consumer price inflation



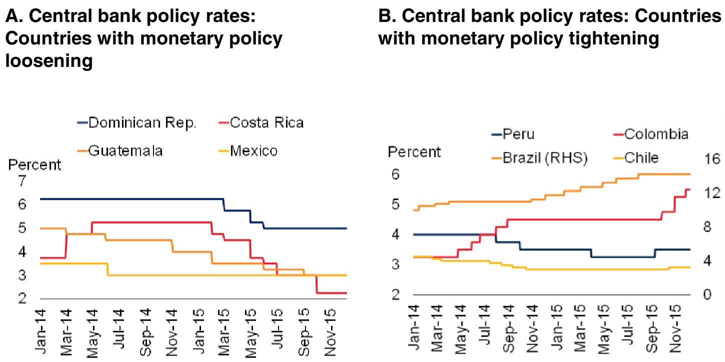
B. Headline and core inflation, selected countries, 2015



Source: IMF 2015i; Haver Analytics.
Note: e = estimated.
A. GDP weighted averages.
B. Year to date, last observation is November 2015, except for Jamaica, which is October 2015.

FIGURE 2.3.6 Central bank policy rates, 2014-2015

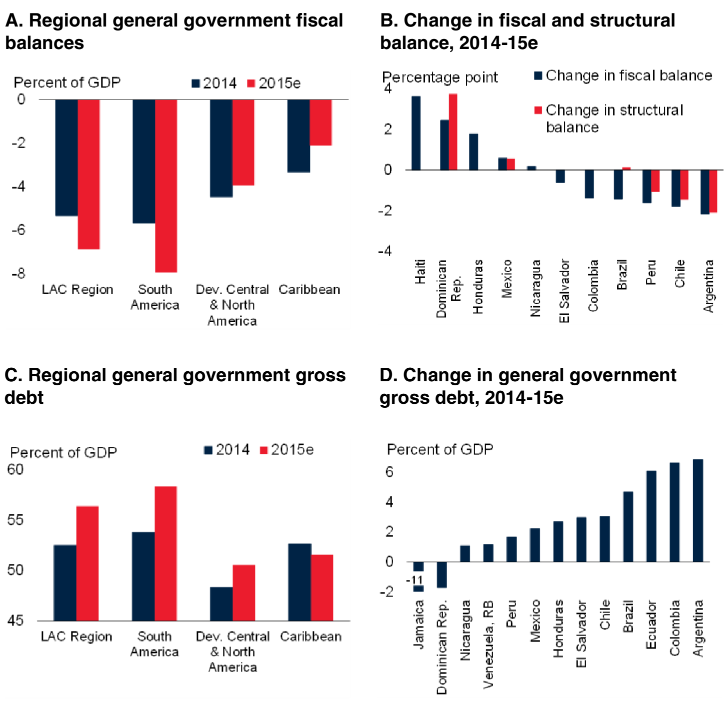
Reflecting different inflation pressures, monetary policies are diverging among countries.



Source: Haver Analytics.
Note: The central bank of Mexico raised its benchmark interest rate by 25bps to 3.25 percent at its December 17th, 2015 meeting.

FIGURE 2.3.7 Fiscal indicators

Fiscal balances are diverging, with balances deteriorating in South America and improving in the rest of the region.



Source: IMF 2015i; World Bank.
Note: e = estimated.
A. and C. GDP weighted averages.

high. Consumer price inflation in the República Bolivariana de Venezuela reached well over 100 percent in 2015, as policy has failed to establish an anchor for inflation expectations.[7] Argentina's inflation also remains elevated, at over 14 percent in the second half of 2015.[8]

Inflation in Colombia is under better control, but has been above the central bank's 2-4 percent target band since mid-2015. Continued weakness in the peso, along with a poor harvest of staple crops, contributed to the increase. To guide inflation back to target, the central bank raised its policy rate in a number of successive adjustments in the latter half of 2015. Similarly, headline and core inflation in Peru have been steadily rising and have remained above the Peruvian central bank's upper bound target of 3 percent since 2014. This prompted the central bank to lift the policy rate in September and December.

Fiscal balances are also on differing paths across LAC. Due to lower commodity and export revenues, coupled with the slowdown in growth, regional fiscal balances deteriorated, and the debt/GDP ratio increased in 2015 (Figure 2.3.7). Given the large proportion of major commodity exporters in the sub-region, fiscal balances in South America as a share of sub-regional GDP are projected to deteriorate by more than 2 percentage points in 2015. The deficit to GDP ratio for Brazil widened further, after doubling in 2014. Weak revenues, swelling interest payments, and losses on central bank dollar swaps, were responsible for the slide. The Chilean fiscal deficit doubled in 2015. Government revenues have been depressed by low copper prices. At the same time, the government has boosted public spending in line with the fiscal stimulus program launched in 2014 to counter slowing growth. In contrast, Ecuador is projected to see a narrowing of the fiscal balance in 2015, due to a series of fiscal consolidation measures. Weaker oil export earnings have led the Ecuadorian government to decrease expenditures by $2.2 billion in 2015, with cuts almost entirely on capital expenditures.

Central and North America, and the Caribbean too saw a narrowing of fiscal deficits in 2015, predominantly due to fiscal consolidation. In Mexico, lower oil prices and production were offset by a sharp increase in non-oil revenues in the wake of the tax reform in 2014 and the

[7] As estimated in IMF 2015i.

[8] Based on official data.

increase in excise taxes on domestic fuels in 2015. In addition, the government enacted spending cuts equivalent to 0.7 percent of GDP. Supported by the 48-month IMF-supported Extended Fund Facility, Jamaica introduced new consumption taxes and reduced the public sector wage bill, as well as sharply lowering gross debt as a share of GDP. After settling a debt due to the República Bolivariana de Venezuela at a sharp discount, the Dominican Republic saw a large drop in its debt service costs and registered a substantial narrowing of its fiscal deficit.

Current account balances deteriorated throughout most of the region. Despite rising volumes of total exports, the LAC's current account deficit as a share of GDP widened to 3.4 percent in 2015 from 2.8 percent in 2014, partly due to reduced export revenues associated with lower commodity prices (Figure 2.3.8). South America's current account deficit is estimated to have widened 0.8 percentage point in 2015 to 3.6 percent of GDP. Developing Central and North America saw a smaller current account deterioration of 0.2 percentage point. As the exception to the trend, the Caribbean's deficit narrowed due to elevated tourism receipts. Colombia saw a current account deficit in the first half of 2015 of more than 6 percent of GDP, due to a plunge in oil export revenues. Similarly, Mexico's current account balance suffered from lower oil revenues, owing both to weaker prices and declining production. However, this was offset by strengthening export performance of manufactures, which represent a far larger share of Mexico's trade and benefited from the weak peso.

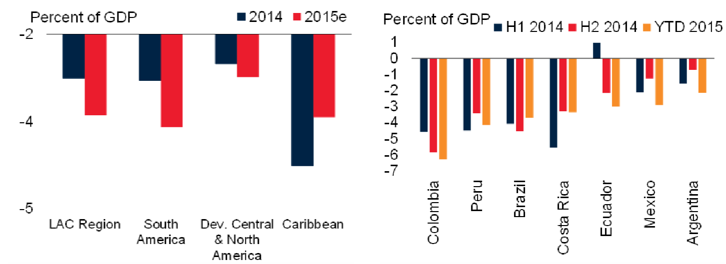
Gross capital flows contracted in 2015. Following the sharp slowdown in flows in 2014, gross capital flows to the region are estimated to have contracted by another 40 percent in 2015 (Figure 2.3.9). Brazil and Mexico accounted for around 80 percent of the decline. Weaker-than-expected growth prospects and increased political uncertainty, especially in Brazil, discouraged investors.

All three components of gross capital flows declined in 2015, with equity issuance contracting the most, falling more than 60 percent. Bond

FIGURE 2.3.8 Current account balances

Current account balances have deteriorated in a number of countries.

A. Regional current account balance **B. Current account balance in selected countries**

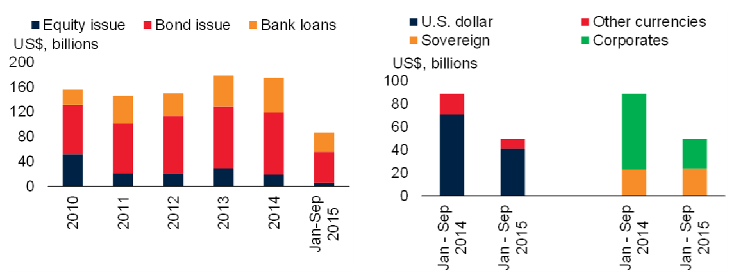


Source: IMF 2015i; Haver Analytics.
Note: e = estimated.
A. GDP weighted averages.
B. Last observation is for Q2 2015, except for Peru, Brazil and Mexico, which is for Q3 2015.

FIGURE 2.3.9 Gross capital flows

Gross capital flows declined in 2015.

A. Gross capital inflows **B. Bond issue by currency and issuer**



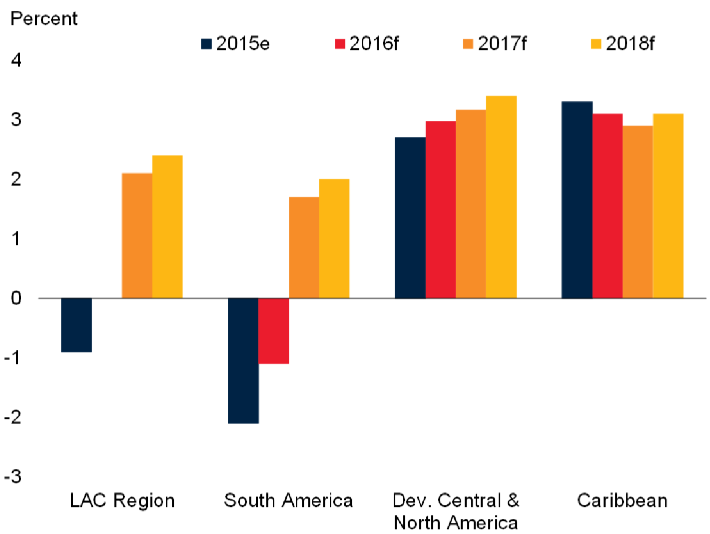
Source: Dealogic, World Bank.

issuance slumped more than 40 percent from 2014 levels, mainly on account of a $35 billion decline in new Brazilian bonds. Other economies took advantage of the still favorable global monetary conditions to put in place refinancing and pre-financing arrangements. In April, Mexico sold the world's first 100-year government notes in euros, as it locked in lower borrowing costs. Colombia issued $4 billion worth of bonds. Syndicated bank lending dove by 20 percent, reflecting local banks' lower funding needs as regional economies cooled.

The large decline in bond issuance mostly occurred among corporate issuers, particularly Brazilian corporate deals. Despite its significant appreciation, the U.S. dollar is still by far the currency of choice for debt issuance in Latin

FIGURE 2.3.10 Regional outlook

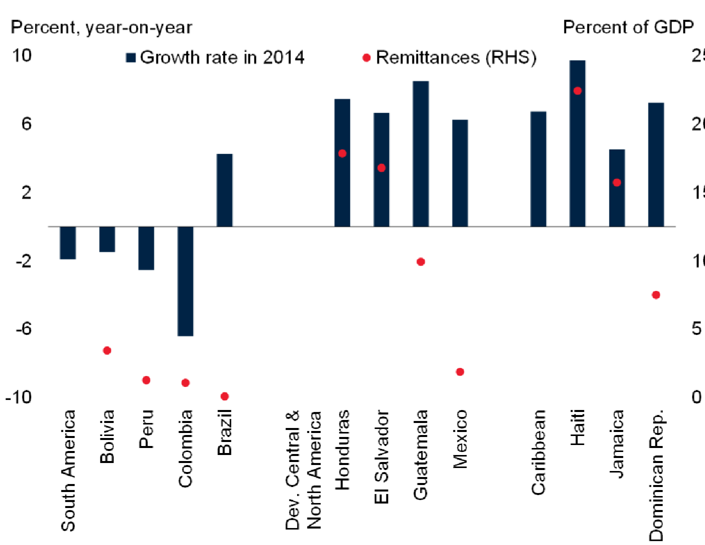
Regional growth is projected to recover in 2016-18.



Source: World Bank.
Note: e = estimated; f = forecast.

FIGURE 2.3.11 Remittance flows

Remittance inflows to developing Central and North America surged in 2014, as incomes in the United States grew, and the U.S. dollar appreciated.



Source: World Bank Migration and Remittances Database, Central Bank of Honduras.

America. From January to September 2015, over 80 percent of bonds issued were denominated in U.S. dollars, slightly higher than the same period a year ago.

Outlook

A gradual return to growth is anticipated over the medium term, as commodity prices stabilize and economic growth firms in the United States and the Euro Area. Activity at the broader regional level is projected to be flat in 2016. Growth will then recover and strengthen to an average of 2.2 percent for 2017-18 (Figure 2.3.10).

South America is not expected to resume growth until 2017. This baseline projection assumes that the sub-region's largest economies gradually adopt policies to reduce macroeconomic imbalances and restore business and consumer confidence. Output is expected to continue contracting in 2016, before increasing by 1.8 percent in 2017-18, on a rebound in investment and exports. Depreciated LAC exchange rates and the ongoing recovery in the Euro Area underpin this projection. Domestic constraints among the regions' largest economies are also expected to gradually ease in the medium term. Brazil continues to grapple with political uncertainty, as the government faces obstacles to fiscal austerity measures in Congress. The forecast nevertheless assumes that an eventual re-anchoring of inflation expectations and narrowing of the fiscal deficit, will lessen the need for further monetary and fiscal tightening. The baseline projection for the República Bolivariana de Venezuela, with its new National Assembly, assumes a very gradual shift towards a stronger macroeconomic and business-friendly environment. The new government in Argentina is expected to implement monetary and fiscal tightening in 2016, pushing a rebound in growth to 2017, as investment slowly strengthens on renewed investor confidence and leads the recovery.

Prospects are brighter for developing Central and North America. The sub-region will benefit from close economic ties to the firming U.S. economy and is projected to see a gradual acceleration in economic activity. Growth is expected to reach 3.0 percent in 2016, and to 3.2 percent by 2017. Output in Mexico, although weighed down by fiscal austerity through 2016, will benefit from a weak peso. This will provide a competitive boost to its export-based manufacturing sector. In addition, the opening of the energy sector to foreign investment has begun to perk investors' interests, resulting in a successful auction of oil sector licenses. Implementation of other planned reforms should unclog various growth bottlenecks, providing growth dividends in the medium term.

Developing Central and North America account for about 60 percent of total remittances flows to LAC, and benefited from an 8 percent surge in remittances in 2014 (Figure 2.3.11).[9] Remittances are projected to stay robust over the next few years, in line with stronger U.S. labor market conditions and improving employment opportunities for migrants in the United States. On the other hand, remittance growth to South America has been sluggish, and even declined in Peru in 2014, partly due weak economic activity in Spain. Some 30 percent of immigrants in Spain are from South America.[10]

Prospects are also favorable for the Caribbean economies. The Caribbean is projected to expand at an average of 3.0 percent in 2016-18, in light of some positive spillovers with the continued U.S. expansion. Similar to Central America, remittance flows to the Caribbean have been robust and stable. Moreover, Caribbean economies have been buttressed by increasing tourism. For example, tourist arrivals to the Dominican Republic between January and September 2015 rose 8.4 percent relative to the same period in 2014, with visitors from the United States jumping nearly 10 percent over the same period. In the years ahead, the ongoing normalization of ties between Cuba and the United States is expected to boost travel to Cuba.[11]

Risks

The balance of risks in the regional forecasts leans heavily towards the downside. The risks are both external and internal, and include potential bouts of financial volatility, protracted slowdown in the region's largest economies, a sharper slowdown in major trading partners and further commodity price weakness, and adverse effects from El Niño weather patterns.

Financial volatility. Higher borrowing costs, amid tighter U.S. monetary policy, and heightened risk aversion could be accompanied by bouts of financial stress. Downgrades to sovereign credit ratings, such as those by Standard and Poor's and Fitch for Brazil recently, could heighten the risk of large capital outflows. Financial market volatility could also be associated with China's efforts to stabilize its economy (IMF 2015j). Should financial stresses ensue, capital flows to the region could stagnate or even reverse, hampering growth. Risks will be most pronounced among developing economies with large levels of short-term or external debt (versus long-term domestic debt), or where credit has been expanding rapidly in recent years.

Protracted slowdown in the region's largest economies. Two of the region's largest economies, Brazil and the República Bolivariana de Venezuela, are grappling with high inflation rates and output contractions, coupled with macroeconomic imbalances and political uncertainty. In Brazil, the baseline projection is predicated on a reduction in the fiscal deficit and an anchoring of inflation expectations without considerable further policy tightening, which may not prove feasible. A protracted slowdown in one or both of these economies could have sustained negative spillovers across the region. Econometric analysis presented in Box 2.3.1 shows that decreases in Brazil's GDP growth lead to statistically significant declines in output growth for Argentina, Chile, Colombia, Ecuador, Paraguay and Peru.[12] Specifically, a one percentage point decline in Brazil's growth tends to reduce growth in Argentina, after 2 years, by 0.7

[9]Fajnzylber and Lopez (2008) found that remittance flows lead to higher rates of economic growth throughout the developing world.

[10]Compared to 5 percent of immigrants from Central America and the Caribbean. Calculated from World Bank Bilateral Migration Matrix 2013.

[11]While U.S. citizens are still not allowed to visit Cuba for the purposes of tourism, President Barack Obama expanded the categories of authorized travel to Cuba in January 2015. U.S. citizens can legally travel to Cuba if they are engaging in 12 categories of activities such as professional research, participating in an athletic event, performing in a concert, working on a humanitarian project, or taking part in educational activities.

percentage point, in Paraguay by 0.6 percentage point, in Ecuador and Peru by 0.3 percentage point, and in Chile and Colombia by 0.2 percentage point. The República Bolivariana de Venezuela's Petrocaribe program, which provides subsidized oil to certain countries, is one possible channel of negative spillovers to its LAC neighbors. The economic downturn in the country has led to a scaling-down of the program, but the impact has been limited by the sharp fall in oil prices.

A downturn in major trading partners and protracted slump in commodity prices. The baseline forecast assumes commodity prices will stabilize at around current levels. A further drop in demand from major emerging markets and continued over-supply of commodities on world markets could lead to further declines in commodity prices, which may lower government revenues, reduce export receipts, and widen current account deficits commodity exporters. Investment, especially in mining industries, could continue to decline. Countries with higher shares of commodity exports are more vulnerable to commodity price declines. On the other hand, lower oil prices in the medium term will again represent an upside risk to the forecast for oil-importing economies in the region.

Adverse effects from El Niño. Recent weather forecasts suggests that the current El Niño episode could be one of the strongest on record (World Bank 2015o). The experience of the 1997-98 episode, which inflicted widespread damage in LAC, suggests that the current El Niño weather pattern is likely to have significant adverse effects on the region's agricultural sector, as well as potentially crippling infrastructure. With growth already negative in 2015, a severe El Niño season could result in a second year of contraction for the region. A number of countries have already experienced volatile and damaging climatic effects. For example, Argentina, Chile, Colombia, Peru, Paraguay, and Uruguay have experienced exceptionally heavy rains and flooding. Drought afflicted Brazil and the north of Uruguay, and led to emergency water restrictions (EIU 2015). Drought has also damaged crops, including coffee, over a wide swathe of Central America. As the El Niño season unfolds, worse effects might yet be in store.

Policy challenges

With commodity prices expected to stabilize around the current low prices through the medium term, economies in LAC, especially commodity exporters, will no longer benefit from commodity-driven global tailwinds to boost economic growth. Regional economies will therefore need to transition to new engines of growth, while using a combination of monetary and fiscal policies to smooth the trajectory, tailored to available policy space at the country level.

Monetary policy trade-offs. In response to tighter monetary policy in the United States (and, at a later stage, in other developed economies), central banks in LAC may need to raise interest rates for a while to stave off currency depreciation and inflationary pressure. However, in countries already grappling with weak growth, some decline in the external value of the currency would be a normal part of the adjustment process. Where expectations of low inflation are firmly anchored, depreciation causes a small, temporary, increase in the inflation rate. In countries where the nominal anchor is weak, however, a drop in the exchange rate risks setting off an inflation spiral, and the central bank may have to tighten its monetary policy stance. Moreover, the effectiveness of an interest rate hike in stemming depreciation pressures depends on the credibility of the monetary policy framework (Arteta, Kose, Ohnsorge and Stocker 2015; Eichengreen and Rose 2003).

Regaining fiscal space. The room for fiscal maneuver has deteriorated across LAC since 2008. The expansionary, countercyclical policies implemented in response to the 2008 global

[12]Uruguay is also expected to be adversely affected by the recession in Brazil as Brazil is the second largest destination for Uruguayan merchandise exports. In addition, the Uruguayan peso has appreciated significantly in real terms against the Brazilian real, further weighing on Uruguayan merchandise exports to Brazil.

financial crisis led to a build-up of debt and a reduction of fiscal space (World Bank 2015n, IDB 2015). The protracted decline in commodity prices and slowdown of economic growth reduced tax revenues and further eroded fiscal positions in several countries. Consequently, most were compelled to embark on new rounds of pro-cyclical fiscal tightening in 2015, deepening the negative output impact of the external shock. Economies that resisted – or were unable to implement required fiscal adjustments – have seen severe declines in fiscal balances and increases in public debt ratios. Only a handful of countries, such as Chile and Peru, have managed to undertake fiscal stimulus measures to support growth in 2015, and even in those cases, spending has been curtailed on account of lower commodity revenues. With commodity prices across the board projected to stabilize around current low levels, regional commodity exporters need to diversify away from commodity-based activities, and over time reestablish fiscal buffers before the next downturn.

Greater investment in infrastructure will be essential to boost competitiveness. The region needs to modernize its transportation infrastructure or risk impeding advances in productivity and development. Physical infrastructure will play a key role, and its modernization will require sizable financial resources. Fiscal reforms are needed to generate the needed revenues, together with strong institutions to monitor public spending. Innovative public-private investment models may help to fund projects. Policy makers undertaking fiscal consolidation, however, often include measures that reduce or postpone capital expenditures (such as Ecuador). This reduces fiscal pressures in the short term, but delays much-needed infrastructure investment, and has detrimental medium- and longer-term consequences to productivity and economic growth. The need for stable infrastructure investment again underlines the urgency of consolidating government consumption outlays when possible, and reducing dependence on commodity-based fiscal revenues.

Economic diversification. Commodities exports represented more than 50 percent of the region's exports for the years 2012-14. The current slowdown could help garner private and public sector support for renewed regional efforts to promote economic diversification. These could promote specialization based on comparative advantage, and encourage participation in cross-border value chains. The associated transfers of know-how can facilitate diversification towards other engines of growth.[13] To this end, initiatives that promote business-friendly environments, enhance workforce skills, and boost physical and telecommunication infrastructure will be crucial for private sector development.

[13]IMF 2015h found that LAC economies could enhance long-term growth if they shift their economies toward producing a wider scope of products that are more knowledge- or technology-intensive. For example, Ecuador would grow approximately 0.4 percentage point faster every year for the next decade if its level of economic modernization was at the LAC average.

TABLE 2.3.1 Latin America and the Caribbean forecast summary

(Annual percent change unless indicated otherwise)

	2013	2014	2015e	2016f	2017f	2018f	2015e	2016f	2017f
							(Percentage point difference from June 2015 projections)		
Developing LAC, GDP[a]	3.0	1.5	-0.7	0.1	2.3	2.5	-1.5	-2.3	-0.6
(Average including countries with full national accounts and balance of payments data only)[b]									
Developing LAC, GDP[b]	3.0	1.5	-0.7	0.1	2.3	2.5	-1.5	-2.3	-0.6
GDP per capita (U.S. dollars)	1.8	0.3	-1.8	-1.0	1.2	1.4	-1.5	-2.3	-0.7
PPP GDP	3.1	1.7	-0.2	0.5	2.5	2.6	-1.4	-2.1	-0.6
Private consumption	3.3	2.0	-0.8	-0.1	1.9	2.1	-1.9	-2.2	-0.4
Public consumption	2.3	2.2	0.1	-0.6	-0.5	0.9	0.1	-0.7	-2.2
Fixed investment	4.2	-0.5	-7.7	-2.2	2.9	3.5	-6.2	-5.0	-0.9
Exports, GNFS[c]	2.7	3.5	4.7	5.0	5.0	5.0	-0.8	-0.6	-0.9
Imports, GNFS[c]	4.3	2.9	-2.1	1.7	2.9	3.9	-5.4	-2.2	-1.3
Net exports, contribution to growth	-0.4	0.0	1.4	0.7	0.5	0.2	1.0	0.4	0.2
Memo items: GDP									
Broader geographic region[d]	2.9	1.0	-0.9	0.0	2.1	2.4	-1.4	-2.1	-0.7
South America[e]	3.3	0.4	-2.1	-1.1	1.7	2.0	-1.8	-2.8	-0.8
Developing Central and North America[f]	1.8	2.5	2.7	3.0	3.2	3.4	-0.1	-0.4	-0.4
Caribbean[g]	3.0	4.2	3.3	3.1	2.9	3.1	-0.2	-0.4	0.0
Brazil	3.0	0.1	-3.7	-2.5	1.4	1.5	-2.4	-3.6	-0.6
Mexico	1.4	2.3	2.5	2.8	3.0	3.2	-0.1	-0.4	-0.5
Colombia	4.9	4.6	3.1	3.0	3.3	3.5	-0.4	-0.9	-0.9

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

a. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Cuba, Granada, and Suriname.

b. Sub-region aggregate excludes Cuba, Dominica, Granada, Guyana, St. Lucia, St. Vincent and the Grenadines, and Suriname, for which data limitations prevent the forecasting of GDP components.

c. Exports and imports of goods and non-factor services (GNFS).

d. Includes the following high-income countries: Antigua and Barbuda, Argentina, The Bahamas, Barbados, Chile, Trinidad and Tobago, Uruguay, and Venezuela, RB.

e. Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Uruguay, and Venezuela, RB.

f. Includes Costa Rica, Guatemala, Honduras, Mexico, Nicaragua, Panama, and El Salvador.

g. Includes Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

TABLE 2.3.2 Latin America and the Caribbean country forecasts[a]
(Real GDP growth at market prices in percent, unless indicated otherwise)

(Percentage point difference from June 2015 projections)

	2013	2014	2015e	2016f	2017f	2018f	2015e	2016f	2017f
Belize	1.5	3.6	3.0	2.5	2.6	2.8	0.5	-0.1	-0.1
Bolivia	6.8	5.5	4.0	3.5	3.4	3.4	-0.8	-0.7	-0.7
Brazil	3.0	0.1	-3.7	-2.5	1.4	1.5	-2.4	-3.6	-0.6
Colombia	4.9	4.6	3.1	3.0	3.3	3.5	-0.4	-0.9	-0.9
Costa Rica	3.4	3.5	2.8	4.0	4.2	4.4	-0.6	-0.2	-0.2
Dominica	1.7	3.4	-3.0	4.0	2.0	2.0	-4.3	2.5	0.4
Dominican Republic	4.8	7.3	5.6	4.6	3.8	3.9	0.4	-0.2	0.4
Ecuador	4.6	3.7	-0.6	-2.0	0.0	0.5	-2.5	-5.0	-4.2
El Salvador	1.8	2.0	2.4	2.5	2.6	2.8	0.2	0.0	0.0
Guatemala	3.7	4.2	3.7	3.6	3.5	3.6	-0.3	-0.3	-0.4
Guyana	5.2	3.9	3.5	3.8	4.0	4.0	-0.2	0.0	0.0
Haiti[b]	4.2	2.7	1.7	2.5	2.8	3.0	0.0	-0.7	-0.3
Honduras	2.8	3.1	3.4	3.4	3.5	3.6	0.5	0.1	0.0
Jamaica	0.5	0.7	1.3	2.1	2.4	2.6	-0.2	-0.1	-0.1
Mexico	1.4	2.3	2.5	2.8	3.0	3.2	-0.1	-0.4	-0.5
Nicaragua	4.6	4.7	3.9	4.2	4.1	4.0	-0.3	-0.1	-0.1
Panama	8.4	6.2	5.9	6.2	6.4	6.6	-0.3	-0.2	-0.1
Paraguay	14.0	4.7	2.8	3.6	4.0	4.2	-1.4	-0.5	-0.1
Peru	5.8	2.4	2.7	3.3	4.5	4.6	-1.2	-1.7	-0.5
St. Lucia	-1.9	-0.7	1.7	1.6	1.9	2.1	2.3	0.8	0.5
St. Vincent and the Grenadines	2.3	-0.2	2.1	2.7	3.0	3.4	-0.5	-0.2	-0.4

	2013	2014	2015e	2016f	2017f	2018f	2015e	2016f	2017f
Recently transitioned to high income countries[c]									
Argentina	2.9	0.5	1.7	0.7	1.9	3.0	0.6	-1.1	-1.1
Chile	4.2	1.9	2.1	2.4	2.9	3.1	-0.8	-0.9	-0.6
Trinidad and Tobago	1.7	1.0	0.0	0.5	1.2	1.5	-1.8	-1.5	-1.0
Uruguay	5.1	3.3	1.5	1.9	2.8	3.0	-1.1	-1.2	-0.4
Venezuela, RB	1.3	-4.0	-8.2	-4.8	-1.1	0.0	-3.1	-3.8	-2.2

Source: World Bank.
World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
a. Cuba, Grenada, and Suriname are not forecast due to data limitations.
b. GDP is based on fiscal year, which runs from October to September of next year.
c. Based on the World Bank's country reclassification from 2004 to 2015.

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean

The Latin America and Caribbean region (LAC) is less open than other emerging and developing regions to global trade and finance. Despite a multitude of regional trade agreements, economic linkages within the region tend to be limited and largely confined to sub-regions. Estimated spillovers from growth slowdowns in Brazil are modest for its South American neighbors (Argentina, Chile, Colombia, Ecuador, Paraguay and Peru), while those from Mexico are negligible.

Introduction

Although there is considerable heterogeneity among countries, the LAC region is one of the least open regions to trade, despite a large presence in global commodity markets. Commodity discoveries, and the prospect of large domestic markets, have attracted considerable FDI and portfolio flows into the region. Among the three sub-regions, South America is most dependent on global commodity markets, while its trade and financial partners are broadly diversified. In contrast, the main economic partner of developing Central and North America, and the Caribbean is the United States. Regional trade and finance flows are limited. However, the three sub regions have forged somewhat closer sub-regional ties, especially in South America.

This box addresses the following questions:

- How open is the LAC region to global and regional trade and financial flows?
- How significant are the potential intra-regional spillovers from the region's two largest economies, Brazil and Mexico?

Brazil and Mexico are the two largest economies in the region. Brazil has slipped into recession due to a combination of global and domestic challenges. While still positive, Mexico's growth has been tepid recently, compared to the pre-crisis and immediate post-crisis years. While the low growth of the region's largest economies may weigh on the outlook of trading partners and financial counterparts elsewhere in the region, limited intra-regional ties reduce the potential drag. Growth slowdowns in Brazil are estimated to have measurable spillovers to South American neighbors (Argentina, Chile, Colombia, Ecuador, Paraguay and Peru), whereas growth decelerations in Mexico have negligible spillovers to other countries in the region.

Note: This box was prepared by Derek H. C. Chen with contributions from Raju Huidrom, Duygu Guven, Jesper Hanson and Mai Anh Bui.

How open is the LAC region to global and regional trade and financial flows?

Of the six World Bank developing country regions, LAC is the least open to trade, and the region's role in global trade is considerably less than its contribution to global activity (Figure 2.3.1.1). The region is not well integrated into international supply chains, in contrast to East Asia, for example (Estevadeordal 2012; De la Torre, Dider, Ize, Lederman and Schmukler 2015). The region's heavy reliance on primary commodity exports, the associated lack of economic diversification, and the narrow product base are additional contributing factors for being relatively closed. However, the region has absorbed a large share of global FDI, which has been attracted by rapidly growing domestic markets, and by commodity discoveries. Portfolio inflows into LAC have been quite high, but the stock of liabilities relative to GDP has declined (Figure 2.3.1.2). Post-crisis, LAC trade has grown broadly in line with the global economy, while remittance flows have lagged behind those of other developing regions. The anemic recovery and weak labor market in Spain, which hosts about 5 percent of South American migrants, has held back remittance flows to the sub-region (Figure 2.3.1.3). Similarly, in the United States, modest growth in the sectors employing a large share of immigrants (construction and agriculture) and stricter enforcement of immigration laws have discouraged migrant inflows from Central America, constraining remittance flows (Chishti and Hipsman 2015).

The United States and Europe continue to be the most important economic partners for the region, accounting for 40-80 percent of LAC's trade and financial flows (Figure 2.3.1.4). The United States remains the largest importer from the region (exceeding 7 percent of regional GDP in 2011-14). That said, for South and Central America as well as the Caribbean, the share of exports to the United States has steadily declined since 2000, as exports to other major destinations and other LAC economies have gained ground (Cesa-Bianchi et al. 2012).

The LAC region does have a large global presence in commodity markets. On average, primary commodities constitute more than 50 percent of regional goods exports

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

and 9 percent of GDP (Figure 2.3.1.5). South America is, by far, the most commodity-intensive sub-region, with commodities making up more than 70 percent of merchandise exports, and nearly 10 percent of GDP. Although developing Central and North America is considerably less commodity dependent than South America, commodities still account for about one quarter of exports, and 7.5 percent of GDP. Reliance on commodity exports tends to be associated with a high correlation between commodity prices and GDP, implying a higher susceptibility to commodity price fluctuations and increased volatility in activity (Camacho and Perez-Quiros 2013).

There are important differences in regional and global integration across the three sub-regions within LAC. Regional economic links are generally modest, and mostly within sub-regions. Examples are trade among Central American countries (excluding Mexico), and trade and remittances within South America (World Bank 2005, ECLAC 2014, Villarreal 2012). Even within regional trade agreements, trade remains modest, partly reflecting low road and rail density (Scholvin and Malamud 2014). Argentina, Bolivia, Paraguay and Uruguay, which are Mercosur members, ship only 20 to 30 percent of their exports to Brazil—compared with 40-60 percent of within -region trade for member countries of the North American Free Trade Agreement (NAFTA) and the European Union (EU) (Chapter 4.1).[1] FDI flows from Brazil and Mexico are largely confined to their respective sub-regions as well (Figure 2.3.1.6).

South America's trade links are well-diversified, but its financial flows predominantly originate from Europe, and its remittances inflows originate about equally from the United States and Europe.

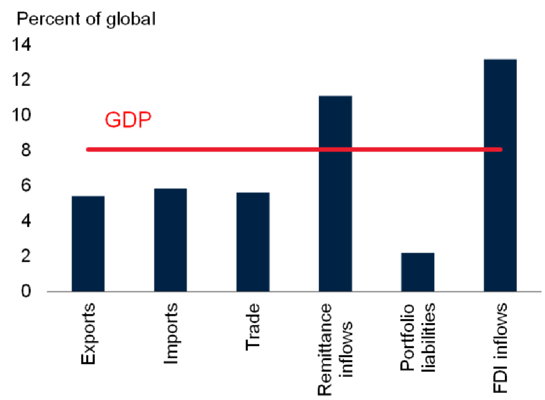
Central America's trade, remittances and, to a lesser extent, portfolio flows, rely heavily on the United States. Other financial flows predominantly originate from Europe. With its economic linkages enhanced by NAFTA, around 80 percent of Mexican exports are shipped to the United States. Mexico's trade with Central America is modest (with the exception of Nicaragua, which ships about 20 percent of its exports to Mexico, IMF 2012a).

[1]Bolivia is an associate state and in the final stages of the accession to become a full and the sixth member of Mercosur.

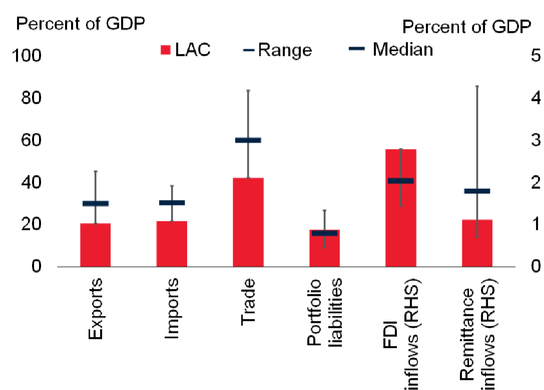
FIGURE 2.3.1.1 International linkages: Cross-region comparison

The Latin America and Caribbean (LAC) region is the least open to trade among the six World Bank developing regions. But it absorbs a large share of global FDI. Portfolio inflows are small on a global scale, but the stock of portfolio liabilities relative to GDP is similar to the average for the other developing regions.

A. LAC share of global activity, trade and finance, 2014



B. LAC trade and finance in regional comparison, 2014



Sources: IMF October 2015 World Economic Outlook, IMF International Financial Statistics, IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Remittance and Migration Database, World Bank World Development Indicators.

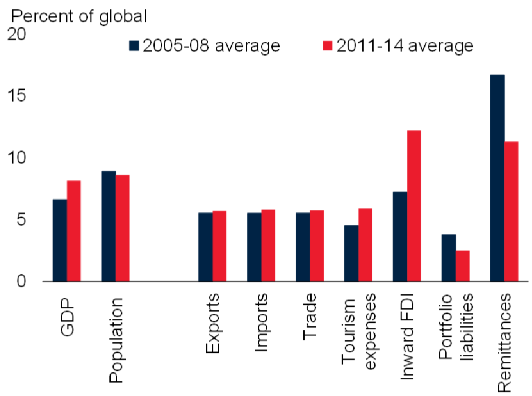
B. The red bar denotes exports, imports, trade, remittance inflows, portfolio liabilities and FDI inflows in percent of GDP on average across LAC countries. The vertical line denotes the range of averages for all six developing country regions.

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

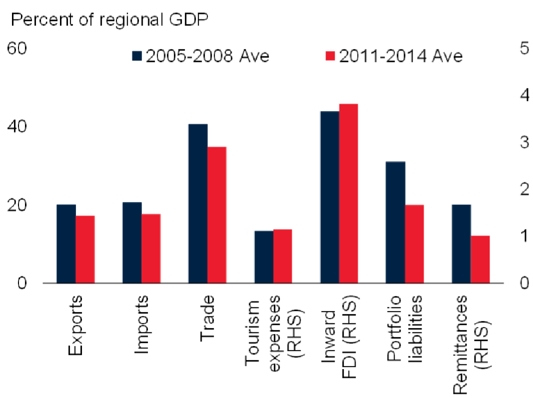
FIGURE 2.3.1.2 Evolution of openness

External ties—other than remittances—have grown broadly in line with the global economy. However, they have shrunk relative to regional GDP as a result of rapid growth led by domestic demand that was supported by policy in the wake of the crisis. Slow growth in Europe and a fragile recovery in the United States have set back remittances.

A. LAC's share of global GDP, population, trade and financial flows



B. Trade and financial flows in percent of regional GDP



Sources: IMF April 2015 World Economic Outlook, IMF International Financial Statistics, IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Remittance and Migration Database, World Bank World Development Indicators.
Note: Tourist arrivals and tourism expenditures data are average 2011-2013.

The Caribbean is deeply tied to the United States and to Japan, via foreign claims on Caribbean banks. Similar to Central America, sub-regional trade is modest (around 16 percent of total sub-regional total merchandise exports in 2014). This may partly reflect countries having similar economic structures and a prevalence of services trade.

Major trade agreements such as NAFTA and CAFTA-DR deepened ties between LAC and North America (World Bank 2014a). The 1994 NAFTA between Canada, Mexico, and the United States, was aimed at eliminating tariffs and substantially reducing nontariff barriers in a broad range of sectors by 2008. NAFTA has greatly boosted trade and FDI flows, and at the same time increased business cycle co-movement among the three North American economies (Lederman, Maloney and Servén. 2005). For example, NAFTA is estimated to have increased Mexican exports to the United States by 5-8 percent per year. Other estimates attribute to NAFTA as much as half of the post-1993 increase in exports from Mexico to the United States.[2]

The Dominican Republic-Central America FTA (CAFTA-DR) is a free trade agreement between the United States and Central American economies (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, the Dominican Republic), which came partially into effect in 2005 and fully in 2009. Total goods trade between the U.S. and the six CAFTA-DR partners increased from $35 billion in 2005 to $60 billion in 2013 (USTR 2015). The trade and growth benefits of the agreements would be considerably enhanced by domestic reforms and infrastructure investment (Lopez and Shankar 2011).

Regional integration has been promoted through various regional agreements within the sub-regions (Figure 2.3.1.4):

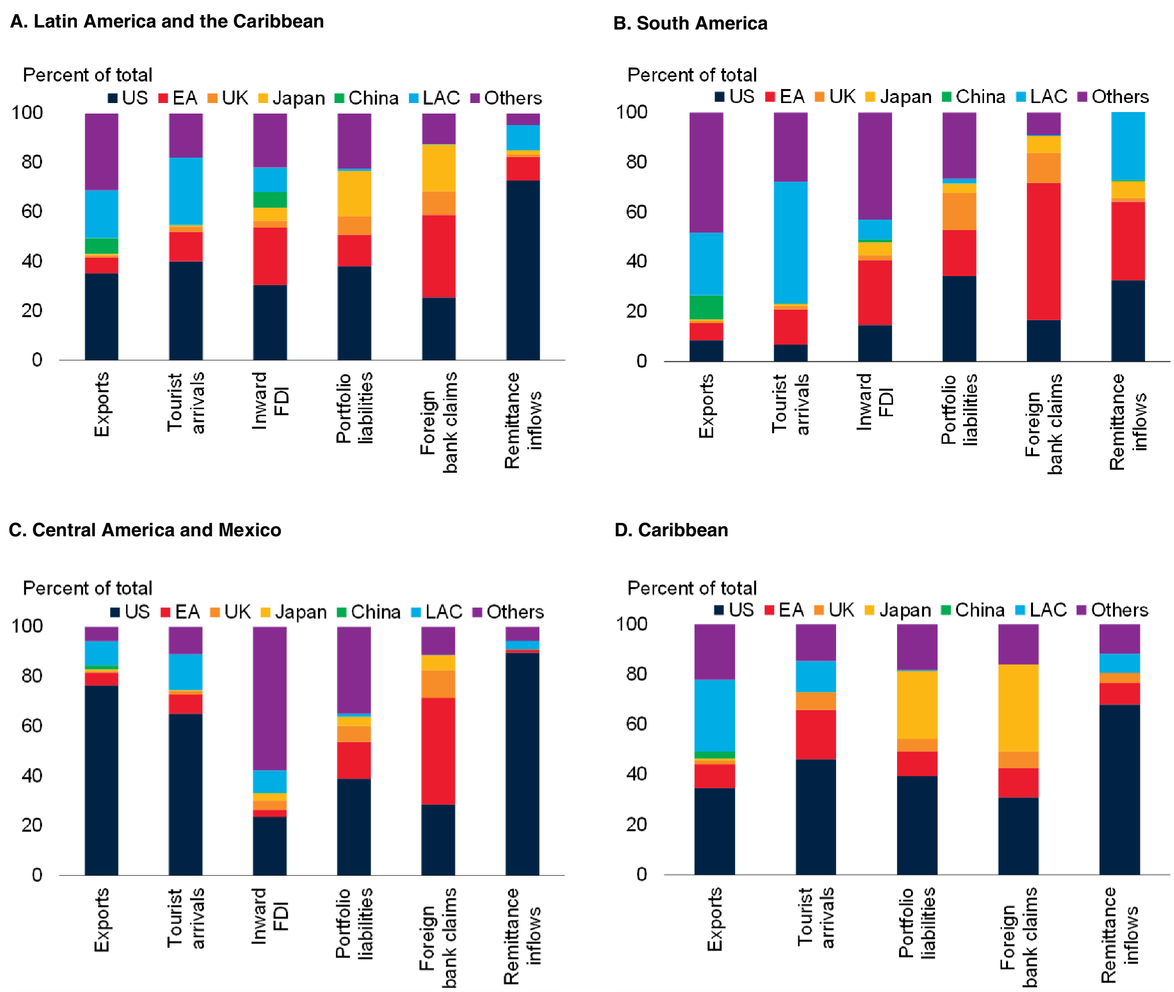
- The Mercosur (Common Market of the South) customs union came into force in 1991, and comprises five member countries—Argentina, Brazil, Paraguay, Uruguay, and the República Bolivariana de Venezuela—and Bolivia, which is in the final stages of the accession to become the sixth member. While

[2]See Romalis (2007); CBO (2003); Easterly, Fiess and Lederman (2003); Cuevas, Messmacher, and Werner (2002); Torres and Vela (2003); Kose, Meredith, and Towe (2005). Lederman, Maloney, and Serven (2005) estimate that Mexico's exports would have been 50 percent lower and its FDI 40 percent less without NAFTA and the agreement may have lifted GDP per capita by some 4 percent during 1994-2002.

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.3 Sources of trade and financial flows

LAC has a diversified set of export markets. Remittances are predominantly from the United States, and financial inflows are mostly from Europe. However, there are considerable differences between sub-regions. Central America, Mexico and the Caribbean are most closely tied to the United States. South America is most closely tied to Europe and other countries within the region.



Sources: IMF April 2015 World Economic Outlook, IMF International Financial Statistics, IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Remittance and Migration Database, World Bank World Development Indicators, UNWTO, Bank for International Settlements.
Note: Exports and remittance inflows are average 2011-14. Portfolio liabilities and tourist arrivals are average 2011-13. FDI inflows are average 2010-12. Foreign banking claims are for 2014.

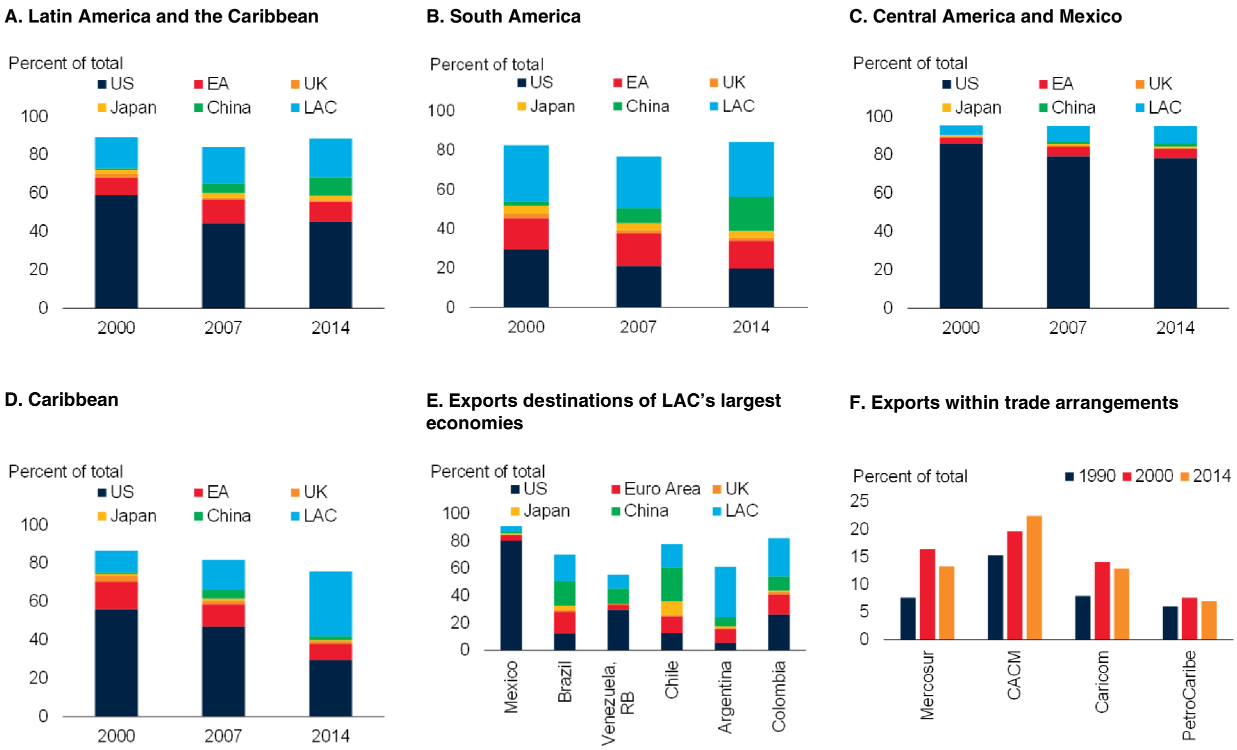
there has been some controversy about the net impact of Mercosur, the share of exports to other members has increased from 7.6 percent in 1990 to 13.3 percent in 2014 (Connolly and Gunther 1999).

- CACM (Central American Common Market) is an association of five Central American nations (Guatemala, Honduras, El Salvador, Nicaragua, Costa Rica) that was formed in 1960 to facilitate regional economic development through free trade and economic integration. Exports among members have steadily increased from about 15 percent in 1990 to around 22 percent of total exports in 2014. Since its inception, CACM is estimated to have tripled

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.4 LAC exports

LAC exports to the United States have grown less rapidly than those to China (especially for South America) and to other LAC countries (especially in the Caribbean).



Source: IMF Direction of Trade Statistics.
E. Data is for 2014.
F. Mercosur members: Argentina, Brazil, Paraguay, Uruguay, and República Bolivariana de Venezuela (established 1991). CACM members: Guatemala, Honduras, El Salvador, Nicaragua, Costa Rica (established 1960). Caricom members: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago (established in 1973). PetroCaribe members: Antigua and Barbuda, the Bahamas, Belize, Cuba, Dominica, Dominican Republic, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Saint Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and República Bolivariana de Venezuela (established in 2005). Chart shows República Bolivariana de Venezuelan exports to PetroCaribe members as a share of total exports.

member country exports compared to a baseline without such an agreement (Baier and Bergstrand 2009).

- Caricom (The Caribbean Community) is a common market established in 1973. Members consist of Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago. Empirical estimates have found that the agreement has had a modest impact on trade among members (Moreira and Mendoza 2007). Within-agreement exports constituted 13 percent of total exports in 2014.

- PetroCaribe is an energy initiative launched in 2005 to supply Venezuelan crude oil to countries in the Caribbean region on discounted terms. Current members of PetroCaribe include Antigua and Barbuda, the Bahamas, Belize, Cuba, Dominica, Dominican Republic, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Saint Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines,

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

Suriname, and República Bolivariana de Venezuela.[3] The share of Venezuelan exports to PetroCaribe members has remained broadly unchanged since the inception of the initiative.

How large are the potential regional spillovers from Brazil and Mexico?

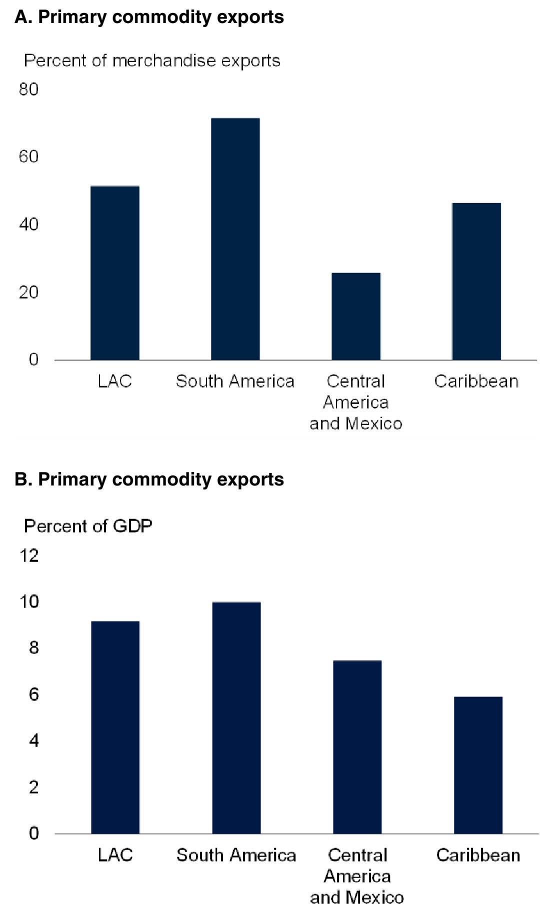
Brazil and Mexico are the largest economies in LAC. Together, these two countries account for 60 percent of regional GDP and trade, 50 percent of population, 75 percent of portfolio and 50 percent of FDI flows and 30-40 percent of tourism expenditures and remittance flows (Figure 2.3.1.7).

Business cycle co-movements can be indicative of intraregional spillovers. Correlations of quarterly growth suggest that business cycles of a number of LAC economies are positively correlated with those of Brazil and Mexico (Figure 2.3.1.8). South American economies tend to exhibit higher business cycle correlations with Brazil, and Central American economies have higher business cycle correlations with Mexico. These correlations appear to be driven mainly by relative trade shares, but they could also be indicative of economies responding together to a common external shock.

To examine the magnitude of spillovers from Brazil and Mexico to their Latin American neighbors, while accounting for common external factors, a series of country-specific Bayesian structural vector autoregressions (VARs) models are estimated. The VARs include G-7 growth, EMBI as a proxy for external financing conditions, growth in China (a major non-G7 trading partner for the region), growth in Brazil and Mexico as source countries of shocks, trade-weighted commodity prices, growth in each spillover destination country, and real effective exchange rates (see Annex 3.2 for details). The analysis includes 13 spillover destination countries in

FIGURE 2.3.1.5 LAC commodity exports

The LAC region's exports are heavily concentrated in primary commodities.



Source: UN Comtrade Database 2015.
A. and B. GDP-weighted averages for 2013-14.

LAC.[4] The data coverage is for 1998 Q1 - 2015 Q2, except for Colombia and Honduras where the data runs from 2000 Q2 – 2015 Q2, and Jamaica, where it 2002 Q2 – 2015 Q2. A dummy variable is included for the global financial crisis.

The results suggest that spillovers from Brazil to neighboring countries are moderate, while those from Mexico are negligible.

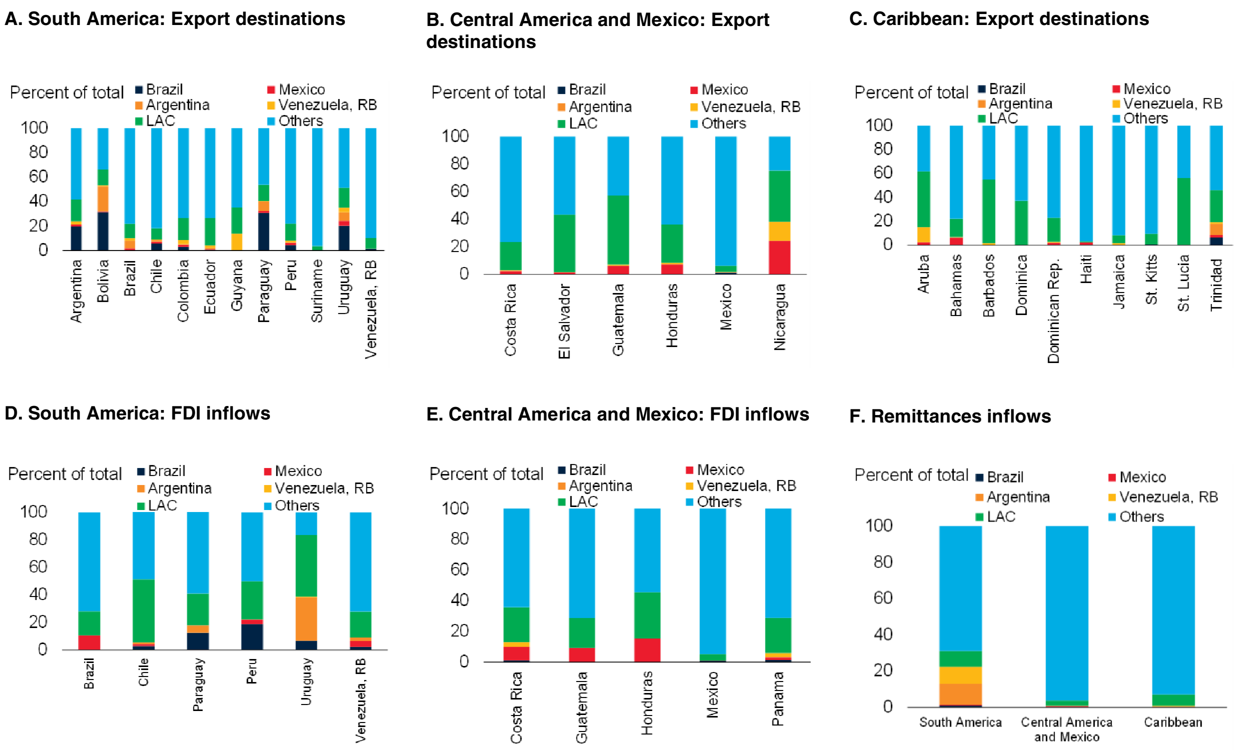
[3]Under the PetroCaribe program, the member countries that purchase oil from República Bolivariana de Venezuela pay for a certain percentage of the oil (depending on world oil prices) within 90 days, and the remainder is paid over a period of 25 years with an interest rate of one percent annually. Part of the cost may be offset by the provision of goods or services. Recently, to secure external funds, the government of República Bolivariana de Venezuela has renegotiated repayment, at deep discounts, of commercial credits to the Dominican Republic, Jamaica and Uruguay.

[4]Southern Cone countries include Argentina, Chile, Paraguay and Uruguay. Andean Community countries include Bolivia, Colombia, Ecuador and Peru. Central America and Caribbean economies include Belize, Guatemala, El Salvador, Honduras and Jamaica.

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.6 Within-region trade and FDI

Brazil accounts for a significant share of trade and FDIs to other South American countries, while Mexico only has significant FDI links. Remittances come predominantly from outside the region.



Source: IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Bilateral Remittance Matrix 2014.
Notes: A-C. Data for 2014.
D-E. Data for average of 2010-12.
F. Data is for 2014.

- *Spillovers from Brazil.* In the estimation results, growth declines in Brazil tend to have measurable or statistically significant spillovers to its South American neighbors. A one percentage point decline in Brazil's growth tends to reduce growth in Argentina, after 2 years, by 0.7 percentage point, in Paraguay by 0.6 percentage point, in Ecuador and Peru by 0.3 percentage point, and in Chile and Colombia by 0.2 percentage point (Figure 2.3.1.9).[5,6]

- Spillovers from Mexico. In contrast, spillovers from Mexico to Central America are negligible or not statistically significant (Figure 2.3.8). This result is in line with findings in other studies (Adler and Sosa 2014; Kose, Rebucci and Schipke 2005; Swiston 2010).

While there are measurable regional spillovers, particularly in South America, they are modest compared to those from the region's main external trade and financial partners. Over the two years following the growth decline, a one percentage point decrease in G7 growth lowers

[5]Brazil is Argentina's largest trading partner. In some sectors, such as automobiles, Brazil accounts for about 80 percent total exports. Spillovers from Brazil to Argentina play a big role in these sectors, and contracting economic activity in Brazil has adversely affected the auto industry in Argentina, spurring waves of production stoppages in major auto plants in 2015.

[6]The estimates from Adler and Sosa (2014) differ somewhat, partly because their sample time period includes the Tequila crisis of 1994. Their results show that spillovers from Brazil are significant for Argentina, Bolivia, Paraguay, Peru, Uruguay, and the República Bolivariana de Venezuela, but less so for Ecuador.

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

growth by more than 1 percentage point in Brazil, Chile, Mexico, Honduras and Ecuador. This is broadly in line with Österholm and Zettelmeyer (2008) who find a roughly one-for-one response to a change in growth in the United States. Similarly, Izquierdo, Romero, and Talvi (2008) also find a pass through of 0.6 percentage point to LAC GDP growth in response in 1 percentage point increase in G7 industrial production.

As a result of deep trade and financial links, spillovers from the United States to the region are particularly strong. Peaks and troughs of industrial production in some of the largest LAC countries—especially Mexico—tend to coincide with those in the United States (Cuevas, Messmacher and Werner 2003; Mejía-Reyes 2004). U.S. growth and U.S. industrial production are significantly correlated with growth in Mexico and Central America (IMF 2007; Fiess 2007; Roache 2008).

In addition, these estimates also show sizable linkages with China. A one percentage point growth deceleration in China reduces growth in Argentina by about 1.9 percentage points, in Brazil, Peru, Paraguay and Uruguay by 0.5 percentage point, and in Ecuador, Chile, Bolivia, Honduras, Guatemala, Colombia, El Salvador, and Mexico by 0.2 percentage point.[7] While larger than the estimated regional spillovers from Brazil and Mexico, the estimated spillovers from G7 economies to the LAC region are smallest among six World Bank regions of developing economies (see Box 3.4 and Figure 3.4.3), largely because the LAC region is more closed to the global economy than other regions. Overall, these findings are broadly in agreement with Boschi and Girardi (2011) and Caporale and Girardi (2012), who find that global factors are somewhat more important sources of output growth variability in LAC than regional factors.[8]

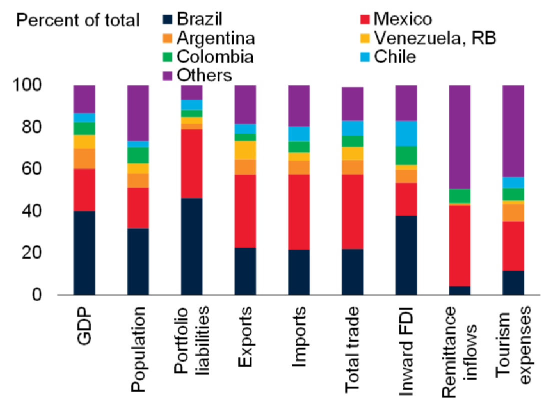
Conclusion

Despite a number of regional agreements, regional trade remains limited, partly reflecting the lack of an extensive

FIGURE 2.3.1.7 The role of the largest economies in LAC

Brazil and Mexico are, by far, the largest economies in the region. In 2011-2014, these two countries accounted for 60 percent of regional GDP and trade, 50 percent of its population, 75 percent of portfolio and 50 percent of FDI flows, and 30-40 of tourism expenditures and remittance flows.

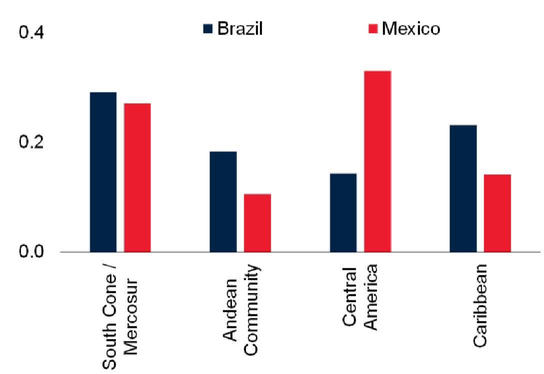
A. Share of regional total, 2011-14.



Source: IMF April 2015 World Economic Outlook, IMF International Financial Statistics, IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Remittance and Migration Database, World Bank World Development Indicators.
Note: GDP, Exports, FDI inflows and Remittance inflows are average for 2011-14. Portfolio liabilities are average 2011-13.

FIGURE 2.3.1.8 Correlations with Brazil and Mexico

Business cycles of a number of LAC economies are positively correlated with cycles in Brazil and Mexico. Correlations tend to be larger for countries in close proximity.



Source: Haver Analytics and World Bank staff estimates.
Note: Cross-country average of contemporaneous correlations in each country's quarterly growth with that of Brazil or Mexico.

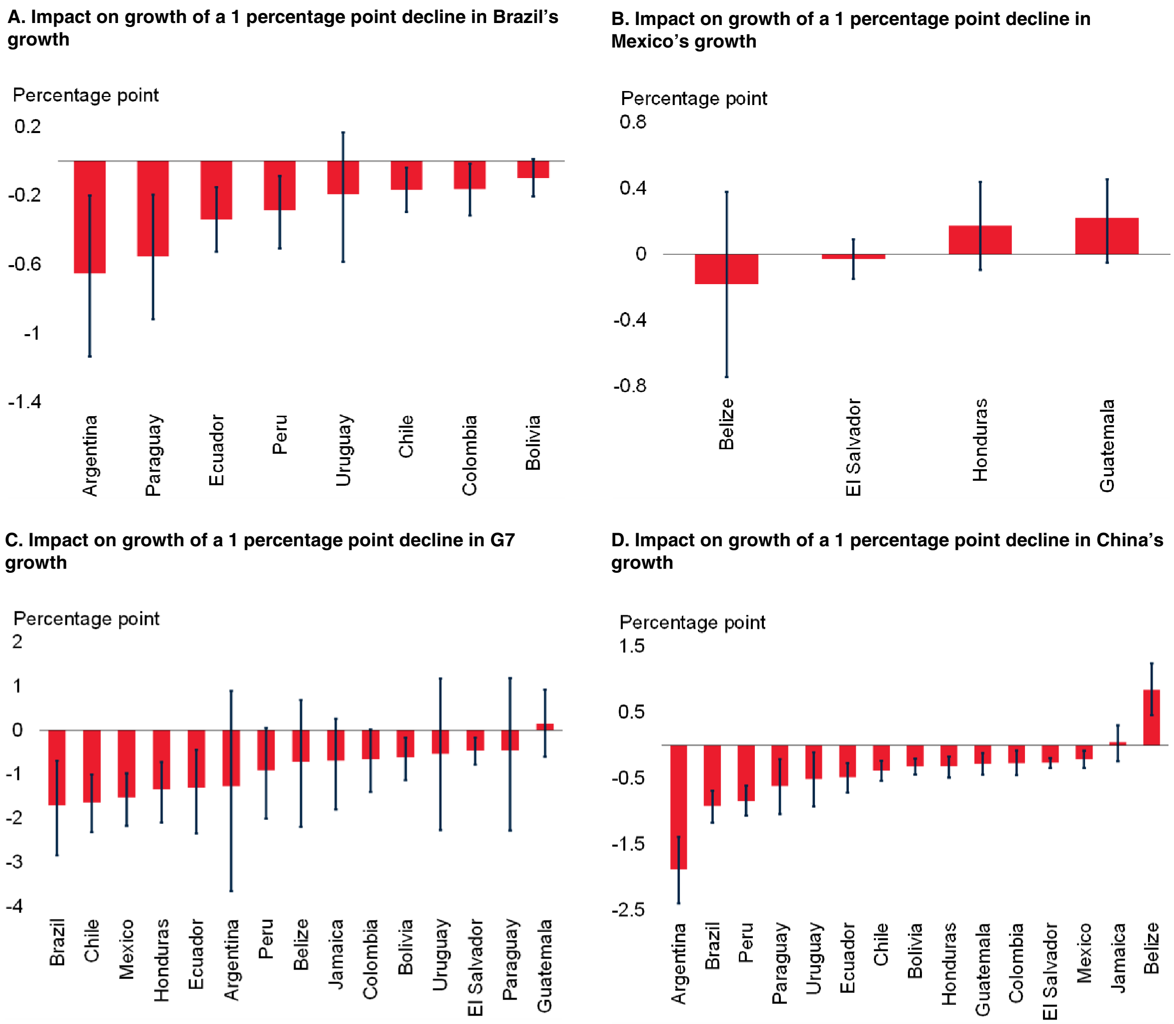
[7]Similar findings were reported in World Bank (2015n) and Cesa-Bianchi et al. (2012).

[8]A number of previous authors who have found that country-specific factors explain the majority of cyclical variation and output variability in LAC growth (Kose, Otrok and Whiteman 2003; IMF 2007; Loayza, Lopez and Ubide 2001; Boschi and Girardi 2011). On the other hand, other studies have also documented that external factors nevertheless do account for a significant share of growth variance of LAC economies (Izquierdo, Romero and Talvi 2008; Österholm and Zettelmeyer 2008; Aiolfi, Catão and Timmermann 2011).

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.9 Spillovers from Brazil, Mexico, G7 and China

Growth shocks in Brazil have measurable spillovers to its South American neighbors - Argentina, Chile, Colombia, Ecuador, Paraguay and Peru. Estimated spillovers from growth shocks in Mexico are not statistically significant. Within-region spillovers are considerably smaller than spillovers from growth shocks in G7 countries or China.



Source: World Bank staff estimates.
Note: Spillover estimates derived from impulse responses after two years from a Bayesian structural vector autoregression estimated using quarterly seasonally adjusted GDP data. The maximum data coverage is 1998Q1-2015Q2; while coverage for some countries is shorter (from 2000Q2 for Colombia and Honduras and from 2002Q2 for Jamaica). The model is estimated for each spillover destination country and the variables include, in this Cholesky ordering: G-7 growth, EMBI, China growth, Brazil and Mexico growth, the country's trade-weighted commodity price growth, the country's real GDP growth, and the country's real effective exchange rate appreciation. Quarterly GDP data was downloaded from Haver Analytics on November18, 2015. Bars represent medians, and error bars 33-66 percent confidence bands.

international value chain network and heavy reliance on commodity exports to external markets. The lack of economic diversification and narrow product base could be another contributing factor to the generally closed nature of the region (IMF 2015h). Poor quality of regional transport networks and associated infrastructure further hinder within-region trade (World Bank 2012a; Figure 2.3.1.10). Intraregional trade linkages and FDI

BOX 2.3.1 Regional integration and spillovers: Latin America and the Caribbean *(continued)*

flows within Latin America are largely confined within sub -regions (De la Torre, Lederman and Pienknagura 2015). These linkages are stronger in South America than in Central America.

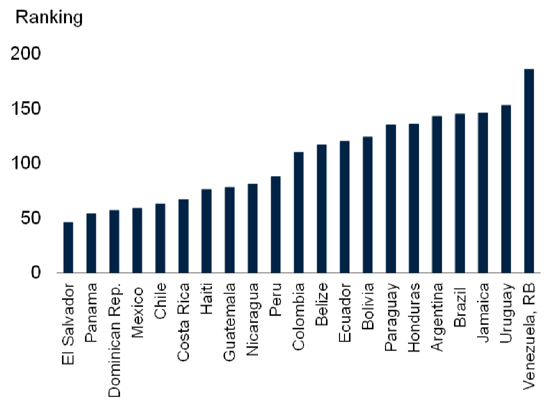
Reflecting these modest within-region ties, spillovers from growth decelerations in Brazil to some of its South American neighbors are estimated to be modest, while spillovers from Mexico are negligible. Spillovers from the region's main trading partners, however, tend to be considerably larger than within-region spillovers, albeit less than in other emerging and developing country regions.

Regional trade could strengthen in the medium term. With commodity prices expected to stabilize around current low levels, export baskets could shift towards a more diversified export product mix among regional commodity exporters, facilitating regional trade. Moreover, the sharp depreciations of regional currencies against the U.S. dollar may favor imports from intra-regional partners at the expense of those from the United States.

FIGURE 2.3.1.10 Ease of trading across borders

LAC economies are ranked low in terms of ease of trading across borders.

A. Rankings in Ease of Trading Across Borders, 2015



Source: World Bank 2015f.

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