

Tailwinds in the Short Run Coupled with Long Run Challenges

Latin America and the Caribbean has been the most affected region by the COVID-19 pandemic with the deepest economic activity contraction in 2020. However, the recent revision of growth forecasts indicates that 2021 will be better than expected, and the GDP gap relative to pre-pandemic levels could be closed earlier than expected. This performance is driven by a favorable context of external factors (low global interest rates and high international prices of foods and metals) that affect the domestic business cycle fluctuations, which is particularly relevant for South America. To sustain growth in the long run, the region needs structural reforms. Among them, a big challenge for the region is to improve the quality of human capital. The postponed agenda of the educational reform must be managed carefully to maintain social peace, in a region characterized by multiple episodes of social unrest. The reforms must deal with an additional obstacle: the political volatility given by an electoral calendar with results strongly influenced by the handling of the COVID-19 pandemic. This report presents our view on the perspectives of a region that profits from tailwinds in the short run but is full of challenges to ensure development in the long run.

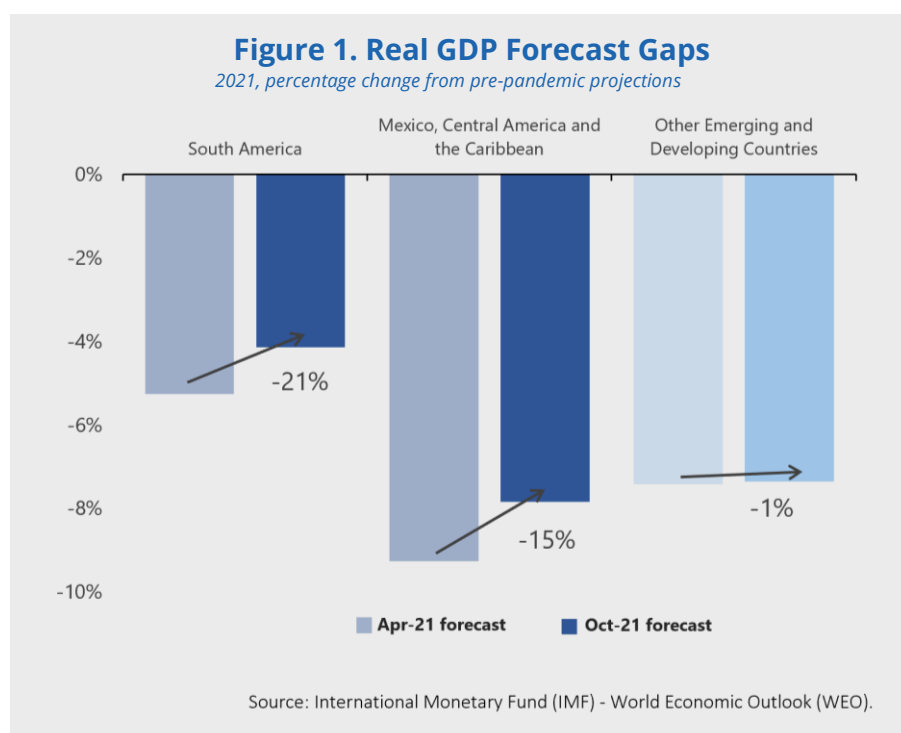
Where does Latin America and the Caribbean stand?

Latin America and the Caribbean (LAC) has been the most affected region by the COVID-19 pandemic. It underwent both the strictest lockdown measures and the deepest economic activity contraction.

According to April International Monetary Fund (IMF) World Economic Outlook (WEO), LAC countries were expected to record the greatest loss in terms of their own economic growth path in 2021. Specifically, the average real gross domestic product (GDP) was expected to be well below pre-pandemic forecasts, with gaps of 5.3% and 9.3% for southern (South America) and northern (Mexico, Central America and the Caribbean) subregions, respectively.

However, the IMF significantly revised upward its growth forecasts for LAC in October WEO. South American countries are now expected to grow 6.3% on average in 2021 (compared to 4.9% in April WEO), while Mexico, Central America and the Caribbean are currently projected to grow at an average annual rate of 5.7% this year (compared to 4.2%). Even though these revisions suggest GDP gaps will close faster than in other emerging regions, this performance would not be sufficient to reach pre-pandemic levels. As depicted in Figure 1, southern and northern subregions would still be about 4% and 8% below pre-pandemic GDP levels, respectively.

Expectations of a better performance are partially explained by a more favorable external context. A vast literature documents the relevance of external factors in GDP growth for the region.¹



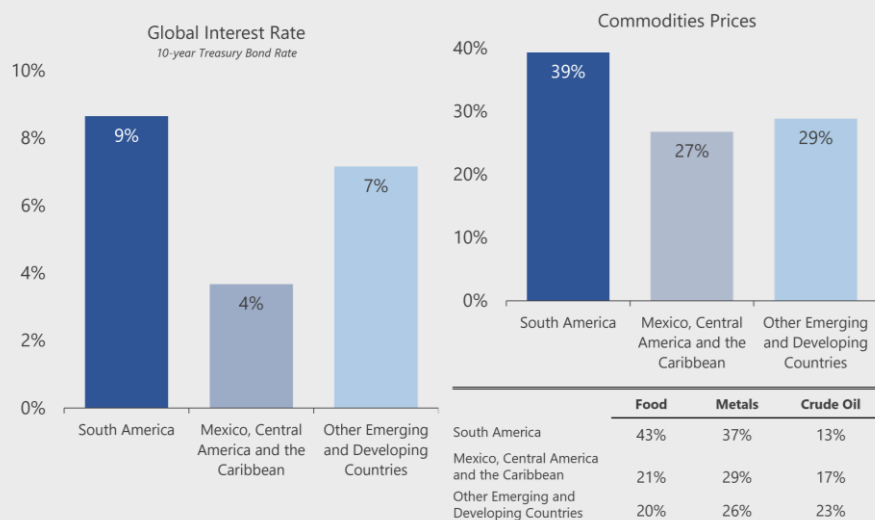
This is particularly relevant for South America, a region that strongly benefits from high commodity prices and low global interest rates. On the one hand, the southern subregion is characterized by a productive structure based on natural resources. Around 30% of its exports are comprised of food related products, 20% of metal and 10% of mineral fuels and oils. These products represent more than half of South American exports, making its business cycle highly sensitive to the evolution of international commodity prices. On the other hand, not only has South America major difficulties to generate savings, but it has also experienced problems in channeling them into investment spending. In fact, gross savings represent 17% of

GDP in South, compared to a 23% among high-income countries. As a result, economic activity has become highly dependent on the evolution of international interest rates, that affect foreign direct investment, financial investments and loans, and public debt financing.

Figure 2 presents the average correlations between GDP growth and key prices for different developing regions. As it can be noticed, South America exhibits the highest correlation between economic activity and both global interest rates and commodity prices. The southern subregion has also the highest correlation with international food prices and international metal prices. The

Figure 2. External Factors – GDP Correlation

Average correlation of variation of the GDP of each country in the region considered and the variation of each corresponding variable, 1990-2019.



Source: International Monetary Fund (IMF), World Bank and Investing.

correlation with international oil prices is weaker than for the northern subregion and the rest of the emerging world.

External factors and short-run economic performance

In a world characterized—now more than ever—by the lack of certainties, external factors are driving the stronger-than-expected recovery of South American and the rest of LAC countries.

Global economic recovery is becoming more of a reality, though heterogeneous and with its sustainability conditioned by COVID-19 vaccination rates. LAC thrives with the expected growth of

China and the developed world, given the pressure it adds to the demand for foods, metals and minerals. In turn, this context also helps the region find higher prices for its exports.

The current economic outlook has been brightened by several factors, including United States (US) 1.9-billion fiscal stimulus released in early 2021, COVID-19 vaccines success, and the expansive monetary policy applied by the Federal Reserve (Fed), with interest rates near the lower bound. Global interest rates, still in historically low levels, is of utmost relevance to LAC countries both as a determinant of the price countries

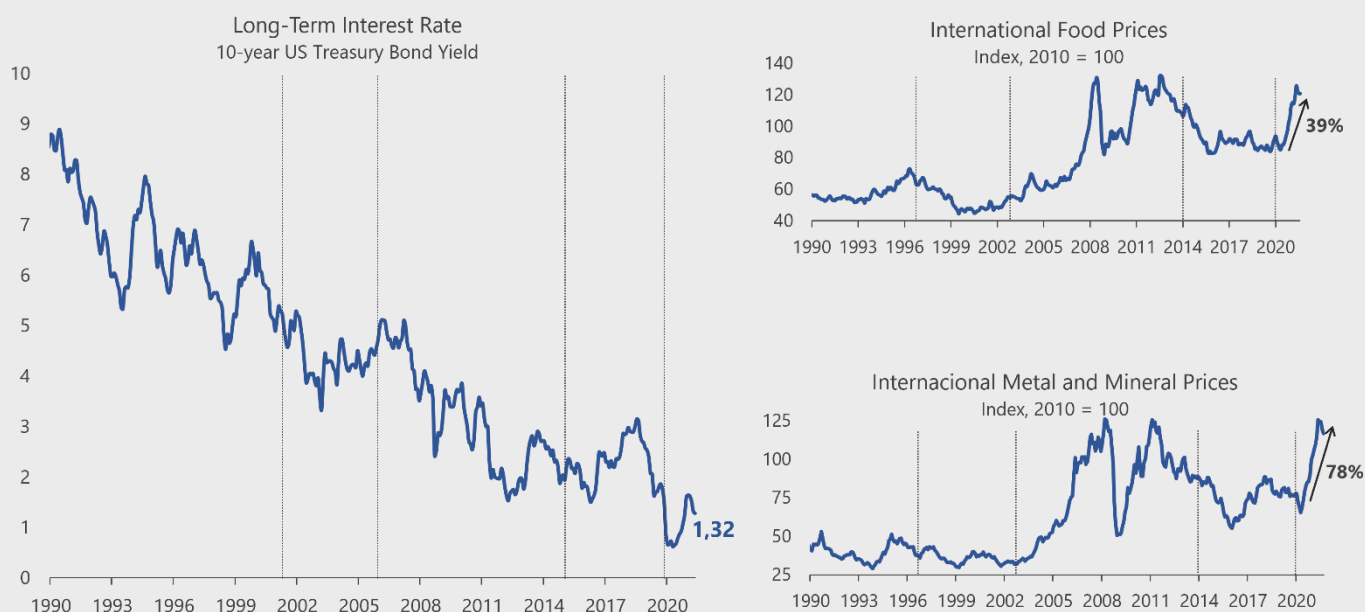
need to pay to finance their debts, and as the benchmark used by investors to compare investment projects (see Figure 3).

However, a lax monetary policy is not free. When the amount of money circulating increases beyond certain limits, inflation might well get out of control. US inflation printed at 6.2% this past October (compared to a 2.5% in January 2020) and Treasury Secretary Janet Yellen does not expect inflation to return to acceptable levels until the latter part of next year. If inflation continues its rise, the Fed is expected to accelerate interest rates hikes. As of today, the Organisation for Economic Co-operation and Development (OECD) expects the US economy to expand at a 6% rate during the current year.

Europe has been one of the regions that suffered the most from the health-related and economic effects of the pandemic. After registering a 6.6% decrease in their GDP in 2020, the main economies of Europe have shown signs of recovery. The OECD expects the Eurozone to grow by 5.3% in 2021 (one point above their May 2021 projection). Business expectations, as reported by HIS Markit, are quite expansive too. This rapid growth has brought inflation problems in several of these economies. Eurozone inflation reads at 0.9% in January 2021 and printed 2.5 points higher in past September (reaching levels not seen in about a decade).

Although the global pandemic began in China, its economy has continued growing and OECD expects the Chinese GDP to expand by 8.5% during 2021. This growth rate is useful to un-

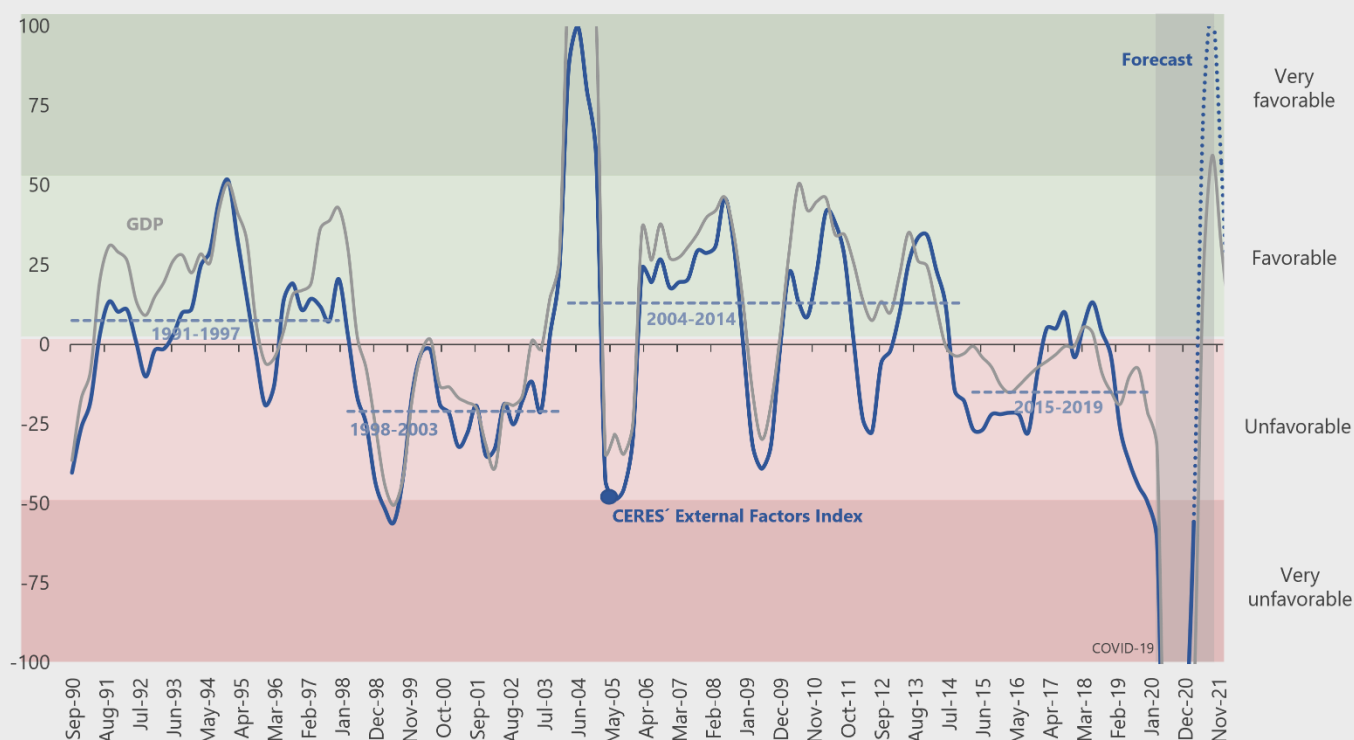
Figure 3. Evolution of External Factors



Source: World Bank and Federal Reserve System (FED).

Figure 4. CERES' External Factors Index for South America

1991-2019 average = 100 South America



Source: National data, International Monetary Fund (IMF) - World Economic Outlook (WEO), World Bank, Organization for Economic Co-operation and Development (OECD), Federal Reserve System (FED) and Merrill Lynch.

Understand the current dynamic of international commodities prices. At the same time (and unlike in several countries) inflation has shown no sign of steering out of control. However, it is necessary to consider that the weak financial situation of some Chinese companies could dent the positive economic outlook. In this context, food prices and metal and minerals prices are above early-2021 levels: 39% and 78%, respectively. Given the magnitude of the net exports, the result should play out favourably for the region (see Figure 3).

The above described global outlook should well be good news for LAC countries. The main global economies are recovering quickly after the unprecedented economic crisis unleashed by the COVID-19 pandemic. This recovery has marked a boost in the demand for the goods the region exports, adding to low interest rates that facilitate the financing, both in the public and in the private sector. In fact, the current external conditions are exceptionally good from a historical perspective.

The CERES External Factors Index (CEFI) measures the temperature South American economies are currently facing in terms of global economic outlook and shows how they are expected to perform under such circumstances. As exhibited in Figure 4, the actual economic performance (grey line) closely follows our index (blue line) composed by a weighted average (by its

relevance to affect GDP fluctuations) of the aforementioned external factors: international food prices (i.e., the food index reported by the World Bank), international metal prices (i.e., iron ore and copper prices in the international markets), and the international interest rates (i.e., the 10-year US treasury bonds yield). While food and metal prices are driving South American commodity exports, the US T-bond rate reflects both the financial environment and the ease of access to financial markets.

According to its historical performance, current CEFI levels suggest that bright times are ahead for South American economies. To provide some context, considering the period that spans from

1991 up to pre-pandemic days, the highest value (CEFI=100) was registered in 2004, while the lowest (-56) in 1999. Regarding the stages of the business cycle in South America, expansions (1991-1997: 7.6% and 2004-2014: 13.1%) and recessions (1998-2003: -21.0% and 2015-2019: -15.0%) are in line with stages depicted by the CEFI. In fact, the index dropped below unprecedented levels (-100) during the first months of the COVID-19 crisis, returning to the positive zone in the first half of 2021. Assuming commodity prices and international interest rates stay constant, the expected 2021 average prints at 44 and indicates—if no major disruptions erupt—that favorable times are up ahead.

Table 1. Lackluster Growth in Latin America

	Average growth rate (1990-2019)
Emerging and Developing Europe	2,10%
Advanced Economies	2,90%
Mexico, Central America and the Caribbean	3,30%
South America	3,40%
Middle East and Central Asia	4,10%
Sub-Saharan Africa	4,20%
Emerging and Developing Asia	5,60%

Source: International Monetary Fund (IMF) - World Economic Outlook (WEO), Our World in Data, Oxford University – Blavatnik School of Government, Der Spiegel and compilation by CERES.

Note: "World" elections consider countries that had presidential or prime minister elections from June 2020 to September 2021, with conclusive results, and comprises 53 elections. "LAC" elections consider also legislative and subnational elections in the group of Latin America and the Caribbean considered countries, giving a total of 13 elections. Countries under authoritarian regimes (according to the Global Democracy Index 2020) or with insufficient data were excluded. For each country, the Lockdown Stringency Index and daily deaths period considered starts the first day with 'lockdown style' policies, which approximates the beginning of the pandemic.

Sustainable long run growth

Despite the favorable external factors, LAC's circumstantial challenges are compounded by the region's structural obstacles to achieving sustainable development, including low productivity, poor educational performance, socio-political instability, and high levels of inequality. These barriers limit LAC economic growth, which is reflected in the fact that it is the region with the lowest historical average growth rate from 1990 to 2019, excluding European countries (See Table 1).

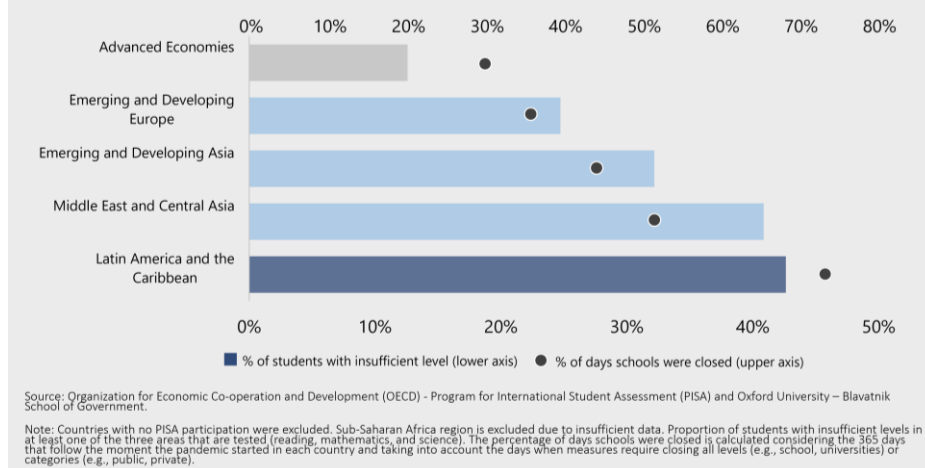
As referred in the previous Latin Macro Vista Regional Report (April 2021), LAC countries must urgently implement a structural reform agenda to improve competitiveness and boost economic activity through private investment. Multiple factors can explain the challenges to improving productivity levels, such as technology availability, political stability, perception of corruption, human capital formation, infrastructure investment, tax burden, trade openness, and wage's rigidity.

Education was one of most affected areas by the COVID-19 shock, given the absence of face to face classes. For LAC countries there were already serious concerns about the quality of schooling. The latest OECD performance evaluations—known as PISA (Program for International Student Assessment)—suggest that LAC was one of the regions with worst results regarding education in 2018. The region exhibits the highest proportion of students with insufficient levels (43%) in the three areas that are tested (i.e., reading, mathematics, and science) and the second highest proportion of students with insufficient levels in at least one of the three areas (72%). Moreover, 51% of the students that reach the end of primary school are not able to read with enough proficiency, a value that is higher than the global average (48%).

Given the changes in access to education suffered to face the pandemic, the future is discouraging. According to Oxford University's Lockdown Stringency Index, LAC countries responded to the pandemic with the strictest school closing measures. Considering the 365 days that follow the moment the pandemic started in each country, schools in LAC were closed, in average, 268 days, which equals to 73% of the time considered. As for the remaining regions, they had their school closed for 30% 52% of the first year dealing with the COVID-19 pandemic.

Therefore, not only was LAC already the region with greater educational backwardness, but it was also worsened by being the most affected in this aspect by the COVID-19, with the strictest

Figure 5. Students Performance and School Closing



school closing, both in terms of measures and time (see Figure 5).

The chances of resuming education once schools reopen decrease as the days of closure increase. Estimations for LAC suggest that the number of students that will not come back to school exceeds three million.² The situation of those that will remain in school is also discouraging: an interrupted learning cycle means not only losing the possibility of acquiring new knowledge but also forgetting part of what they had already learned. Therefore, once at school again, teachers will have to explain new things as well as doing a full review of the topics seen before the pandemic.

Education levels are expected to decrease in the following years. World Bank (2021) estimates that, in a scenario where schools close 10 months (a reality for most of the region's countries), the percentage of students below the minimum proficiency level would significantly rise in LAC and the loss of education adjusted years of learning would be of 1.3 years.³

The loss in performance has repercussions in the possible income that students could receive throughout their life and in the productivity of each country. Considering again a scenario of 10 months of schools closed, World Bank (2021) estimates that the loss of income could be of \$23,628 in lifetime earnings, which equals \$1,313 of annual income.⁴ Regarding productivity, the aggregated costs given the foregone income are estimated to be \$1.7 billions.⁵

The consequences are even worse for students who are poor, girls, and/or live in rural areas. This is because a lot of them were faced with the need of contributing economically at home or had to take responsibility of the housekeeping and care of the little ones. Even so, if students from the most deprived homes were lucky to have the time to

study, internet access would still be challenging: just 45% of students from the lowest quintile have access to the Internet in LAC.⁶

The pre-pandemic situation concerning education was already unfavorable, but it was worsened by the policies implemented to reduce mobility. This exacerbates the problem related to the low quality of education in the region, which not only limits productivity but also prevents an increase in social mobility, a historical problem for LAC. To mitigate it, the region must make up for lost time with policies that guarantee access to the most marginalized and encourage those who have dropped out to return to school.

In their last Regional Economic Outlook (IMF 2021), in the same line, the IMF takes note of the problem and said that "measures to help reverse the setback to human capital accumulation from school closures, which have been particularly large in LAC, given prolonged school closures in the region".

The required educational reform is very complex to implement. Not only does it come hand in hand with a deep ideological discussion, but they also affect status-quo private interests, and the pandemic has introduced a new ingredient to the usual combo to deal with: the volatility given by the electoral cycle.

Political volatility

For LAC countries, there is still a long road ahead towards recovery after being hit by the coronavirus pandemic, where political and electoral challenges are also crucial. Given that political instability remains as an underlying issue, it is essential to analyse what went down in recent elections and keep an eye out for the ones that are scheduled for the rest of 2021 and the forthcoming year.

Table 2. Election Results and Pandemic Indicators

	Election Result	Real GDP 2020	Lockdown Stringency Index (average until election)	Daily Deaths (average until election)
World	Change	-7,3%	60,4	2,2
	No change	-4,9%	50,5	0,6
LAC	Change	-7,6%	74,1	4,0
	No change	-8,1%	59,8	0,3

Source: International Monetary Fund (IMF) - World Economic Outlook (WEO), Our World in Data, Oxford University – Blavatnik School of Government.

Note: "World" elections consider countries that had presidential or prime minister elections from June 2020 to September 2021, with conclusive results, and comprises 53 elections. "LAC" elections consider also legislative and subnational elections in the group of Latin America and the Caribbean considered countries, giving a total of 13 elections. Countries under authoritarian regimes (according to the Global Democracy Index 2020) or with insufficient data were excluded. For each country, the Lockdown Stringency Index and daily deaths period considered starts the first day with 'lockdown style' policies, which approximates the beginning of the pandemic.

Looking back at the worldwide elections that have taken place since the second half of 2020,⁷ it can be noted that there is a strong negative correlation between the number of deaths caused by COVID-19 and voting for the ruling party. On average, in the presidential elections that determined a shift for the opposition, the average daily number of deaths (up until the election) was more than three times higher than in governments in which the ruling party remained in power (see Table 2). This negative correlation can also be verified in the strictness of mobility measures and voting for the ruling party and the support for the ruling party. Countries whose government implemented strong mobility restrictions—measured by the Stringency Index—experienced how the population chose to penalize the government with their vote.

To go deeper in the data analysis, we estimated an econometric model that considers the probability of shifting for the opposition in each country's election as a function of their 2020 real GDP variation, Lockdown Stringency Index and daily deaths (averages until the election). The results show that the average daily deaths variable and the mobility restrictions index are both statistically significant, while GDP is not statistically significant to explain the changes in government in the latest elections.

In LAC this phenomenon was experienced particularly in the south of the continent: in the general elections of Peru, Bolivia, Ecuador and Dominican Republic, and in the legislative or subnational elections of Bolivia, Chile, Argentina, Brazil, and Mexico. It happened regardless of whether the government in office was from left-wing or right-wing ideology.

According to information from *Latinoamérica 2020*, less than half of Latin Americans prefer democracy to any other form of government and 70% say they are dissatisfied with the way democracy works in their country. While their confidence in democracy has been tested by the pandemic, there were no drastic changes in their attitudes

towards it compared to previous years. Even so, the underlying discontent of Latin Americans is such that they "want to vote and want their voices to be heard".⁸

Elections represent the main democratic mechanism with which the population can make their opinion heard, but they were debilitated as an after effect of COVID-19. Indeed, almost 80 countries decided to postpone the date of their national or subnational elections.⁹ Despite this, said LAC countries managed to channel their discontent, and made the continent the home to numerous manifestations because of issues that had been aggravated due to the pandemic.

Social unrest

LAC was already undergoing a complex situation before the pandemic began. In 2019, several violent mobilizations took place: in January in Guatemala; in May in Brazil and El Salvador; in June in Costa Rica, Honduras, and Dominican Republic; in July in Paraguay; in August in Mexico; in September in Argentina and Peru; in October in Chile and Ecuador; in November in Colombia and Panama, and all year in Nicaragua. This represents a structural problem for the region.

The growing social unrest expressed in the protest wave of 2019—that was forced to go dormant during confinement—reappeared towards the end of 2020, motivated by the economic and health-related effects of COVID-19. Mobilizations taking place in Colombia, Bolivia, Peru, Paraguay, Nicaragua, Guatemala, Honduras, Costa Rica, Jamaica, Mexico, Chile, Argentina, Panama, El Salvador, Ecuador, Brazil, and Trinidad y Tobago are examples of that.

These protests share some of the elements of social unrest that were developing in several countries and were aggravated by the pandemic. These countries are facing not only the worst economic contraction when compared to other economies, but also important fiscal restrictions. This situation

hinders the possibility of answering the unceasing demands for a greater social expenditure to mitigate the effects of COVID-19. In addition, the pandemic exposed existing social inequities of the region, which were increased by the strict mobility-reducing measures implemented (that includes loss of schooling) by LAC governments.

In this regard, the Social Risk Index (2020) elaborated by the Euler Hermes Global Consultant allows us to identify those countries with a higher propensity to suffer violent protests in the streets or other incidents which could change the rules of the game in the creation of policies or impact the decisions of investors.¹⁰ The index includes variables such as the increase of the per capita income, employment, strength of the dollar, income distribution, social public spending, political stability, government effectiveness, government trust and perception of corruption. Alongside Africa, LAC is one of the most seriously affected regions, with the lowest scores. On the other hand, the best scores are reserved to the most advanced economies. Within the LAC region, Uruguay has the best score, followed by Costa Rica and Trinidad y Tobago. On the contrary, Mexico and Colombia are the lowest on the ranking.

Final remarks

LAC was the region most affected by the pandemic. However, recent revision of growth forecast indicates that 2021 will be better than expected and the GDP gap relative to pre-pandemic levels could be closed earlier.

This behavior is partially explained by the favorable context of external factors that affect the domestic business cycle fluctuations, which is particularly relevant for South America. Short-run growth is now positively influenced by historically low global interest rates and international prices of foods and metals.

In the long run, to sustain growth rates, the region needs to implement structural reforms to enhance productivity. Among them, a big challenge is to improve the quality of human capital. The postponed agenda of the educational reforms must be managed carefully to maintain social peace, in a region characterized by multiple episodes of social unrest.

The changes to implement must also deal with an additional obstacle: the political volatility given by an electoral calendar with results strongly influenced by the handling of the COVID-19 pandemic by national governments. The future of the region deeply depends on the ability of the current and new governments (both from center to left or from center to right) to implement the educational reforms to enhance economic development and social sustainability.

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Notes

- ¹ See Reinhart et al. (1993), Reinhart et al. (1994), Calvo (1998), Österholm and Zettelmeyer (2007), Izquierdo et al. (2008), Inter-American Development Bank (2008), and Cohen and Levy Yeyati (2012).
- ² See UNICEF (March, 2021): "114 million children still out of the classroom in Latin America and the Caribbean."
- ³ For education adjusted years of learning they consider "Learning Adjusted Years of Schooling" (LAYS), which is a metric that combines the amount of schooling that children typically reach with the quality of learning during school years, relative to a benchmark.
- ⁴ In 2017 PPP (Purchasing Power Parity).
- ⁵ In 2017 PPP.
- ⁶ See The Economist (June, 2021): "Latin America's silent tragedy of empty classrooms".
- ⁷ Selected countries had presidential or prime minister elections from June 2020 to September 2021, with conclusive results. Countries under authoritarian regimes (according to the Global Democracy Index 2020) or with insufficient data were excluded.
- ⁸ See The Economist (October, 2021): "Latin American democracy is in poor but surprisingly stable health."
- ⁹ See International Institute for Democracy and Electoral Assistance (October, 2021): "Global overview of COVID-19: Impact on elections".
- ¹⁰ The index analyzes 12 indicators in 102 countries, which are ranked with a value between 0 and 100: 0 representing the highest risk and 100 the lowest.

Definitions

Emerging and Developing Countries:

- Latin American and the Caribbean (LAC):
 - o South America: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay.
 - o Mexico, Central America and the Caribbean: Barbados, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Trinidad and Tobago.
- Emerging and Developing Asia: Bangladesh, Cambodia, China, India, Indonesia, Lao P.D.R., Malaysia, Moldova, Mongolia, Nepal, Philippines, Sri Lanka, Thailand, Vietnam.
- Emerging and Developing Europe: Albania, Bulgaria, Croatia, Hungary, Poland, Romania, Russia, Serbia, Turkey, Ukraine.
- Middle East and Central Asia: Algeria, Azerbaijan, Bahrain, Egypt, Georgia, Islamic Republic of Iran, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Tajikistan, Tunisia, United Arab Emirates, Yemen.
- Sub-Saharan Africa: Angola, Botswana, Burkina Faso, Burundi, Cabo Verde, Cameroon, Chad, Côte d'Ivoire, Ethiopia, Gabon, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Namibia, Nigeria, Rwanda, Senegal, Seychelles, South Africa, Tanzania, The Gambia, Uganda, Zambia, Zimbabwe.

Advanced Economies: Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, United States.

