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Allianz Research

# Latin America: Shall we dance?

## What's the outlook for Latin American economies?

# Executive Summary

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With the contribution of
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- **This time was different: Latin America's post-pandemic paso doble with inflation and the exchange rate.** Reactive monetary policies, supportive commodity prices and increased investor confidence have helped keep inflation and exchange rate volatility relatively in check. The region has become more resilient, thanks to lessons learned from previous crises, including reducing its reliance on foreign currency financing, improving financial regulation and supervision and maintaining the independence of central banks. For 2024, we expect a gradual economic recovery, with growth converging to around +2%, as central banks will proceed more cautiously and take a more gradual approach to further rate cuts, followed by +2.2% in 2025. Brazil's economic growth is set to slow down to +1.7% due to a less promising harvest and lower commodity prices, while in Mexico, recovering agricultural production and more modest growth in industrial production will temper economic growth to +2.0%. Nevertheless, most of Latin America will reap the benefits of the commitment to stabilizing inflation, avoiding the usual hard landing. Insolvency risk remains proportionally higher in Latin America, according to our sector risk ratings which might undermine confidence in the region's businesses and penalize them among foreign suppliers, increasing working capital requirements of Latin American companies. Allowing 30 extra days of payment on imports would free up around USD120bn in working capital, equivalent to the 2023 GDP of Ecuador, Latin America's seventh largest economy, or 2% of the region's GDP.

- **Mastering the rhythm. Latin America can be at the forefront of the new green industrial deal and the big trade reshuffling.** Latin America is a key producer of critical raw materials, accounting for more than one-third of total global production of silver, copper and lithium. In fact, the "lithium triangle" of Bolivia, Argentina and Chile collectively accounts for more than half of global lithium reserves. This puts the region in pole position to benefit from the global race to secure the supply of critical raw materials to accelerate the green transition. However, rising resource nationalism and technological difficulties, as well as local opposition, could somewhat undermine these growth prospects. At the same time, the global shift towards friend-shoring and near-shoring is already benefiting countries such as Mexico, which has emerged as one of the big winners, especially in the auto sector. To circumvent US tariffs and restrictions, Chinese auto players have increasingly invested in Mexico: in 2023, the value of Chinese auto parts manufactured in Mexico and exported to the US reached USD1.1bn (+14.9% from 2022 and +52.1% from 2021). While Canada's share in US exports has stagnated and China's has declined sharply, Mexico's share has steadily risen from 12.2% in 2013 to 15.1% in 2023. But to fully capitalize on the opportunities from friend-shoring and unlock its growth potential, the entire Latin American region will need to address the low levels of intra-regional trade and improve trade infrastructure and logistics.

- **It takes two to tango. Managing political, social, fiscal and financial credibility remains key.**

**Social risks remain contained, but the digital divide remains vast. Social unrest declined in 2023 and the first quarter of 2024 suggests that this trend could continue.** However, asymmetric developments on digitization and preparedness for artificial intelligence could be a challenge for stability in the long-term. Digital inequality is acute, with only a quarter of the population in rural areas having access to the internet (compared to 75% in urban areas).

**Climate change challenges the region's growth prospects.** Estimates suggest Latin America could face losses equivalent to 11% of GDP by 2050, with Argentina affected the most by flooding (projected damages equivalent to 2.1% of GDP), Chile by droughts (7.4%) and Brazil by lost productivity due to heatwaves (6%). Since the socioeconomic impacts of climate change are disproportionately distributed, the most vulnerable populations with the least resources tend to face the greatest challenges. In this context, adaptation strategies must be tailored locally but coordinated on a global scale to mitigate the most severe consequences effectively. The use of artificial intelligence could also help mitigate the effects of extreme weather events.

**Fiscal and financial risks are non-negligible either.** Fiscal slippages remain likely as Brazil and Colombia are still on our fiscal policy watchlist. Mexico can enter it depending on the fiscal approach adopted by the new administration. At the same time,  the increase in US bond yields is causing a drawback in foreign portfolio flows in Latin America. In this context, as in the past, being able to maintain investor confidence will be crucial to keep fiscal and financial risks in check. Brazilian non-financial corporates could feel the pinch, given their 2024 financing needs, while Mexican peers will see their financing needs peak in 2027.

**Demographic change is also a cause for concern given that the pension systems are largely unfit for purpose.** Latin America's fiscal risks could be amplified by demographic change. The number of people aged 65 and older is set to increase to 142mn in 2050, from 63mn today, and account for almost 20% of the total population. Consequently, the old-age-dependency-ratio (OADR) will sharply rise, too, from today's 15.8% to 32.6%; in Chile, it will reach 46.2%. But Latin America's pension systems are largely unfit for purpose, suffering from low coverage ratios and inadequate private savings, among others. In this context, policymakers should use all instruments – from direct subsidies to tax breaks – to mobilize savings (equivalent to half of those of Asia, i.e. 217% of GDP). This would yield a triple dividend: alleviating the fiscal burden of aging by reducing old-age poverty, providing another pool of capital for the green and digital transitions and mitigating the high inequality in the region.

# This time was different

## Latin America's paso doble with inflation and the exchange rate

**Inflation and exchange rate volatility, the main economic and social specters of Latin America, have been relatively benign in recent quarters, with the only exception of Argentina.** Inflation rates are converging within central banks' target ranges, and local currencies have improved against the US dollar. This positive trend is the result of prudent monetary policies, stable commodity prices and increased investor confidence in the region. Most Latin American economies have been able to cope with rising interest rates in the US and Europe to contain inflation and cope with global shocks, such as supply chain disruptions and conflicts seen elsewhere. The region has clearly become more resilient, thanks to lessons learned from previous crises, i.e. reducing reliance on foreign currency financing, improving financial regulation and supervision and maintaining the independence of central banks.

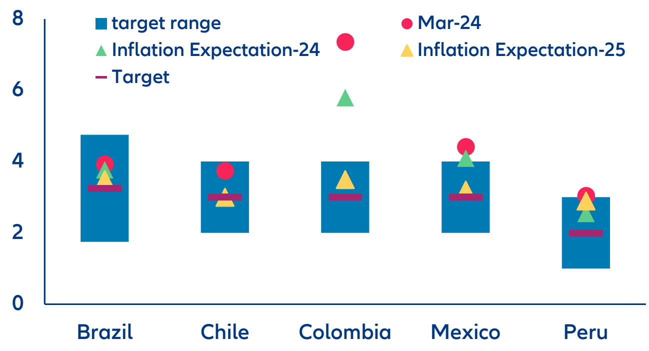
**Inflation will keep slowing but at a more gradual pace, making central banks more cautious.** Much of the disinflation process has already taken place, but the last mile to the targets will be more difficult and gradual. Core inflation has remained relatively strong in the major economies – a clear concern for the Brazilian central bank at the last Monetary Policy Committee (Copom) meeting – which should limit or reduce the extent of monetary easing cycles across the region (Figures 1 and 2). In addition, the sharp interest rate cuts already implemented in countries such as Chile (-475bps since the start of the easing cycle last September) have weighed on currencies – the Chilean peso (CLP) has depreciated by 10% this year, one of the worst performers against the USD. As the weakening of a currency has a non-negligible impact on inflation, and in a context where there is still debate over when the Fed will begin its monetary easing cycle, it is very likely that central banks in Latin America will proceed more cautiously and take a more gradual approach to further rate cuts. Fiscal concerns are also expected to increase due to governments' reluctance to undertake necessary austerity measures, potentially leading to higher country risk premia and currency depreciations.

**Table 1:** Key macro indicators in LatAm-5

| | Brazil | | Chile | | Colombia | | Mexico | | Peru | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2019 | 2023 | 2019 | 2023 | 2019 | 2023 | 2019 | 2023 | 2019 | 2023 |
| Real GDP (%) | 1.2 | 2.9 | 0.7 | 0.0 | 3.2 | 1.0 | -0.3 | 3.3 | 2.2 | -0.6 |
| Inflation (%, aop) | 3.7 | 4.6 | 2.2 | 7.6 | 3.5 | 11.7 | 3.6 | 5.5 | 2.1 | 6.3 |
| Local currency per 1 USD | 4.0 | 4.9 | 751.4 | 873.3 | 3278.5 | 3874.0 | 18.9 | 16.9 | 3.3 | 3.7 |
| Benchmark interest rate (%) | 4.50 | 11.75 | 1.75 | 8.25 | 4.25 | 13.00 | 7.25 | 11.25 | 2.25 | 6.75 |
| FX reserves (USD bn) | 356.9 | 355.0 | 53.2 | 59.6 | 40.7 | 46.4 | 174.2 | 208.3 | 68.4 | 71.3 |
| Fiscal balance (% GDP) | -5.0 | -7.1 | -2.7 | -1.6 | -3.5 | -3.5 | -2.3 | -3.9 | -1.4 | -2.2 |

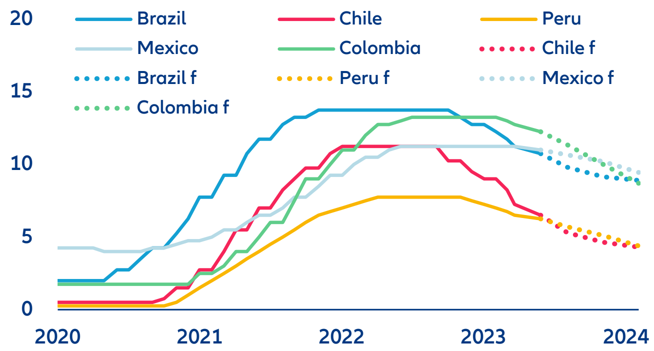
Sources: LSEG Datastream, Allianz Research

**Figure 1:** Inflation rates (annual average, %)




Sources: LSEG Datastream, Allianz Research

**Figure 2:** Policy rate path (%)

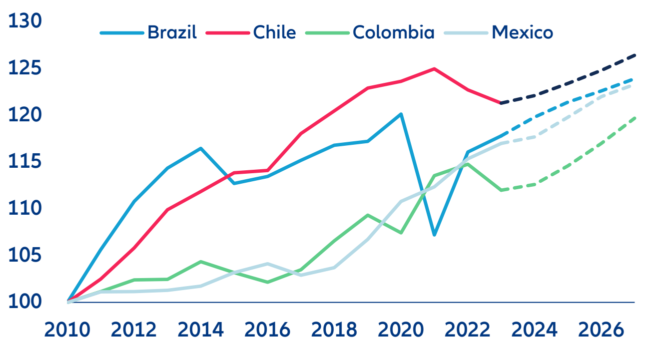



Sources: Bloomberg, Allianz Research

**Tight labor market conditions in most Latin American economies have led to rising wages, which cushioned the high inflation period and supported consumption.** Unemployment rates have reached very low levels, particularly in Brazil and Mexico. This led to strong wage growth, averaging above double digits in nominal terms in 2023, which in turn led to significant income gains across the region. With GDP growth expected to slow across the region, labor market conditions are likely to become more flexible from now on. This, together with further declines in global inflation, means that wage growth is likely to slow in the coming quarters. However, strong core inflation makes the case for a cautious approach in cutting interest rates going forward.

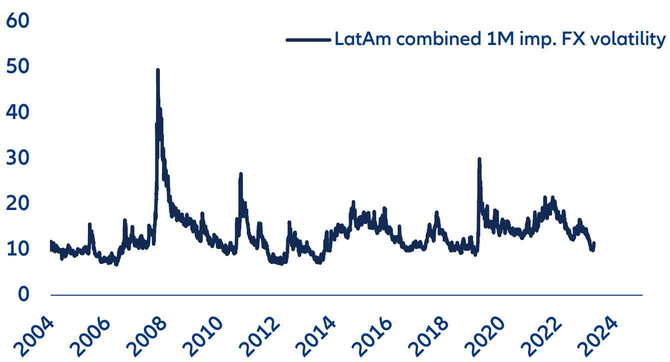
**Exchange rate volatility for Latin American currencies increased considerably and reached its local peak in 2022 but has seen a notable turnaround since.** Throughout 2023, these currencies have shown signs of both strengthening against the USD and decreasing volatility (Figure 4). Proactive policies undertaken by central banks and improved trade balances, thanks to commodity prices, have played an important role. This decrease in volatility has continued into 2024 despite the slight USD comeback. This less volatile environment, together with a general improvement in market sentiment on hopes of an easing of financing conditions, is helping Latin American governments and corporates to navigate the complicated waters of high interest rates. And except for Argentina, it has also supported the growth of FX reserves that suffered in 2022.

**Figure 3:** Real wages




Sources: EIU, Allianz Research

**Figure 4:** Latin American currencies implied volatility




Sources: LSEG Datastream, Allianz Research. Calculated as the average implied volatility of BRL, MXN, CLP and COP.

**Latin America's proactive stance and economic orthodoxy have buffered it against capital outflows.** Such outflows have historically exacerbated volatility and economic downturns in emerging markets during similar periods of global financial tightening. This time, despite central banks across developed markets raising interest rates, Latin America managed relatively well.

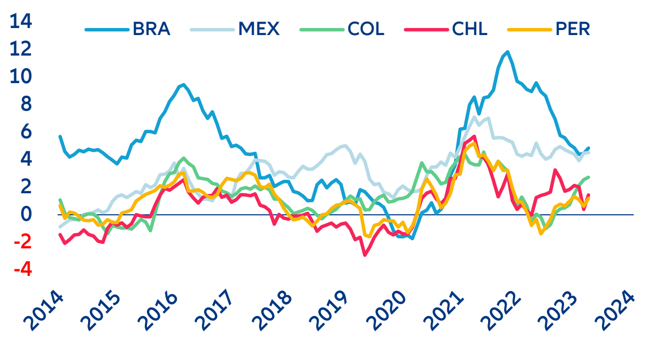
**However, reining in fiscal expenditure and inflation reduced economic activity towards the end of 2023, with growth expected to moderate in the coming quarters.** Regional GDP growth (excluding Argentina and Venezuela) was just +0.2% q/q in Q4 2023, the weakest pace since the pandemic downturn. On the other hand, Brazil and Mexico outperformed expectations, ending the year with GDP growth up +2.9% and +3.2%, respectively. Factors such as reduced fiscal support, the unwinding of one-off props to growth, political struggles in the Andean economies and deteriorating terms of trade due to exchange rate appreciation contributed to soft regional growth.

**2024 should see a gradual recovery, with growth in the region converging to around +2%, followed by +2.2% in 2025 (see Figure 6).** Brazil's economic growth is set to slow down to +1.7% due to a less promising harvest and lower commodity prices, while in Mexico, recovering agricultural production and more modest growth in industrial production will temper economic growth to +2.0%. Most of Latin America will reap the benefits of the commitment to stabilizing inflation, avoiding the usual hard landing that typically follows episodes of high inflation in the region.

**The more favorable economic and financial environment is expected to help contain business bankruptcies at the regional level (+2% and -2% in 2024 and 2025, respectively), after the sharp jolts seen in previous years (-16% in 2022 and +24% in 2023).** 2023 already ended with fewer cases than in 2019 (-14%), and this should repeat in 2024. This stands in contrast to the levels observed in Western Europe (+8%), Africa (+10%) and Central and Eastern Europe (+13%). However, there are still notable disparities between countries. This regional picture would indicate (i) a slight decline below the historically high annual average observed since 2018 in Colombia; (ii) a return below pre-pandemic levels and well below the record levels of 2019 and 2020 in Chile and (iii) a continuation slightly above pre-pandemic levels in Brazil, with an expected 2,800 cases in 2024 and over 2,900 in 2025 i.e. 5% above the 2016-2019 average.

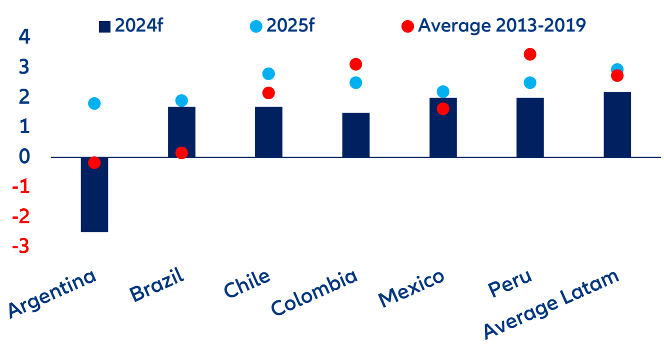
**Insolvency risk remains proportionally higher in Latin America, according to our sector risk ratings[1].** sectors (9% vs. 4% worldwide) – notably construction and textiles, ahead of household equipment, electronics, metals and automotive – and a low proportion of 'low' risk (5% and 9%, respectively) ones. This counterparty risk might undermine confidence in the region's businesses and penalize them among foreign suppliers. The lack of inter-company credit translates de facto into an increase in the working capital requirements of Latin American companies, against which they mobilize financing capacities that could be more judiciously employed (such as for debt reduction or investment in production capacity, business development or research and development). For Latin America, which imports over USD1,500bn of goods and services every year, allowing 30 extra days of payment on imports would free up around USD120bn in working capital. This is equivalent to the 2023 GDP of Ecuador, Latin America's seventh largest economy, or 2% of the region's GDP.

**Figure 5:** Real interest rate differential vs. US, %




Sources: LSEG Datastream, Allianz Research. "Real" interest rates calculated as policy rates minus inflation.

**Figure 6:** GDP growth (%)



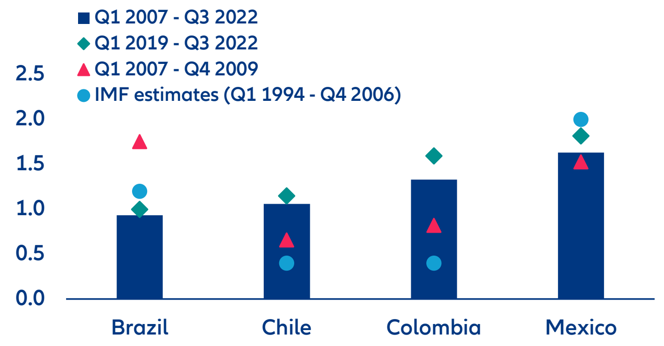

Sources: LSEG Datastream, Allianz Research. Average Latam includes Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Mexico, Panama, Peru and Uruguay

[1] See our recent report on https://www.allianz-trade.com/en_global/economic-research/sector-reports.html

**Current trends in commodity prices bring mixed news for the region, depending on each country's trade basket.** But in general, commodity prices have slowed and are slowly returning to pre-pandemic levels, which means that terms of trade are likely to decline, signaling less impetus from the external sector. That said, the US's expected economic resilience in 2024 may bring positive surprises for the region (we revised our forecasts from 1.4% to 2.4% for 2024) as the US economic cycle has a non-negligible impact on growth. On average, the impact of a US growth shock is roughly one-to-one in the region. Of course, different economic characteristics mean that the impact varies considerably (Figure 7). A rough estimate to capture the exposure of the region's major economies to US growth shows that Mexico would be the most affected, which can be explained by its geographical proximity and its export dependence – Mexico is among the key trading partners of the US. South American economies have limited trade links with the US but would be indirectly affected by the impact on global growth and commodity prices. Much of Central America's exports are destined for the US, although these countries tend to have a more diversified export market base. Remittances from migrant workers in the US also play a key role (Figure 8).

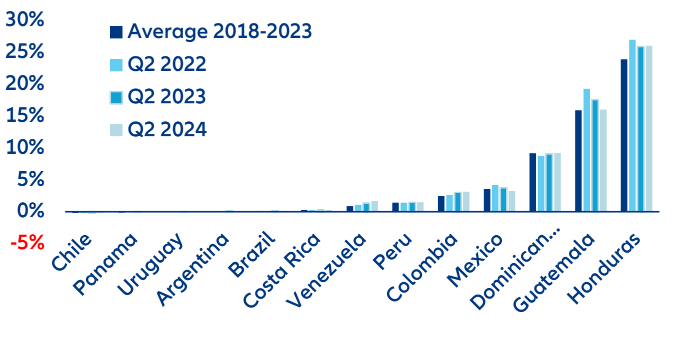
**Risks to this scenario include lower growth in major trading partners.** A sharper-than-expected slowdown in China or disappointing growth in the US could have a significant impact on the region's growth through lower exports, commodity prices remittances and tourism. A significant near-term risk is posed by the non-negligible chance of a Trump II administration in the US from 2025 onwards, which we estimate will have a negative impact on US and global growth (see Trump pape r). Box 1 highlights the main implications for Latin America in several areas, based on the experience of the Trump 1 administration. In addition, greater volatility in commodity prices could lead to greater uncertainty about the trajectory of key commodity prices for the region, affecting production, investment and exports in commodity-dependent economies. Moreover, new outbreaks of global inflationary pressures, for example due to the intensification of geopolitical issues and/or climate-related shocks, could lead to higher food and fuel prices, with a particular impact on Central America as the countries in the region are net importers of oil, for example. Tighter-than-expected global financial conditions, especially lower-than-expected interest rate cuts by the Fed, could lead to tighter financial conditions in Latin America and the Caribbean and currency depreciations, which would increase inflationary pressures. Rising global geopolitical tensions could lead to higher commodity prices in the short term and greater restrictions on capital flows and trade in the medium term. While higher commodity prices could support economic activity across the region, they would increase inflationary pressures. Increased restrictions on capital flows and trade could reduce external financing and adversely affect the region's growth prospects.

**Figure 7:** Latam-4: Growth elasticities to the US cycle




Sources: LSEG Datastream, IMF, Allianz Research

**Figure 8:** Net workers remittances (% GDP)




Sources: LSEG Datastream, IMF, Allianz Research

## Box 1: Implications of a potential second Trump presidency on Latin America

**Is Trump's bark worse than his bite?** To find out, we compared his words to his actions notably on Mexico (see Table 2). We find that he has kept his promises about 58% of the time, looking at promises that were fully kept and those that were mixed/partial (the score drops to 29% for promises that were fully kept), mostly on energy and trade policy. But he had a much harder time changing social policy/immigration. This may be because Congress, not the president, has authority over federal spending, and these issues are also highly sensitive. Initially, both the House and Senate were controlled by Republicans, but the dynamic changed in 2019 when the House became controlled by Democrats while the Senate remained Republican. This shift made it more difficult for Trump to pass legislation, particularly on divisive issues such as immigration. Other issues, such as energy independence, may have been less divisive.

**Adding to the complexity, state and local governments also play a role in influencing legislation.** However, in areas such as foreign policy, where the president typically takes the lead and Congress and the Supreme Court have less oversight/veto power, Trump had more room to maneuver. This is evidenced by his ability to follow through on promises of diplomatic engagement with other nations, such as Canada and Mexico.

**Should Trump return for a second term, his policy outcomes would again be influenced by Congress and the judiciary. But this time their ability to act as a check is likely to be diminished.** Most of the Republicans in Congress who have occasionally disagreed with Trump have left or will leave the administration by 2025. They have been, or are likely to be, replaced by pro-Trump Republicans. Similarly, the Supreme Court is likely to be more favorable to Trump, thanks to his own appointments in his first four years. As a result, some of the cases that Trump lost in his first term are likely to go the other way if he wins a second term.

**A potential second term for Donald Trump could see significant shifts in U.S. foreign policy towards Latin America, particularly in the areas of trade and immigration.** Trade policy would likely see the implementation of a blanket 10% tariff on imports, along with the introduction of the "Trump Reciprocal Trade Act" to address perceived unfair treatment, potentially targeting countries such as Brazil and Mexico. Specifically, Trump has accused Mexico of undermining the U.S. auto industry and helping China avoid tariffs, and has proposed a 100% tariff on Mexican-imported cars. However, his stance on trade has shown some ambiguity, as he has publicly advised against renegotiating the USMCA. Immigration remains a central issue for Trump, with promises to revoke work permits for undocumented immigrants, use Title 42 to curb immigration and human trafficking, end catch-and-release practices, continue construction of the border wall, reinstate the "Remain in Mexico" policy, and use military and law enforcement to aid in deportation efforts. Trump justifies these policies by citing concerns about fiscal stability, welfare dependency, economic impact on African Americans and Latinos, and increased crime rates. In terms of foreign policy, Trump has expressed a conditional willingness to work with Latin American leaders, particularly Argentine President Milei, suggesting the possibility of a rapprochement with Argentina. With a more transactional approach to foreign policy, Trump's administration is signaling that Latin America's relationship with the U.S. will likely hinge on the concessions leaders are willing to make to align with U.S. interests.

**Table 2:** Donald Trump's promises vs actions

| Promise | Result | Notes |
|---|---|---|
| Renegotiate NAFTA | Kept | Replaced NAFTA with USMCA. Also withdrew from Trans-Pacific Partnership negotiations. |
| Achieve energy independence | Mixed | The US is progressing toward energy independence but still imports oil, natural gas, etc. |
| Raise tariffs on goods imported into the U.S. | Kept | Tariffs increased on select goods from specific countries. Proposed tariffs on all Mexican imports never implemented. NAFTA rewrite tightened rules for tariff-free imports from Mexico and Canada. |
| Use U.S. steel for infrastructure projects | Kept | US imports 10%+ of its steel from Mexico. |
| Reverse Barack Obama's Cuba policy | Kept | Imposed travel and commercial restrictions on Cuba, tightened financial and banking regulations against the regime, restricted shipping, and declined to appoint a US ambassador to Cuba. |
| Limit legal immigration | Kept | Set a cap for refugees coming from Latin America/Caribbean to 3000. |
| Increased fees for border crossing cards. | Broken | |
| Replace J-1 Visa with Inner City Resume Bank | Broken | |
| Have mandatory minimum sentences for criminals caught trying to re-enter the US illegally | Broken | |
| End birthright citizenship | Broken | |
| Build a wall, and make Mexico pay for it | Mixed | Started building the wall. Mexico did not pay for it. |
| Triple ICE enforcement | Broken | |
| Remove criminal undocumented immigrants | Mixed | From fiscal years 2017 to 2019, ICE agents arrested and deported around 205,000 convicted criminals and about 36,000 immigrants with pending criminal charges. |
| Remove all undocumented immigrants | Broken | |
| Cancel visas to foreign countries that won't accepted deported nationals. | Mixed | Latin American countries mostly unaffected and the focus was primarily on government officials. |
| Cancel all funding of sanctuary cities | Broken | Sanctuary cities limit police cooperation with federal immigration authorities. Courts deemed Trump's order unconstitutional. |
| Terminate Obama's immigration executive orders. | Mixed | Federal court ordered full restoration of DACA, protecting young immigrants from deportation. DAPA ended. |

Sources: Politico, Allianz Research

# Mastering the rhythm?

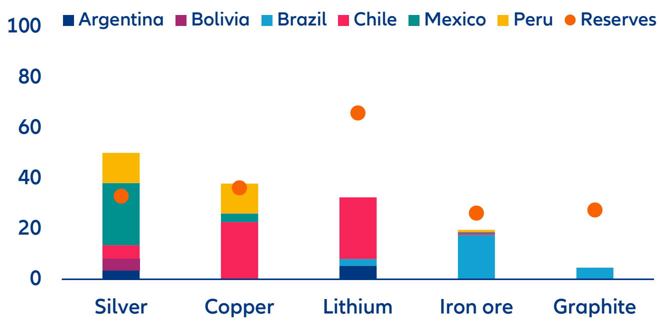
## The bounty and hidden cost of critical raw materials

**Looking ahead, Latin America can be at the forefront of the new green industrial deal and the big trade reshuffling.** The region is a key producer of critical raw materials, accounting for more than one-third of total global production of silver, copper and lithium. It is also a major producer of other minerals, such as iron ore and graphite (Figure 9). Given its abundant reserves, additional investment could unleash vast potential in the region's mining and manufacturing industries. Between 2000 and 2014, the exploration and start-up of offshore oil projects and the growing demand for soft and hard commodities from China had initiated a season of major investment across the region. Ten years on, this could be repeated, with all the associated risks.

**The growing demand for lithium has provided substantial growth opportunities for the region, with most of these resources concentrated in three countries.** Bolivia, Argentina and Chile, collectively known as the "lithium triangle", account for 53.3% of global lithium reserves (Figure 10). As EVs gain traction, lithium has emerged as "white gold" due to its critical role in EV batteries. It is the most important material, accounting for more than 50% of the total material costs on average, and is present in nearly all major battery components, including the cathode, anode and electrolyte. The demand for lithium increased by more than +250% from 2018 to 2023, reaching approximately 989,000 metric tons per year. Moreover, Latin America remains within the usual business perimeter of North America's investors and geographically close, making it attractive for international investment against the backdrop of intensifying geopolitical tensions. The surging demand for lithium and the changing geopolitical landscape place Latin America at the center of a strategic geopolitical and economic battleground.

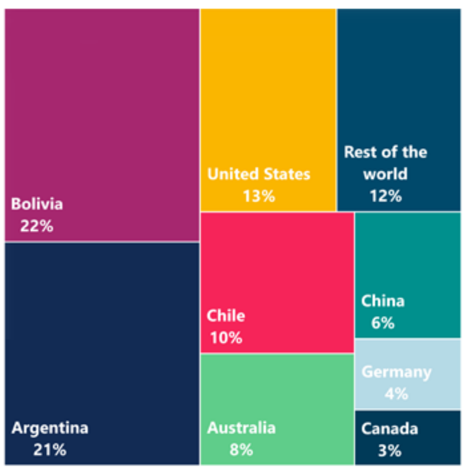
**The securitization of the supply chain seems more important for technology companies than price volatility in the current phase.** The production of lithium rose by +23% globally in 2023. However, prices fell significantly due to worries about a temporary glut, the end of the Chinese government's ten-year program of subsidies for electric vehicle (EV) purchases and lower-than-expected EV sales globally. Technology firms and exploration corporations have continued to form strategic alliances and joint ventures to guarantee a steady, varied supply of lithium for battery manufacturers and automakers. Among the biggest projects worldwide are two brine operations each in Chile and Argentina and one mineral tailings operation in Brazil.

**Figure 9:** Production and reserves of selected critical materials in 2023, % of global total




Sources: European Commission, Allianz Research

**Figure 10:** Global lithium reserves by country




Sources: US Geological Survey, Allianz Research

**However, a series of challenges could undermine these growth prospects, ranging from rising resource nationalism to technological difficulties.** Governments in Latin America have begun to assert more control over their lithium resources. Chile, for instance, is pushing for a nationalized approach to lithium extraction and the establishment of public-private partnerships under President Boric's administration. Similarly, all lithium deposits are owned by the state in Bolivia under the state-owned firm Yacimientos de Litio Bolivianos. The governments of Argentina, Bolivia, Brazil and Chile are discussing the formation of a "Lithium OPEC" to control global prices. Although these moves are aimed at ensuring greater national benefits, they risk deterring foreign investment due to perceived instability and the increased royalties required. The technological difficulties associated with lithium extraction also pose challenges for Latin America countries, particularly in Bolivia where the high magnesium content of the brine complicates processing, leading to lower extraction efficiencies. This technical hurdle is exacerbated by a general lack of local expertise and the longer evaporation process posed by Bolivia's rainy season, which can delay production schedules and increase costs. Consequently, despite possessing the world's largest share of lithium reserves – 22% of the global total – Bolivia's output remains disproportionately low and has seen minimal growth.

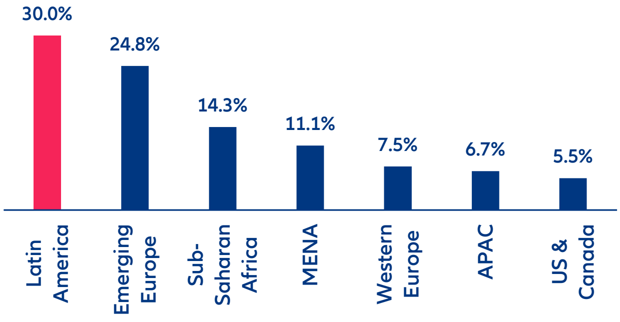
**Local opposition also creates formidable hurdles.** In regions where lithium mining is prevalent, there is growing discontent among indigenous and local communities, who often feel sidelined in the development discussions. This sentiment is compounded by environmental concerns, such as water usage and pollution, which directly affect their livelihoods. For example, in Chile, increased lithium mining activities have been linked to worsening drought conditions, which fuels further resistance from local communities. The issue is also prevalent in Argentina and Bolivia.

**Graphite consumption is also set to rise further, mostly due to increasing demand from the lithium-ion battery sector.** Since 2019, demand from the global battery market has tripled. In December 2023, top-producer China, which accounts for three-quarters of global output, introduced export restrictions on several graphite items, including flake graphite. Such measures usually trigger friend-shoring initiatives. For example, the construction of graphite mines mostly by Canadian companies continues in Brazil (the world's second-largest reservoir after China), Madagascar and Tanzania, with plans to increase supply by around 240,000 tons per year, equivalent to 15% of global production in 2023.

**The number of open international arbitration cases related to extractive industries shows how complex the region can be for producers and traders, and how costly this process can become for governments.** This is especially true for a region that has historically been known for a higher-than-average level of state-investor disputes (Figure 11), considering that the extractive sector (crude oil, natural gas and mining) is also where similar issues are most likely to be encountered (Figure 12).

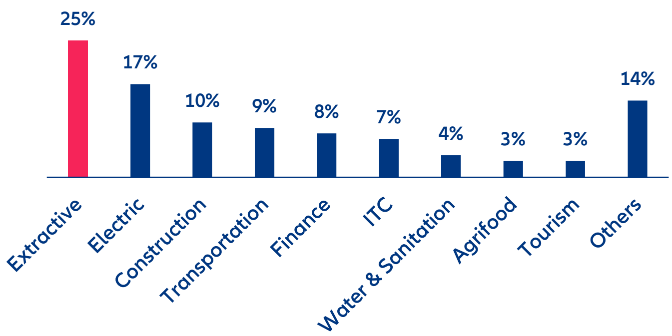
While some projects result in agreements that balance economic interests with environmental and social considerations, others underscore the challenges of reconciling competing priorities and navigating complex legal and regulatory landscapes. Finding sustainable solutions that prioritize the well-being of communities and ecosystems remains paramount in shaping the future of resource extraction.

**Figure 11:** Distribution of international arbitration cases




Sources: ICSID, Allianz Research.

**Figure 12:** Economic sectors involved in international arbitration




Sources: ICSID, Allianz Research.

# Harnessing growth opportunities from the structural shift in the auto sector

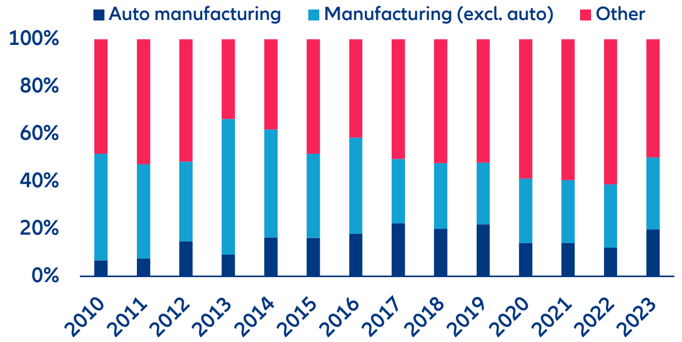
**Mexico has emerged as a winner of "nearshoring" and "friend-shoring" in the deglobalization era.** After battling a series of supply chain disruptions and intensifying geopolitical tensions, countries are increasingly looking for geographically and politically closer trading partners. In the auto sector, Mexico has emerged as one of the biggest beneficiaries from the upheaval with its free-trade agreement with the US and its access to US's electric vehicle (EV) subsidies under the Biden Administration's Inflation Reduction Act (IRA). The IRA provides up to USD7,500 in tax credits for the purchase of new EVs but excludes those with Chinese components, setting strong restrictions on the imports of materials, batteries and vehicles from China. To circumvent US tariffs and restrictions, Chinese auto players have increasingly invested in Mexico. In 2023, the value of Chinese auto parts manufactured in Mexico and exported to the US reached USD1.1bn, a +14.9% increase compared to 2022 and a +52.1% increase compared to 2021. Last year, there were 33 Chinese auto suppliers registered in Mexico, 18 of which exported to the US.

**Major global automakers are also expanding their footholds in Mexico to benefit from the US subsidies, relatively lower labor costs and well-established supply chains.** Manufacturing has been the major recipient of foreign direct investment (FDI) in Mexico, accounting for half of total FDI in 2023 (Figure 13). The auto sector in particular has attracted growing investment and emerged as the largest source of FDI within the manufacturing segment since 2012. It represented almost 40% of manufacturing investment in 2023. The trend is still moving upwards. In 2023, FDI in the auto manufacturing surged by +62.5%, reaching a total of USD7.2bn (Figure 14).

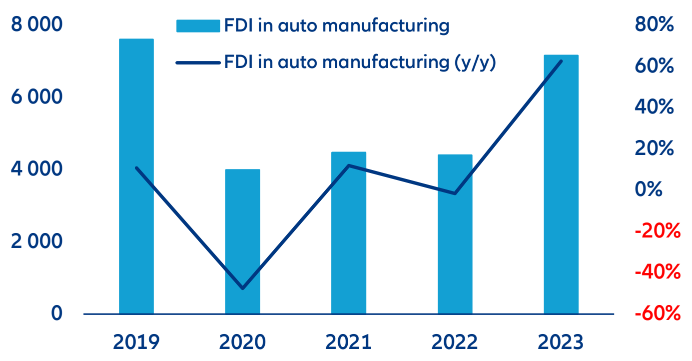
**As a result, Mexico has become the largest supplier of goods and services to the US, with the import of autos and auto parts seeing especially dramatic growth.** Over the last decade, Mexico's share of total US imports has steadily risen from 12.2% in 2013 to 15.1% in 2023. This growth is juxtaposed against the relative stagnation of Canada's share and the sharp decline of China's (Figure 15). Consequently, Mexico overtook Canada as the second-largest trading partner of the US in 2016 and

**Figure 13 & 14:** Foreign direct investment in Mexico

Foreign direct investment in Mexico by economic activity, % of total




Foreign direct investment in Mexico's auto manufacturing (USD mn)

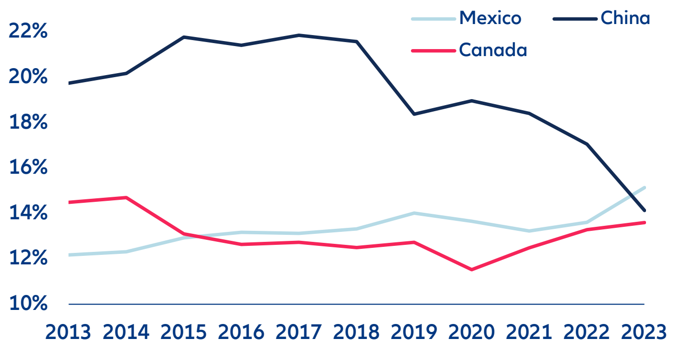



Sources: Secretariat of Economy, Allianz Research dethroned China to become the largest trading partner of the US last year. Notably, imports of vehicles and vehicle parts have seen a strong post-pandemic rebound, recording compound annual growth rates of +25.5% and +16.0% from 2020 to 2023 (Figure 16), consistent with the ongoing investment spree in the auto sector.

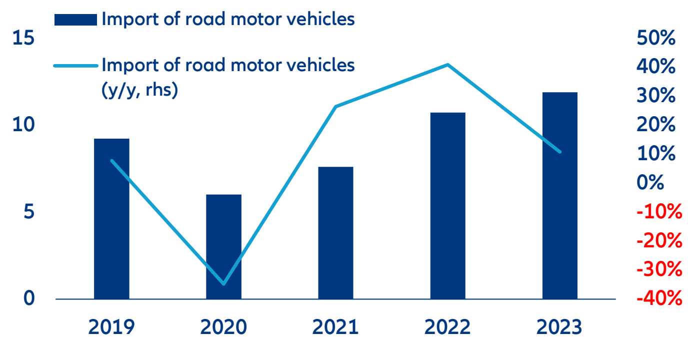
**Brazil's green incentives are attracting a record amount of investment from global automakers and are set to help domestic production continue its recovery from the pandemic-induced disruption.** Earlier tthis year, the Brazilian government launched the Green Mobility and Innovation (MOVER) Program to incentivize automakers to invest in energy efficiency through financial credits. The BRL19.3bn worth of subsidies on offer have already drawn massive investment from international automakers – at least seven major automakers have pledged to invest more than BRL65bn in Brazil in the coming years since the MOVER Program was launched. The total investment in the auto sector is expected to reach BRL100bn by 2029, according to Anfavea. We expect this wave of investment to strengthen Brazil's position as an export hub of EVs in Latin America and help domestic production continue its recovery from the pandemic disruption. After two years of growth, Brazil's auto production fell by -2.3% in 2023 to 1.8mn units, remaining 27.2% lower than the production level of 2019 (Figure 17). However, we think the green incentives for auto manufacturers alone might not be enough to stimulate the EV demand in the domestic market. Currently, import taxes for battery electric vehicles (BEVs), plug-in hybrid electric vehicles (PHEVs) and hybrid models stand at 10%, 12% and 15%, respectively, and will all be increased to 35% in July 2026, according to the government's plan. The rising import taxes, coupled with a lack of EV infrastructure, will create formidable hurdles for further market uptake.

**Figure 15 & 16:** Imports to the US

Import share by country (% of total)

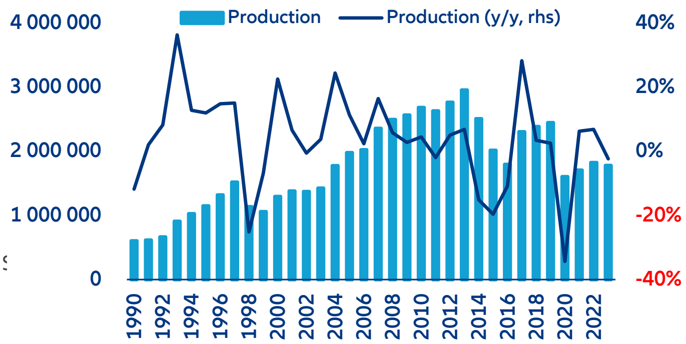



Imports from Mexico (USD bn)




Sources: Census of Bureau, ITC, Allianz Research

**Figure 17:** Auto production in Brazil



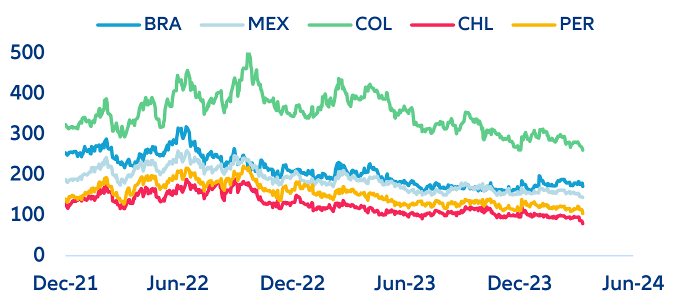

Sources:ANFAVEA, Allianz Research.

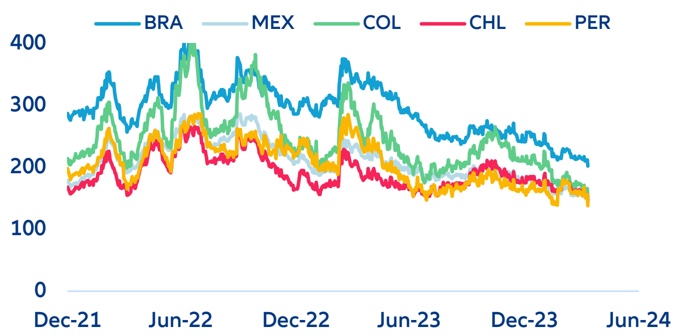
# Investment is graceful footwork

**Latin America's economic stability is increasing its appeal for investors.** Since Q4 2023, we have seen an uptick of both sovereign and corporate issuances to international bond markets that continues to gain momentum, and the compression of Latin American spreads (Figure 18. This growing confidence is in part an acknowledgement of the relatively better performance of the continent during the post-pandemic inflationary period, as well as the search for diversified trade and investment partnerships following the outbreak of war in Ukraine and the shift in global market sentiment ahead of the anticipated easing cycle. A particular case within this trend is Argentina, where President Javier Milei's calls for radical economic reforms, market deregulation and fiscal austerity, along with his clear pro-US stance, have initially attracted investors' interest. Although he is not exempt from internal opposition, and with what happened after the initial euphoria with Mauricio Macri's presidency still fresh, this reflects the multiple opportunities that the region offers and how investors are willing to engage with its potential even in the face of only expectations of change for the moment.

**However, downside risks are looming.** These include potential changes in sentiment should Trump be elected, as well as any delays to the rate easing cycle in the US if inflation does not ease quickly enough. Should any of these risks materialize and global financial conditions shift adversely, it could become difficult for Latin American governments and companies to secure new sources of finance without facing prohibitive costs.

**Figure 18 & 19:** Spreads of USD-denominated bonds of sovereign (LHS) and IG corporates (RHS)



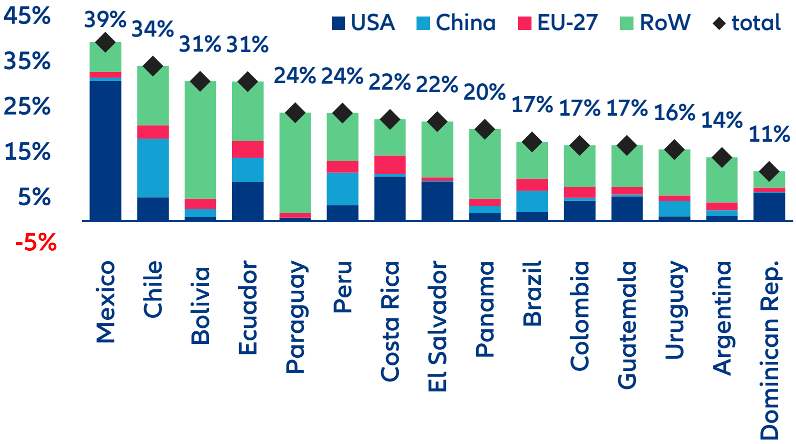

Sources: LSEG Datastream, Allianz Research

# Drawing in the nearshoring crowd amid increasing global fragmentation

**Too closed or too reliant on trade?** Exports are an important driver of growth for emerging economies. However, Latin America lags other regions in terms of trade performance due to structural weaknesses such as the geographical and sectoral concentration of trade, complex integration architectures (custom union projects, preferential trade agreements), poor infrastructure and the low quality of governance. In 2022, trade openness[2] remained low at 57%. This compares to 61% in East Asia and the Pacific and a global value of 63%. This would suggest that the region is both too dependent on a limited number of buyers but also less open than other regions. Overall, we expect a modest contribution of 0.2pp from the region to our global trade growth forecasts of +3% and +3.1% in 2024 and 2025, respectively, in volume terms.

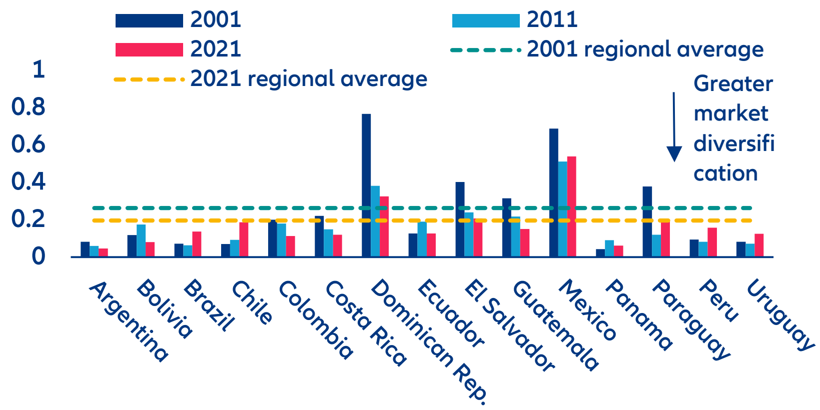
**Exports from the region are concentrated towards the US, followed by China and the EU** (Figure 20). Still, the region has made significant progress in terms of export market diversification. This is evidenced by the Hirschman Herfindahl market concentration index for most economies in the region, which was below the regional average in 2021 – with the exceptions of Mexico and the Dominican Republic (Figure 21). The trajectories of countries such as Brazil, Chile and Peru, however, have moved in contrast to the declining regional average and exhibit vulnerabilities in terms of market concentration.

**Figure 20:** Exports of selected economies in Latin America, by destination in 2022, % of GDP




Sources: LSEG Datastream, ITC, Allianz Research.

**Figure 21:** Hirschman Herfindahl index for selected economies in Latin America



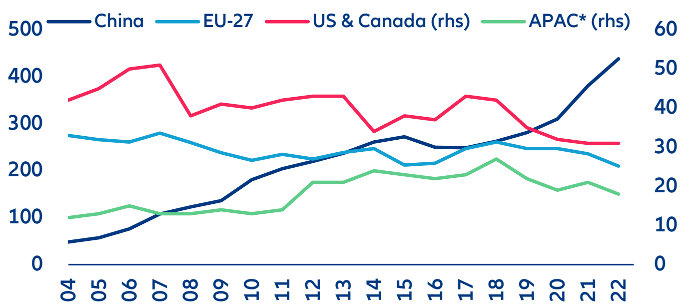

Sources: LSEG Datastream, ITC, Allianz Research.

[2] The ratio of the sum of exports and imports to gross domestic output.

**In terms of import dependency, China has replaced the EU as Latin America's main supplier of critical dependencies since 2018, accounting for 438 product types as of 2022.** Using the critical dependency[3] framework, we compute and aggregate critical dependencies imported by Brazil, Argentina, Chile, Mexico, Peru and Colombia from the 17 largest suppliers to the region that account for more than 75% of total Latin American imports. First, we find that between 2004 and 2022, imports of critical dependencies from China have grown by almost 10x. Second, China overtook the EU as the largest supplier of critical dependencies in 2018. More precisely, these economies imported 438 critical dependencies from China, with a total value of USD39bn in 2022. In other words, Latin America imports a sizeable share of products from China that cannot be easily substituted – 15% of its imports from China were critical dependencies in 2022 (up from 2% in 2004). While these figures highlight the importance of China as a trade partner for the region, they also highlight vulnerabilities arising from import concentration. In terms of sectoral concentration, critical dependencies from China were mostly concentrated in the computers and telecom, electronics and household equipment sectors (USD21bn), followed by textiles (USD7bn) and chemicals (USD6bn, Figure 22). On the other hand, critical dependencies imported from the EU were concentrated in sectors such as commodities, construction, energy, pharmaceuticals and papers (USD3.1bn) and chemicals (USD3bn).

**Across the region, sectors such as iron and steel, vehicle and vehicle parts and wool and woven fabric have emerged as winners in the context of the US decoupling from China.** Proximity to the US – the world's largest consumer – and trade relationships with China – the world's largest supplier – place Latin America in a sweet spot in terms of trade opportunities. There is already notable evidence of shifts in terms of trade towards the region, especially towards Mexico, with the country acting as a 'connector' economy between the US and China. We compared the 'sectoral winners' in Latin America and the Caribbean to 'winners' in Asia excluding China in terms of the US market shares gained between 2015 and 2022 (and broadly lost by China). There is a clear clustering and sectoral division, with sectors such as iron and steel, vehicle and vehicle parts and wool and woven fabric emerging as winners in Latin America & the Caribbean, while sectors such as electrical machinery and equipment and textiles have emerged as winners in Asia excluding China (Figure 23). In addition to geopolitical factors, owing to the abundance of commodities such as lithium, copper, graphite, cobalt and other minerals, the region faces favorable initial conditions in the context of the green transition, which should contribute to attracting multinational firms in the context of the diversification of supply chains.

**Figure 22:** Number of critical dependencies imported to the region, from their main trading partners

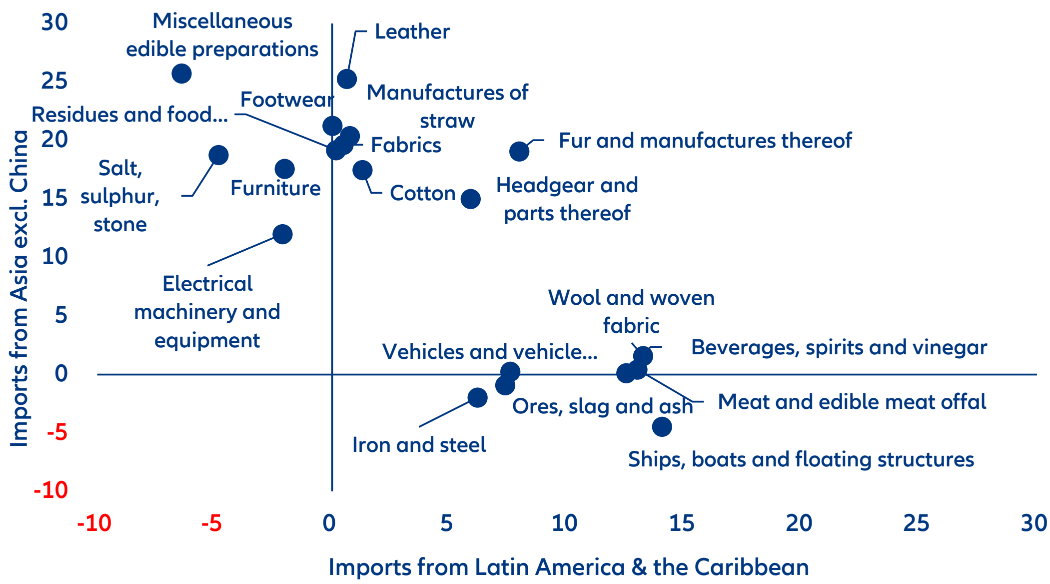



Sources: ITC, Allianz Research. *APAC includes Indonesia, India, Japan, South Korea, Malaysia, Singapore, Thailand, Taiwan and Vietnam.

[3] See our recent report China: keeping the Dragon awake for a detailed analysis and classification of critical dependencies..

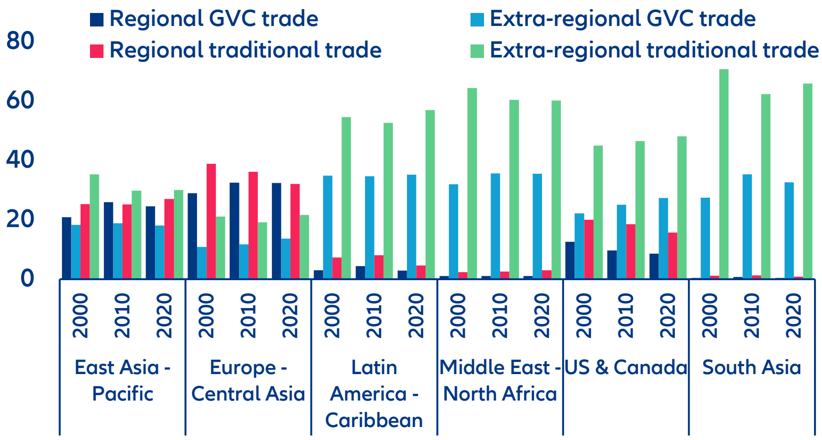
**Addressing challenges in terms of regionalization should be a priority to capitalize on the opportunities from friend-shoring.** Apart from structural vulnerabilities, the region's trade potential is also constrained by low levels of intra-regional trade – accounting for less than 20% of total trade. This is significantly lower than economies in East Asia or Central and Eastern Europe, for instance. Further, with the exception of Mexico, the region's participation in the global value chain (GVC) remains low as they are primarily focused on the exports of commodities rather than intermediate or final goods. The regional character of supply chains in Latin America has limited the exchange of capital flows, trade flows, knowledge and technology adoption within the region. Increased regionalization would induce positive spill over impacts through these channels. More comprehensive and stronger free-trade agreements, and the reduction in trade barriers, can be key strategies to increase regionalization as existing evidence suggests that the region's free-trade agreements are either not very comprehensive or riddled with exceptions.

**Figure 23:** Change in share of US imports between 2015 and 2022, pp




Sources: TC, Allianz Research.

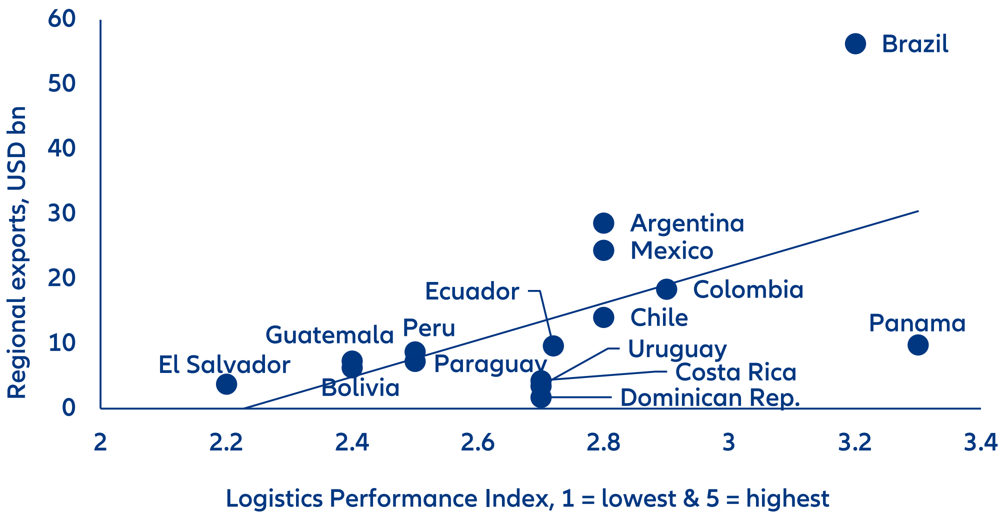
**Figure 24:** Decomposition of gross trade by region, %




Sources: WITS, Allianz Research.

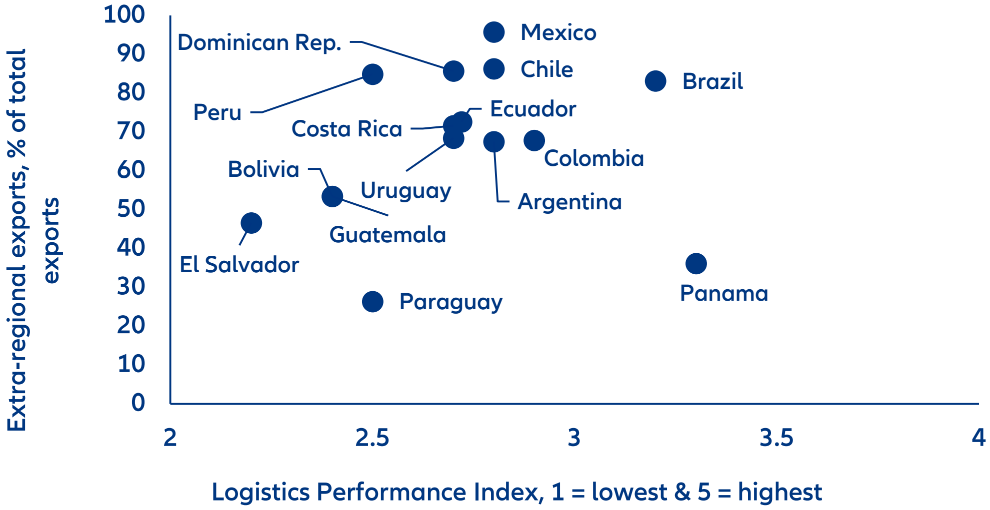
**Improving infrastructure and logistics in terms of transportation and administrative procedures would also help boost exports and unlock growth potential.** Researchers at the IMF highlight that reducing the infrastructural gap between the region and advanced economies by half could lower trade costs and result in a +30% increase in exports. In fact, the logistics performance index for the region in 2023 scored 2.7 on average – this compares to 3.3 in East Asia and the Pacific and Europe and Central Asia. There is clear evidence for the positive relation between logistics performance and regional exports (Figure 25). This also highlights that economies in the region may not be adequately prepared in the face of stronger demand in the context of friend-shoring (Figure 26). For instance, among prime candidates such as Mexico and Vietnam, Mexico recorded a score of 2.9 while Vietnam recorded a score of 3.3, which may influence the decisions of multinational firms that look to diversify away from China.

**Figure 25:** In 2022, economies with a higher logistics performance index (1 = lowest, 5 = highest) performed well in terms of regional exports (USD bn)




Sources: World Bank, ITC, Allianz Research.

**Figure 26:** Improvements in logistics performance can increase economic resilience in the face of increased external demand




Sources: World Bank, ITC, Allianz Research.

[4] Sources: United Nations Global Survey on Digital and Sustainable Trade Facilitation, 2023

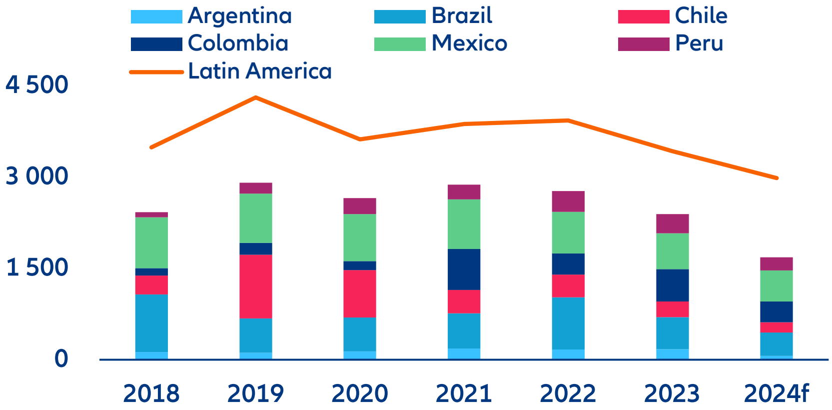
**Challenges in Latin American trade infrastructure highlight the urgent need for investment.** Latin American countries have an average implementation rate of 76% when it comes to the main measures of trade facilitation , seven points above the global average of 69%. Mexico, Peru, Brazil, Ecuador, Colombia, Costa Rica and Chile even surpass 80%. However, a big part of trade costs is set by transportation, which is mostly decided by the infrastructure that is available. This comprises not just port facilities, airports, border crossings and international roadways, but also domestic transportation infrastructure and the availability of high-quality logistical services at reasonable prices. In this field, the region shows considerable deficiencies. Total infrastructure investment has steadily dropped from its 1980s peak of 4.1% of GDP. Limited economic growth during the last decade, combined with the need to direct spending toward combating resurgent poverty, has resulted in low levels of governmental investment. Total infrastructure investment (public and private) is now at 2% of GDP, despite many studies indicating that the region needs 5%-8% of GDP per year to ensure adequate infrastructure services. This is particularly true if we consider that an average of 85% of all freight is carried by road. This makes the region and particularly countries with fewer logistical alternatives, such as Argentina, Bolivia and Peru, more exposed to trade disruption. This includes both disruptions caused by climatic causes, such as the suspension of traffic in the Panama Canal, or man-made ones, such as roadblocks in the Andean countries, port personnel strikes in Argentina or organized crime in Mexico and Colombia.

# It takes two to tango: credibility remains key

**Social unrest declined in 2023.** Recent years have shown how sudden and localized riots can cause severe damage to property and businesses (e.g. Chile and Colombia) or block trade flows (e.g. along river routes in Argentina). The outcome of elections in several countries surprised analysts and led to radical changes, with parliaments of different or more tenuous color than that of the president-elect. While the resilience of democratic systems is not in question, the credibility of candidates' commitments and the effectiveness of government action still needs to be tested, and this could be exploited by organized crime. However, 2023 recorded the lowest number of social unrest events since 2018, while the first quarter of 2024 showed a similar trend, which could result in an even lower frequency for the full year (Figure 27).

**While political upheaval has subsided, with new administrations taking office, the risk of increased interventionism could change the trajectory of the region's major countries in the next 12 months** (Table 3). The main macroeconomic challenge is to build the resilience of social contracts and continue to transform economies into reliable economic and trade partners. The many changes that Latin American governments will face in a short time could incentivize countries with a historical inclination towards interventionism to return to a more protectionist approach. This shift could potentially lead to increased diplomatic tensions and conflicts within the region as countries compete for resources and economic opportunities. It may also result in a reversal of progress made towards regional integration and cooperation.

**Figure 27:** Events of social unrest in the region and in selected countries, by year




Sources: ACLED, Allianz Research.

**Table 3:** Key political events with potential implications for the region in the next 12 months

| Date | Event | Location | Regional implications |
|---|---|---|---|
| 05 May 2024 | General election | Panama | Former President Ricardo Martinelli led polling, but his disqualification for money laundering rendered the race a toss-up. Drought and water usage prioritization continue to pose risks to Panama Canal operations. |
| 19 May 2024 | General election | Dominican Republic | President Luis Abinader is leading opinion polls. |
| 02 June 2024 | General election | Mexico | Incumbent President Andres Manuel Lopez Obrador (AMLO) cannot be re-elected. Claudia Sheinbaum, from the ruling party, and Xochitl Galvez are the main candidates. Security concerns, policy deviations and future government support to certain economic sectors, such as oil and gas, may affect the outlook and advantage regional competitors. |
| 28 July 2024 | Presidential election | Venezuela | The government retains a number of tools to ensure the desired electoral outcome, though the last 2018 presidential election culminated in the a presidential crisis the year after, with then-US President Donald Trump recognizing National Assembly President Juan Guaido as interim president. |
| Aug-Sept 2024 | End of the Ceasefire | Colombia | Colombia's government and National Liberation Army (ELN) rebels have extended their bilateral ceasefire for another six months on 06 Feb 2024. Gustavo Petro's government has held six rounds of peace talks with the ELN, a process supported by Brazil, Chile, Cuba, Mexico, Norway and Venezuela as guarantors. |
| October 2024 | BRICS summit | Russia? | Brazil is likely to participate to the first summit with expanded BRICS membership (Egypt, Ethiopia, Iran and the UAE). |
| October 2024 | Local elections | Brazil | Test for the government of President Luiz Inácio Lula da Silva particularly in the city of São Paulo. |
| October 2024 | UN Convention on Biological Diversity (COP16) | | Colombia will be home to COP16. The country hosts 10% of the world's biodiversity and a progressive agreement was reached in 2023 to ensure critical conservation by 2030. |
| Oct-Nov 2024 | General election | Uruguay | First round on 27 October with a potential runoff on 24 November. |
| 05 November 2024 | Presidential election | US | The 2025 outlook of several countries depends greatly on the outcome and the relationship with the elected administration. |
| November 2024 | G20 | Brazil | Rio de Janeiro is set to host the G20 leaders' summit. |

Sources: Various, Allianz Research.

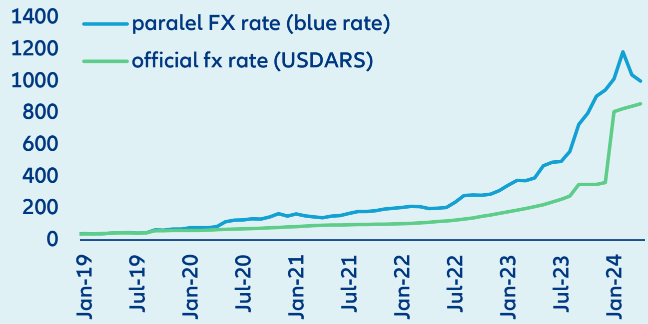
# Box 2: Argentina – Macroeconomic stabilization underway, pace limited by political factors

**The economic adjustment continues and will be painful in the short term.** Milei's government began its tenure with two main goals: rebalancing relative prices, i.e. via a currency devaluation, and fiscal consolidation. In December, the currency was significantly devalued (-54%) and the government adopted a crawling peg, with a depreciation rate of 2% per month. This measure was urgently needed to restore the country's competitiveness as the Argentine peso was artificially overvalued, undermining exports. But the pass-through to prices has been extremely quick, pushing inflation over 200% in January. We expect it to reach 300% in Q2, given the reduction of subsidies on energy and transport. In this context, it is very likely that the government will increase the monthly rate of currency devaluation in the coming months as inflation offsets the competitiveness gains from December's devaluation. Assuming that the current devaluation rate will be 2% until December 2024 – that is, a further devaluation of around 130% in one year (Dec/2023-Dec/2024) – and given our inflation scenario, a competitiveness gain would only be observed at the end of the year (Figure 28).

**At the same time, the government's ambitious fiscal consolidation goals will mean severe cuts to expenditures.** The government has set a target of primary surplus of 2% in 2024, most of which would be achieved through reductions in expensive energy and transport subsidies, a freeze on capital spending and a reduction in transfers to the provinces (Figure 29). However, implementation is at risk because the government has not been able to raise taxes – even temporarily – and further spending cuts seem complicated at a time when more than half of government spending goes to pensions and social assistance, the economy is facing stagflation and nearly 50% of the population lives in poverty. It should be noted that the seventh review of the IMF program showed confidence in the new government's policies and that the current macroeconomic environment will be adjusted. Clearly, the change in policy direction has helped Argentina secure waivers for missing the 2023 targets and put the program back on track. Among the key points of the new revision is the complete elimination of monetary financing of the fiscal deficit in 2024, but the lack of political support could ultimately jeopardize such renewed support. Structural reforms are more difficult, and we expect progress on this front to be more limited in the short term. The omnibus bill and labor reforms are likely to be watered down. However, if political capital remains high and these reforms are passed unchanged, allowing for a faster opening of the capital account and a move to a floating exchange rate, this may prove positive for the economy and national assets.

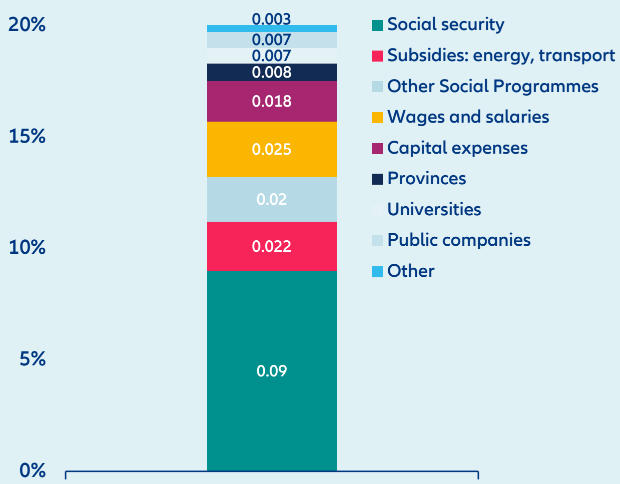
**The context of high inflation and fiscal contraction means that consumers will be hit particularly hard.** We expect real income to decline by nearly 10% in 2024, strongly hitting consumption. In this scenario, we expect negative GDP growth of -2.5% in 2024, with the recession being partially offset by an increase in exports, especially supported by strong agricultural harvests of corn and soybeans (analysts expect growth of more than 64% and 160%, respectively), which together with wheat account for about 45% of the country's exports. This combined with further improvements in the energy balance and a sharp reduction in imports could help the current account move to a surplus of around 4% in 2024. The economy would start to recover in late 2024 as the initial headwinds fade and distortions are removed. For the time being, we expect growth to rebound to around +2% in 2025, driven by exports and a general improvement in the country's economic sentiment due to adjustments and progress in reforms. Of course, this will depend on the resolution of the political turmoil and continued reforms, and risks remain high.

**Figure 28:** Exchange rates




Source: LSEG Datastream, Allianz Research, Higher values imply currency depreciation

**Figure 29:** Composition of fiscal expenditures (% of GDP, cumulative 12 months)




Source: LSEG Datastream, Allianz Research

# Asymmetric developments on digitization, government unpreparedness on AI and gender gaps persist

**Latin America still struggles with economic inequality, which could challenge the ability to maintain democratic governance and stability in the long term.** Economic inequality is most cited amongst political scientists as the fundamental cause of political instability in Latin America (see Figure 30). The region has a long-standing history of significant gaps between the rich and poor, which exacerbates social and political tensions and undermines trust in democratic institutions. Furthermore, the transition to democratic regimes that started in the twentieth century is far from complete and the ever-present challenge is to build high-quality institutions with capable and reformed states to leave behind the authoritarian past.

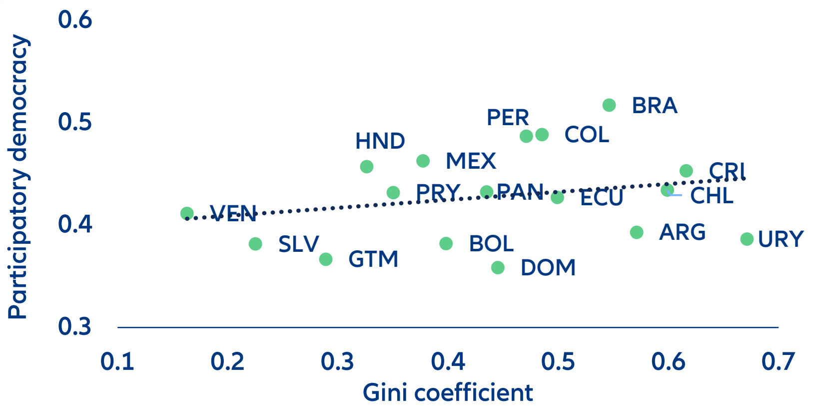
**A great challenge in the region, as well as in the US, is migration.** In the case of the US and Mexico, for example, building engagement and dialogue can help countries on both sides of the Rio Grande address their shared challenges by increasing civil participation and remembering what keeps the heart of democracy alive: supporting civil societies and grassroots movements, fostering free and independent media and – most importantly – reinforcing human rights (see Figure 31).

**Inequality plays a role in asymmetric developments on digitization.** The limited public investment in science and technology in Latin America, as well as the insufficient skill levels necessary to adopt, embrace and implement artificial intelligence (AI), are reflected on the initial AI uptake data (see Figure 32). While AI is forecasted1 to contribute up to 5.4% of Latin America's GDP by 2030, equivalent to approximately USD0.5trn, this number falls behind those for the US and Canada, which are poised to gain over 14.5% of GDP in the same period. Another issue for AI update is the highly informal economy dominated by small enterprises as well as the digital divide. Digital inequality is so acute that while nearly 75% of the population in urban areas have access to broadband coverage in the region, only 25% of the rural inhabitants have access. Additionally, only five of the regional largest economies have 5G commercial capabilities (Brazil, Chile, Colombia, Peru and Mexico). If Latin America is to reap the potential development gains that come from the AI revolution, it must overcome its existing challenges related to the digital economy. Moreover, policies implemented should be inclusive, ethical and sustainable. According to the UNDP, a deliberate regional commitment is needed to build a robust AI ecosystem that must include substantial investment in digital public infrastructure, education and the upskilling of the workforce, as well as effective digital and AI governance.

**Governments and skills are not ready for the AI transition.** Research indicates that approximately 80% of the US workforce could have at least 10% of their work tasks affected by the introduction of GPTs, while around 19% of workers may see at least 50% of their tasks impacted. Similarly, for Latin America, a region riddled by long working hours and relatively low pay, the danger of the outsourced jobs to be replaced by AI casts a somber shade over the long-term employment in the region.

**But there is a silver lining: the AI revolution could also present an opportunity to bridge gender gaps in Latin America.** More than 60% of women in Latin America go to university, compared to less than 50% of men, leaving them prepared with the skills required to thrive in the AI revolution. New job creation could present an important opportunity for women to add 10-20% to their wages and bridge gender pay gaps (see Figure 33).

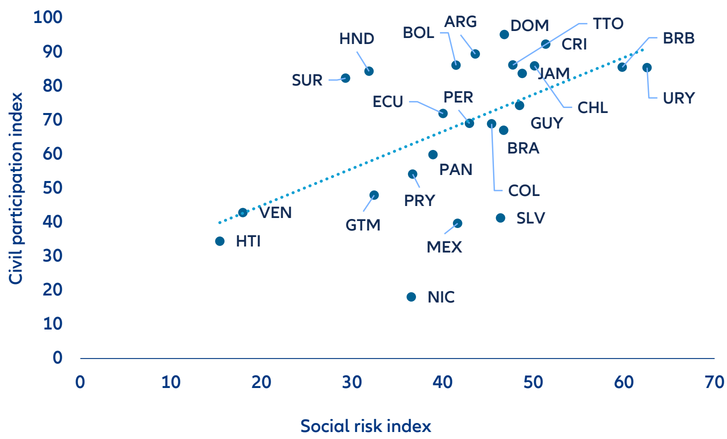
**Figure 30 :** Inequality and participatory democracy in Latin America




Notes: Gini coefficient: 1=total inequality, 0= total equality. Higher values in participatory democracy indicate closer alignment to the ideal of a participatory democracy.

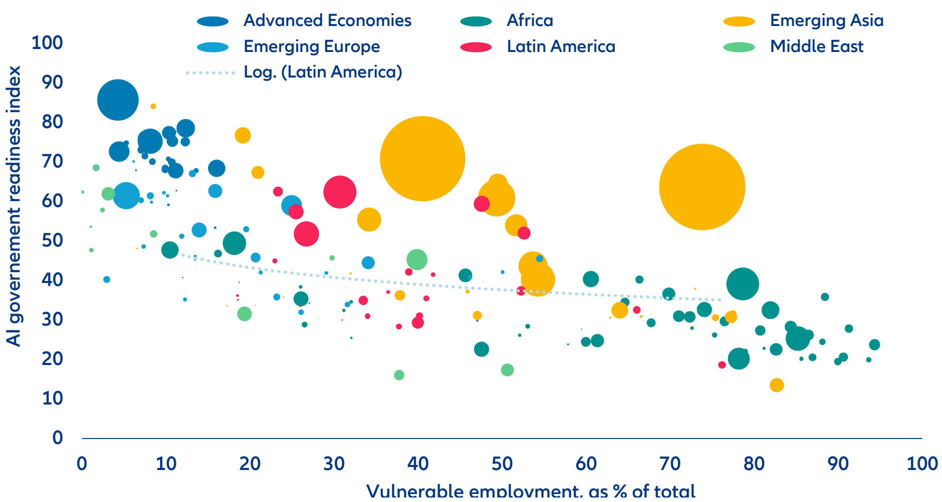
Sources: V-Dem, World Bank, ECLAC, Allianz Research.

**Figure 31 :** Civil participation, social risk



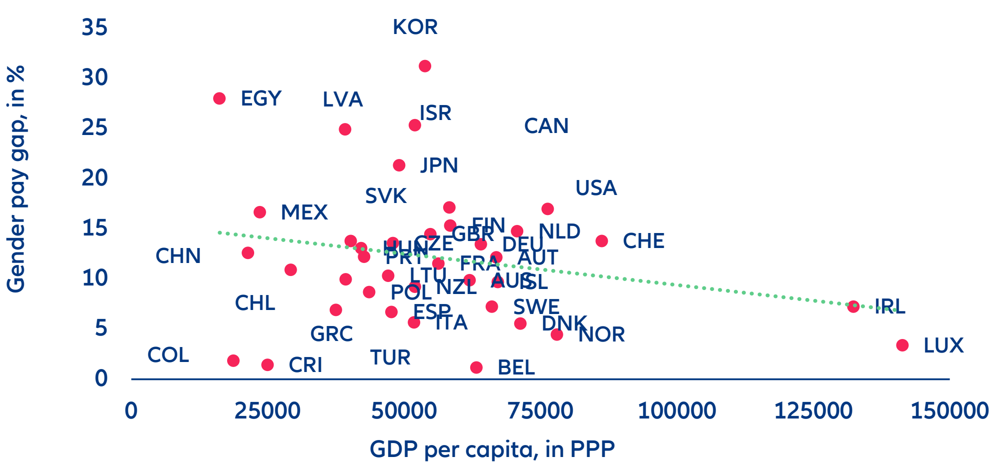

Sources: V-Dem, Allianz Research

**Figure 32:** AI government preparedness, vulnerable employment and population (bubble size




Sources: World Bank, Oxford Insights, UN population division, Allianz Research

**Figure 33:** Bridging gaps while profiting from the AI revolution




Sources: OECD, IMF, Allianz Research

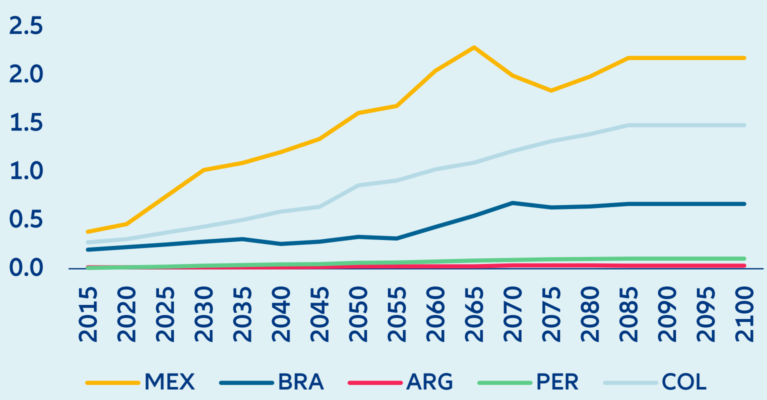
## Box 3: Leveraging the power of AI for climate evaluation in Latin America

**Climate-induced changes in temperature and rain patterns, as well as extreme weather events, have started to affect food security, changing crop yields and quality[5].** In this context, AI could play an important role in mitigating climate risks affecting the region. AI-powered climate modelling is a disruptive paradigm that has greater potential to assess, predict and mitigate the risk of climate change with the efficient use of data, learning algorithms and sensing devices. From a technical perspective, AI offers better climatic predictions, shows the impacts of extreme weather, finds the actual source of carbon emitters and includes numerous other reasonable contributions. This can raise awareness of issues that are not fully addressed and underfunded in Latin America.

**Moreover, even though close to half of all emissions are released by one-tenth of the global population – and Latin America is below the global average emission per capita – Latin America and the Caribbean is one of the most vulnerable regions to extreme weather events, with five of the top ten countries most affected in the region**. Developments in AI allow for the prediction of climate patterns with unprecedented accuracy, which could also benefit the region.

**However, current models are often prone to bias.** The example below measures the population exposed by crop failure given current policies. Here crop failures are defined as those years in which yields reach extremely low values, which appear on average 2-3 times in a century under preindustrial climate conditions. The keyword is pre-industrial climate conditions. Impacts can already be felt for less drastic events, which are not captured by the event definition employed here. On top of this, some geographies don't have baselines, therefore the impact is underreported.

**Figure 34:** Fraction of the population annually exposed to crop failures, pps




Sources: FAO, Allianz Research

[5] Karanth. S. et al. (2023). Importance of artificial intelligence in evaluating climate change and food safety risk. Link: https://www.sciencedirect.com/science/article/pii/S2666154322002186

# Climate change threatens growth prospects

**Latin America could face losses equivalent to 11% of GDP by 2050 under the current policy scenario[6] .** The economic repercussions of climate change come from both physical risks (e.g. cyclones, floods, heatwaves) as well as labor productivity loss due to increasing heat. These risks vary by geographic location and can change over time based on changes in population, economic growth and migration patterns. Still, Figure 35 shows that Asia and Africa are projected to face more than double the economic losses due to global warming compared to Latin America in a scenario where the global temperature increase reaches 2.0°C above preindustrial levels by mid-century, with a potential rise to 2.9°C by the year 2100. The biggest costs to Latin America in 2050 will come via productivity losses of about 5% of GDP, droughts (about 3%) and heatwaves (about 2%).

**The impact varies considerably by country.** Figure 36 presents a comparison of climate risk across four major Latin American economies, where the total economic losses range from 11.6% to 13.7%. Among these countries, by 2050, Argentina will be the most affected by flooding, with projected damages accounting for 2.1% of its GDP. Brazil will experience the most significant losses due to reduced productivity from heat, estimated at 6%. Chile's economy will be notably impacted by droughts, with an anticipated 7.4% loss in GDP. Meanwhile, Mexico will suffer from the effects of severe heatwaves, which are expected to cause losses amounting to 2.1% of its GDP. In contrast, tropical cyclones are expected to contribute minimally to the total losses in these countries, which is why their effects are not prominently displayed in the figure. But these climate threats are already severely affecting the individual countries today.

**Argentina often encounters significant flooding,** especially in the Pampas region, which disrupts agriculture – one of the nation's crucial economic sectors – and leads to substantial economic losses. Flooding also poses threats to urban areas, including Buenos Aires, where it impacts infrastructure and housing. Moreover, climate variability influences Argentina's agricultural sector with irregular rainfall patterns and temperature fluctuations that affect crop yields and livestock conditions.

**Brazil is particularly vulnerable to heat-induced productivity losses due to its vast size and tropical climate.** Heatwaves can significantly decrease labor productivity, especially in physically demanding sectors such as agriculture and construction. Additionally, issues are compounded by deforestation and drought, especially in the Amazon, where these conditions exacerbate drought severity, affecting water availability, biodiversity and climate regulation both locally and globally.

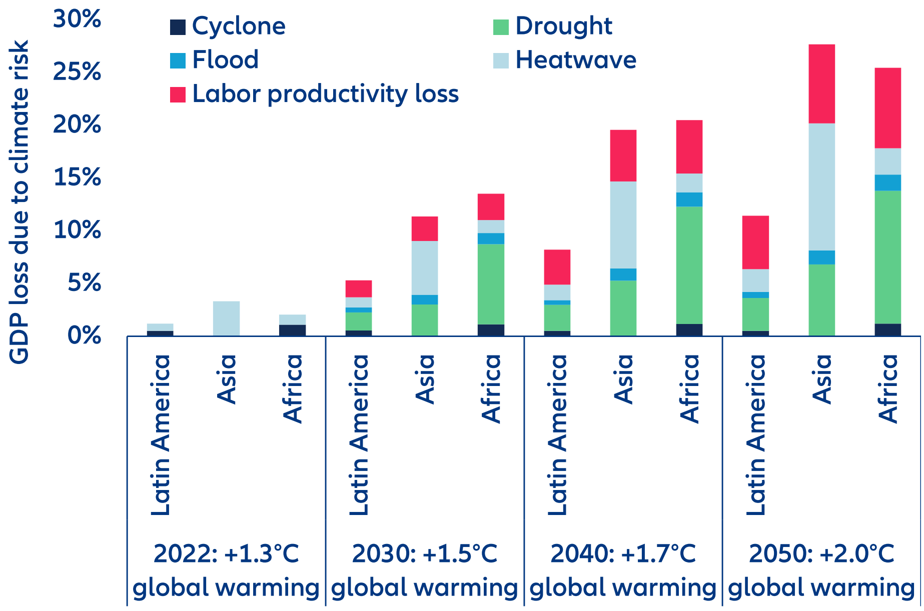
**Chile is still grappling with one of the worst droughts in its history,** which severely affects its central region, vital for agriculture and wine production. The ongoing drought is straining water resources, necessitating increased investment in desalination and water-reuse technologies. Also, the heightened risk of wildfires due to increased temperatures and prolonged droughts cause extensive damage to forestry, agriculture and populated areas.

**In Mexico, prolonged and intense heatwaves affect public health and increase energy consumption as the demand for cooling rises.** These conditions also put pressure on water resources and agricultural productivity. Although the economic losses from hurricanes and tropical cyclones are relatively lower, the coastal regions, particularly along the Caribbean and Gulf coasts, face high vulnerability to hurricanes, which can inflict catastrophic damage to infrastructure and communities.

**To address these vulnerabilities, each country needs tailored adaptation strategies.** This involves enhancing infrastructure resilience by improving flood defenses and water-management systems and building heat-resistant urban infrastructure. It also includes developing sustainable agricultural practices such as creating drought-resistant crop varieties, improving irrigation efficiency and adopting sustainable land management practices. Public health initiatives are crucial as well, including implementing heat action plans, raising public awareness of heat risks and enhancing healthcare responses to heat-related illnesses. Moreover, since the socioeconomic impacts of climate change are disproportionately distributed, the most vulnerable populations with the least resources tend to face the greatest challenges. Adaptation strategies must therefore be tailored locally but coordinated on a global scale to mitigate the most severe consequences of climate change effectively. This approach ensures that both immediate and long-term climate risks are addressed, preserving economic stability and promoting sustainable development.

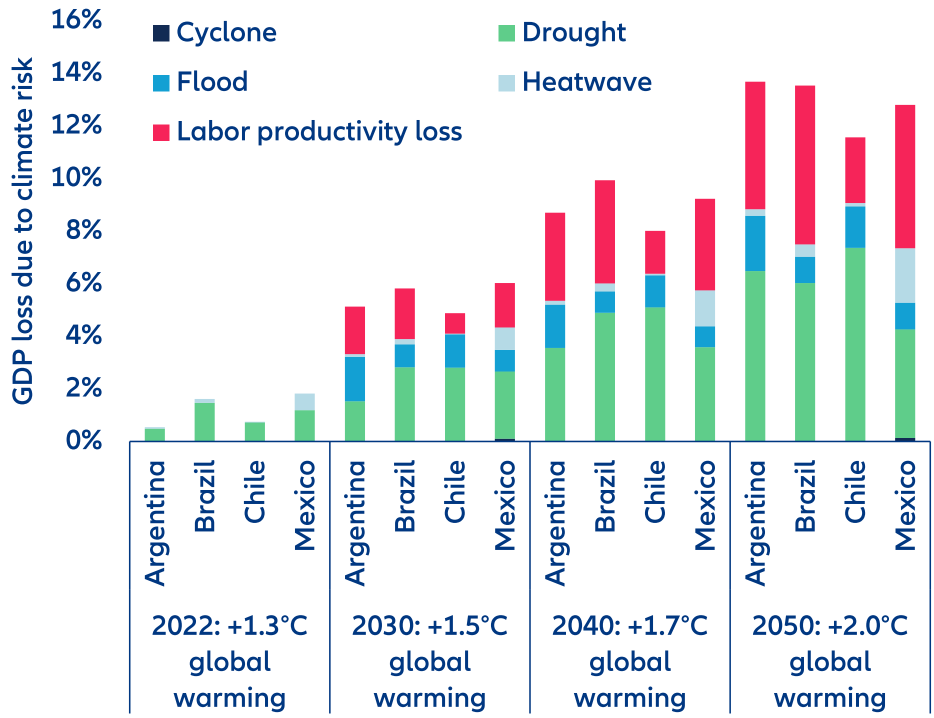
[6] As defined by the financial regulator's and central bank's Network for Greening the Financial System (NGFS).

**Figure 35:** Comparing GDP loss from climate risk in Latin America to Asia and Africa




Sources: NGFS, Allianz Research.

**Figure 36:** Comparing GDP loss from climate risk in selected Latin American countries.




Note: Tropical cyclone impacts in the selected countries are relatively small compared to the other perils and thus are not obviously visible in the figure.
Source: NGFS, Allianz Research.

# Fiscal and financial risks are non-negligible either

**Tight monetary policy may strain government and corporate finances if global financial easing is delayed.** However, effective debt-management strategies have significantly softened the impact so far. The upside risks to US inflation are postponing expectations of a global easing, increasing US yields and by extension causing a drawback in foreign portfolio flows in Latin America. In this context, as in the past, being able to maintain investor confidence will be crucial to keep fiscal and financial risks in check. During the recent period of tight monetary policy, both governments and corporates in Latin America strategically limited the issuances of new debt, especially foreign-denominated debt, to mitigate the increase in borrowing costs. As an example, sovereign yields on local currency debt have increased by an average of 500bps for the Latam-5 since end-2020, compared to around 350bps for USD-denominated debt. If these increases were translated into the effective cost of all outstanding debt, a simple “r-g” debt sustainability approach shows that the region would have needed a significant acceleration in growth to avoid serious sustainability problems. Moreover, the spectacular earnings recovery since the 2020 slump has also acted as a buffer so far. However, if the sustained high rates begin to impact economic activity more broadly, this resilience could be further put to test. This has started to become evident as corporates have experienced a deterioration in their interest-coverage ratios.

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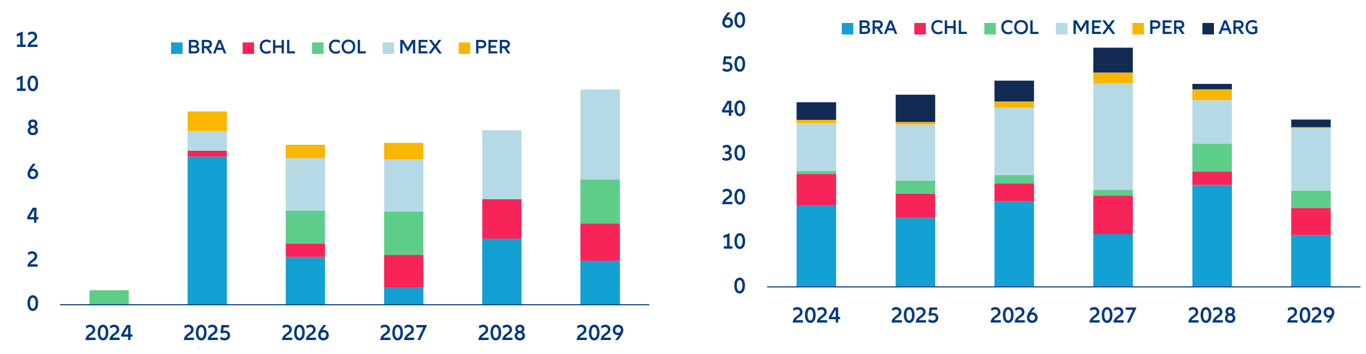
**The late 2023 easing of financial conditions provided a window of opportunity to slightly alleviate sovereign and corporate borrowing needs.** Throughout late 2023 and into early 2024, both capitalized on the decrease of borrowing costs to tap the market. As investors are currently repricing both US long-term yields and Fed fund rates, and financial conditions are starting to deteriorate again, having tapped the market in Q1 seems to have been a good decision, especially in terms of USD debt. Moving forward, Latin American sovereigns will face a quiet rest of 2024 in terms of USD-bond maturities, finding themselves in a relatively insulated position against temporary volatility in interest rates, which contrasts to the corporate sector – although exposure varies significantly by country. Brazilian non-financial corporates are highlighted in Figure 37 for their 2024 financing needs, while those of their Mexican peers will gradually grow, reaching a peak in 2027.

**Figure 37 & 38:** USD-denominated bond repayments by maturity for sovereign (LHS) and non-financial corporates (RHS)



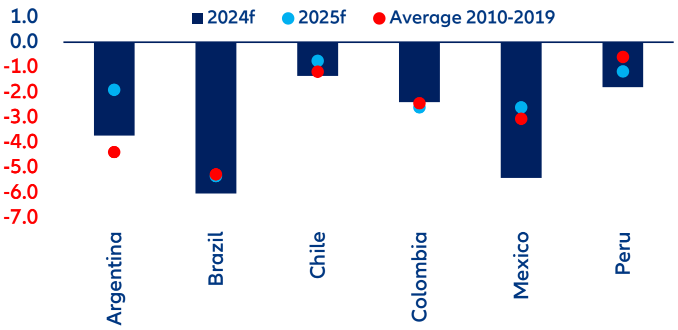

Sources: IIF, LSEG Datastream, Allianz Research. Note: bonds already matured this year are not included. Argentina sovereign bonds have been excluded as their timeline mainly reflects the results of subsequent restructuring processes.

# Several countries remain on the fiscal policy watchlist

**Fiscal slippages remain likely as Brazil and Colombia are still on our fiscal policy watchlist.** Mexico can enter it depending on the fiscal approach adopted by the new administration. Brazil's government is very unlikely to meet its 0% fiscal target in 2024. Our estimates project a primary deficit of -0.7% in 2024, with the consensus in a similar range. The budget deficit is likely to narrow from around 9% of GDP in 2023 to 6% in 2024 (see Figure 39). Government accounts also point to a continued rise in the public debt-to-GDP ratio. Given Brazil's relatively low country risk premium today, any escalation of fiscal concerns and changes in the fiscal targets could put upward pressure on bond yields and the currency. Meanwhile, fiscal consolidation remains a concern in Colombia, where fiscal deficit projections for 2024 due to expected revenue shortfalls exceeding planned expenditure cuts. Mexico also remains on watch as fiscal tightening will be needed in 2025 to bring the country back on a sound path after recently introduced measures.

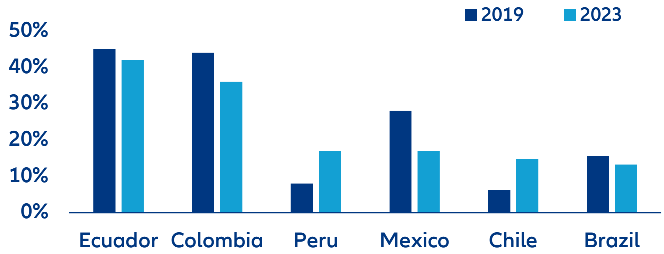
**Several countries have increased their exposure to foreign creditors in recent years (see Figure 40).** However, the two largest economies, Brazil and Mexico, find themselves in a more secure position today than in 2019 in terms of available liquidity from the government with respect to short-term maturities (see Figure 41). This provides some comfort should contingent liabilities materialize.

**Figure 39:** Fiscal balance (% GDP)



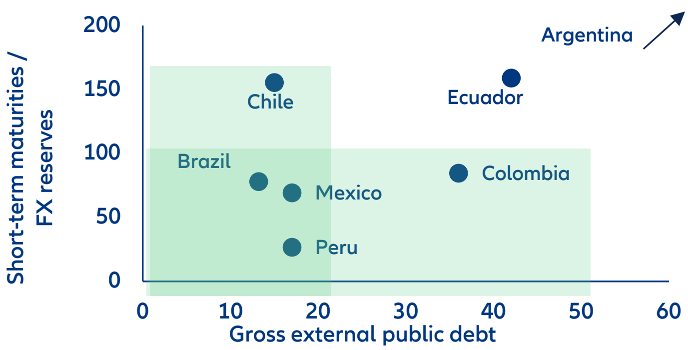

Sources: IMF, Allianz Research.

**Figure 40:** External debt, % of GDP




Sources: IMF, Allianz Research.

**Figure 41:** Liquidity remains tight for some countries with moderate exposure to foreign debt




Note: Short-term maturities correspond to what we call "Gross External Financing Requirement", which is defined as the percentage of current account balance + external debt repayments maturing in the next 12 months on foreign currency reserves. If the ratio is above 100% existing FX reserves are not enough to meet short-term commitments. This threshold can be increased for high-income countries with a relatively stable exchange rate.

Sources: IMF, National sources, Allianz Research.

# Demographic change is also a cause for concern

**Latin America's fiscal risks could be amplified by demographic change.** Like the rest of the world, Latin America is aging – but even more rapidly. Today, around 63mn people aged 65 and older live in the region; this number is set to increase to 142mn in 2050, comprising almost 20% of the total population. As a consequence, the old-age-dependency-ratio (OADR) will sharply rise, too (Figure 42), from today's 15.8% to 32.6%; in Chile, it will reach 46.2%. Globally, the increase will be more muted, reaching 29.5% (up by "only" 62.5% from today's level). Going further into the future, the challenge becomes even more daunting: at the end of the century, the region's OADR will likely be at 64%, more or less on par with the level of today's high-income countries – and a whopping 20pps above the global average.

**Latin America's pension systems are by and large not fit for purpose, as our Global Pension Report[7] reveals.** The results of our Allianz Pension Indicator, which assesses how prepared global pension systems are for demographic change, show that despite some recent reforms, the sustainability and adequacy of Latin America's pension systems have hardly improved. They still range in the middle to lower half of the ranking of 75 countries, with the overall assessments ranging between 3.5 (Mexico, #33) and 4.3 (Brazil, #65) on a scale from 1 (best) to 7 (worst). Pension systems differ substantially in the region – from Brazil's PAYG-system to Colombia's hybrid and to Chile's fully funded system – and thus have also different weak spots, e.g. (too) high contributions rates (Argentina and Brazil), (too) low retirement ages (Chile and Colombia) or low benefit ratios (again Chile). But there are also two common features that beset all pension systems across the region: low coverage ratios and inadequate private savings. The former is mainly due to a large informal labor market, while the latter reflects low savings efforts (for the lack of incentives) and huge inequalities – which are clearly connected to the informal labor market.

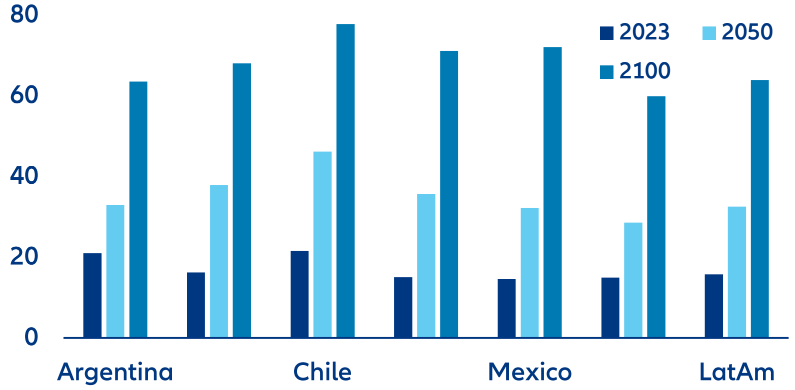
**Mobilizing savings to close pension gaps will require extra political efforts.** At first glance, the development of financial assets held by households looks impressive: Since the beginning of the century, these assets, measured as a percentage of GDP, almost doubled, with particularly strong increases in Brazil and Colombia (Figure 43). However, in the last decade, development slowed markedly – and came to a full standstill since the pandemic. The reason? Many governments (notably Chile and Peru) decided to prioritize present gain over future pain and allowed savers to withdraw funds from their pension accounts (which were often the only savings available). At the end of 2021, more than 4mn Chileans, or 38.5% of the pension fund members, were left without any savings in their pension accounts; in Peru an estimated 2.1mn of these members (37%) have depleted their funds completely.[8] No wonder then that private wealth declined markedly over the last years. As result, the gap to the rest of the world widened further (global average: 275%); in Asia, private wealth is almost twice as high (217%).

**In this context, the region must reverse course and use all instruments – from direct subsidies to tax breaks – to incentivize savings instead.** Such a policy would yield a triple dividend. It can alleviate the fiscal burden of aging by reducing old-age poverty, and it can provide another pool of capital for the green and digital transition.

**Last but not least, it can also mitigate the high inequality in the region.** Latin America has to reverse course and use all instruments – from direct subsidies to tax breaks – to incentivize savings instead. Such a policy would yield a triple dividend. It can alleviate the fiscal burden of aging by reducing old-age poverty, and it can provide another pool of capital for the green and digital transition. This would lower the dependency on international capital markets and mitigate inequality in the region.

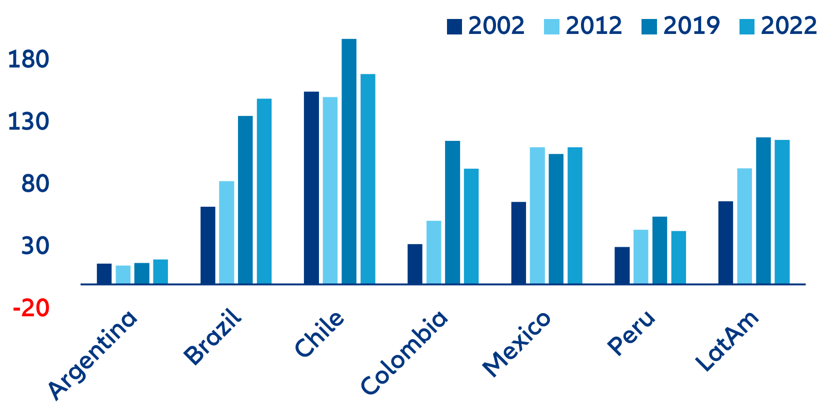
[7] 2023-04-19-PensionReport.pdf (allianz.com)
[8] 2022_01_28_PensionReport_LatAmSpecial.pdf (allianz.com)

**Figure 42:** Rapid aging in Latin America: old-age dependency ratio (65+/20-64) in %




Sources: UN 2022 Population Prospects, Allianz Research.

**Figure 43:** Low private savings in Latin America: total financial assets of households in % of GDP




Source: Allianz Global Wealth Report 2023.

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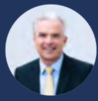

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