

## Latin America: Post-pandemic challenges

As the Covid-19 crisis abates across the region, investors are eager for signs that governments will be able to transition to a more hawkish fiscal policy stance in 2021, amid mounting fiscal concerns



Rio de Janeiro, Brazil

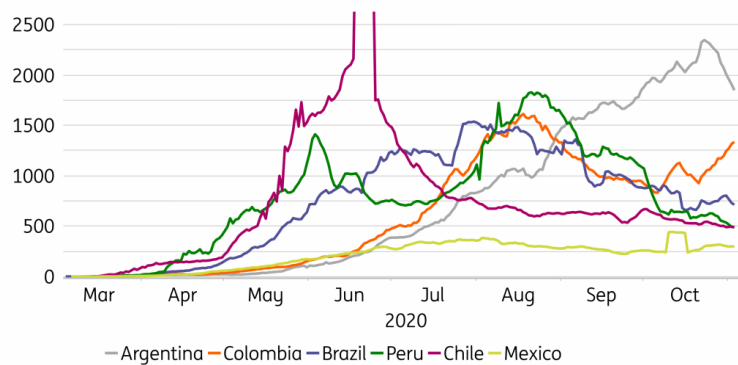
Source: Shutterstock

### Recovery should continue, but at a slower pace

Latin America has largely avoided, so far, any signs of a second-wave resurgence of Covid-19 cases, as seen in much of the Northern Hemisphere. As the region reopens, while managing to mitigate the virus's death toll through more targeted restrictions, its macro outlook should improve, especially in contrast to other emerging market regions where mobility restrictions have intensified.

## No signs of a second wave yet in LATAM

7-day increase in Covid cases/Mn People



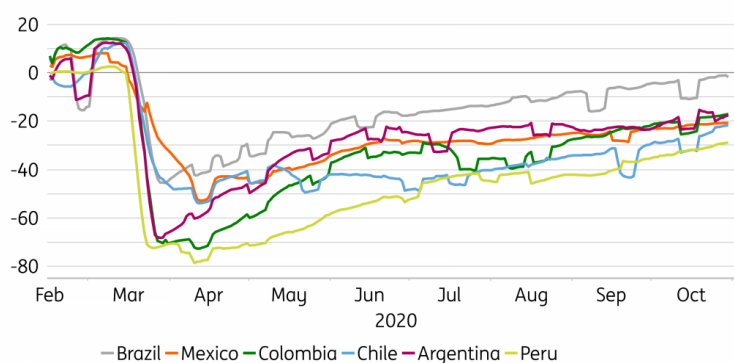
Source: Macrobond, ING

Such an inter-regional divergence would deepen if LATAM manages to avoid a second wave, and further lockdowns, until a vaccine becomes available, possibly early in 2021.

Despite the reduction in Covid cases, mobility indicators (see chart below) suggest that, apart from Brazil, where evidence of a stronger-than-expected recovery is most evident, workplace visits have plateaued somewhat since July. This suggests that the fast pace of recovery generally seen up to July, may have lost steam since then.

## Brazil's faster normalisation of workplace visits remains an outlier

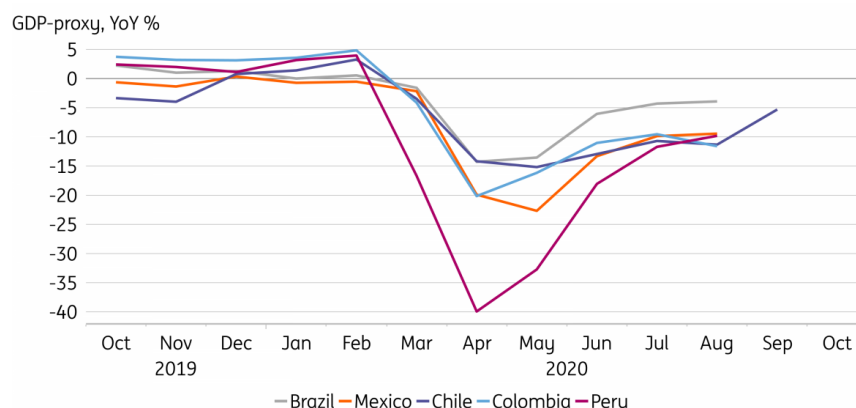
Google mobility indicator (workplace)



Source: Macrobond, ING

There's some evidence that the recovery lost steam in the third quarter, in some countries (see chart below). This would be consistent with the accumulated impact of job losses and reduced government transfers, while continued fear of Covid transmission and social distancing practices continue to depress certain activities, notably in the service sector.

## After a strong 2Q, 3Q has been marked by mixed results in some places



Source: Macrobond, ING

It's still hard to say how countries will continue to adjust but, overall, recent trends suggest that even in the absence of a second wave, the economic recovery throughout the second half of the year may be insufficient to return economic activity to pre-pandemic levels. This could last possibly until a vaccine is widely distributed.

### Coping with a challenging fiscal legacy

Regardless of whether the region surprises with a faster recovery in the second half or disappoints, macro uncertainties are unlikely to dissipate quickly for the region.

The scarring effects left behind in terms of business closures and layoffs, along with the enormous fiscal toll represented by the sharp increase in government spending and reduction in tax collection, suggest that it may take several quarters before we have a clear post-pandemic assessment of regional economies.

For now, fiscal sustainability appears to have become the primary concern for investors across the region, as it enters 2021 with much-weakened fiscal accounts.

This is best illustrated by the underperformance of Brazil's FX and FI assets relative to Mexico's, two countries that adopted vastly different strategies during the pandemic. Brazil reacted to the pandemic by announcing vigorous stimulus measures, including large fiscal transfers to households and businesses. In contrast, the Mexican administration's reaction was unusually muted, both in terms of monetary and fiscal policies.

Thanks in large part to those initiatives, Brazil's post-pandemic activity indicators are the best among major economies in the region. Mexico's recovery prospects are much weaker than Brazil's but, judging by the rally in MXN assets relative to their BRL counterparts, financial markets vastly prefer Mexico's hawkish policy stance.

## Testing LATAM's ability to adapt economic policies to a new reality

In our view, faced with the pandemic, LATAM policymakers acted correctly by implementing robust monetary and fiscal policy stimulus. That was the most adequate course of action in March, but it's clear that there's no additional scope for fiscal easing.

Mounting fiscal concerns suggest that fiscal policies must, gradually, turn more hawkish, while monetary policies remain expansionary, with the policy rate kept at or near their technical lower bounds.

In our view, the medium-term outlook for local assets should be determined, to a large extent, by each country's ability to successfully transition to a fiscally-responsible stance in the coming months, while keeping the policy mix slightly expansionary.

In other words, the extraordinary set of circumstances governments faced in 2020 justified, in our view, Brazil's forceful policy stimulus. The problem that Brazil faces now is the political reluctance to firmly commit to normalise spending and/or raise taxes to help offset 2020, and re-anchor fiscal dynamics.

This difficulty in normalising fiscal spending post-pandemic, and to bolster fiscal frameworks to return fiscal trajectories to a sustainable path, is playing out in most countries in the region, including in Chile, Peru and Colombia.

In the shorter-term, so long as fiscal uncertainties remain unaddressed, investors may continue to prefer exposure to Mexican assets while Brazil and, to a lesser extent, Chile, Peru and Colombia, continue to be avoided.

We expect relative-performances to be reversed at some point, as confirmation of a strong recovery in Brazil, for instance, helps mitigate fiscal uncertainties and reduces the risk premium incorporated into local assets. This contrasts with the more difficult prospects for the recovery in Mexico, for instance, which suggests that fiscal risks should remain elevated there, in 2021, reducing the scope for appreciation in local assets.