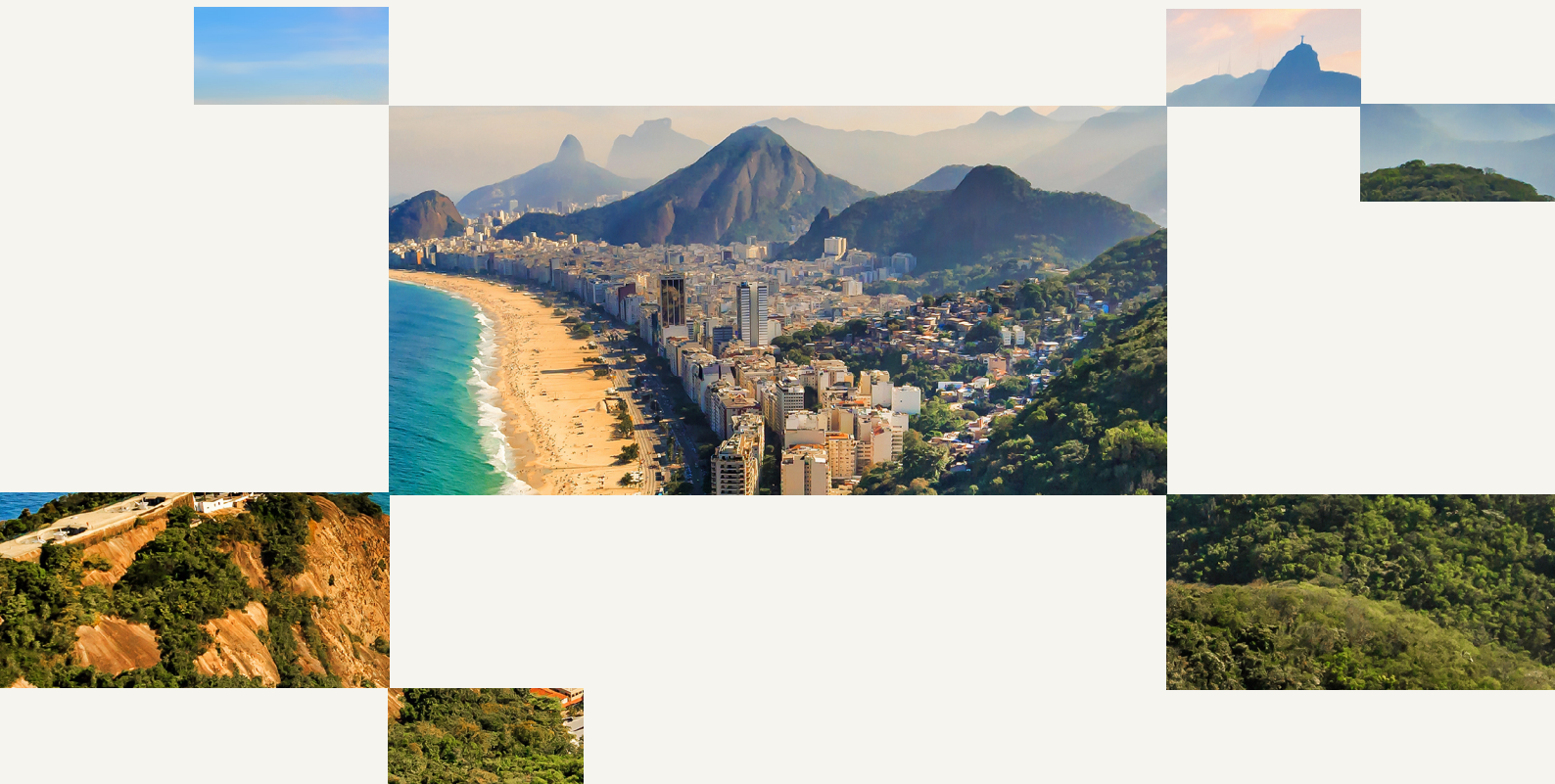


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Latin America outlook 2023

Spotlight on new governments



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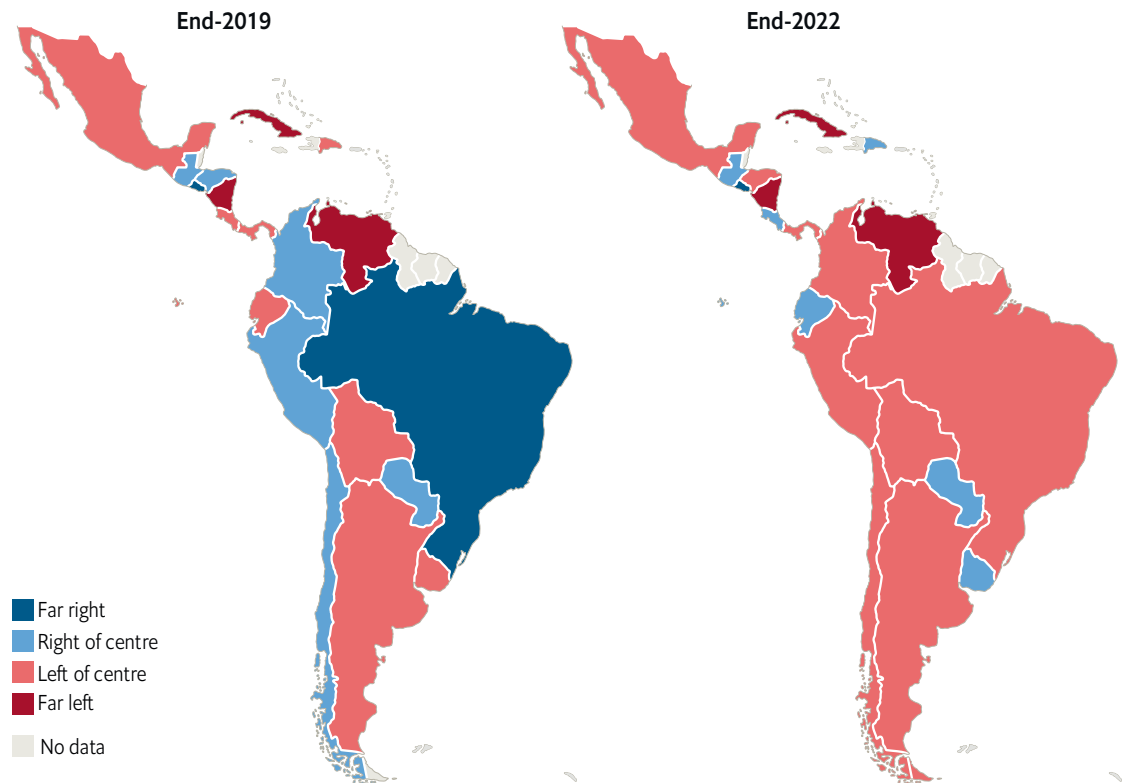
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Spotlight on new governments

- **Latin America is facing significant global headwinds that will weigh on the economic outlook for 2023. Domestic policy will be holding growth back too, amid still-tight monetary policy and looming fiscal consolidation.**
- **However, perhaps the most significant development to watch in Latin America in 2023 is the success or failure of the many new governments in the region as they attempt to address the voter demands that swept them into office, all while grappling with serious macroeconomic dilemmas and divided legislatures.**
- **Despite this difficult political and economic environment, there will be opportunities for growth in 2023, particularly in agriculture, mining and nearshoring. However, to take advantage of these, the region's new governments will have to roll out policy reforms in 2023 that respond to public concerns without causing too much damage to the investment climate. In this white paper, EIU highlights some of these challenges.**

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As the pandemic ebbs, a leftward tide rises

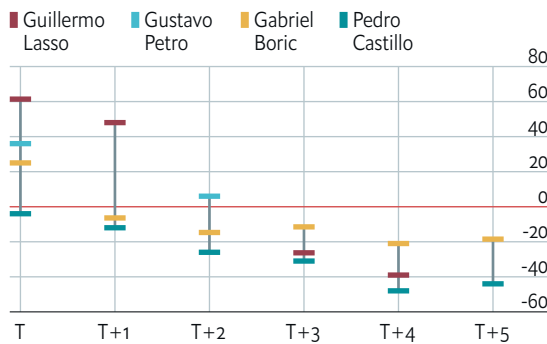


Note. Brazil's new left-of-centre government will take power in January 2023.
Source: EIU.

For Latin America’s new presidents, now comes the hard part: governing

Latin America had another big election year in 2022, with important implications for policymaking in 2023 and beyond. **Policy shifts are on the cards as voters call for change**, not only on issues with a particular regional significance like crime and corruption, but also on the economy. One one—of consequence of the crises that have buffeted Latin America in the past three years is an increasing demand for a big state that spends more and regulates more. Accordingly, over the past year voters have elected candidates on the left of the political spectrum who are promising that kind of shift. It is no coincidence that tax reform—in order to ring-fence social spending—features among the top priorities of new leftwing governments in Chile and Colombia. Greater regulation (and taxation) of important commodity sectors, which are perceived to be the “winners” of the 2022 commodity shock, also looks likely.

Most recently elected presidents have had short honeymoons or none at all
 (net approval rating, %)



Note. T represents the first month in office. Each subsequent month is numbered.
 Sources: Cadem; Invamer; IPSOS Perú; Perfiles de Opinión; EIU.

However, Latin America’s new left-wing presidents will not find governing easy. A collapse in electoral support for the moderate centre across the region has enabled populist right-wing political movements (in some cases, far-right ones) to gain ground too. Some of these movements have control of Congress and could easily block legislation; most countries have an extremely fragmented and divided legislature, making for, at best, a fractious process of mustering support on a bill-by-bill basis. This is not altogether a bad thing, as it represents something of a policy straitjacket and a moderating force, guarding against radical changes to the business environment.

Nevertheless, it will make policymaking a slow process, which may frustrate public demands for speedy—and substantial—results. **Expectations have been raised by the current election cycle, and Latin America’s new presidents will find it hard to come up with the goods;** in this context, honeymoon periods will be extremely short and disillusionment will be quick to set in. All of this raises the risk that, having turned up to the ballot box to effect change this year, voters will resort in 2023 to the kind of large-scale protests that rocked the region in 2019.

US-China rivalry will create problems and some (nearshoring) opportunities too

The decoupling of the US and China—forcing other countries to choose sides on strategic issues in an increasingly bifurcated global economy—will be a major trend underpinning geopolitics and geoeconomics for decades to come. The effects of this are already being felt in Latin America, and that will remain the case in 2023. A crucial question is, of course, which side of the divide Latin American countries will fall. In reality, the region’s governments view both the US and China as important

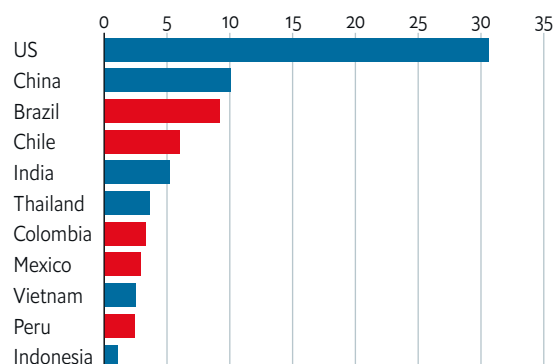
partners and will not want to choose between them. If and when they are forced to take sides on strategic issues like tech development, we think that the US will come out on top. For the most part, Latin America has strong diplomatic ties with the US, even in countries (particularly the big commodity producers in South America) where China has become the most important trade partner.

However, the decision is far from being clear-cut, bearing in mind that while China has been rolling out its Belt and Road Initiative (BRI) across Latin America, the US government has had little to put on the table. In our view, the lack of US engagement largely reflects the reluctance of US private-sector firms to invest in certain countries in the region for one reason or another (traditional obstacles have included weak infrastructure, low productivity, corruption concerns and macroeconomic instability). The promising Build Back Better World (B3W) initiative that was announced by the US administration (in conjunction with European governments), focusing on infrastructure in areas such as health, technology and climate, has failed to get off the ground.

In this environment, China is likely to make further inroads into Latin America in 2023, in strategic areas like lithium mining, and in countries like El Salvador, where increasing authoritarianism is putting the country at odds with the US, traditionally a close ally. A country to watch in 2023 will, of course, be Brazil, where Luiz Inácio Lula da Silva will take over as president in January. Although Lula enthusiastically increased engagement with China when serving as president back in the 2000s, we think that he will try to strike a balance between the two superpowers and keep both on side (as far as possible) this time around.

Meanwhile, the bifurcation of the world economy will present a huge opportunity for Latin American countries in the form of nearshoring. The year 2023 could well bring more investments to this end, particularly in Mexico. Our own analysis shows that Latin America is becoming increasingly competitive vis à vis the rest of Asia on labour costs, and it has other advantages such as proximity to the US. However, many countries in the region simply have too many disadvantages in too many areas, including weak infrastructure, low levels of skills and technological readiness, and political concerns about predictability, stability and security. Compared with major Asian economies, our business environment rankings suggest that Mexico, Costa Rica, Chile and Brazil are best placed to compete and benefit from nearshoring trends. Anecdotal evidence suggests that Mexico has indeed made some progress on this front; its share of US goods imports appears to be growing steadily. However, there are broader concerns about contract rights and the rules of the game in Mexico that will constrain the country's vast nearshoring potential in 2023.

Latam labour cost competitiveness boosted by rapid Asian wage growth
(labour costs per hour, US\$; 2026 forecast)



Source: EIU forecasts.

Some Latam economies are better placed than others to compete for nearshoring investment

(score out of 10 in the business environment rankings)

	Political effectiveness	FDI policy	Foreign trade & exchange controls	Labour market	Infrastructure	Technological readiness	Average
Taiwan	7.8	8.2	9.1	6.9	7.8	9.2	8.2
Chile	7.1	8.2	8.7	6.5	7.0	7.8	7.5
Malaysia	6.4	7.8	8.2	6.9	7.0	7.8	7.4
Costa Rica	7.1	7.3	8.7	7.6	5.0	6.3	7.0
Mexico	5.3	6.9	9.6	6.4	6.0	6.9	6.8
Vietnam	5.7	6.0	8.7	6.6	6.0	6.9	6.6
Brazil	5.3	7.8	8.2	6.0	4.6	6.6	6.4
China	4.1	5.1	6.4	6.2	6.8	8.9	6.3
Colombia	5.2	6.9	6.9	5.9	6.0	6.3	6.2
Dominican Republic	5.8	7.3	8.7	5.2	5.5	4.4	6.1
Peru	3.9	6.4	8.7	5.7	5.5	5.2	5.9
Argentina	6.0	6.0	5.1	5.5	5.5	6.6	5.8
Ecuador	5.0	6.4	7.3	5.1	5.3	3.5	5.4

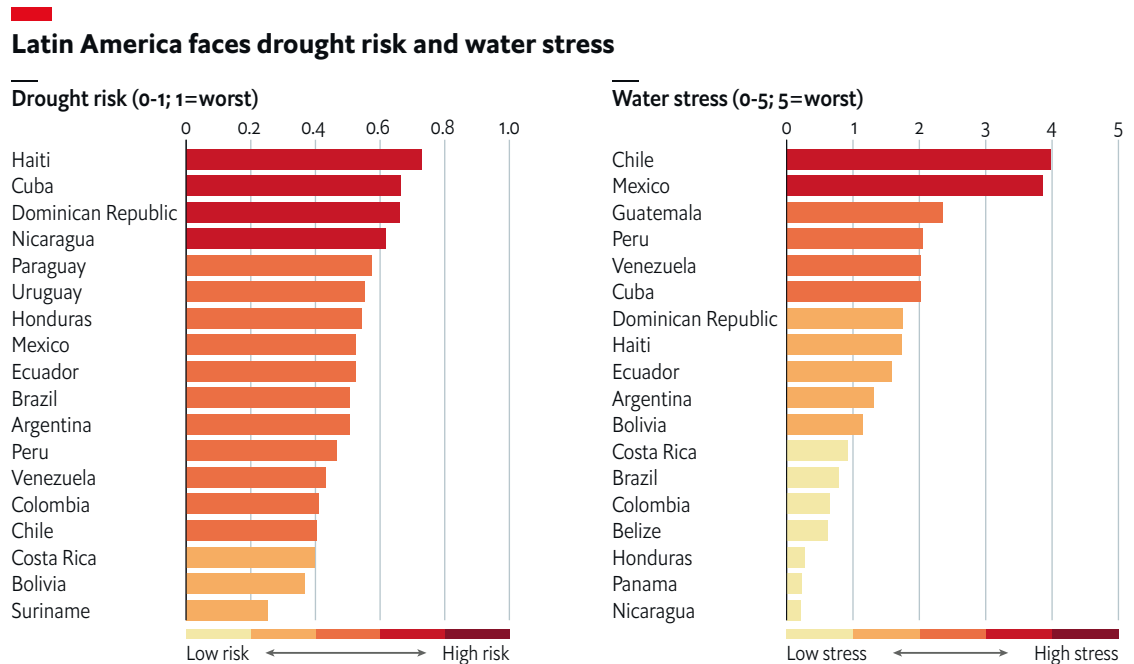
Source: EIU, business environment rankings.

Water, water everywhere? Water supply will become a major political issue

Latin America has the most abundant water resources in the world. However, sources of water supply are not always well connected to sources of water demand, and droughts are becoming increasingly common, putting resources in many countries in the region under severe strain. The situation in 2023 is likely to be no different; according to the US climate prediction centre, there is a 76% chance of the La Niña weather pattern occurring in the approaching northern hemisphere winter (December-February). This would mark a rare “triple dip”—a third straight year of La Niña (and the drought conditions that it brings) for much of Latin America.

Whether drought conditions persist in 2023 or ease slightly, the issue of water stress (the gap between water demand and supply) will not go away, and is in fact likely to be high on policymakers’ agendas for next year, considering the severe and widespread knock-on effects of drought and water stress. The region’s traditionally vast water resources have led to a heavy reliance on hydropower for electricity generation, meaning that low water levels can result in power supply problems, as seen in Brazil in 2021. Latin America’s big agricultural powerhouses are also extremely susceptible to drought conditions, as reflected in underwhelming production figures in some countries in the past couple of years, even in an environment of high prices. Goods exports can be affected by drought too; a crucial river transport route that conveys Paraguayan exports to Argentina (from where they travel on to other important export markets) has dried up, curbing transits. The risk of these problems recurring in 2023 is high.

Above and beyond this hit to activity, **the water issue will become a pressing political and policy question in 2023,** as all of the main water consumers (business users in industry, agriculture and mining) will attract criticism from the public and politicians alike for contributing to household



Note. Water stress is the gap between water demand and water supply.
 Sources: Aqeduct, World Resources Institute; EIU.

water shortages. Business supply has not been badly affected by drought conditions to date, owing to generous long-term water supply contracts that were signed before the problem of water stress arose. Now, however, these contracts are coming under fire in the likes of Mexico and Chile (both of which are among the top 25 water-stressed countries in the world). In Mexico, the president, Andrés Manuel López Obrador, has already threatened to end brewery operations in the drought-affected north of the country, and although this may simply be bluster, there is a risk that he will follow through on this threat in 2023. In Chile, meanwhile, the regulation of scarce water resources will undoubtedly be taken up in a renewed effort to rewrite the constitution that is getting under way. In both countries (as in the rest of the region), **there is a strong chance that new regulations end up crimping future mining and agriculture development.**

Agriculture: filling the grains gap?

The upending of global agricultural supply chains amid the Russia-Ukraine war raises the question of whether Latin America’s agricultural powerhouses can step in and fill a supply gap left by the loss of Ukrainian production. **The answer is yes (in Brazil) and no (in Argentina).** Brazil and Argentina are the region’s two large global agricultural commodity producers; in fact, Brazil is the world’s largest net agricultural commodity exporter. Both are top exporters of soybeans and corn, and Argentina is also an important wheat exporter. However, despite these apparent similarities, the nearterm fortunes of the agriculture sector in the two countries look very different.

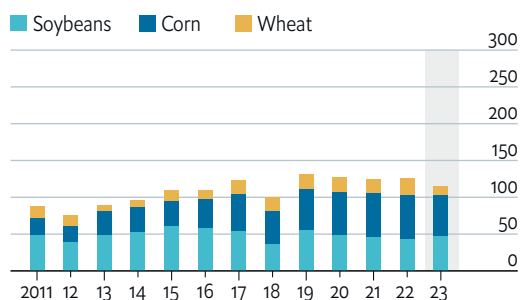
This is partly down to luck. According to official projections, climate conditions will be fair in Brazil, whereas Argentina is set to record a third consecutive annual drop in overall grain production on the back of continued drought conditions. Argentina’s soil is naturally highly fertile and requires less fertiliser per hectare than is the case in most other countries, but even so, a drop in fertiliser use in

the face of spiking global prices will also constrain yields. Farmers have responded to the rising cost of inputs like fertiliser with crop switching, for example by shifting from corn to soybeans, which are more resilient to dry weather and less fertiliser-intensive.

Luck is not the only factor, however; Argentina is facing other headwinds that will prevent an expansion of investment and production in 2023 (and beyond). Years of macroeconomic instability have subdued investment, as have a heavy burden of export taxes (imposed to secure much-needed access to foreign exchange) and export quotas (introduced in a misguided attempt to contain domestic prices). These factors also reduce the incentive for farmers to try to take advantage of still-high global prices by ramping up production. The Argentinian government has tried to tempt them to boost output through a de facto subsidy in the form of a parallel exchange rate for the sector (the idea is to boost pesos earned for each dollar of exports and discourage stockpiling, which the country's farmers have a long tradition of doing as they await another of Argentina's frequent currency devaluations). Even so, the near-term outlook for Argentina's agriculture sector is discouraging.

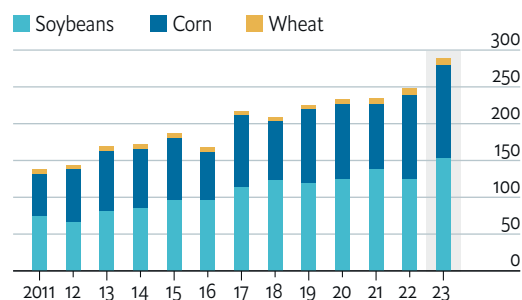
Grains production lags in Argentina and booms in Brazil
(m tonnes)

Argentina's output continues to falter



Sources: Secretaría de Agricultura, Ganadería y Pesca; BCR; Conab; EIU.

Brazil will post a record harvest in 2023



Note: 2023 are latest projections.

Brazil, meanwhile, looks set for a record harvest in the 2022/23 crop year. The principal factors supporting this outlook include early efforts by Brazilian farmers to ramp up fertiliser imports, enabling them to secure crucial supplies and protect yields. Although the cost of fertilisers has rocketed, high soft-commodity prices will still provide Brazilian farmers with a solid profit margin. Another significant driver behind the increase in agriculture production in 2022/23, as in the past decade, is an expansion of arable land dedicated to crop production.

Looking ahead, however, this very expansion is a potential obstacle for the sector in Brazil. The US Department of Agriculture recently projected that land dedicated to agriculture, which currently stands at just over 40m ha, could expand by another 20m ha in the next decade. However, at least some of the recent expansion has been in areas surrounding the Amazon, giving rise to substantial environmental concerns and suggesting that when Lula takes office in January, he may impose restrictions on agriculture in order to meet global environmental commitments. **Finding a way to comply with these commitments without disrupting one of the fastest-growing—and important—sectors of Brazil's economy, will be a tough challenge for Lula in 2023 and beyond.**

Mining reform on the agenda as Latin America holds the key to the global energy transition

A number of factors—including post-pandemic “build back better” infrastructure initiatives and increasing public demands for clean energy in the battle against climate change—are raising demand for mining minerals that are crucial to the global energy transition. At the same time, the race to secure reliable sources of supply is heating up owing to global supply-chain issues and the intensifying US-China rivalry. **These trends have shone a spotlight on Latin America’s abundant supply of strategic minerals such as lithium, copper, nickel, cobalt and rare earth elements.**

Latin America is home to some of the world's largest deposits of minerals crucial to the global energy transition

(global ranking of mining reserves)

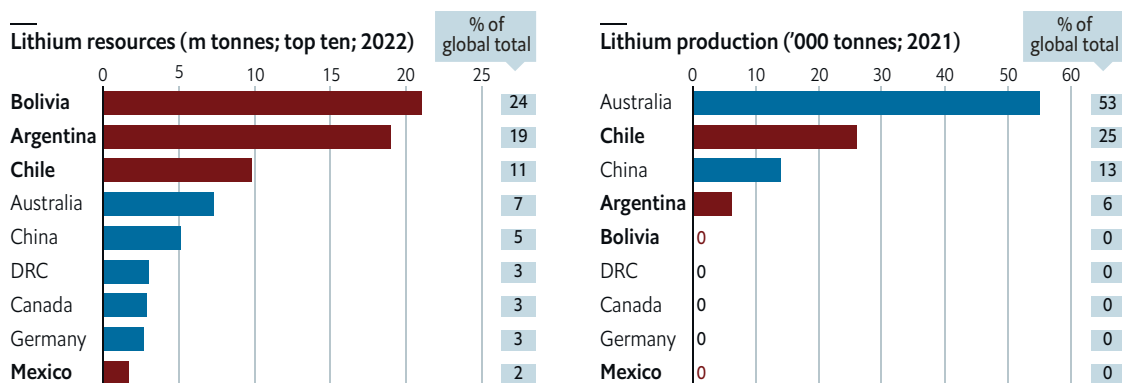


Latin America is home to a significant portion of all of these minerals: well over half of the world’s lithium is in the region (mostly in the “lithium triangle” of Bolivia, Argentina and Chile); Chile has the world’s biggest supply of copper; and Brazil holds the third-largest reserves of rare earth elements (about 10% of the global total). In a few cases, production levels reflect these large stocks. Chile and Peru, for example, are long-established global leaders in copper mining. However, although foreign investment in mining in Latin America is extensive, production of these materials does not, for the most part, come anywhere near potential, even though they are so critical for technology and clean energy. Bolivia’s lithium resources have, for example, barely been commercialised at all.

There are several major obstacles to production. One, of course, is the weak overall business environment in some Latin American countries, which raises business concerns about contract rights and the rules of the game. Another is the complex nature of some of these mining operations, as they

require large investments and technical expertise. For example, Bolivia’s salt-pan lithium deposits are harder to access than Australia’s hard-rock deposits. A third issue is an increase in protests and blockades by local communities, both on environmental grounds and in order to ensure that they get what they perceive to be a fair share of the rewards from local mining activity. Finally, and most importantly, the mining regulatory regime in much of Latin America is in flux. Among their other priorities, new governments across the region are seeking to address voter demands for stronger environmental regulation and fairer water usage. They will also want to fund spending by amending the tax and royalty rules that govern these windfall commodities.

Latam has huge lithium resources, but production is lagging



Sources: US Geological Survey; EIU.

In 2023 therefore, a major task in countries like Chile (where a process to rewrite the constitution will undoubtedly touch on the mining sector) is to clarify via pending reforms the new rules for the mining sector. To the extent that these address environmental concerns while still allowing for profitable private-sector operations, the stage will be set for a ramping-up of production. If, however, new regulations put Latin American mining operations at a substantial cost disadvantage relative to other global producers, or if governments push for their cash-strapped public sectors to lead the way on mining development, output will prove disappointing.

Given the region’s ample resources, we expect next year to bring more investment announcements as companies accept the risk of a bumpy ride in order to secure resources, but output is likely to be slow to approach its potential, in 2023 at least. Moreover, there is a significant risk that output of key minerals such as copper falls back in the long term, as local protests grow in strength and the mining framework becomes less attractive.

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