OUTLOOK
11 January 2023

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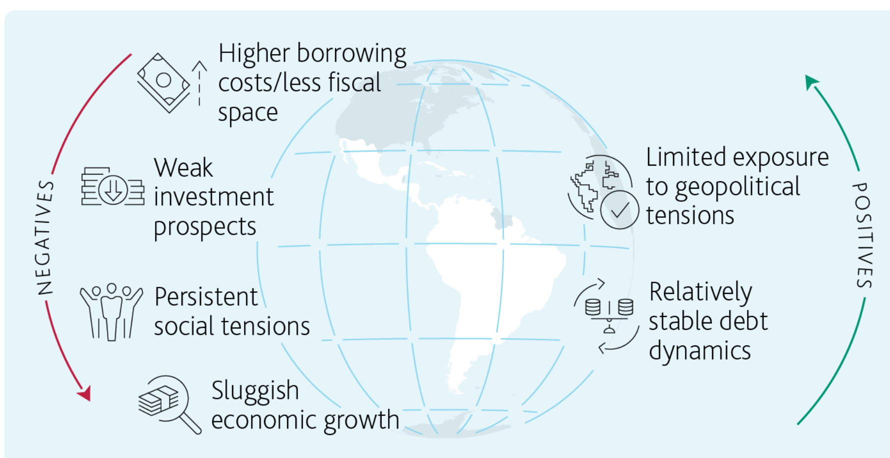
Sovereigns – Latin America & Caribbean

2023 outlook is negative as slower growth and higher borrowing costs lead to challenging policy tradeoffs

Summary

Our outlook for Latin American (LatAm) and Caribbean sovereign creditworthiness in 2023 is negative, reflecting our expectations for the fundamental credit conditions that will drive sovereign credit over the next 12 months. Sluggish economic growth, higher borrowing costs and a backdrop of a persistent increase in the cost of living will lead to difficult policy choices for sovereigns in the region. As LatAm economies come down from the post-pandemic rebound in activity, global supply-demand imbalances linger, dragging 2023 growth prospects and continuing to fuel inflation, albeit at a decelerating pace. Although the region is spared the direct effects of geopolitical tensions, the indirect effects of high energy and food prices will affect society's most vulnerable. Already stretched fiscal balance sheets will face challenging policy tradeoffs that will likely favor social spending, leaving little fiscal space for public investment including expenditures on cleaner technologies, sidelining environmental concerns. Against this backdrop, social policy effectiveness will be key in designing targeted social programs to avoid waste and investing resources toward desired social outcomes.



Outlook definition

The negative outlook reflects our view of credit fundamentals in the sovereign sector of Latin America and the Caribbean over the next 12 months. Sector outlooks are distinct from rating outlooks, which, in addition to sector dynamics, also reflect issuers' specific characteristics and actions.

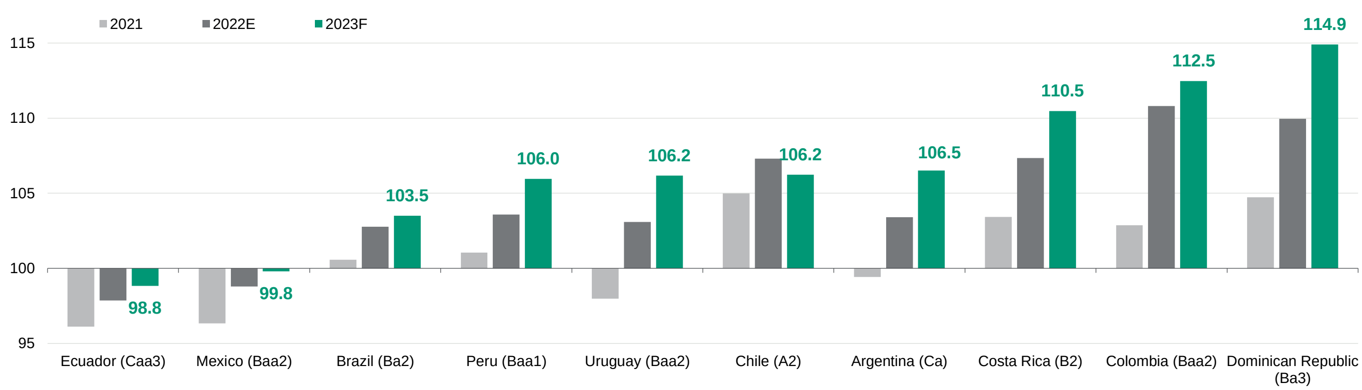
A sector outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of rating outlooks.

Economic growth across the region will slow, with external downside risks relatively contained compared to other regions

In 2023, most LatAm economies will see a strong growth slowdown. Investment and private consumption, the main contributors to growth in 2021-22 amid pandemic pent-up demand, are likely to drag activity. Inflation, particularly food and energy prices, will remain high in 2023. Sources of inflation have varied by country, but the shock has been widespread and persistent, making disinflation a challenging process that has led to rapid monetary tightening. Tighter external financial conditions as a result of global central banks removing monetary stimulus will also weigh on domestic activity, including through lower capital inflows, higher financing costs and slower private credit growth. Slowing global growth will weaken commodity prices, negatively affecting activity in the region compared to last year, especially for net commodity exporters in South America and the Caribbean. Central American remittance-dependent economies will see reduced inflows, but lower financial integration will mitigate risks from tighter external financial conditions. Despite the deteriorating growth outlook, the region will be comparatively less affected by the global slowdown and the commodity price impact of Russia's invasion of Ukraine (Caa3 negative) has created some opportunities for hydrocarbon, metal and food exporters.

» **Economic growth will weaken following two years of post-pandemic rebound.** We estimate that the broader Latin America and Caribbean region will grow 2.7% on average, slowing from 3.8% in 2022 and 7.1% in 2021, with a more notable slowdown in LatAm economies than in the Caribbean where tourism flows continue to recover from a low base that is supporting short-term activity. The vast majority of LatAm and Caribbean economies will long exceed their 2019 level of output, with very few exceptions (see Exhibit 1). Paraguay (Ba1 positive), the only economy to contract in the region in 2022, will post 4.5% growth, which along with the Bahamas (B1 stable), Barbados (Caa1 stable), Bolivia (B2 negative), the Dominican Republic (Ba3 stable) and Panama (Baa2 negative) will be the fastest growing economies in the region, expanding between 4%-4.5%. We expect the rest of the region's economies to grow over 1%, except for Brazil (Ba2 stable) at 0.7% and Chile (A2 stable) where output will contract by 1%.

Exhibit 1
Growth slows down following rebound in 2021-22, but some still to reach 2019 output level
Real GDP indexed to 2019



Sources: Haver Analytics and Moody's Investors Service

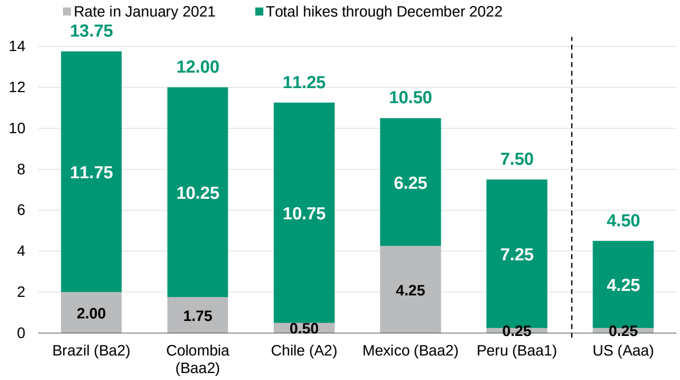
» **Tighter monetary policy will slow inflation but will also cool economic activity.** As central banks raise interest rates to tame inflation and mitigate reduced capital inflows, domestic demand in the region will slow markedly. Investment will be lower than pre-pandemic given more negative economic sentiment across the region and a higher cost of capital (see Exhibits 2 and 3), while domestic consumption will continue to feel the bite of inflation even as it eases off its 2022 peak. Although price pressures will ease in 2023, inflation will remain above target despite high policy rates. For most countries in the region, lower gross capital accumulation will stunt employment creation, further exacerbating structural obstacles to productivity including informality, labor market rigidity, complex and distortive tax policies, and poor governance, negatively affecting potential growth rates in 2023 and beyond. Countries in the region are unlikely to actively address these long-standing challenges to growth in 2023 given the focus on navigating the uncertain economic environment. Although Ecuador's (Caa3 stable) government attempted to enact a reform agenda, political tensions and social backlash have led to policy paralysis that will persist through 2023. Similarly, political uncertainty in Colombia (Baa2 stable) and Peru (Baa1 stable) will continue to weigh on capacity to implement reform, while the policy agenda in Chile remains focused on the process of rewriting the constitution.

» **Stagflation is a risk for the region, but a moderate one, given that inflation is likely to slow and trade openness is limited.** Monetary authorities responded early and with relative strength, fostering credibility and financial stability such that inflation will trend down, but will remain above target levels in 2023, converging with the upper target band in most countries by year-end at the earliest. Even so, high inflation relative to the recent past continues to be a meaningful concern given the limitation that it represents for households' real disposable incomes and the possibility that this could widen inequality gaps.

» **No support from the external side.** External conditions will be less favorable and act as a drag on growth throughout the region. As mentioned, the terms of trade for many countries will be less benign in 2023 than in 2022 – subtracting growth momentum for commodity exporters – all while slowing growth in the US (Aaa stable) and still below-potential growth in China (A1 stable) reduces external demand. Although the accompanying fall in commodity prices will bring some relief to inflation pressures, mineral exporters like Chile and Peru, and hydrocarbon producers like Bolivia, Ecuador and Trinidad & Tobago (Ba2 stable), will see diminished benefits from net exports. US economic growth will remain marginally positive, lending very limited support to activity in the region; however, risks for US growth remain skewed to the downside. Countries that are more dependent on domestic demand for growth, like Brazil, are likely to be less affected; countries with greater trade integration like Mexico (Baa2 stable), Panama and Costa Rica (B2 stable) could be more negatively affected by a further US slowdown, while remittance-dependent economies like Guatemala (Ba1 stable), El Salvador (Caa3 negative), Nicaragua (B3 stable) and Honduras (B1 stable) are also exposed. Limited balance of payments vulnerabilities will remain a feature of most countries in LatAm, with the slowdown in domestic demand driving lower imports. However, tighter global financial conditions will have negative credit implications for sovereigns that struggle with weak external liquidity like Argentina (Ca stable), Bolivia, Ecuador and El Salvador, because their external finances will continue to depend on public indebtedness for attracting hard currency inflows.

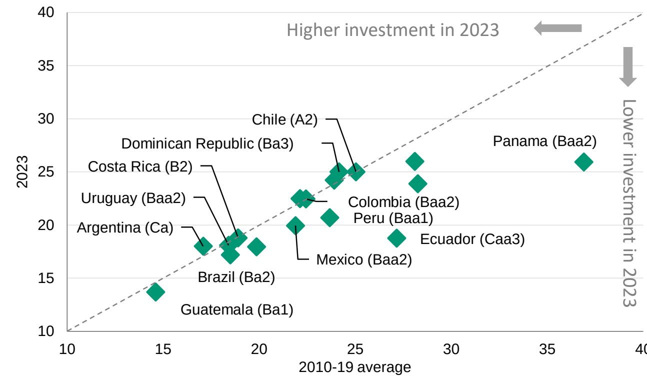
» **Despite the slowdown and external risks, this region will perform comparatively better than others.** A global economic slowdown will weigh on LatAm's growth. However, whereas the Russia-Ukraine conflict has prompted a reset of Europe's energy system, and led to a terms-of-trade shock for other regions, LatAm's reliance on Russia's and Ukraine's export baskets is very limited. The export baskets of some countries within the region bear some similarities to those of Russia and Ukraine, particularly in terms of food and energy. Moreover, the global shift to green technologies could support demand for exports from countries with a large endowment of metals used in the energy transition like Brazil, Chile, Mexico and Peru.

Exhibit 2
Fast pace of hiking will contribute to growth slowdown...
Monetary policy rates (%)



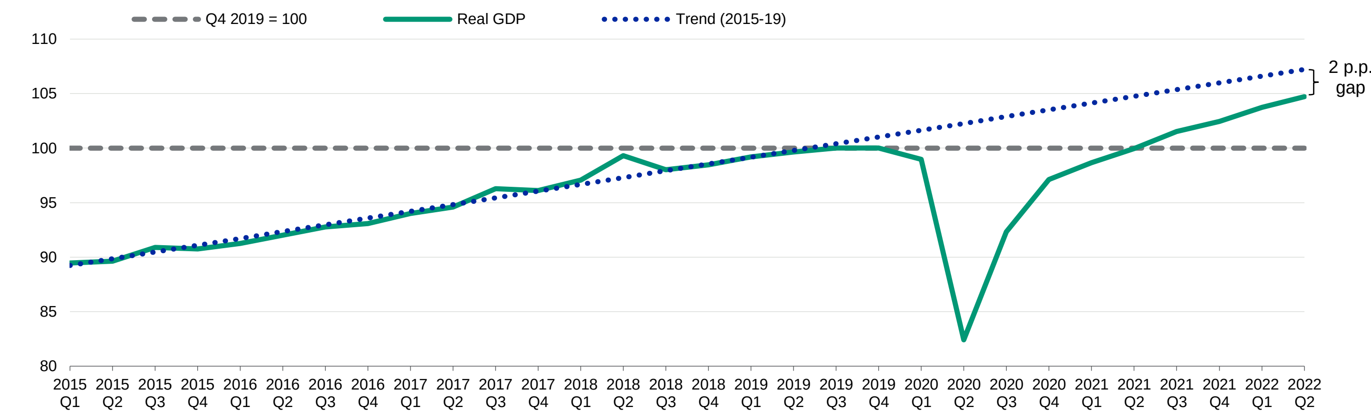
Sources: Haver Analytics and Moody's Investors Service

Exhibit 3
...by complicating investment prospects in 2023
Investment to GDP (%)



Sources: Haver Analytics and Moody's Investors Service

Exhibit 4
Growth rebounded strongly but still lags pre-pandemic trend
LatAm* real GDP (level, Q4 2019 = 100)



* excludes Caribbean economies.
Sources: Haver Analytics and Moody's Investors Service

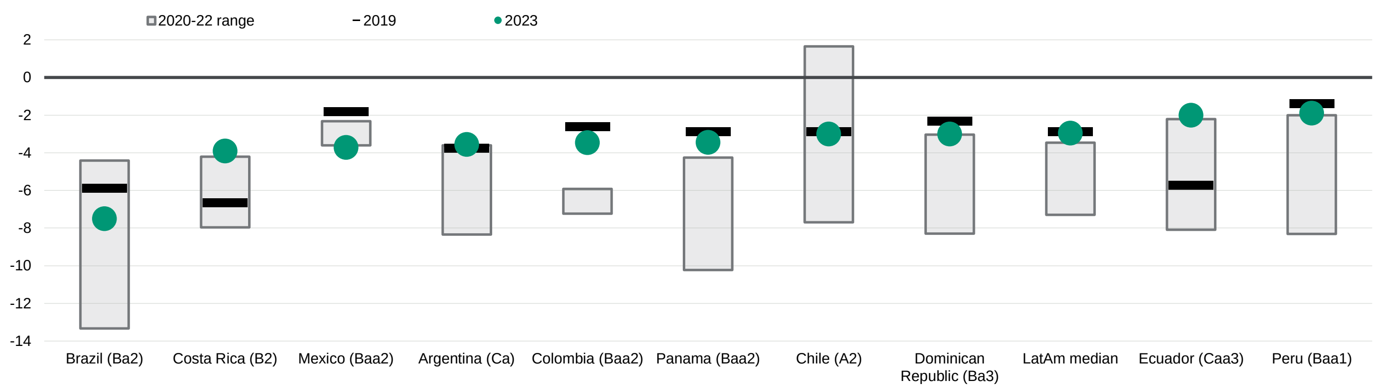
Debt will remain broadly stable following a sustained narrowing of fiscal deficits, but social demands and slowing growth will raise spending pressures

Debt metrics for most LatAm sovereigns will be largely unchanged compared to 2022. Following significant volatility in government finances in 2020-22, we expect fiscal deficits to largely return to their pre-pandemic levels. Notwithstanding the absence of a material improvement or deterioration in debt metrics, we expect several undercurrents from the 2020-22 period to carry over into 2023 and pressure sovereigns' creditworthiness. In particular, social pressures for increased spending will be sustained by slowing economic growth and weaker household real incomes. The degree to which governments were able to reign in wide fiscal deficits in 2021-22 will drive credit differentiation and determine how much fiscal space governments have to absorb increased social spending. At the same time, unfavorable financing conditions amid elevated borrowing costs are likely to undermine debt repayment capacity, especially for lower-rated LatAm sovereigns.

» **Fiscal deficits will stabilize around their pre-pandemic levels, while social pressures hamper ability to further narrow deficits.** The wide range of fiscal results recorded in 2020-22 will give way to fiscal outturns broadly in line with pre-pandemic results (see Exhibit 5). However, considering slowing economic growth and that inflation dented household real incomes, we expect sustained spending pressures to persist and limit the scope for narrowing fiscal deficits in 2023. Governments that successfully managed to reign in large deficits in prior years, such as Chile and Peru, will have greater space to absorb an increase in social spending – Chile, in particular, plans to boost spending by around three percentage points of GDP after narrowing its fiscal deficit in 2022 by more than seven percentage points. Other countries like Brazil, Panama and Ecuador will also seek to adopt measures to alleviate price pressures on households despite having more limited fiscal space. In Colombia, higher social spending will be financed by increased revenue derived from fiscal reforms.

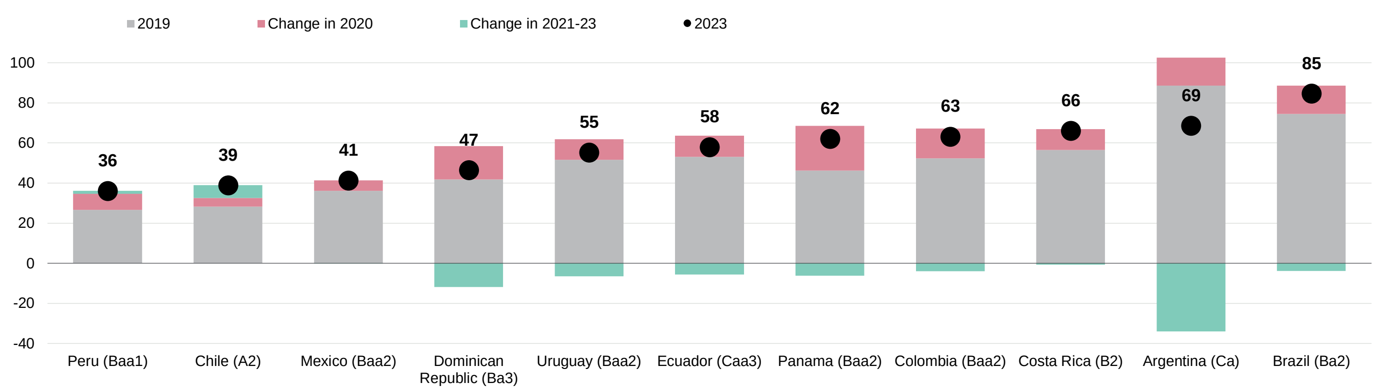
» **Debt burdens will be stable.** After broad declines in 2021-22, debt ratios will mostly stabilize in 2023 for countries like Peru, Ecuador, Uruguay (Baa2 stable), Panama and Paraguay (see Exhibit 6). In a few instances like Brazil, Mexico and Chile, debt will increase marginally as fiscal deficits remain wide and growth slows. Conversely, debt levels will decline materially throughout most of the Caribbean as the recovery in tourism flows continues to gain momentum, moving economic output toward pre-pandemic levels; we project the debt-to-GDP ratio will decline by roughly five percentage points for Barbados, Belize (Caa2 stable), Jamaica (B2 stable) and St. Vincent and the Grenadines (B3 stable).

Exhibit 5
Following substantial volatility, deficits will return to pre-pandemic levels...
Fiscal balance (% of GDP)



Sources: Haver Analytics and Moody's Investors Service

Exhibit 6
...supporting more stable debt dynamics
Government debt (% of GDP)

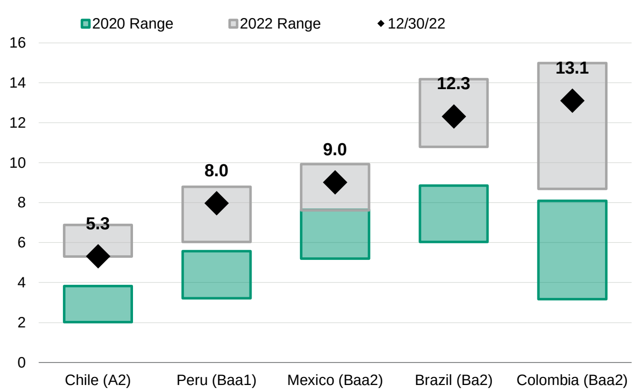


Sources: Haver Analytics and Moody's Investors Service

- **Scope for improving debt affordability will be constrained by high policy rates.** Interest costs will remain high as central banks maintain higher policy rates to bring down inflation (see Exhibit 7). We do not expect a material worsening of interest-to-revenue, however, as stubborn (albeit lower) inflation will continue to support fiscal revenues, helping to mitigate the impact of higher interest payments (see Exhibit 8). Still, a sustained period of high interest rates may lead to a deterioration of debt structures and an increase in rollover risks. The higher-rated sovereigns in the region that continued to access international capital markets (at a hefty premium in 2022 owing to elevated financial volatility), may opt for shorter-dated issuances to lessen the fiscal cost. Meanwhile, some of the region's lower-rated sovereigns with large financing needs face the risk of losing market access, complicating debt repayment capacity and increasing rollover risks.

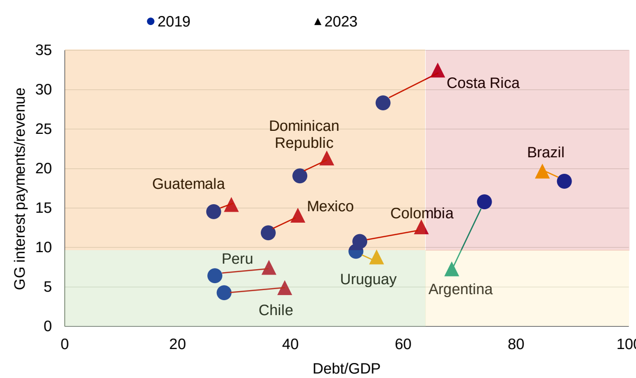
- **Shifting spending priorities amid unfavorable financing conditions are likely to weigh on fiscal profiles.** For many sovereigns, attending to social demands and managing higher borrowing costs will prove a challenging task. Elevated social pressures on governments are likely to increase spending in areas such as subsidies and social programs, which are difficult to reverse. At the same time, higher borrowing costs will increase the opportunity cost of public funds for other spending needs, tightening budget constraints. Assuming that governments are likely to reduce public investment and boost social spending while increased borrowing costs crowds out other spending, we expect that the underlying composition of government spending will become more rigid in 2023. These trends will not only weigh on the region's economic growth potential, but also on governments' capacity to respond to shocks.

Exhibit 7
Borrowing costs are near record highs
10-year local bond yields (%)



Sources: Haver Analytics and Moody's Investors Service

Exhibit 8
Reduced fiscal space for most of the region
Debt burden (x axis, %), debt affordability (y axis, %)*



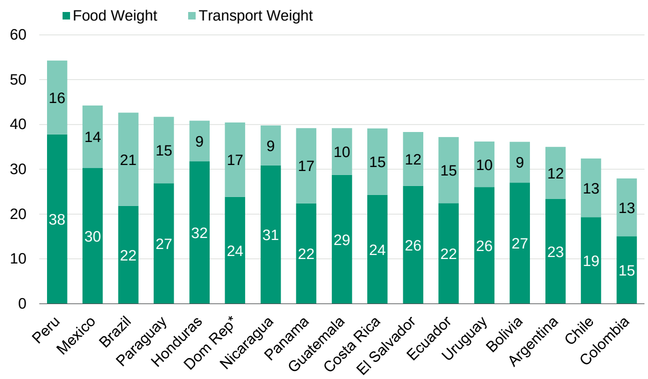
* Note: Quadrants delineated by LatAm medians (debt-to-GDP, 63.9%; interest-to-revenue, 9.5%)
Sources: Haver Analytics and Moody's Investors Service

Governments will face challenge of increasing spending efficiency while supporting households amid soaring food and energy prices

High inflation, along with surging food and energy prices, has translated into a politically tenuous cost-of-living crisis that has forced governments throughout the region to adopt fiscally costly policy measures to protect households against large losses in real income and food insecurity (see Exhibit 9). However, in prioritizing social concerns over other issues, governments in the region have shown a proclivity for subsidies or controls that are costly and ineffective, sometimes toward products with negative externalities like more pollutant energy inputs, and have postponed efforts toward carbon transition in favor of providing some relief to households from food and energy price increases. Some countries were already facing social unrest as demands grew on policymakers for greater efforts to curb inequality, to expand health and education coverage, or to strengthen democratic institutions. Against a backdrop of increased borrowing costs that also reduce fiscal space, sovereigns face the challenge of increasing spending efficiency while supporting households amid the cost-of-living crisis. This suggests that the policy agenda will continue to focus on providing near-term relief to households, subordinating other policy goals like investing in growth-enhancing infrastructure or preparing economies for the green energy transition.

- **The social agenda is now top of mind for most governments in LatAm.** Social tensions the region have grown in complexity and magnitude, making social risks (the 'S' from our ESG Sovereign Framework) a prominent policy concern. The first signs of unrest began with the growth deceleration that followed the end of the previous commodity boom. These social tensions began driving political and policy developments, but unmet demands continued to fester and led to severe backlash in countries like Chile where discontent with high living costs, the quality of public services and inequality resulted in a shift in the direction of fiscal policy. The increase in poverty and inequality in the region during the pandemic resurfaced some of these tensions, which are exacerbated by the increase in food and energy prices, leading to a loss of income and a deterioration in quality of life, especially for the most vulnerable within society. These conditions have had a hand in pushing electoral outcomes toward the political left in countries like Peru, Chile, and Colombia. In the case of Brazil, although these factors played a role, persistent political tensions have had a greater influence and led to recent events that are challenging governability.
- **A differentiating factor in fiscal policy outcomes will be spending efficiency, as governments in the region will be forced to learn to do more with less.** Improving public services not only entails spending more, but also improving the quality of that expenditure, and as a result, social policy effectiveness will be key in designing targeted social programs to avoid waste and investing resources toward desired social outcomes. Countries like the Cayman Islands (Aa3 stable) and Uruguay have high policy effectiveness, while countries like Ecuador, Belize, Bolivia, El Salvador, Cuba (Ca stable) and St. Vincent and the Grenadines have low effectiveness (see Exhibit 10). This underscores the importance of preparing a strategy and building better information systems to make social support readily scalable and better targeted, such that governments are able to respond promptly and flexibly to deliver support to those who really need it, a substantial challenge in the region. Sovereigns with higher institutions and governance strength are better suited to confront these challenges. Competing fiscal priorities, heightened social pressures and low growth following the recovery, against a backdrop of increased borrowing costs, will stretch policymakers' ability to deal with all these issues effectively. Sovereigns with strong policy frameworks, responsive institutions and a favorable track record of crisis management are more likely to succeed when confronting these challenges.
- **Social spending is likely to be sticky and unlikely to be wound down even after inflation subsides, increasing spending rigidity.** The composition of spending will continue prioritizing current, rather than capital expenditures, which along with higher borrowing costs will lead to a structural decrease in fiscal space. This will lead to challenges in narrowing fiscal deficits in the future and hamper governments' ability to respond to future shocks. Governments in the region for the most part lag developed economies in terms of public spending on health and education relative to GDP (see Exhibit 11), such that increases in these expenditures and in other subsidies are likely to be seen as necessary, rather than temporary, by the region's citizens, and likely to continue crowding out public investment in physical infrastructure that is easier and less painful to cut when authorities are forced to adjust spending.
- **Addressing economic insecurities will hold back progress on climate change and energy transition objectives.** The cost-of-living crisis driven by rising food and fuel prices has forced governments to focus on immediate policy concerns that provide relief to households. Although environmental concerns are still top of mind across the region, governments have deployed broad subsidies to more pollutant fuels used by the general public rather than higher grade fuels. Such spending trends suggest that governments use of fiscal resources to address pressing economic concerns will encumber ongoing and future efforts to manage a shift to cleaner energy sources and greener policy outcomes. That said, not all sovereigns are at an equal starting point (see Exhibit 12). Countries like Costa Rica, Paraguay and Uruguay derive almost all of their electricity generation from renewable sources, while many countries, especially smaller Caribbean countries, are dependent on fossil fuels. Still, beyond the composition of a country's energy matrix, there's a dearth in green investments. In 2023, the lack of resources to advance investments centered on carbon transition, diverse energy matrices, and climate resiliency will be tangible as governments struggle to dial back current expenditure and boost capital spending on green projects. Moreover, any efforts to raise revenue to finance such projects are likely to be politically unfeasible, auguring slow progress on existing sustainability targets.

Exhibit 9
Higher food and energy prices pressuring households
Weights in consumer price basket (percentage points)

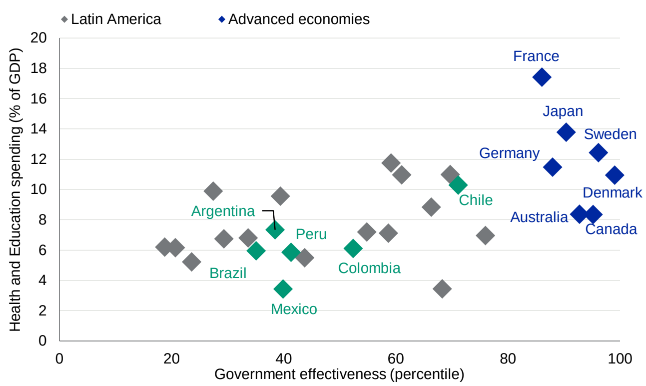


* Dominican Republic
Sources: Haver Analytics and Moody's Investors Service

Exhibit 10
Favorable social outcomes are supported by high spending efficiency
LatAm fiscal policy effectiveness and social risks scores

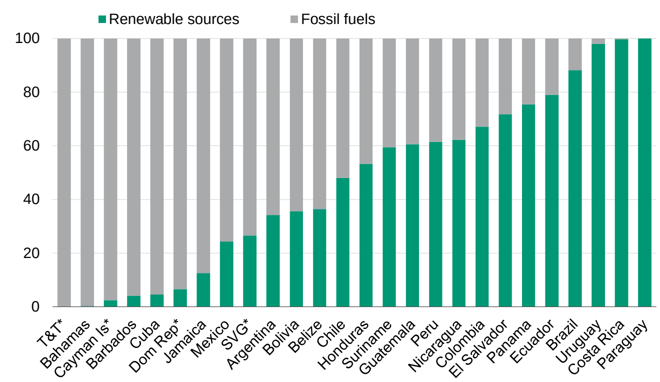
Note: The countries in the high social policy effectiveness quadrant include the Cayman Islands and Uruguay; countries in the low social policy effectiveness quadrant include Cuba, Belize, Bolivia, Ecuador, El Salvador, and St. Vincent and the Grenadines.
Source: Moody's Investors Service

Exhibit 11
Public services spending still lags developed economies
Government effectiveness (x axis, percentile), social spending (y axis, % of GDP)



Sources: Haver Analytics, World Bank, and Moody's Investors Service

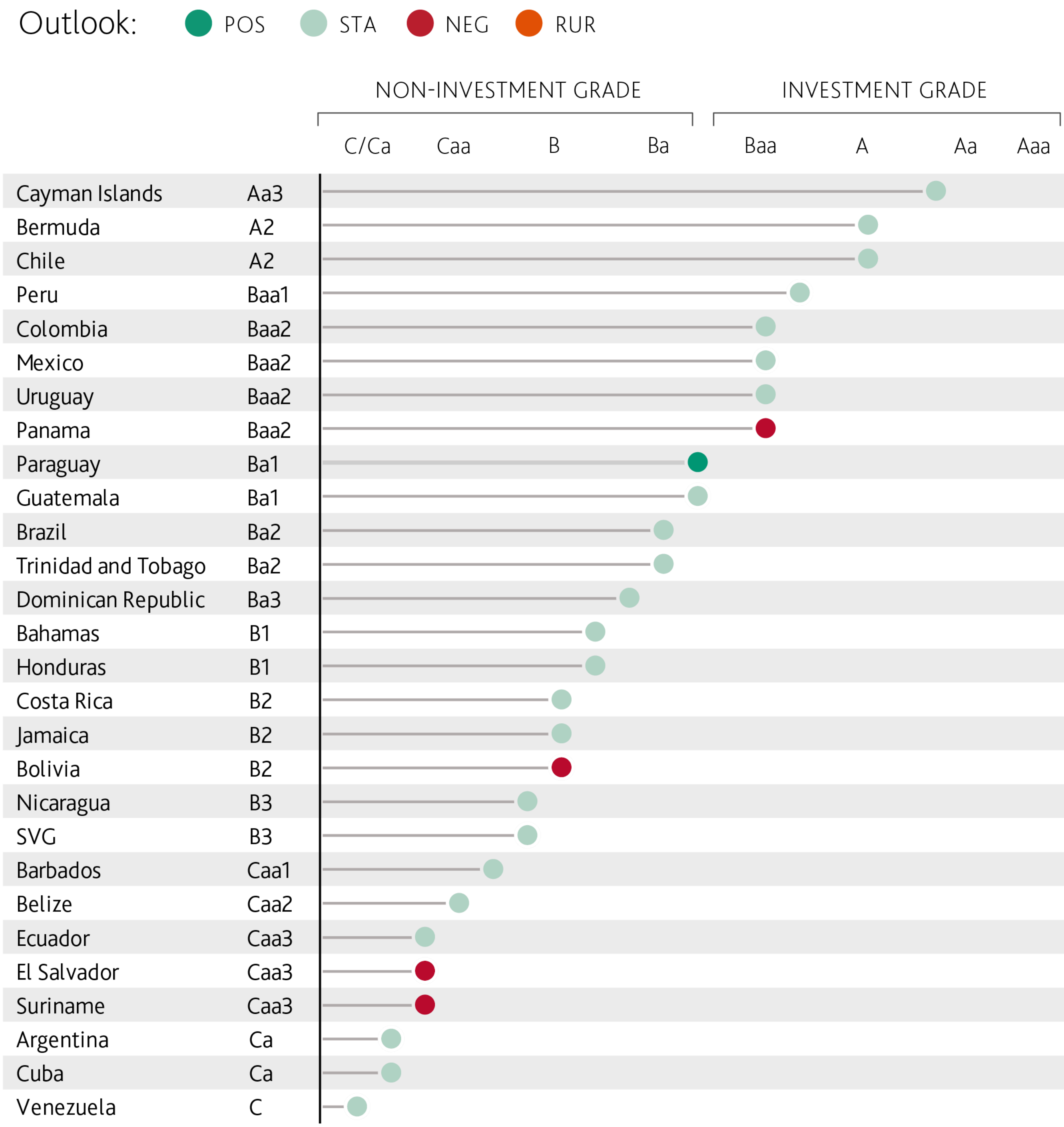
Exhibit 12
Nearly half the region's energy matrices still pending progress toward carbon transition
As a share of electricity generation (%)



* Trinidad and Tobago, Cayman Islands, Dominican Republic, Saint Vincent and the Grenadines
Sources: CIA World Factbook and Moody's Investors Service

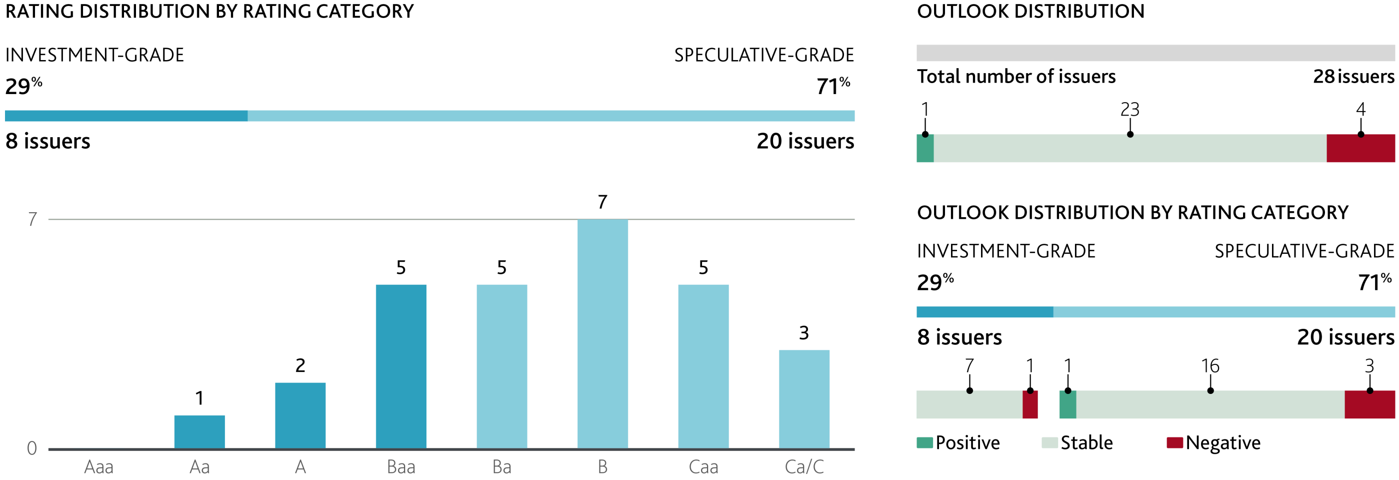
Rating, outlook and action summary

Exhibit 13
LatAm ratings and outlooks as of 31 December 2022



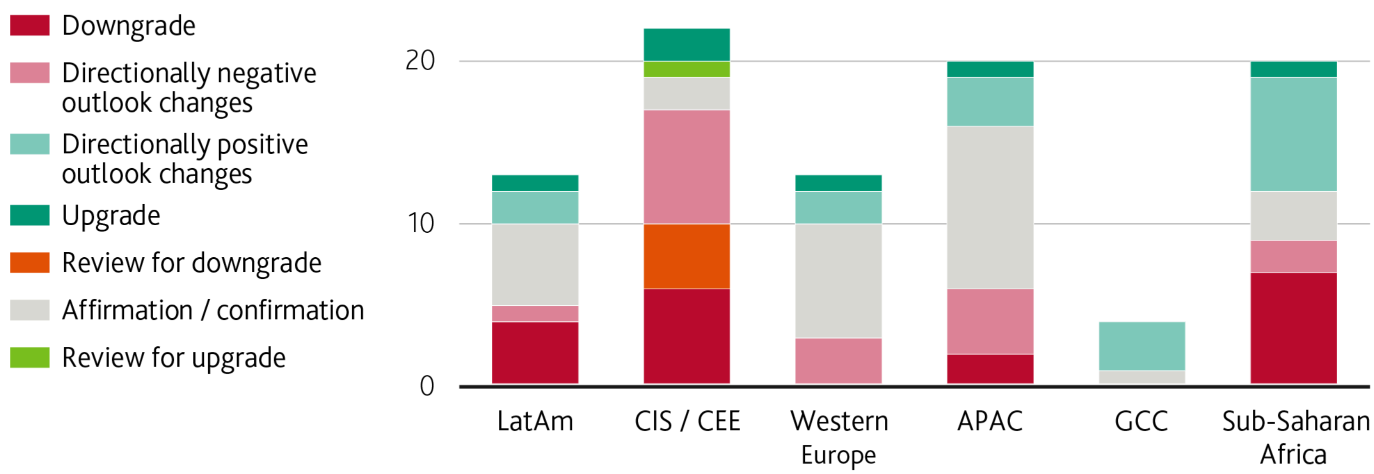
Source: Moody's Investors Service

Exhibit 14
Distribution of LatAm ratings and outlooks



Source: Moody's Investors Service

Exhibit 15
Summary of sovereign rating actions in 2022, by region



Source: Moody's Investors Service

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