

Perspectives 2023: Better than expected, but not so much

The first quarter of 2023 has shown favorable signs for the Latin American and the Caribbean (LAC) economy, with rising prices for key exports like food products and lower oil prices, along with moderating inflation in major economies. However, LAC countries face challenges such as high levels of public debt and the need for greater trade openness. Nearshoring presents a short-term opportunity, but the consolidation of democracy is necessary to fully capitalize on it. Recent elections have demonstrated the importance of democracy in achieving sustainable growth and development, especially for vulnerable citizens.

Where does Latin America and the Caribbean stand?

Perspectives for 2023

After negative signals for the economy of the region in the second half of last year, 2023 started with mixed signals, but better than expected. The International Monetary Fund (IMF) has projected that Latin American and the Caribbean (LAC) economies will grow by an average of 1.6% in 2023, according to its latest World Economic Outlook released in January 2023, increasing slightly by 0.1 percentage points from the previous projection published in October 2022. This forecast is higher than the projected economic growth for advanced economies, which is expected to be 1.2% in 2023 (also 0.1 points above the previous projection). Furthermore, the IMF estimates that Emerging Markets and Developing Economies will experience a growth rate of 4.0% in 2023, which is 0.3 points higher than the previous projection. Meanwhile, the global growth rate is estimated to be 2.6% in 2023, according to the Organization for Economic Co-operation and Development (OECD) Economic

Outlook released in March 2023.

Factors such as the war in Ukraine and high interest rates resulting from the fight against inflation are expected to be major components affecting the Latin American and the Caribbean economies this year. However, the latest global financial disruptions have created uncertainty regarding the future of interest rates in the coming months.

The first three months have shown some favorable signs for the region due to the improvement in external conditions of LAC, such as the slightly increase in the price of the main export products (e.g., food products), as well as the drop in the price of the barrel of oil. As a result, growth projections for the region have been revised upward. Another good sign is that inflation continue to ease in the world's main economies—although not so much—and the banking turmoil that began in March have led to expect that rates will not continue to rise for the rest of the year. But the fact is that LAC is facing a year with higher interest rates than it has been used to in recent years.

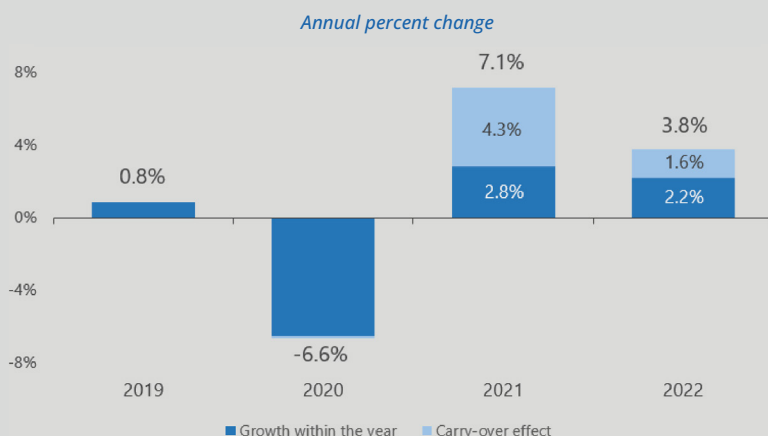
The regional Gross Domestic Product (GDP) growth projected for LAC for 2023 (1.6%) is significantly lower than the 7.1% growth observed in 2021 and the 3.8% estimated for 2022. However, it is important to keep in mind that the economic growth in the region in both years was notably boosted by the statistical carry-over effect. This concept refers to the magnitude that a variable dynamic carries over from one year to the next, and it can be either positive (if the initial year ends above the average for the year) or negative (if the initial year ends below the average). It is the percentage difference between the value of a variable at the close of a year and its average value in that year. In this case, the region's average statistical carry-over from 2021 to 2022 was 1.6%. Since the average growth rate for the year was estimated to be 3.8%, the genuine growth during the year was 2.2%, as illustrated in **Figure 1** and detailed in **Table 1**.

The seasonally adjusted growth in the first half of 2022 for LAC was higher than the expected for the whole year without carry-over effects. In fact, all the growth in 2022 occurred in the first semester, when the external context was favorable. In the second half of the year, the situation deteriorated, and economic activity fell.

Therefore, because this effect is expected to be minimal or non-existent for 2023, it makes sense and is fair to compare the 2022 data without carry-over effects with the expected GDP growth in 2023 (with carry-over effects). In this case, the economy is expected to grow less than last year, from 2.2% to 1.6%. This result shows that the region will continue with very low economic growth. Forward details can be seen in Table 1.

Prior to the pandemic, the region was already experiencing stagnation in ter-

Figure 1. Annual GDP growth, carry-over effect, and growth within the year in LAC



Source: official statistics from each country and International Monetary Fund (IMF) – World Economic Outlook (WEO). Note: Regional aggregate is purchasing-power-parity GDP-weighted average; estimated real GDP growth for 2022. Venezuela is excluded from the analysis.

ms of economic growth, and despite the rebound from the pandemic, it is proving difficult for the region to achieve significant growth rates—even growth projections for the next few years are not very promising—pointing out the need for growth reforms. This is why we are seeing the reappearance of challenges faced by the region. One of these challenges is the region's dependence on the international context, which has not been very favorable due to the interest rate hikes that began last year and the weakening of commodity prices. Another challenge is the issue of debt, which is closely tied to the need to achieve growth. Additionally, the region is facing barriers to trade openness, which is related to the opportunity of nearshoring. Another major challenge is political stability, as the deterioration of social peace and the risk of worsening economic stagnation pose a threat to the institutionality and democracy of LAC, which, although resilient, is once again under stress.

Brief description of the economy in 2022

The economies of Latin America and the Caribbean expanded in 2022, where growth is estimated to have been almost 4% in the region. During the first half of 2022, commodity prices, which rose sharply after Russia invaded Ukraine, and the low interest rates were very beneficial to LAC. Nevertheless, these external conditions shifted radically at the beginning of the second semester. Not only did the prices of the most exported products fall apart, but also the global interest rates increased significantly to combat inflation.

Over time, the most important economies of the western world showed signs of economic stagnation and an end to the post-Covid bounce-back. Meanwhile, inflation became an uphill struggle as it fostered in ways not seen by the most developed countries in the previous years. For instance, inflation was seen in the United States (US) as a transitory evil at the beginning of the year. Yet, it showed more resistance than expected. Moreover, LAC was not exempted from this disease. Therefore, central banks of developed and developing countries had to increase their interest rates.

2022 ended with some positive signals: inflation began to decelerate in most countries, commodity prices stopped falling, and China began to reopen its economy, ending the "zero-Covid" policy after almost three years. At the same time, the weakening of the dollar since

its peak in November provided the region with some relief. Globally, economic growth in the fourth quarter of the year was stronger than expected—especially in the US—with solid labor markets and strong household consumption and investment.

Better than expected, but not so much

Interest rates: will they continue to rise or slow down?

As mentioned above, 2022 was marked by high inflation worldwide, prompting central banks to apply the traditional recipe of raising interest rates. In both the US and Europe, interest rates more than tripled in the last 12 months, negatively impacting Latin America and the Caribbean. The signs of the year's first three months were not encouraging either.

On the one hand, although inflation in the US has been coming down since its peak in June (9.1%), it remains high—as well as core inflation—and the economy is not cooling off sufficiently. Latest labor market and retail sector data surprised analysts, showing that the economy remains hot. While there is optimism that a "soft landing" will be reached, the battle against inflation is far from over. Higher interest rates are already influencing demand, and in February, the manufactur-

ing sector contracted for the fourth consecutive month to a Purchasing Managers' Index (PMI) of 47 (see **Figure 2**).

In its latest meeting in March, the Federal Reserve opted to rise the federal funds rate to a new target range of 4.75 to 5 percent, despite putting further strains on the financial and banking system that is having great concern in the global economy due to the collapse of Silicon Valley Bank and Signature Bank, and the rescue of Credit Suisse Bank from UBS. It is interesting to see how the Fed's projections for the federal funds rate for the end of 2023 and 2024 have been increasing over time.

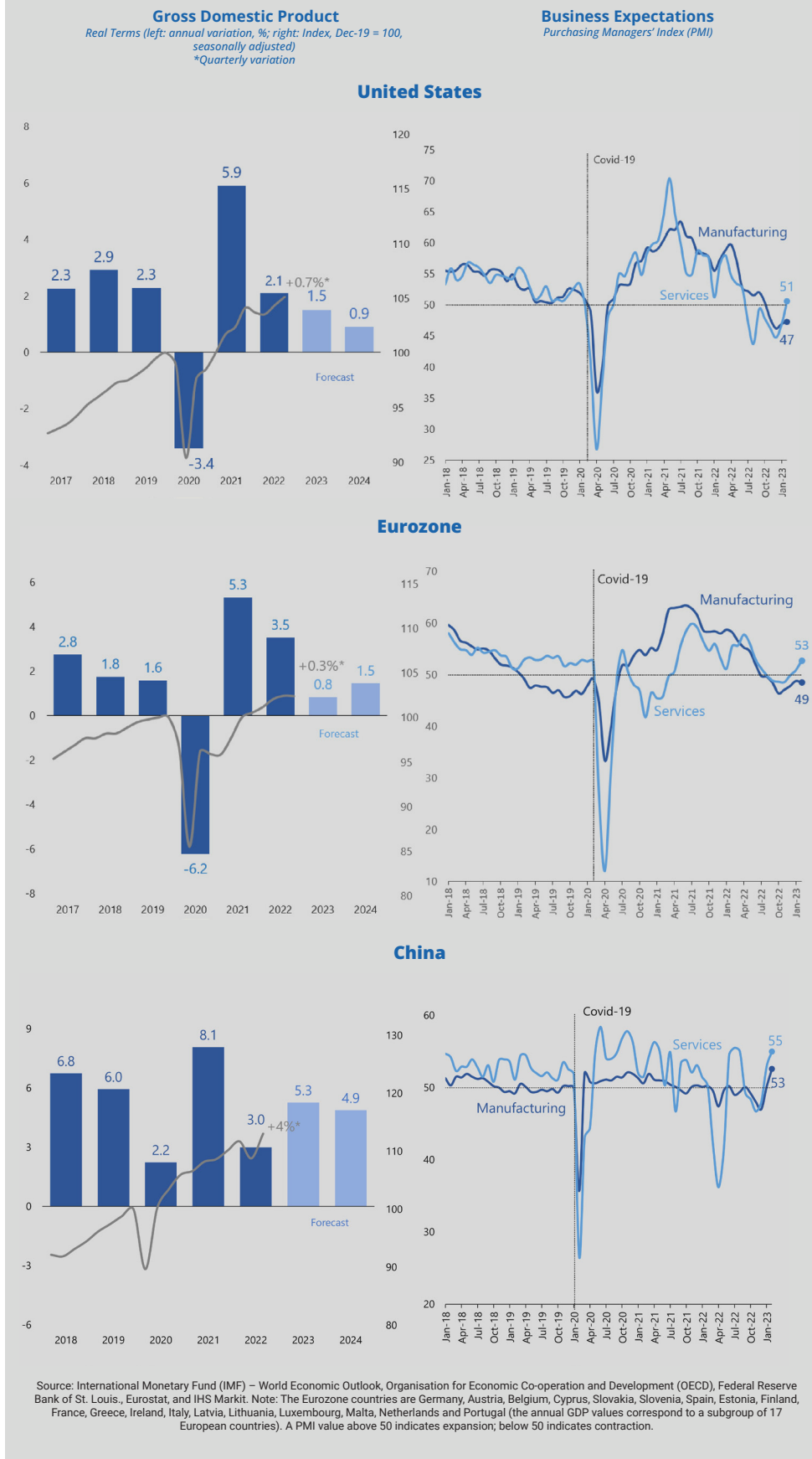
Exactly one year ago, the rate was expected to end 2023 and 2024 at 2.8%. However, in September 2022 the rate was already expected to stand at 4.6% in 2023 and 3.9% in 2024. Today, the Fed expects the rate to be 5.1% in 2023 and 4.3% in 2024. In other words, in one year the projected rate by the end of 2023 increased by 2.3 percentage points. It is expected from most officials the policy rate to peak at 5-5.25 percent in 2023 and to remain for that level until at least next year where rates can start to decrease. An important highlight is the projection for the 10-year US Treasury bond. In particular, the yield on the bond is expected to rise to 4.06% in June 2023 and then fall towards the rest of the year. Moreover, in March 2023, the yield on the 10-year treasury bond fell to its lowest level since September.

Table 1. Annual GDP growth, carry-over effect, and growth within the year
Annual percent change

	Real GDP growth A		Carry-over effect B		Growth within the year A-B		Real GDP growth forecast 2023
	2021	2022	2021	2022	2021	2022	
Argentina	10.4%	4.6%	4.8%	3.2%	5.6%	1.4%	2.0%
Bolivia	6.1%	3.4%	6.7%	0.2%	-0.6%	3.2%	2.9%
Brazil	5.0%	3.1%	3.8%	0.9%	1.2%	2.2%	1.2%
Chile	11.7%	2.7%	4.0%	3.9%	7.7%	-1.2%	-1.5%
Colombia	10.7%	8.1%	5.4%	5.6%	5.3%	2.5%	1.1%
Costa Rica	7.8%	4.3%	0.9%	2.6%	6.9%	1.7%	2.9%
Ecuador	4.2%	2.7%	0.6%	1.3%	3.6%	1.4%	3.0%
El Salvador	10.3%	2.6%	6.9%	0.3%	3.4%	2.3%	1.7%
Guatemala	8.0%	4.0%	4.2%	0.9%	3.8%	3.1%	3.4%
Honduras	12.5%	3.4%	3.2%	2.2%	9.3%	1.2%	3.5%
Mexico	4.7%	3.1%	4.2%	0.4%	0.5%	2.7%	1.7%
Nicaragua	10.3%	4.0%	3.5%	3.0%	6.8%	1.0%	3.0%
Panama	15.3%	9.0%	4.6%	4.3%	10.7%	4.7%	4.0%
Paraguay	4.2%	0.2%	3.1%	-0.8%	1.1%	1.0%	4.3%
Peru	13.6%	2.6%	8.7%	-1.3%	4.9%	3.9%	2.5%
Dominican Rep.	12.3%	5.0%	4.0%	2.7%	8.3%	2.3%	4.3%
Uruguay	4.4%	5.3%	2.6%	3.6%	1.8%	1.7%	3.6%
LAC	7.1%	3.8%	4.3%	1.6%	2.8%	2.2%	1.6%

Source: official statistics from each country and International Monetary Fund (IMF) – World Economic Outlook (WEO). Note: Regional aggregate is purchasing-power-parity GDP-weighted average; estimated real GDP growth for 2022 and projected for 2023. Venezuela is excluded from the analysis.

Figure 2. International economic activity and business expectations



As seen in Figure 2, the OECD projected in March an estimated growth of 1.5% in 2023 for the US, 1 point above from November's Economic Outlook.

On the other hand, inflation in the Eurozone exceeded expectations in February, reaching 8.5%. At the same time, core inflation continued to grow and reached

5.6%. In addition, business activity grew more than expected in February, where the Purchasing Managers' Index of services rose to 53, although manufacturing's PMI stood at 49 (see Figure 2).

The European Central Bank (ECB) has taken the decision to raise interest rates by 0.5 points in last meeting of March, signaling that it remains committed to its goal of fighting inflation, despite the recent panic in the banking sector caused by the US bank failures and concerns about Credit Suisse. The move means that the ECB's deposit rate has been raised from 2.5% to 3%, a move that had been hinted at by the central bank in previous weeks. Although it had been suggested that the financial turmoil might lead the ECB to take a pause or raise borrowing costs by a smaller amount, the central bank's decision suggests that it remains committed to its goal of maintaining price stability and preventing inflation from getting out of control. The OECD, in its latest report, has projected a growth of only 0.8% in 2023 for the Euro area, although 0.3 point above November's Economic Outlook.

Meanwhile, in Latin America and the Caribbean, thanks to early and determined efforts by central banks, as well as lower food and energy prices, inflation is receding after a year of soaring inflation. As shown in Figure 3, in February the regional average rate stood at 7.4%, falling for the seventh consecutive month, from 8.7% last July (excluding Argentina, which exceeded 100% inflation in February)¹.

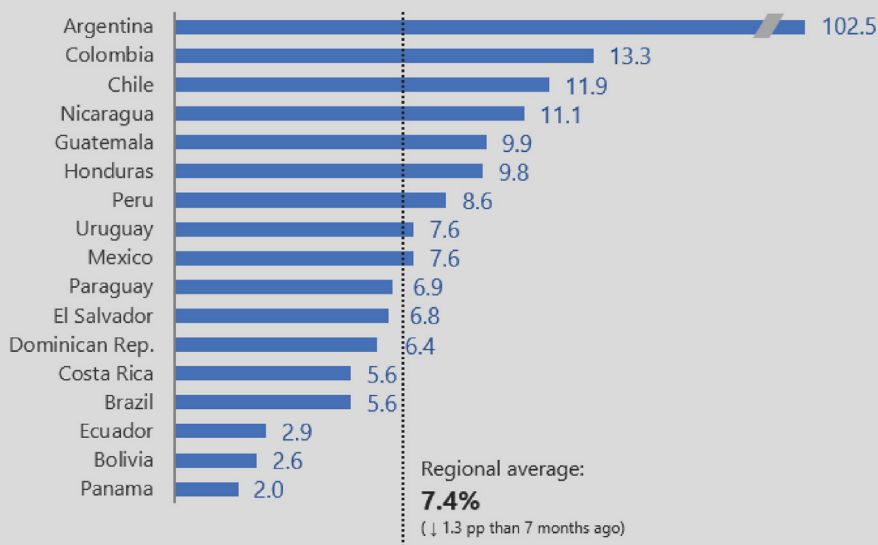
In Brazil, the Central Bank maintained the SELIC rate at 13.75% at its March's meeting, despite the economic slowdown and pressure from part of the government, suggesting that the rate will remain high for quite some time.

China's drastically policy shifting

Among the positive signs mentioned above is China's shift in the "zero-Covid" policy led by President Xi Jinping, who lifted mobility restrictions after three years of application, bringing hope for a significant economic revival in the country. The reopening of the Chinese economy comes in the wake of massive protests around the country that began on November 26 due to "zero-Covid" policies that included mass testing, detention centers for the infected, and mobility restrictions, which involved eternal quarantines and the closure of entire cities.

Apart from Covid-19 constraints, pro-

Figure 3. Inflation
12-month, % (February 2023)



Source: Official data from each country. Note: The regional average excludes Argentina; "pp" refers to percentage points. Venezuela is excluded from the analysis.

testors put long-known issues such as freedom of the press and speech on the Table. Furthermore, some groups were demanding even the fall of Xi Jinping and the Chinese Communist Party. Therefore, on the 8th of December, constraints began to diminish, and vaccination started to intensify in the oldest segments of the population, which showed low vaccination ratios.

As a result of these actions, China's growth is expected to rebound this year, and projections in March from the OECD locate around 5.3% for 2023 (see Figure 2). The latest number supposes a 0.7 percentage point increment regarding November's projection. China's manufacturing activity expanded at its fastest monthly pace in a decade in February. In the same month, China's services PMI hit 55, the highest level in six months. Such an economic reactivation implies significant changes in global demand. This leaves great room for speculation on the price of iron, copper, and other commodities. In this scenario, prices will rise and eventually benefit the countries of Latin America and the Caribbean that are exporters of these products.

Commodities: a better look for the region

It is common knowledge that commodity prices have a significant economic impact for countries that rely strongly on the primary sectors, such as in LAC. In the previous edition of the Regional

Report, the importance of the high commodity price levels during the first half of 2022 was emphasized.² Most of the reasons for this could be summed up by low interest rates, a revived global demand, the Russian invasion of Ukraine, and high-cost supplies and transportation. Afterward, prices fell sharply from their peak in May and went down for the rest of the year. United Nations' Food and Agriculture Organization (FAO) index reported a fall for nine months in a row for their agricultural prices. A historic wheat harvest in Russia and some excellent ones for corn and soybean in Brazil made the prices drop. Fertilizers have also fallen in their price as well as the price of critical nutrients. Moreover, wheat is 40% down compared to its peak in the last year.

Fortunately for the region, the latest signs have been of a slowdown in price declines, allowing for a more optimistic outlook in this aspect for 2023 than in the last months of 2022. According to the World Bank, its food price index rose 0.4% in January and 1.0% in February, although it locates 14% below compared to its peak in May. Something similar occurs with metals and minerals, which remain 25% below from its peak in March. Geopolitical uncertainty, volatile energy prices, and climate change—such as droughts or significant weather events—pose major threats to the food supply this year.

On the other hand, recent news, such as

China's economic revival led to forecasts of higher oil and metal prices, such as the price of copper, iron ore, steel, and aluminum. Also, massive protests in Peru against the government affected copper production. These supply and demand shocks have caused the price of copper to increase by more than 20% in three months.

Recent crises in the banking sector have contributed to the tumble in oil prices, as it has stoked fears for financial markets and the global economy. Since its peak in June Brent Oil decreased 31% and settle in March 2023 at its lowest level since December 2021. As shown in the April 2022 LMV Regional Report, most countries in the region are net oil importers, and a decrease in the price benefits them very significantly. Equally, some other countries in the region are net oil exporters, which hurts them. The International Energy Agency (IEA) reported rising oil inventories, which indicates weakening of consumptions; however, IEA has predicted that global demand for oil will accelerate sharply to a record high later this year, which indicates that this current situation may be temporary.

Meanwhile, demand for gold rose to its highest level in more than a decade in 2022, due to big purchases by central banks, the largest in 55 years, as a strategy to diversify reserves away from the dollar. Gold demand rose 18% last year to 4,741 tons, the largest since 2011, according to the World Gold Council. Gold does not yield, which reduces its attractiveness to investors when interest rates on low-risk bonds rise. However, demand from central banks and retail investors helped keep gold from losing even more value and set the stage for a powerful rally since November.

Among the many threats that can affect commodity prices, the evolution of the war between Russia and Ukraine will be decisive. In March, Ukrainian Black Sea grain export deal extended for at least 60 days. It allows exports of commercial food and fertilizer from three Ukrainian ports in the Black Sea—Odesa, Chornomorsk and Yuzhny/Pivdennyi. The Black Sea grain initiative, agreed in July under the auspices of the United Nations and with Turkish mediation, help eased pressure on global food prices, but any failure in the agreement between the two countries could trigger prices again.

CERES External Factors Index

To measure the economic climate Latin American economies are facing, the CERES

External Factors Index (CEFI) has updated. The CEFI represents a weighted average (by its relevance to affect GDP fluctuations) of the quarterly changes of the relevant external factors for the region, which are international food prices (i.e., the food index reported by the World Bank), international metal prices (i.e., the metal index reported by the World Bank), international interest rates (i.e., the 10-year US treasury bonds yield), oil prices (i.e., Brent crude oil), and seasonal GDP for both China and the US.

As **Figure 4** shown, the Latin American GDP (grey line, also presented as an average of their quarterly changes, were the highest registered=100 and average 1992-2019=0) has a strong correlation with the CEFI behavior (blue line) considering periods of booms and busts of the activity. The index values for 2023 and 2024 are forecasted to magnify the external conditions the continent is expected to face.

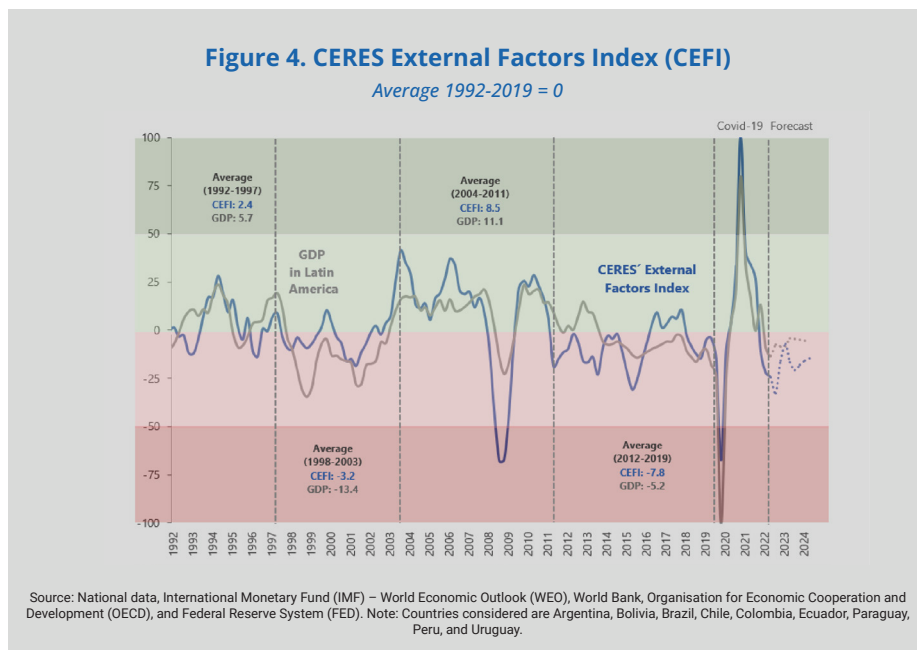
For 2023, the outlook has improved since the October LMV Regional Report mostly due to better expectations for both China and the US economy as mentioned above. Meanwhile, as higher food prices and lower oil prices are forecasted—considering most countries in Latin America are food net exporters and net oil importers—it encourages a better scenario in the short term. On the other side, the high 10-year US treasury bonds yield expected for the current year boosts the concern over the region due to its negative consequences already mentioned.

For 2024, mostly driven by a decline in the growth rate expected for both giant economies, the CEFI values worsened.

The challenge of starting to grow again

Overindebtedness in Latin America and the Caribbean

Public debt management is a major concern for LAC countries, and the Inter-American Development Bank (IDB) report *"Dealing with debt: less risk for more growth in Latin America and the Caribbean"* highlights the challenge posed by the increase in public debt in the region in recent years. Between 2014 and 2019, public debt increased by 19% of GDP, while growth was less than 1%. During 2020, debt grew another 13% of GDP, showing that the pandemic has exacerbated debt management challenges in the region. As public debt increases, the cost of debt servicing (interest payments and amortization) also increases, which



can limit the ability of governments to invest in important areas, namely health and education.

Global factors, such as the Russian invasion of Ukraine and problems in global supply chains, may also have a significant impact on the region's economy. In addition, high inflation and tight monetary policy may limit economic growth and increase debt ratios in the coming years.

Due to the significant challenges facing LAC economies in resuming strong and sustained growth, a crucial concern is the trajectory of their average debt in the coming years, which was 59.6% of GDP in 2022. CERES conducted a debt sustainability analysis using different scenarios (Figure 5) to address this, assuming the current primary fiscal result of 0.1% of GDP and average real interest rate for issued bonds of 7.2%. Table 2 details the current debt situation of each LAC country.

Scenario 1

In this scenario, we assume LAC economies will grow at rates of 1.6%, 2.0%, and 2.3% for 2023, 2024, and 2025, respectively, while maintaining the 2022 levels of average real interest rate and primary fiscal result. This results in an increasing debt trajectory, with the debt-to-GDP ratio projected to reach 69% in 2025 (blue line in Figure 5).

Scenario 2

In Scenario 2, we assume more optimistic economic growth rates of 3%, resulting in a moderate increase in LAC debt ratios due to higher values in the denominator (light blue line in Figure 5).

Scenario 3 (A)

Under this scenario, we estimate the growth rates required to maintain the debt-to-GDP ratio at its 2022 level. Our analysis suggests that LAC economies must grow at an average rate of 7.1% per year, which is practically impossible to achieve (grey line in Figure 5).

Scenario 3 (B)

Similarly to Scenario 3 (A), we estimate the average primary balance required to prevent the debt-to-GDP ratio from increasing by 2025. To maintain this ratio at its 2022 level, LAC economies must report an average primary fiscal surplus of 3.3%, 3.1%, and 2.9% in 2023, 2024, and 2025, respectively (grey line in Figure 5).

Trade Openness: mother of all reforms

On an international scale, empirical evidence has proven that trade openness leads to development. Over the last 25 years, 81% of emerging economies that have improved their Human Development Index have implemented policies to reduce tariffs on imports and exports⁵. Therefore, improving international integration should be the most crucial reform on the agenda for the region to increase productivity and resume growth.

Previous Latin Macro Vista Regional Reports have stressed the urgency of implementing a structural reform agenda to improve competitiveness and stimulate economic activity through private investment. However, several challenges to improving productivity exist, such as

technology availability, political stability, perception of corruption, human capital formation, infrastructure investment, tax burden, wage rigidity, and trade openness.

Opening up an economy and increasing imports and exports creates more competition, forcing businesses to adapt to a new reality of lower protection. This fosters the improvement of human capital with greater training and appropriate labor regulation, as well as promotes the improvement of the country's infrastructure and the efficiency of the state. These changes lead to an increase in investment and innovation. Evidence shows that public policies aiming to improve trade openness positively impact a country's level of innovation, a relationship even stronger in emerging markets⁶. As a result, trade openness is the mother of all other reforms, many of which are difficult to change and on which there has yet to be any recent progress in most countries in the region.

We cannot wait to be "ready" before opening up to the world. Instead, we must open up to the world and incentivize further growth. **Figure 6** indicates that Latin America and the Caribbean has one of the most closed economies among emerging economies, with high tariff rates (4.1% on average) and low trade flows (exports and imports summing up to 65% of GDP).

Among the Latin American and the Caribbean subregions, the Mercosur is one of the worst performers in this regard. For the four countries of Brazil, Argentina, Uruguay, and Paraguay, the average trade openness decreases to 50% of GDP, and tariff rates rise to 6.2%. However, the free trade agreement between the European Union and Mercosur, influenced by the geopolitical world context and Lula's new government in Brazil, may finally be reached in the first half of 2023, bringing fresh impetus to the region's trade relations.

LAC faces new opportunities to diversify its trade partners and enhance its investment possibilities by opening up to the world. Therefore, the region must improve its trade openness to achieve long-term development goals.

Nearshoring: an opportunity for the region

One of the key concepts that will be discussed this year is nearshoring, a term that refers to business strategies to produce closer to the market from which it sells its products. This concept is con-

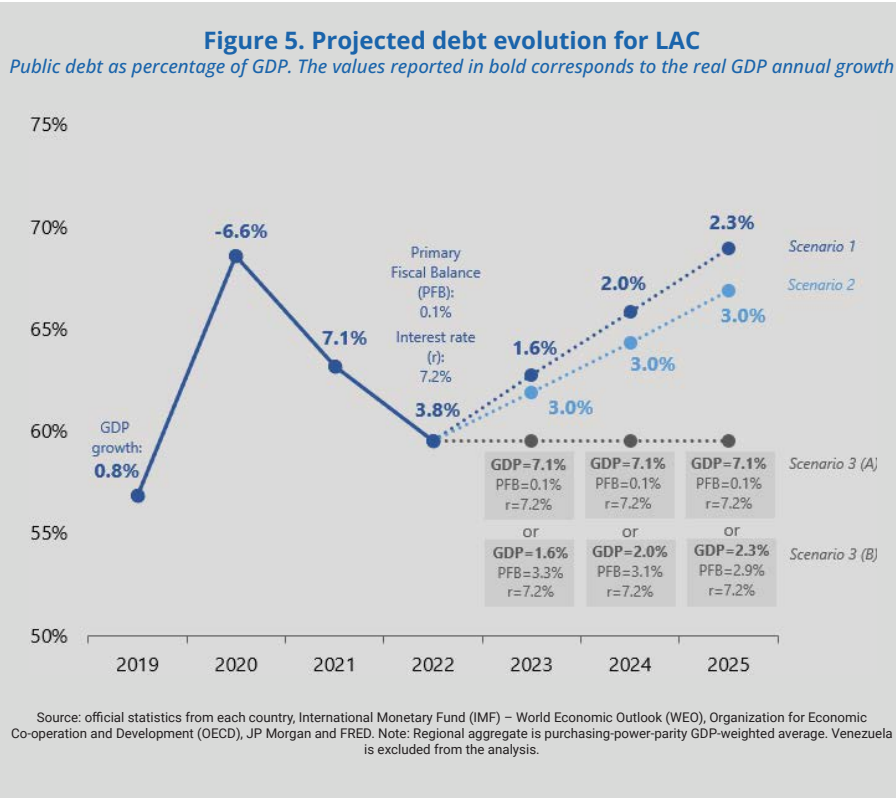


Table 2. Fiscal balance and debt
2022

	Primary Fiscal Balance (%GDP)	Interests payments (%GDP)	Overall Fiscal Balance (%GDP)	Debt (%GDP)	Real Interest Rate	Real Interest Rate estimated
Argentina	-1.7%	1.8%	-3.5%	62.9%	2.9%	24.7%
Bolivia	-5.7%	1.5%	-7.2%	65.7%	2.3%	8.6%
Brazil	1.3%	5.9%	-4.6%	73.4%	8.0%	5.9%
Chile	2.5%	1.4%	1.1%	38.5%	3.6%	4.7%
Colombia	-2.7%	3.1%	-5.8%	63.5%	4.9%	6.9%
Costa Rica	1.9%	4.7%	-2.8%	65.0%	7.2%	7.3%
Dominican Rep.	0.6%	2.9%	-2.3%	47.1%	6.2%	7.2%
Ecuador	1.6%	1.6%	0.0%	65.7%	2.4%	14.4%
El Salvador	3.2%	5.1%	-1.9%	62.9%	8.1%	24.2%
Guatemala	0.8%	2.6%	-1.8%	29.9%	8.7%	5.8%
Honduras	1.6%	2.9%	-1.3%	31.9%	9.1%	9.4%
Mexico	-0.3%	2.9%	-3.2%	51.5%	5.6%	7.0%
Nicaragua	6.1%	1.3%	4.8%	61.5%	2.1%	-
Panama	-2.4%	1.9%	-4.3%	62.3%	3.0%	5.7%
Paraguay	-1.6%	1.2%	-2.8%	29.9%	4.0%	5.0%
Peru	-1.0%	1.5%	-2.5%	34.0%	4.4%	5.3%
Uruguay	-0.7%	2.7%	-3.4%	67.6%	4.0%	4.3%
LAC	0.1%	3.6%	-3.6%	59.6%	5.8%	8.5%

Source: official statistics from each country, International Monetary Fund (IMF) – World Economic Outlook (WEO), Organization for Economic Co-operation and Development (OECD), JP Morgan and FRED. Note: Regional aggregate is purchasing-power-parity GDP-weighted average. Venezuela is excluded from the analysis.

trary to "offshoring" (taking the factories to, for instance, China to produce cheaper), which was the main driver of trade in the past decades. The phenomenon deepened because of the pandemic and the interruption of the supply chains generated by China's "zero-Covid" policy, deriving in times delays in receiving the products from China and soaring costs of marine transport. These issues have

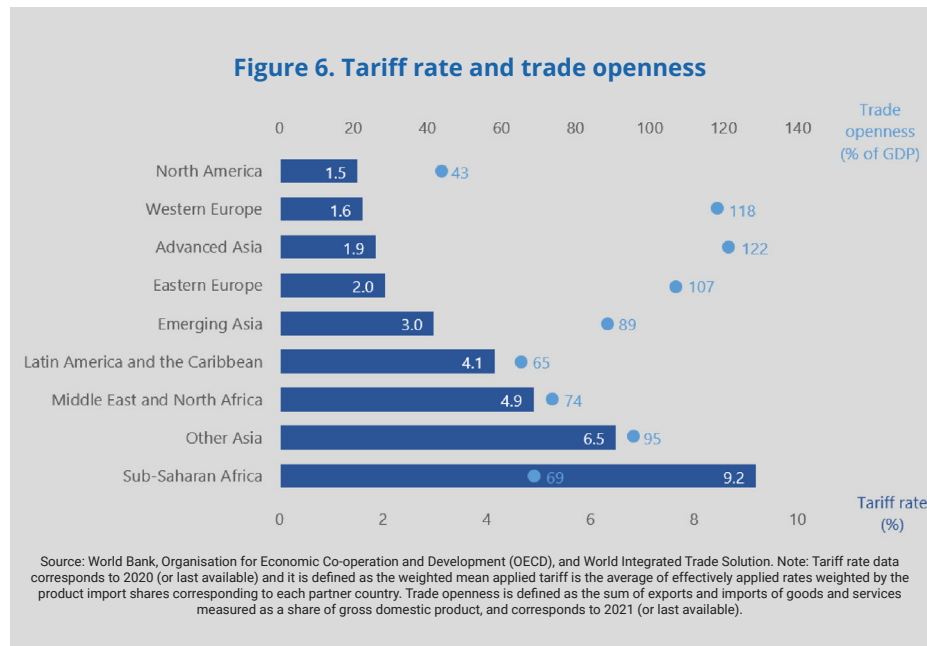
led many industries to question the advisability of continuing to manufacture so far away. Some also call it "friendlyshoring" to describe a new production system in which companies seek to manufacture their products in countries that are politically aligned with the West or are considered friendly.

Mexico has recently stood out for benefi-

ting from nearshoring. Some of the main reasons why this country is one of the best destinations for global firms, especially for the Asiatic firms, is the proximity to the largest market in the world: the United States of America. It is also because of the labor force cost, the tensions between the US and China—which were deepened in recent months—and the advantages of the new North America Free Trade Agreement (T-MEC) that started in 2020, which eased the flow of trade between Mexico, Canada, and the United States.

Nowadays, there are global firms that, in most cases, are still functioning in the Asiatic region but, simultaneously, are relocating or broadening their manufacturing in Mexico to sell in the US market. One of the sectors that are leading the nearshoring is the automotive sector. According to the Mexican Association of Industrial Parks, estimates suggest that nearshoring will generate approximately USD 30 billion in Mexico by 2022. The Secretariat of Economy reported that in 2022 total Foreign Direct Investment (FDI) increased by 12% compared to the previous year, and 48% was new, reflecting nearshoring. Other LAC countries could also benefit from this phenomenon.

Moreover, in the framework of the current global geopolitics, it is difficult to assume that the tension between the US and China will be reduced in the coming years. In addition to the West's concern about the Chinese government, there is also Russia, which will be key in develo-



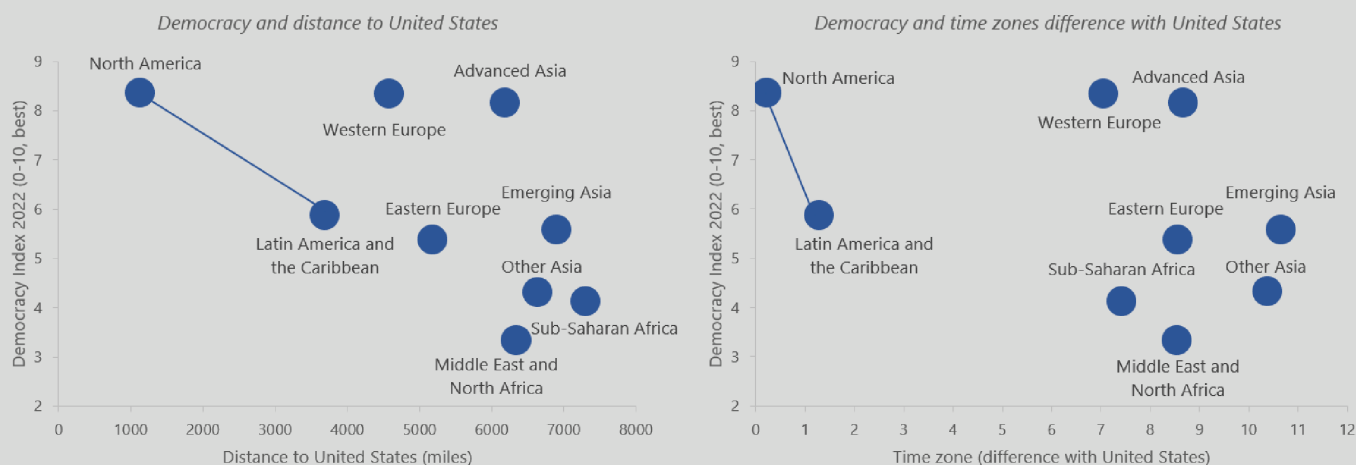
ping this new type of strategy for multinational companies to manufacture in closer and more reliable countries. Therefore, this can be a real opportunity for the region associated with nearshoring.

It is also important to mention the Americas Partnership for Economic Prosperity (APEP), a US government initiative to strengthen trade relations between countries committed to the values of liberal democracy. Canada has recently joined this initiative, increasing the scope and importance of the program.

Canada's Foreign Minister, Mélanie Joly,

was forceful a few days ago: "APEP is an excellent opportunity for the democracies of the continent to work together on projects of common interest to strengthen the economic development of the region." The idea is to actively support Barbados, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico, Panama, Peru, and Uruguay in developing their value chains, which translates into greater economic integration and a greater ability to compete in the global marketplace. This can be an excellent opportunity for Latin America and the Caribbean countries, as they can receive technical and financial support to improve their infrastructure, training, and technology, which in turn can im-

Figure 7. Nearshoring: Democracy, geographical distances, and time zones



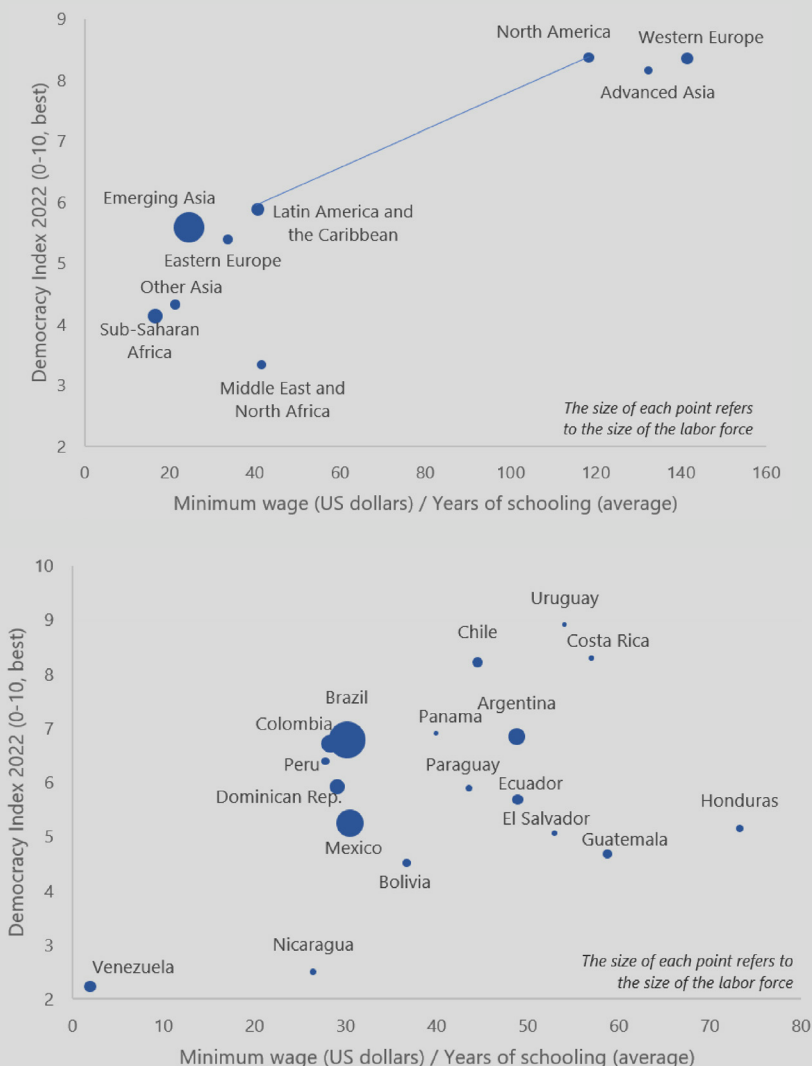
Source: Economist Intelligence Unit (EIU) and compilation by Centro de Estudios de la Realidad Económica y Social (CERES). Note: The geographical distance from the United States is calculated using the centroid of each country. For those countries with more than one time zone, the weighted average by population was considered.

prove productivity and economic growth. This program is still in its early stages, and much must be done. However, it is a positive sign that there is a commitment on the part of the US and Canadian governments to deepen economic relations with the region. Therefore, monitoring developments and opportunities that may arise as this initiative moves forward in the coming years is important.

CERES analyzed a set of indicators to identify potential candidates to benefit from this new trend. The data confirms the spirit and strategy of the APEP. To illustrate political affinity, the 2022 Democracy Index of the Economist Intelligence Unit, which ranges from 0 to 10 (best), is reported on the vertical axis of **Figure 7**. On the other hand, considering that nearshoring can materialize in manufacturing and service activities, the horizontal axis of the left panel records the geographic distance of each country to the United States, while in the right panel, the time difference between each country to the United States is recorded. Shorter client-supplier distances can be advantageous in nearshoring industrial projects, as it means shorter and cheaper transportation routes with different mode possibilities (road, rail, maritime shipping, air cargo) and minimizing logistics inefficiencies. Meanwhile, time zone compatibility can be important for service provisions, such as software development, IT infrastructure set-up and maintenance, customer support, and HR functions like payroll, accounting, and finance, among others. The results show the potential of LAC to be, on average, the region closest to North America in democratic values, geographical location, and time zone at the same time.

For companies to decide where to locate one of the links in their production chain (which also includes, for example, a contract with a supplier), not only geographic location matters but also other economic conditions that naturally make it viable. Labor costs are one of the most influential factors, which is why to analyze this, we consider the salary level—using the minimum wage of each country as a comparable indicator—and the educational level—through the average years of education of the adult population—thus reflecting, through the division of both variables, the cost per year of education that each country offers to companies that settle there. This emphasizes the relevance of education and training policies, pending and permanent reforms in the region.

Figure 8. Nearshoring: Democracy and human capital



Source: Economist Intelligence Unit (EIU), World Bank, International Labour Organization (ILO), and United Nations Development Programme (UNDP) - Human Development Report (via Our World in Data). Note: Minimum wage data (2022) refer to the statutory nominal gross monthly minimum wage; in some cases, an average of multiple regional minimum wages is used; and in countries where the minimum wage is set at the sectoral level or occupational level, the minimum wage for manufacturing or unskilled workers is generally applied; the minimum wage is not reported for countries for which collective bargaining is in place for minimum wages. Years of schooling data (2017) refer to the average number of years people aged 25+ participated in formal education.

Figure 8 combines these factors with the democratic level of each country and, in turn, the size of the labor force, which represents both the "availability" of human capital and the potential of the new market for companies that would settle there (approximating the population). As can be seen, LAC is the potential destination region that offers the best conditions, with competitive labor costs and the highest democratic levels among emerging regions. On the other hand, the developed regions of Advanced Asia and Western Europe, while they rank better in political terms, present high salaries, even higher than North America.

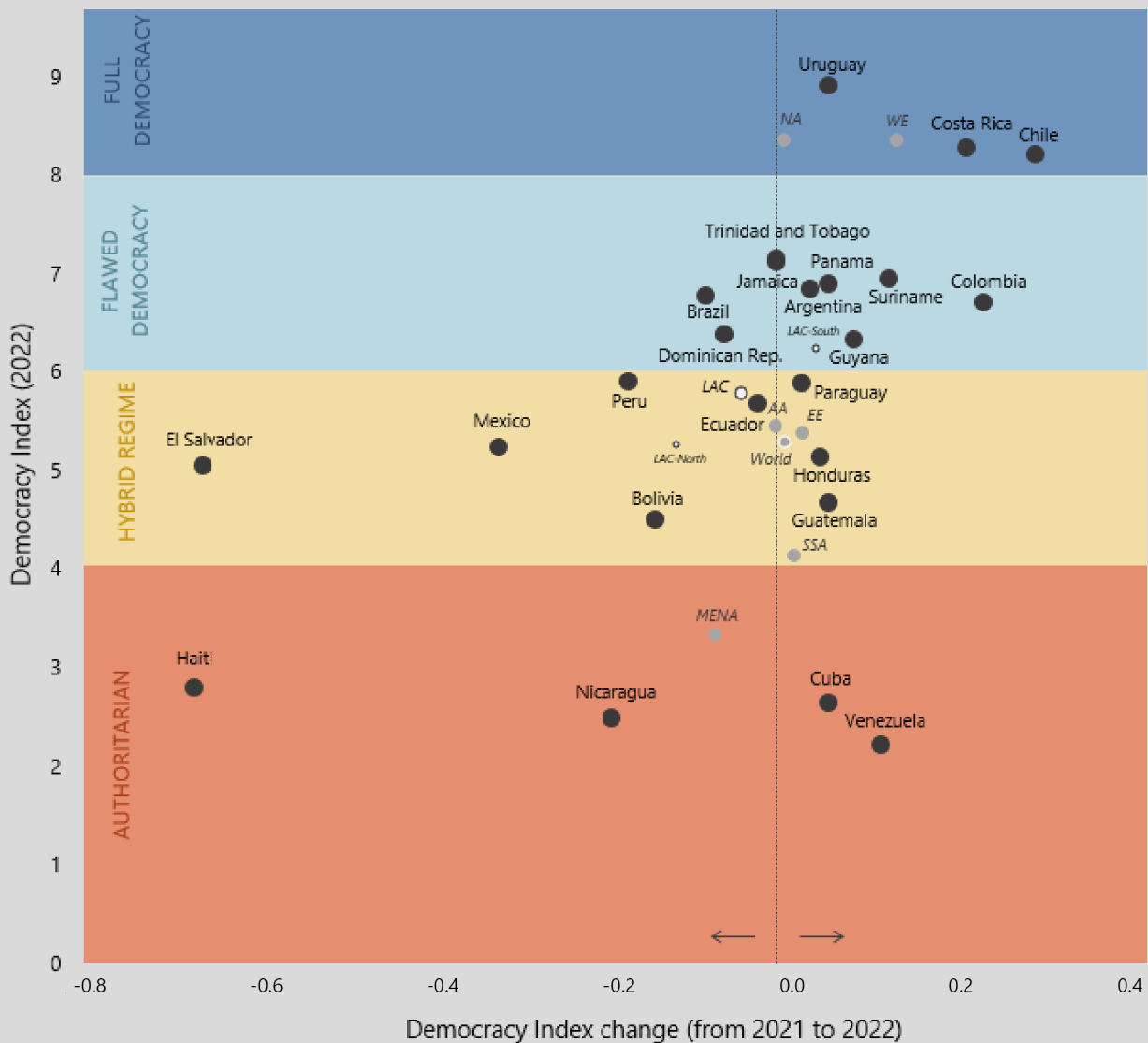
The same analysis is conducted in the lower panel of **Figure 8** but at the le-

vel of LAC countries. The results can be divided horizontally and vertically. Below Mexico are the least democratic political regimes in the region and, therefore, with fewer possibilities of "friendlyshoring" in this sense: Honduras, El Salvador, Guatemala, Bolivia, Nicaragua, and Venezuela. It is worth noticing that the United States did not invite these countries to the Summit for Democracy held in December 2021, a Biden initiative that illustrates the Administration's commitment to putting democracy and human rights at the heart of US foreign policy.

Vertically, the economies located further to the right would have greater potential in terms of service provision,

Figure 9. Democracy Index in Latin America and the Caribbean

Index score out of 10, 10 being the best



Source: Economist Intelligence Unit (EIU). Note: LAC = Latin America and the Caribbean, AA = Advanced Asia, EA = Emerging Asia, OA = Other Asia, EE = Eastern Europe, MENA = Middle East & North Africa, NA = North America, WE = Western Europe, SSA = Sub-Saharan Africa. LAC-South = South America, LAC-North = Mexico, Central America, and the Caribbean.

a sector associated with higher salary remuneration and educational levels. Therefore, countries with better conditions would be particularly Uruguay, Costa Rica, and Chile, which have higher values on the democratic index. On the other hand, the further to the left, the lower the labor costs per year of education, so it can be thought that the cluster of countries located in that area of the graph has potential for the manufacturing sector (Brazil, Colombia, Peru, the Dominican Republic, and Mexico). Several countries in this group are the largest in terms of the labor force, which would align with the benefit that could repre-

sent for this type of activity.

A resilient democracy

LAC countries have been facing a complex and challenging political landscape in recent years. Its democracy was already progressively deteriorating before the Covid-19 pandemic outbreak, which worsened the regional situation. Implemented mobility restrictions curtailed individual liberties and increased social unrest. Last year the problem was exacerbated due to —among other factors—strong inflationary pressures that shoot up living costs, influenced by the

Russian war in Ukraine. However, some positive and hopeful signs can also be identified in the recent regional events and trends.

According to the 2022 Democracy Index of the Economist Intelligence Unit, more than half of Latin Americans live in a democracy of some sort (56%), compared with 45% of the world's population living under this system⁷. This index provides a snapshot of the state of democracy worldwide, based on five categories: electoral process and pluralism, functioning of government, political participation, political culture,

and civil liberties.

This measurement shows that LAC is the region with the highest average score (5.79 on a 0-10 scale) after North America (8.37), Western Europe (8.36) and Advanced Asia (8.16), exceeding the world's average (5.29) (see **Figure 9**). Meanwhile, the average score for Emerging Asia, Eastern Europe, Other Asia, Sub-Saharan Africa, and Middle East and North Africa is 5.59, 5.39, 4.32, 4.14, and 3.34, respectively.

Although Latin America and the Caribbean has recorded the most significant democratic recession of any region over the past two decades, the democratic deterioration process became progressively slower in 2022 compared to the previous year's pace (-0.04 points in 2022 and -0.26 in 2021). The positive effect of lifting coronavirus-related restrictions in 2022 was canceled by other adverse regional developments, failing to improve its average score. This lack of post-lockdown revival mirrors global results: essentially stagnant. However, according to a subregional approach, South America alone experienced a modest increase in its score (+0.05), whereas the northern subregion (i.e., Mexico, Central America, and the Caribbean) decreased (-0.11).

The LAC region has improved its average score in the political participation category, rising from 5.58 in 2021 to 5.97 in 2022 and surpassing the pre-pandemic levels (5.46 in 2019). Across all countries of the region, the subindex increased or remained the same as in 2021. Said occurrence might be justified by the deterioration in the economic situation in many countries in 2022—combined with political and social conflicts—that fueled citizens' dissatisfaction and led to greater willingness and propensity to organize and participate in public demonstrations of said discontent and protests. These visible social mobilizations and protests also represent an opportunity for the governance agenda⁸.

On the other hand, LAC's score for democratic political culture declined from 4.35 in 2021 to 4.11 in 2022. This negative trend was present in more than half of the region's countries, while the score remained steady in the rest of them. Weak state capacity is possibly a significant cause of this low score, as a profound skepticism about the ability of democratic governments to overcome the region's difficulties continues to grow, and tolerance for military rules and authoritarian governance strengthens⁹.

The region's score for the electoral process and pluralism fell slightly, from 7.35 in 2021 to 7.19 in 2022, but keeps standing well above the global average of 5.59. Likewise, the civil liberties category (6.61) scores higher than the world average (5.43). It remained virtually unchanged in 2022 for LAC, as well as the functioning of the government category (5.07).

Among the 24 LAC countries measured, nine scores increased in 2022, two remained unchanged, and 13 decreased. Haiti (-0.68), El Salvador (-0.66), and Mexico (-0.32) suffered the worst year-over-year declines, followed by Nicaragua (-0.19), Peru (-0.17), Bolivia (-0.14) and Brazil (-0.08) with more modest deteriorations.

The threat to democracy in the Latin American and the Caribbean region is growing, as seen in the case of El Salvador. Its president, Nayib Bukele, has been moving towards authoritarianism with heavy-handed policies and a state of emergency. Although this has led to a significant decrease in the country's homicide rate, it has also eroded civil liberties and human rights violations, including torture and unjustified detentions. Bukele has also ousted magistrates of the Supreme Court and expressed his intention to run for re-election in 2024, despite constitutional prohibitions. President Andrés Manuel López Obrador's recent reform plan in Mexico has weakened the independence of electoral organs and limited their supervisory powers. At the same time, the country is experiencing increased violence against journalists and the expansion of the armed forces in the public sphere.

Meanwhile, Peru is undergoing a severe political crisis—aggravated by the failed attempt of a self-coup d'état by former president Pedro Castillo—with intense protests calling for a revision of the legal constitution, the dissolution of Congress, and early general elections. In Brazil, the 2022 presidential election resulted in a closely contested race between Jair Bolsonaro and Luiz Inácio Lula da Silva, with the latter winning by a narrow margin. Bolsonaro contested the results, with thousands of supporters calling for military intervention. This was followed by a violent attack on buildings representing Brazil's significant public authorities. The legitimacy and trust of democratic institutions have been severely damaged.

Finally, authoritarian regimes in Venezuela, Nicaragua, Cuba, and Haiti remain among the worst-ranked countries in the index. Although Venezuela's government

has resumed dialogue with the opposition, doubts remain over the feasibility of elections due to a lack of "guarantees." In Haiti, the challenge of high levels of violence and instability must be addressed to establish favorable conditions for new elections with international support. While some countries try to work their way into a firm democracy, others do not show interest in the acquisition of the regime. Unlike many of the countries mentioned above, Cuba and Nicaragua don't seem willing to participate in any democratic transition; on the contrary, the state of repression seems to be on a deteriorating path¹⁰.

On a more encouraging note, the region is also the host of some of the strongest democracies in the world; these are Uruguay, Costa Rica, and Chile. All three of them progressed positively in terms of democratic improvement in 2022. Chile even rejoined the "full democracy" group after lifting restrictive Covid-19 measures.

Additionally, despite the region's democracy deterioration tendency, a better gaze at the facts reveals that a most democracies in the area stay solid. Numerous examples can be used to display the resilience of Latin American and the Caribbean democratic culture and institutions and allow us to have some hope for the future of the region.

Democratic and law enforcement institutions responded right on constitutional cue to Castillo's attempted coup to dissolve Peru's Congress. The police and the military refused to back him, and he was peacefully removed, swearing in Vice President Dina Boluarte as the country's first woman president, who later proposed a constitutional reform to hold early elections—a request resisted by the Congress.

The Brazilian government reacted jointly, quickly, and decisively towards the fraught country's elections. Authorities of the congress, judiciary, electoral bodies, and several right-wing politicians, proclaimed Lula's victory, despite Bolsonaro's silence, and the armed forces, as such, showed no interest in disrupting the electoral process. In this way, the government had its transition, and Brazilian democratic institutions managed to withstand the attacks from Bolsonaro and his hard-line supporters.

In Chile, the wave of social unrest—expressed in violent street protests in late 2019—was channeled into a constitutional reform process that used participa-

tory mechanisms and sought to strengthen citizens' rights. Even though this first attempt misfired, with an overwhelming rejection of the proposed constitution in a referendum held on September 2022, it was a learning experience, and Congress approved a plan to draft a new constitution in 2023. The demands for change were addressed in a democratic way, the people decided, and apparently, they are in favor of a more moderate approach with respect to some of the profound changes proposed, so the government seems to recognize that the diverse opinion of the population must be taken into account. Moreover, this new process includes the creation of a constitutional council of elected officials and a commission of experts.

Several other signs can be glimpsed across the region: the judiciary in Argentina showed independence and can indict powerful government officials, and in Mexico, the opposition, opinion leaders, and thousands of people in the streets demonstrated against the reform proposal that modifies the electoral institution and the Supreme Court is expected to evaluate a challenge to these measures as unconstitutional.

Citizen support for democracy in LAC also shows that it remains resilient. According to AmericasBarometer (LAPOP) data, while only 43% of the population showed satisfaction with how democracy works, 61% share that democracy is better than any other form of government¹¹. Besides, both indicators slightly improved with respect to their values in 2018 but still stand below those a decade ago (56% and 69% in 2010, respectively), probably because citizens have been internalizing the political sphere setbacks and conflicts they perceive. However, history shows that this situation can improve; in the last 40 years, LAC made the most significant gains worldwide, becoming the third most democratic region in the world¹².

Democracy is an ally, not an obstacle, and as such, it offers institutional channels that can serve all citizens, especially the most vulnerable¹³. Recent electoral results are a clear example of this, with a defeat of the ruling party in practically all national elections in the region between 2019 and 2022, suggesting that dissatisfaction with governments is reflected at the ballot box.

The 2023 electoral agenda will include three presidential elections in the

region, in Paraguay (April), Guatemala (June) and Argentina (October), and several other important electoral processes. In Argentina, where it is expected that the center-right opposition will retake power from the left-wing, the election can represent an opportunity to overcome the challenging political environment—replicating the increase in the democracy index that the country registered with the change of government in the previous elections—and the economic instability. This could also benefit their international integration, favoring, for example, an eventual adherence to APEP.

Throughout 2022, liberal democracy stood firm in the face of populism in several countries, and electoral results were aligned with the shifts in voter preferences. In Brazil, Jair Bolsonaro lost the elections to a moderate coalition and the support of Fernando Henrique Cardoso. In Colombia, Petro defeated a populist and appointed José Antonio Ocampo (a well-known moderate economist) as Minister of Finance and Public Credit. Additionally, in Chile, the people said no to the radical changes proposed by the Constitutional Assembly, and in Peru, the armed forces and the police reacted quickly in favor of democratic institutionality by not supporting Castillo's attempted coup d'état. In the United States, voters also punished Trump-backed candidates in the midterm elections.

As stated in a recent global report by the University of Cambridge's Centre for the Future of Democracy, there are clear signs that the so-called "populist wave" could be diminishing¹⁴. It shows that, worldwide, support for populist parties, approval of populist leaders, and agreement with populist attitudes have collapsed during the coronavirus pandemic. The study is based on a mega-dataset survey of over half a million participants' political attitudes since 2020 across 109 countries. The approval rating of populist leaders fell, on average, by ten percentage points between mid-2020 and the end of 2021. The mishandling of the Covid-19 crisis by populist leaders—along with a desire for stability and a decline in "polarizing" attitudes resulting from the pandemic—starts to move public opinion. The experience of facing a common crisis has proven to be a unifying event for citizens in many societies. Besides, populists are not only rated worse by their citizens on their management of

coronavirus, but they are also less trusted as a source of information about it. As a result, the threats posed by the pandemic saw a "technocratic" shift in political authority, with increased trust in government and experts such as scientists and civil servants.

Final remarks

The first quarter of 2023 has brought some promising developments to the LAC economy, driven by external factors such as a rise in prices for key exports like food products, as well as a drop in oil prices. Additionally, inflation appears to be moderating in major economies worldwide. Despite the financial turbulence that began in March, interest rates are expected to remain stable for the remainder of the year, providing a measure of stability for the region.

The current situation has highlighted two significant obstacles that LAC countries must overcome to achieve sustainable economic growth. The first challenge is the high level of public debt, which increases the cost of debt servicing (interest payments and amortization). This limits governments' ability to invest in critical areas such as health and education. The second challenge is the need for greater progress toward trade openness. LAC countries have some of the most closed economies among emerging economies, with high tariff rates and low trade flows. By diversifying their trade partners and opening up to the world, LAC countries can enhance their investment possibilities and achieve their long-term development goals.

Nearshoring presents a valuable short-term opportunity for the LAC region. According to an analysis by CERES, the region is an attractive destination for global companies due to its proximity to North America in terms of democratic values, geographical location, and time zone. It also offers competitive labor costs (relative to years of schooling). However, to fully capitalize on this opportunity, the region must prioritize the consolidation of its democracy. A strong democracy offers institutional channels that can serve all citizens, especially the most vulnerable. The outcome of recent elections underlines the dissatisfaction of the electorate with their governments, underscoring the importance of democracy as a key factor in achieving sustainable growth and development.

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Notes

- ¹Considering data of Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru and Uruguay
- ²CERES (2022).
- ³CERES (2021).
- ⁴Projections for 2023 and 2024 growth were taken from IMF, while projection for 2025 was taken from IDB.
- ⁵Munyo (2016).
- ⁶Dotta and Munyo (2019).
- ⁷For the analysis of this section based on the Democracy Index, Cuba, Guyana, Haiti, Jamaica, Suriname, and Trinidad and Tobago were also included in the group of Latin American and the Caribbean countries.
- ⁸IDEA and UNDP (2022).
- ⁹EIU (2023, 2022).
- ¹⁰Sahd et al. (2023)
- ¹¹Data for 2021. The same group of countries included in the EIU Democracy Index is considered, excluding Cuba.
- ¹²Zovatto, D. (Brookings) (2020).
- ¹³IDEA (2022).
- ¹⁴Foa et al. (University of Cambridge) (2022).

Definitions

- *Latin America and the Caribbean*: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela.
- *North America*: Canada, United States.
- *Western Europe*: Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Malta, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom.
- *Eastern Europe*: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.
- *Advanced Asia*: Australia, Hong Kong, Japan, New Zealand, Korea, Taiwan.
- *Emerging Asia*: China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam.
- *Other Asia*: Afghanistan, Bangladesh, Bhutan, Cambodia, Fiji, Lao P.D.R., Mongolia, Myanmar, Nepal, North Korea, Pakistan, Papua New Guinea, Singapore, Sri Lanka, Timor-Leste.
- *Middle East and North Africa*: Algeria, Bahrain, Egypt, Islamic Republic of Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syrian Arab Republic, Tunisia, UAE, Yemen.
- *Sub-Saharan Africa*: Angola, Benin, Botswana, Burkina Faso, Burundi, Cabo Verde, Cameroon, Central African Republic, Chad, Comoros, Congo, Côte d'Ivoire, Democratic Republic of Congo, Djibouti, Equatorial Guinea, Eritrea, Eswatini, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Tanzania, Togo, Uganda, Zambia, Zimbabwe.