BOX 2.3.1 Recent investment slowdown: Latin America and the Caribbean

Investment growth in the region dropped from 12.5 percent in 2010 to -4.8 percent in 2015, reflecting political and policy uncertainty in several of the region's major economies, a severe terms-of-trade deterioration, and a broad-based slowdown in economic growth across the region. Remaining investment needs are sizable, especially in education and infrastructure.

Latin America and the Caribbean (LAC) accounted for 7 percent of global investment in 2010-15.[1] During this period, investment growth slowed sharply in the region, from about 12.5 percent in 2010 to -4.8 percent in 2015, well below its long-term (1990-2008) average of 4.6 percent. Regional investment is projected to decline further, by more than 1 percent, in 2016.

This box discusses the following questions.

- How has investment growth in the region evolved?
- What were the main sources of the investment slowdown?
- What are current and prospective investment needs?
- Which policies can address these investment needs?

The decline in investment growth in the LAC region in 2010-15 was concentrated in commodity exporters. It reflected domestic macroeconomic challenges, a sharp terms-of-trade deterioration resulting from declines in global commodity prices, and slowdowns in economic growth, with outright recessions in some cases. Current and prospective investment needs are sizable, especially in education and infrastructure.

How has regional investment growth evolved?

The LAC region accounted for 7 percent of global investment during 2010-15, less than LAC's 8 percent share of global output. This investment underperformance reflects low investment-to-GDP ratios in LAC, averaging around 22 percent during 2010-15, significantly below the EMDE average of 32 percent. Current private investment-to-GDP ratios have fallen below levels prior to the global financial crisis (IMF 2015e).

Regional investment has contracted since 2014 amid deep recessions in several of the region's largest economies (Argentina, Brazil, República Bolivariana de Venezuela) and growth slowdowns in the rest of the region (Figure 2.3.1.1). In 2015, investment growth was below its long-term average in two-thirds of LAC economies and negative in one-third of them (Brazil, Chile, Ecuador, Jamaica, and Peru). Preliminary data point to a further investment decline in the first half of 2016.

The declines mark a sharp reversal of the region's robust investment growth before 2010, when LAC countries were buoyed by robust overall growth prospects, still-elevated commodity prices, and relative political stability in the region. During 2010-15, investment growth averaged 3.9 percent, significantly below the 7.8 percent average during 2003-08. The recent weakening of investment growth has returned investment-to-GDP ratios near their levels in the early 2000s. The slowdown in investment growth has been broad-based across various sectors, and across public and private investment. In light of the weakened economic growth prospects for the region, investment growth is expected to remain low in the short to medium term.

South America, with a large share of commodity exporters, experienced the sharpest downturn in investment growth in the LAC region as these economies' terms of trade deteriorated sharply (World Bank 2016k; IMF 2015e). Investment in Mexico and many other countries in Central America has been more robust as reform agendas, especially in Mexico, have bolstered confidence. Investment growth has also picked up in the Caribbean, partly due to strong construction growth supporting the tourism sector.

What were the main sources of the investment slowdown?

The post-crisis slump in commodity prices and associated deterioration in the terms-of-trade triggered sharp investment drops in commodity-producing sectors, in particular mining, across the region (IMF 2015e, World Bank 2016l; Figure 2.3.1.2). Investment also declined in non-commodity-producing sectors. Public investment was curtailed as fiscal revenues shrank and fiscal deficits widened as a result of lower commodity prices and slowing growth. Private investment declined as investor confidence in growth prospects waned, especially among major commodity exporters (IADB 2016, IMF 2015b). Political

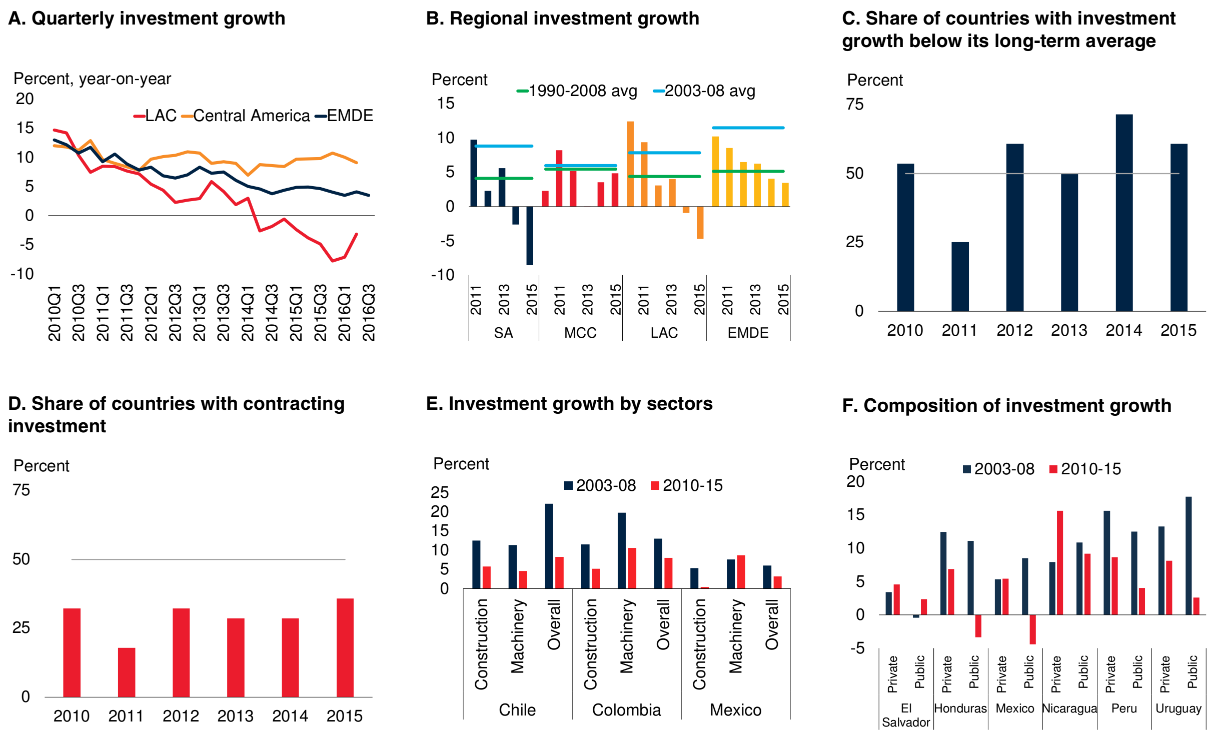
Note: This box was prepared by Derek Chen.

[1] Throughout this box, unless otherwise specified, investment refers to real gross fixed capital formation (public and private combined). For the sake of brevity, "investment" is understood to indicate investment levels. Investment growth is measured as the annual percent change in real investment.

BOX 2.3.1 Recent investment slowdown: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.1 Investment growth slowdown

Partly due to weak overall economic growth, investment growth slowed sharply during 2010-15. The investment slowdown was broad-based across various sectors and across both private and public investment. Investment growth is expected to remain low and may decline further in the short to medium term.



Sources: Haver Analytics, International Monetary Fund, Oxford Economics, World Bank.
A. GDP-weighted averages. Includes quarterly data for Bolivia, Brazil, Chile, Colombia, Costa Rica, Guatemala, Mexico, Nicaragua, Paraguay, Peru, and Uruguay. Central America includes Costa Rica, Guatemala, Mexico, and Nicaragua. "EMDE" stands for emerging market and developing economies.
B. Averages weighted by investment levels. "SA" stands for South America. "MCC" stands for Mexico, Central America, and the Caribbean.
E. For Chile, 2003-08 data begins in 2004.
F. Figure shows growth rates of gross fixed capital formation in constant 2010 U.S. dollars.

and policy uncertainty has also dampened investor confidence and discouraged investment expenditures in several countries in recent years (Argentina, Brazil, Haiti, República Bolivariana de Venezuela) (IMF 2016l).

Tightening financing conditions in the region further weighed on investment. As the U.S. Federal Reserve began to reduce monetary accommodation in 2014-15, currencies of major commodity exporters in the region depreciated against the dollar, some by around 30 percent in 2015 (Brazil, Colombia). Coupled with severe weather conditions that affected domestic food supplies, upward pressures on inflation led some central banks in the region, especially in South America, to raise interest rates in 2015-16 to contain price rises despite weak output growth (Argentina, Brazil, Chile, Colombia), further dampening investment growth.

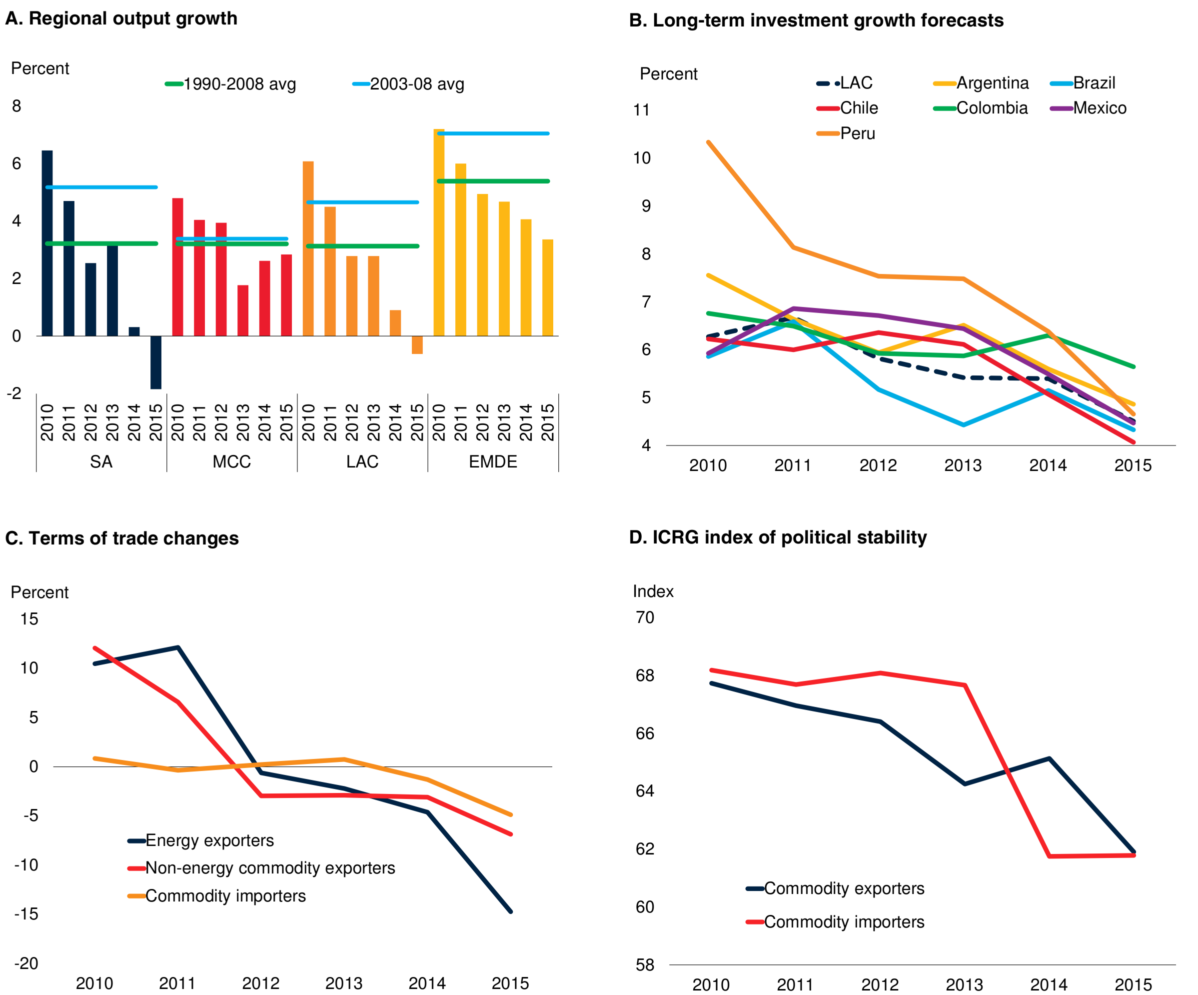
What are current and prospective investment needs?

Investment needs in the region remain significant. The low quality of infrastructure and poor skills of the labor force are bottlenecks to the achievement of faster productivity growth, for example in Brazil (World Bank 2016k), and to poverty reduction. Infrastructure has not kept pace with urbanization in the region (IADB 2010), while the majority of the poor in LAC are in urban areas. Immediate needs for investment in infrastructure and education have also been identified in country studies of Belize, Bolivia,

BOX 2.3.1 Recent investment slowdown: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.2 Correlates of investment growth slowdown

The investment slowdown has coincided with severe terms-of-trade deteriorations, sharp output growth slowdowns, slowing FDI inflows, political tensions, and domestic policy tightening. Over the medium term, investment growth is expected to remain low.



Sources: Haver Analytics, Consensus Economics, World Economic Forum (2016), World Bank.
A. GDP-weighted averages. "SA" stands for South America. "MCC" stands for Mexico, Central America, and the Caribbean.
B. Consensus Economics five-year ahead investment growth forecasts.
C. GDP-weighted average annual change in terms of trade. Negative value indicates deterioration. Energy exporters include Bolivia, Colombia and Ecuador. Non-energy commodity exporters include Argentina, Brazil, Chile, Costa Rica, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Peru, and Uruguay. Commodity importers include Dominican Republic, El Salvador, Haiti, and Mexico.
D. ICRG is the International Country Risk Guide, an index of political stability produced by the PRS Group. A decline indicates greater political instability.

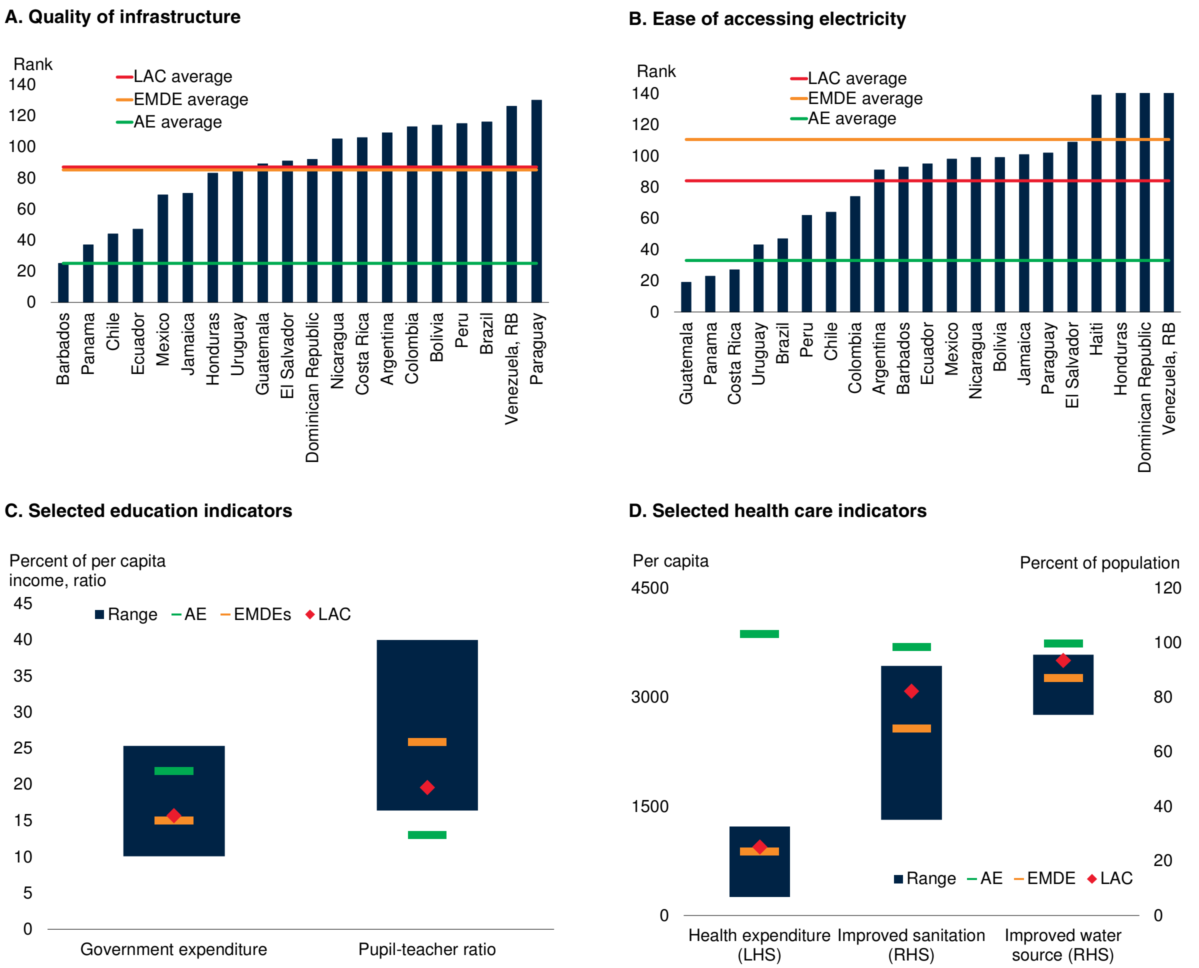
Colombia, Costa Rica, El Salvador, Guatemala, Haiti, Honduras, Panama, and Uruguay (World Bank 2015i-q, and 2016l).

Infrastructure investment. On average across the 16 EMDEs in LAC over 2008-2013, infrastructure investment amounted to just 3.7 percent of GDP, well below the 5-6 percent of GDP required just to sustain current economic growth rates (IADB 2016m; Bhattacharya, Romani, and Stern 2012; Kohli and Basil 2010; Fay and Yepes 2003; Calderón and Servén 2003; and Perrotti and Sánchez 2011). Apart from low investment levels, the quality of infrastructure in the LAC region is poor relative to that of advanced economies and Asian emerging markets. The

BOX 2.3.1 Recent investment slowdown: Latin America and the Caribbean *(continued)*

FIGURE 2.3.1.3 Investment needs

A number of LAC countries rank poorly on access to quality infrastructure. Important among current investment needs are infrastructure and education, in terms of both quantity and quality.



Sources: World Bank (2017), World Economic Forum (2016).
A. Rankings out of 138 countries.
B. Rankings out of 190 countries.
C. Blue bars denote range of unweighted regional averages across EMDE regions. Government expenditure per primary student (in percent of per capita income), unweighted averages of 87 EMDEs, 32 AEs, and 20 LAC economies. Pupil-teacher ratio in primary education (headcount basis), unweighted averages for 165 EMDEs, 31 AEs, and 23 LAC economies. Latest available data available during 2011-15.
D. Blue bars denote range of unweighted regional averages across EMDE regions. Health expenditure per capita in purchasing power parity terms, unweighted averages of 199 EMDEs, 34 AEs, and 31 LAC economies. Access to improved sanitation facilities (in percent of population), unweighted averages for 150 EMDEs, 33 AEs, and 28 LAC economies. Access to improved water sources (in percent of population), unweighted averages for 148 EMDEs, 34 AEs, and 30 LAC economies. Latest available data available during 2011-15.

average LAC economy ranked 82nd out of 138 economies (around the 40th percentile) on quality of infrastructure (World Economic Forum 2016; Figure 2.3.1.3). Priority infrastructure needs in the region include improving road conditions through maintenance and rehabilitation (Uruguay), upgrading infrastructure relating to energy (Panama), increasing access to electricity in rural areas (Bolivia), enhancing the quality of roads and ports (Costa Rica), and reducing the prices of electricity (Costa Rica).

Education. While public education expenditure in the region is on par with the EMDE average, various metrics of the quality of education systems, such as the average student-teacher ratio, fall short of EMDE comparators.

BOX 2.3.1 Recent investment slowdown: Latin America and the Caribbean *(continued)*

Urgent education needs include improved pre-school education and access to early childhood education; better teacher training and quality; and a reorientation of education programs towards employer needs, such as information technology and English language skills (Belize, Bolivia, Costa Rica, El Salvador, Guatemala, Panama).

Public health. The region's public health expenditures are slightly above that of EMDE comparators. Health infrastructure, such as access to improved sanitation and improved water sources, exceeds that of EMDE peers. However, urgent health care investment needs remain (World Bank 2015j, n). These include tackling malnutrition (Guatemala), increasing access to improved sanitation in rural and urban areas, and access to specialized health care services for women and children (Bolivia).

Which policies can help address investment needs?

While policy priorities differ across countries, most economies in the region have limited funds to expand public investment spending. The lack of resources places a premium on the efficiency of public investment, which may be enhanced by leveraging public funds with public-private partnerships and implementing reforms to stimulate private investment.

- Strengthening the efficiency of public investment includes streamlining the process for the development, approval, and selection of projects (IADB 2016). Transparency in the project selection process and its monitoring and coordination between multiple stakeholders can help remove inefficiencies.

- Several countries have begun to develop public-private partnership frameworks (Chile, Colombia, Peru). If designed well, these can improve the efficiency of public investment spending (Engel, Fischer, and Galetovic 2014).

- LAC economies rank low on ease of business startup and tax compliance (South America and Central America), as well as trading across borders and registering property (Caribbean and South America) (World Bank 2017). Reforms to ease these constraints can also encourage investment.