Executive Summary

The global economy remains in transition, reflected in a slower pace of global activity. Recovery in advanced economies continues to be modest and uneven. In the *United States*, an expanding economy driven by consumption has enabled an interest rate lift-off, marking a first step toward gradual monetary normalization. But recovery elsewhere, notably, in Japan and the euro area, remains fragile. With further monetary easing in Europe and Japan, influences from major central banks over global financial conditions are diverging. In emerging market economies, growth continues to slow on a broader basis—led by slower but more sustainable growth in China, while stress continues in several large economies mired in recession. Growing concerns of slower global growth and lack of policy space have contributed to generally tighter financial conditions and heightened market volatility. At the same time, commodity prices remain weak, with prospects that they will remain lower for longer. Risks stemming from these ongoing transitions could derail global growth if not managed well. This increases the urgency for broad-based policy responses to strengthen growth and secure resilience. Although added demand support is currently not needed in the United States, a credible medium-term fiscal consolidation plan would provide greater policy space if growth were to weaken. In *Canada*, a new fiscal stimulus package should provide welcome support to growth that has remained sluggish as the economy navigates lower oil prices.

Against this backdrop, economic activity in *Latin America and the Caribbean* has been hard hit and is likely to contract for the second consecutive year in 2016. The regional recession, however, masks the fact that most countries continue to grow, modestly but surely. Differences in growth outcomes are shaped by varying influences of external and domestic factors. The ongoing U.S. recovery continues to support activity in Mexico, Central America, and the Caribbean, but China's manufacturing-based slowdown has reduced the demand for exports from South America. At the same time, further declines in commodity prices have added to the accumulated terms-of-trade shock for commodity exporters. With heightened financial market volatility and tighter financial conditions in the region, corporate vulnerabilities are rising. In the context of more fragile external conditions, adjustment has been relatively smooth in countries where macro policy frameworks had improved over the past two decades. However, in a handful of countries, policy missteps, domestic imbalances and rigidities have led to sharp declines in private demand.

Growth prospects over the next five years will likely remain subdued, particularly for those facing lower commodity prices and weak investment. Throughout the region, policies and economic reforms should be tailored to manage this transition. Exchange rate flexibility remains important in supporting ongoing adjustment in the external accounts. Where further accommodation might be warranted, macro policy space is limited. In particular, fiscal policy space is constrained by high debt and new realities of slower growth and lower revenues, including from commodities. At the same time monetary policy faces trade-offs. Although exchange rate pass-through to inflation has declined relative to the past, large and persistent depreciations have put upward pressure on consumer prices. Given weak domestic demand, monetary policy can remain accommodative in countries with credible central banks and well-anchored inflation expectations, but should be geared toward preserving central bank credibility in countries facing rising medium-term inflation expectations. Overall, structural reforms are imperative to address the region's declining productive capacity.

In *South America*, policies should be tailored toward facilitating a smooth adjustment in response to the new reality of lower commodity prices. Fiscal consolidation should continue to contain rising debt and preserve or build buffers, but it should safeguard public investment to support growth. Countries with flexible exchange rate regimes have experienced large and persistent depreciations, and current account adjustments are ongoing.

Despite the decline in exchange rate pass-through, inflation on average has increased, creating tensions for monetary policy. The regional outlook will start to look more promising only when the domestic challenges facing the contracting economies have been resolved.

In *Central America*, a favorable outlook has triggered both fiscal and current account adjustment, but further efforts are needed to institutionalize fiscal discipline, build stronger fiscal buffers, and boost potential growth. Accelerating regional cooperation in prudential supervision and anti–money laundering would help contain risks. While low commodity prices continue to support the tourism-based countries in the *Caribbean*, growth prospects are deteriorating for commodity-based economies. Addressing fiscal vulnerabilities and strengthening the financial sector remain overarching objectives for most *Caribbean* countries.

This issue of the *Regional Economic Outlook* features three analytical chapters, assessing corporate vulnerabilities in Latin America, analyzing the degree of exchange rate pass-through in the region, and evaluating the state of economic infrastructure and trends in public and private infrastructure investment in Latin America and the Caribbean. Key findings are:

- Firms in Latin America are facing tighter financial market conditions at the global level along with lower potential growth and challenging macroeconomic adjustments at home. Changes in external conditions—particularly measures of global risk aversion—constitute a dominant driver of corporate risk in the region and present a risk going forward. Macroeconomic conditions, such as the pace of currency depreciation and higher sovereign spreads, and weak firm fundamentals have also contributed to an increase in corporate risk since 2011, underscoring the importance of robust policy frameworks and rigorous monitoring of systemic corporate risks.

- The sizable currency depreciations observed across many Latin American countries during the past few years have placed upward pressure on inflation, but their impact has been more muted than in the past. Improvements in monetary frameworks over the past two decades have led to substantial and generalized declines in exchange rate pass-through to consumer prices. Vigilance is nonetheless warranted in economies where second-round effects remain sizable. In countries with well-anchored medium-term inflation expectations, policymakers can afford to take a more accommodative stance.

- Inadequate infrastructure has been widely viewed as one of the principal barriers to growth in Latin America and the Caribbean. The region's infrastructure network has been upgraded over the past decade, but still compares relatively poorly with their export rivals. For most countries in the region, the efficiency of public investment needs to be improved, notwithstanding improvements in fiscal institutions and frameworks for public-private partnerships in some large economies.