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Latin America: a soft patch in 2014

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Latin America Outlook - 3Q14 | Madrid, 6 August 2014

Key messages

1. **The global cycle remains robust, despite the soft patch in the first quarter.** Global growth will rise from 3.0% in 2013, to 3.3% in 2014 and 3.8% in 2015.

2. **Low volatility in international financial markets has spread to LatAm,** even with the sharp slowdown in activity, but runs the risk of going into reverse if there is significant volatility after the Fed raises interest rates.

3. **LatAm will grow 1.6% in 2014 and 2.5% in 2015, similar to 2013.** The sharp downturn in regional growth in the first half of this year is behind us. The Pacific Alliance will grow by 3.1% and 4.0% in 2014-15, well above the regional average.

4. **Slowdown reduces pressure on external deficits,** but increases the pressure on fiscal accounts.

5. **Weak growth has tended to bias the region's monetary policies towards a more accommodative tone,** even in economies where high inflation leaves doubts about the space for further monetary stimulus.

Overview

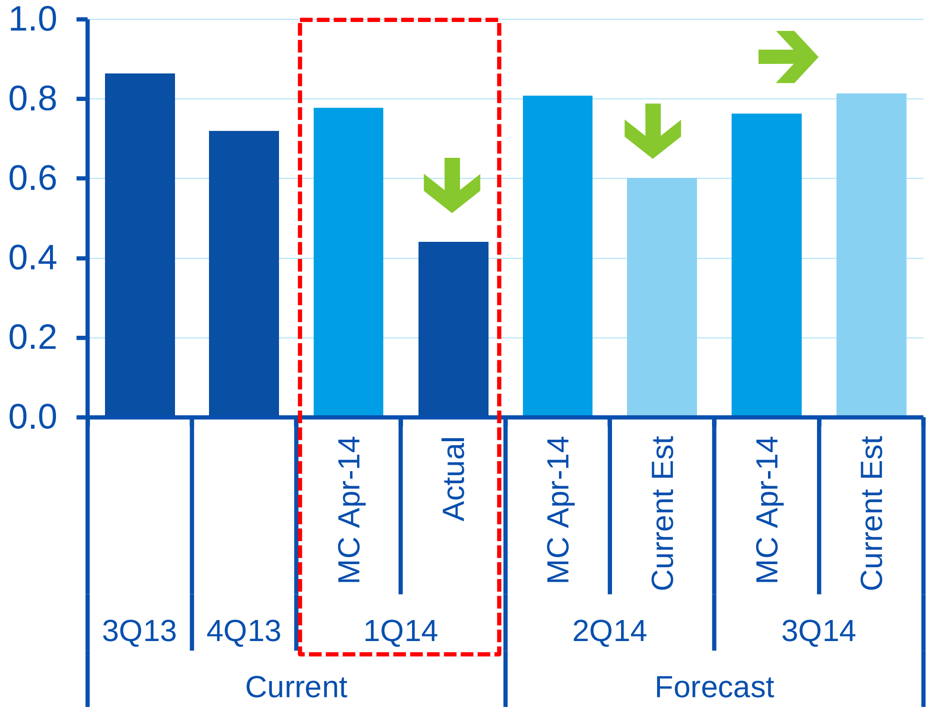
1 Global economy: recovery will continue, after the setback in the first quarter

2 LatAm: sharp slowdown in the first half of 2014 is behind us

Global cycle: global growth will increase after the temporary setback in 1H14

Global GDP growth (% QoQ)

Source: BBVA Research

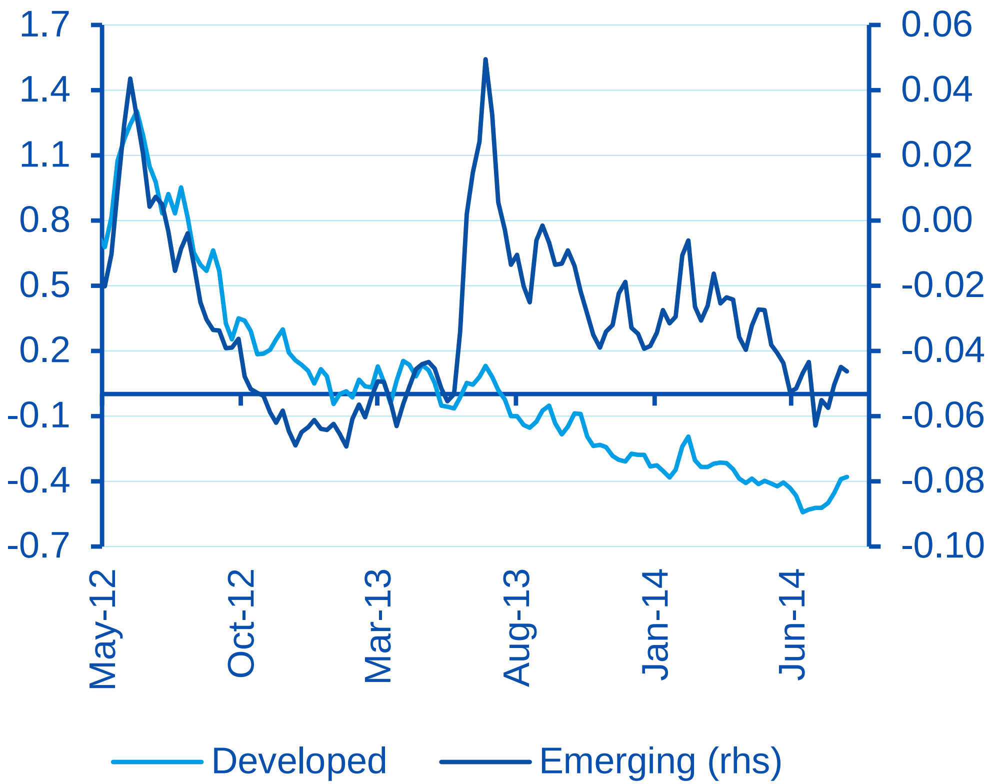


Growth continues to be solid and will improve after the setback in 1H14

Lower growth in 1Q14 was largely due to the negative weather shock in the US

Tensions have eased in financial markets since the beginning of the year

BBVA financial stress index, developed and emerging markets Source: BBVA Research



Low volatility in international financial markets continues …

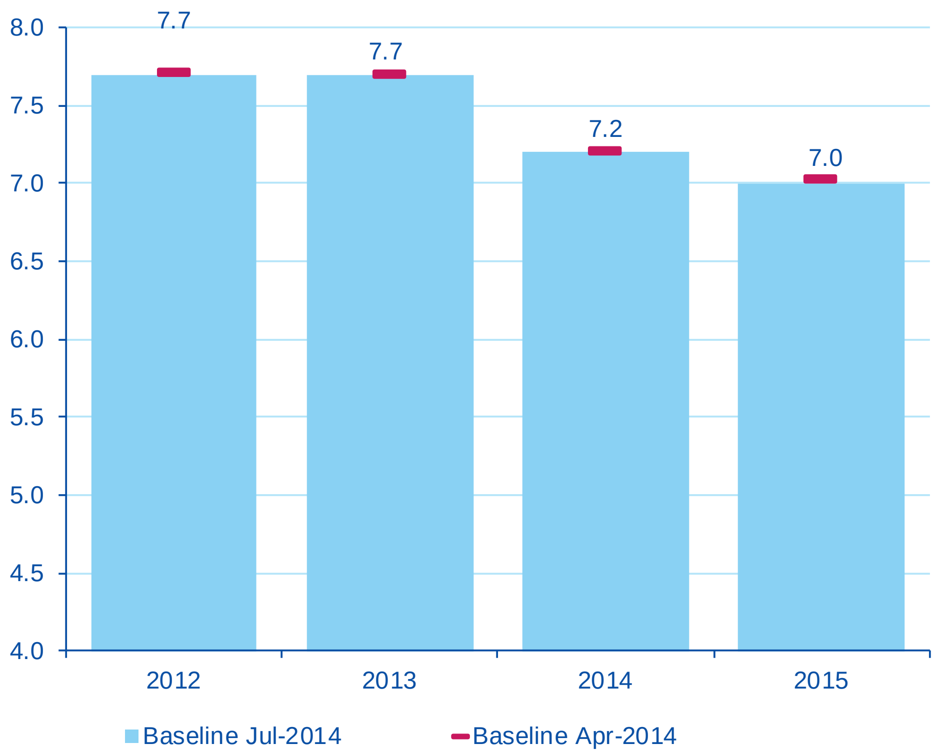
… in both developed and emerging economies

The recent upturn in emerging market stress index is specifically linked to Russia, an idiosyncratic event which has not spread to other emerging economies

We stick to our central scenario for China: growth of over 7%

China: GDP growth (%)

Source: BBVA Research



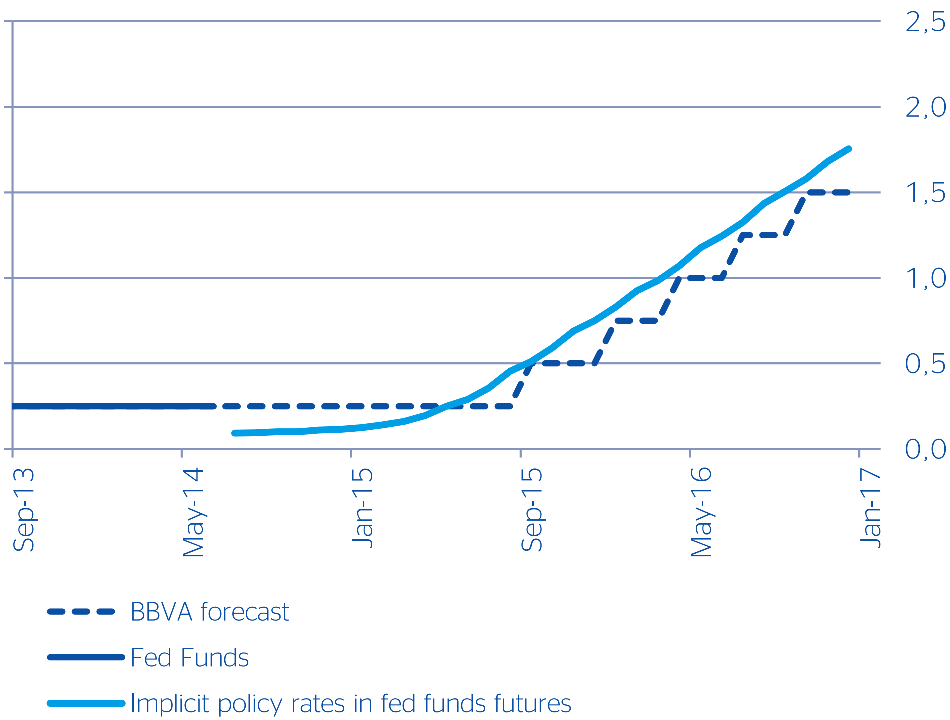
The gradual rebalancing of expenditure, from consumption to investment, will continue

The government will continue taking measures to support growth, but is not succeeding in breaking the dependence on loans

Softening of monetary policy, with lower reserve requirements, while interest rates will remain unchanged

US: growth surged in 2Q14. The Fed will match improvements in growth by raising interest rates

US: Fed funds (%)
Source: BBVA Research



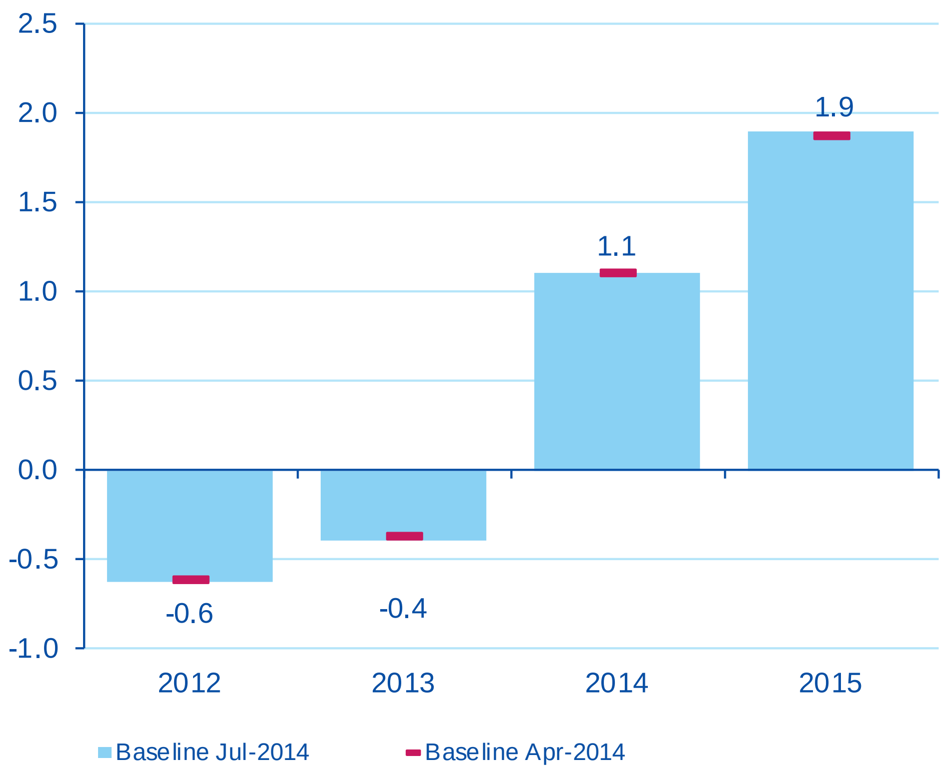
After a poor first quarter, growth recovers in the second

The Fed will stop expanding its balance sheet in October 2014 and interest rate hikes could start in September 2015; rates will be dependent on improvements in the labour market

The Fed's communication policy about its withdrawal strategy will be increasingly influential

Eurozone: ECB measures bias upwards both growth and inflation

Eurozone: GDP growth (%)
Source: BBVA Research



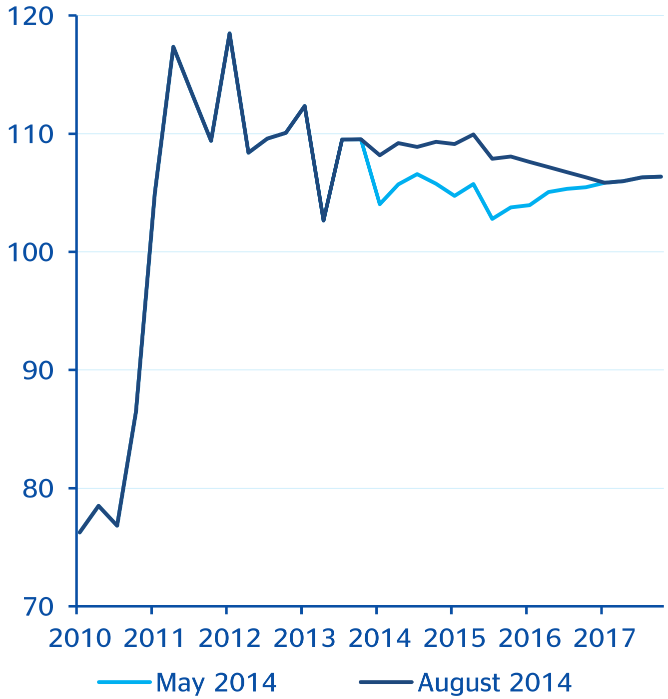
Economic recovery will be based on
(i) positive policy combinations;
(ii) progress on banking union;
(iii) improvement in the external environment

The ECB's measures (TLTROs, LTROs, negative deposit rates, non-sterilisation, QE?) strengthening interest-rate guidelines and the monetary policy transmission mechanisms

Oil prices will stay high because of geopolitical risks. Soy bean and copper trending downwards

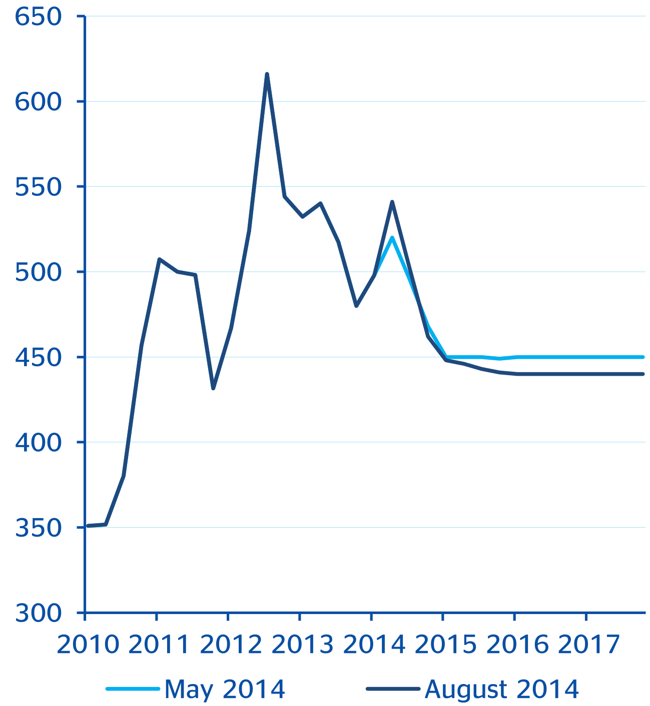
Brent Crude: (USD/barrel)

Source: BBVA Research and Bloomberg



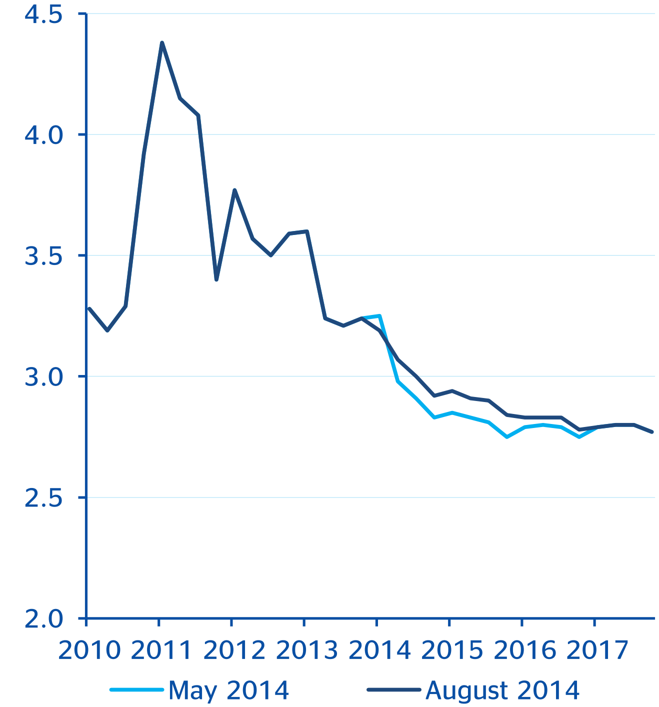
Soy bean: (USD/mt)

Source: BBVA Research and Bloomberg



Copper: (USD/lb)

Source: BBVA Research and Bloomberg

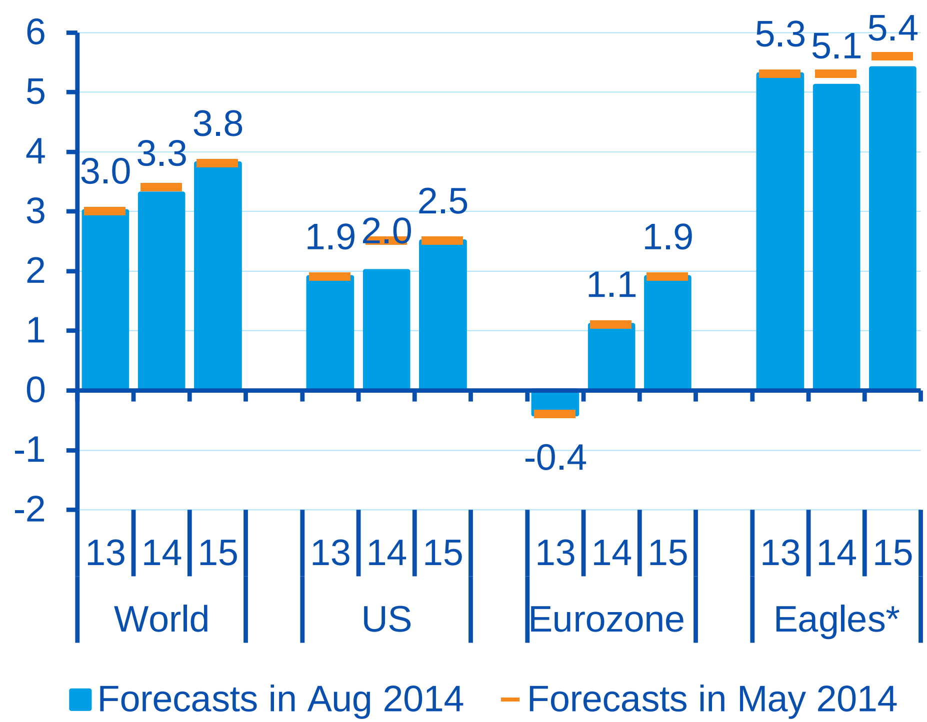


Adjustment in the oil price scenario as a reflection of greater geopolitical risks

Soy bean and copper prices will continue to fall back down to their long-term values, very similar to our estimates three months ago

In short, increasing global growth in 2014 and 2015

World growth forecasts (%)
Source: BBVA Research



Global growth will continue, with improvements in developed markets, the US and the eurozone, with a mild deceleration expected for China

The risk of a sharp slowdown in China is low and the Fed is keeping financial volatility well anchored, but geopolitical risks are cropping up all over the place

EAGLEs is the emerging markets group which will contribute most to world GDP in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.

Overview

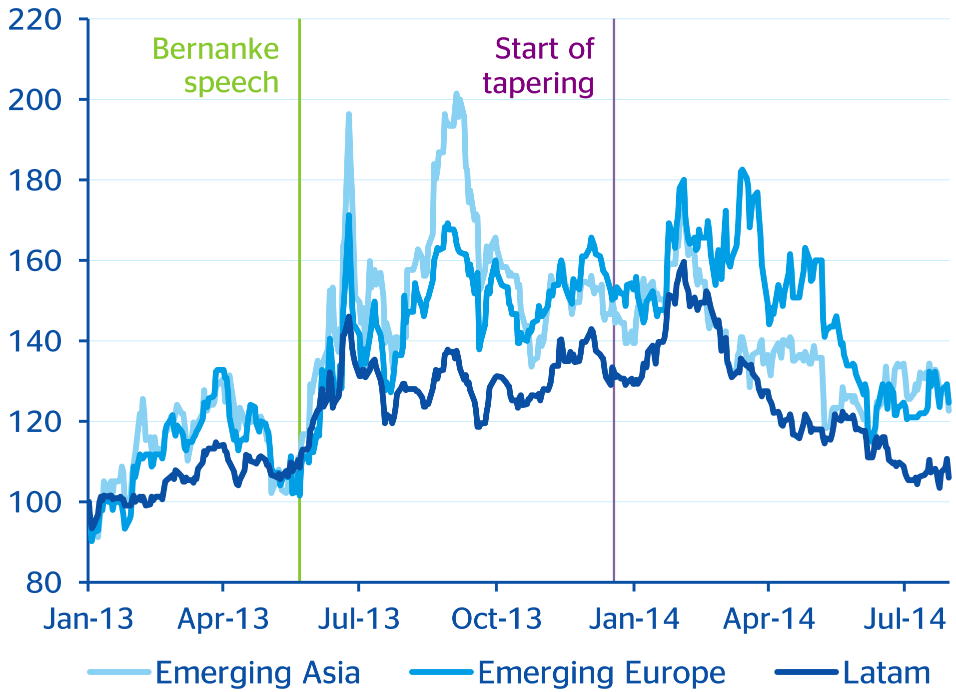
1 Global economy: recovery will continue, after the setback in the first quarter

2 LatAm: sharp slowdown in the first half of 2014 is behind us

Calm in the international financial markets also reached LatAm

Sovereign spread in emerging economies (%)

Source: BBVA Research and Haver Analytics



The widespread recovery in asset prices in LatAm (bonds, stock exchanges) continues

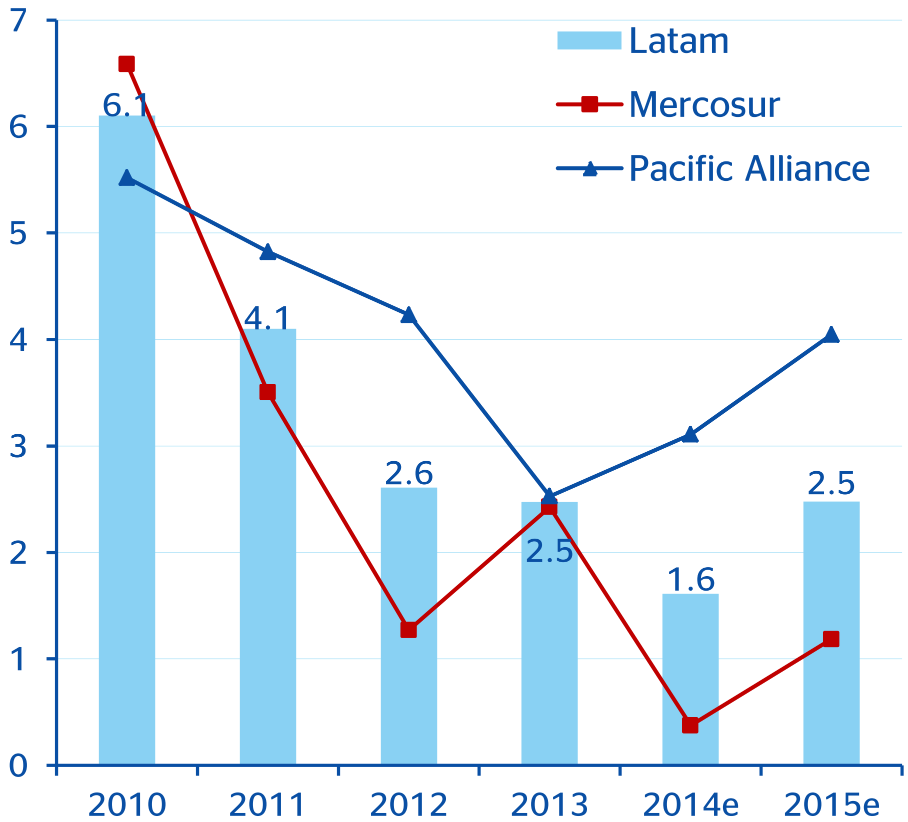
Capital flows to LatAm recover, buoyed by moderation in international financial tensions and abundant liquidity

But the risk of an adjustment in asset prices in LatAm does exist, should the Fed's interest rate hikes generate too much volatility

Latin America will grow 1.6% in 2014 and 2.5% in 2015, similar rates to those of 2013

LatAm*: GDP growth (%YoY)

Source: BBVA Research



* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

Activity figures surprised to the downside in the first half of 2014, except in Colombia

Severe moderation of private-sector investment in the region (BRA, CHI, MEX) and in the public sector (CHI, PER)

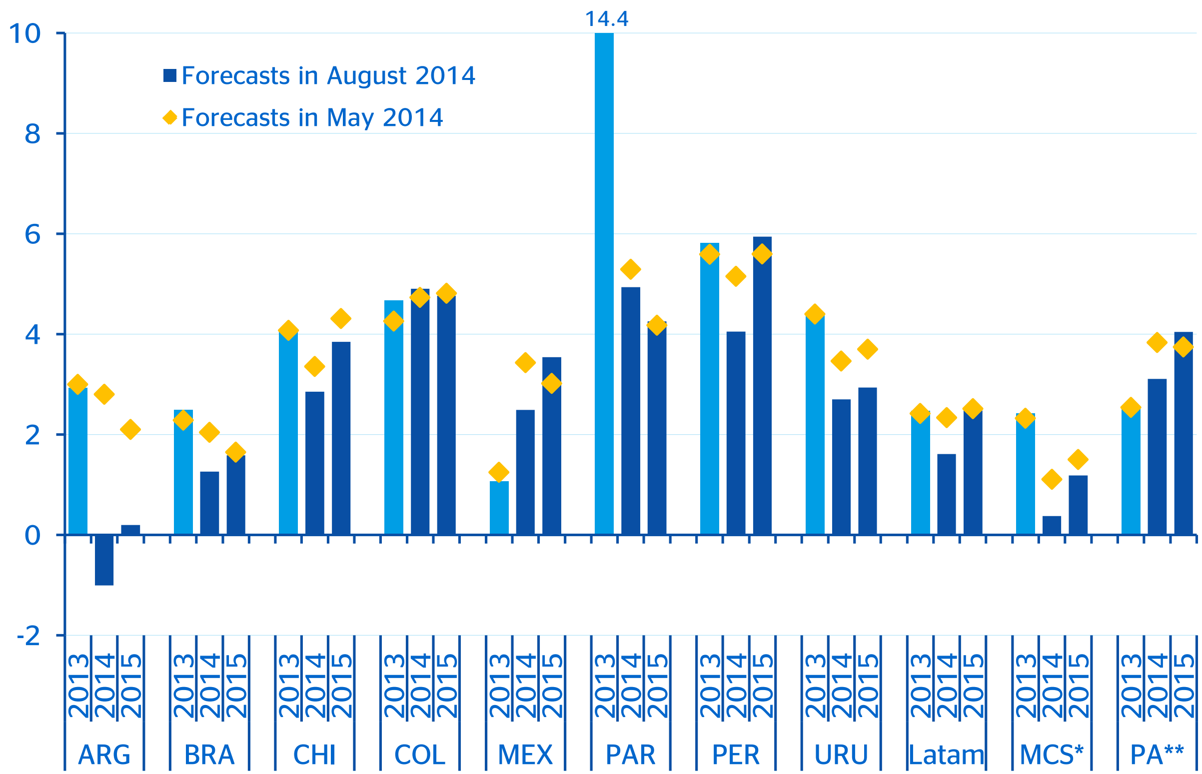
Growth will rise from a low base from 3Q onwards, due to higher global growth and increased public investment

Increasing differentiation: Pacific Alliance countries will grow by 3.1% in 2014 and 4% in 2015, well above the regional average

Growth will continue to be very heterogeneous, with the 3 Andean countries and Paraguay standing out

LatAm countries: GDP growth (%)

Source: BBVA Research



Downward adjustments in most countries, apart from Colombia

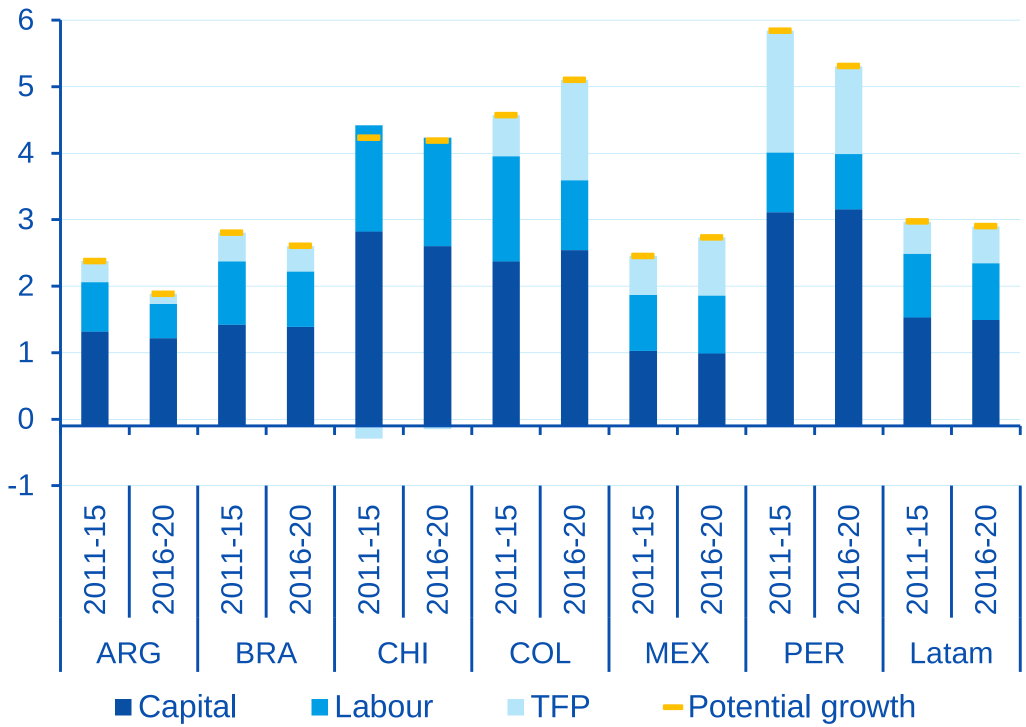
Significant increase in growth in 2015, compared to 2014, in Peru, Mexico and Chile. Momentum will continue in Colombia

Brazil’s growth will remain very moderate

Box 1: Slight downward revision of potential growth rate in LatAm

LatAm: Potential GDP growth (% YoY avg.)

Source: BBVA Research



Potential growth in Latin America is slightly above 3%, although with strong heterogeneity by country. Downward revision because of ARG, BRA and CHI

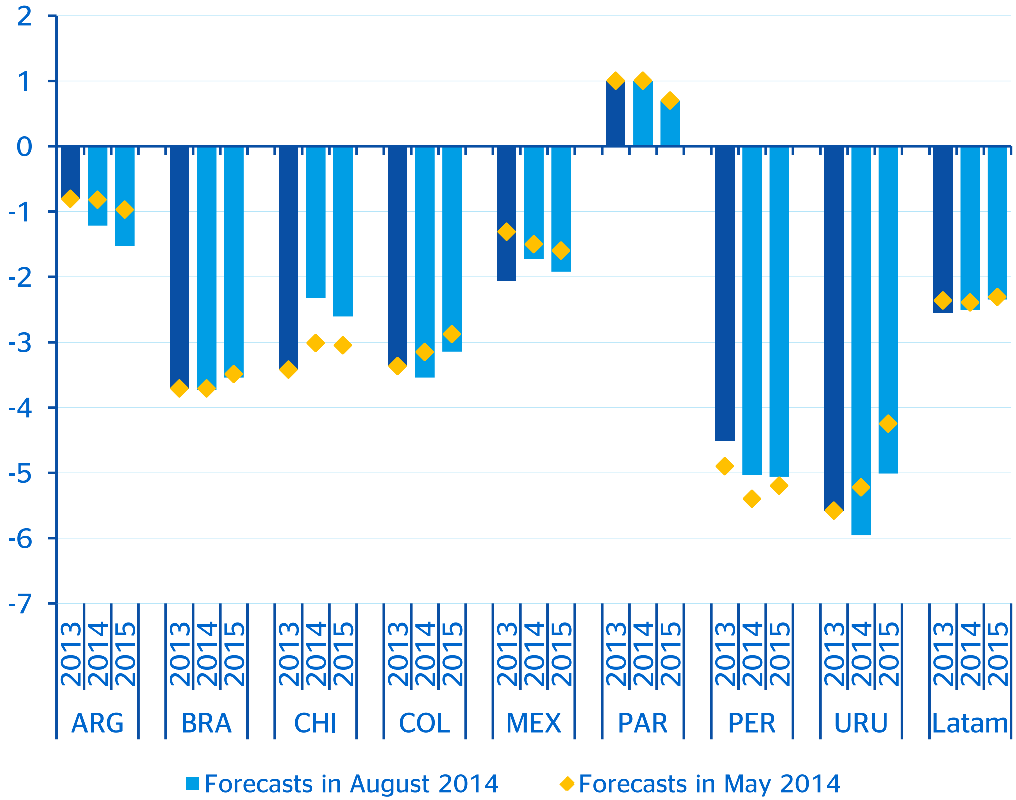
Strong contribution of total factor productivity (TFP) in Colombia, Mexico and Peru

Increased TFP in Mexico and Colombia, thanks to reforms. Total effect could be even greater

Economic deceleration reduces the pressure on external accounts …

LatAm: Current account deficit (% GDP)

Source: BBVA Research and Haver Analytics



External deficits will start to fall from 2014 and 2015, due to weak internal demand and rising global growth …

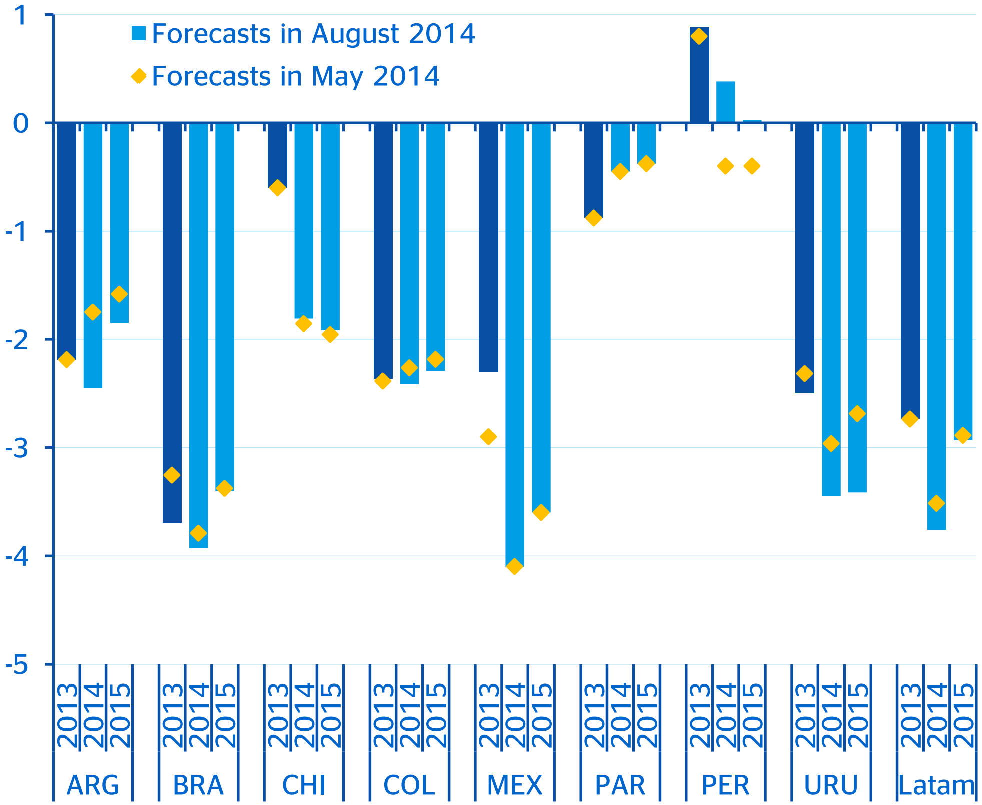
… the end of a series of supply shocks in the export sector (Peru, Colombia, Chile, Argentina)…

… and weaker exchange rates, which will partly offset the lower terms of trade

… but raises it on fiscal accounts

LatAm: Fiscal deficits (% GDP)

Source: BBVA Research and Haver Analytics



The slowdown in demand and lower commodity prices will put downward pressure on tax revenues

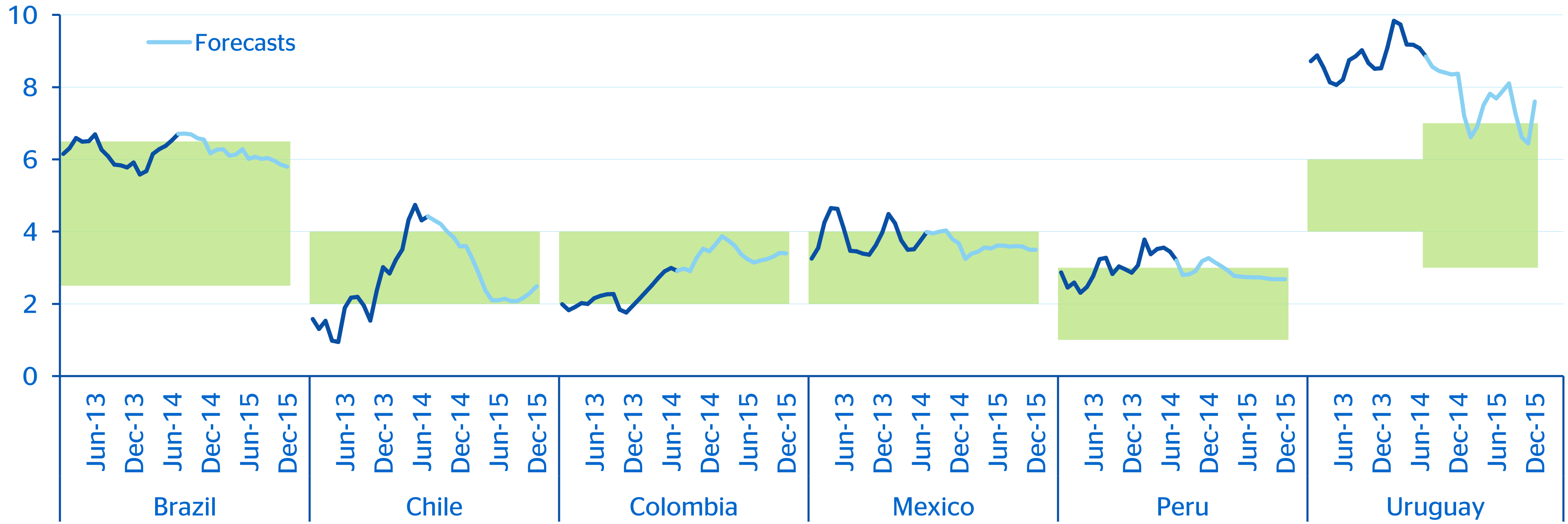
In Mexico and Chile this will be offset by the effects of the income tax reforms

We also expect greater fiscal impulse in the Pacific Alliance countries and a higher financial burden of debt in Brazil and Argentina

Upward pressures on inflation start to slacken

LatAm: inflation (% YoY) in countries with inflation targets

Source: BBVA Research and Haver Analytics



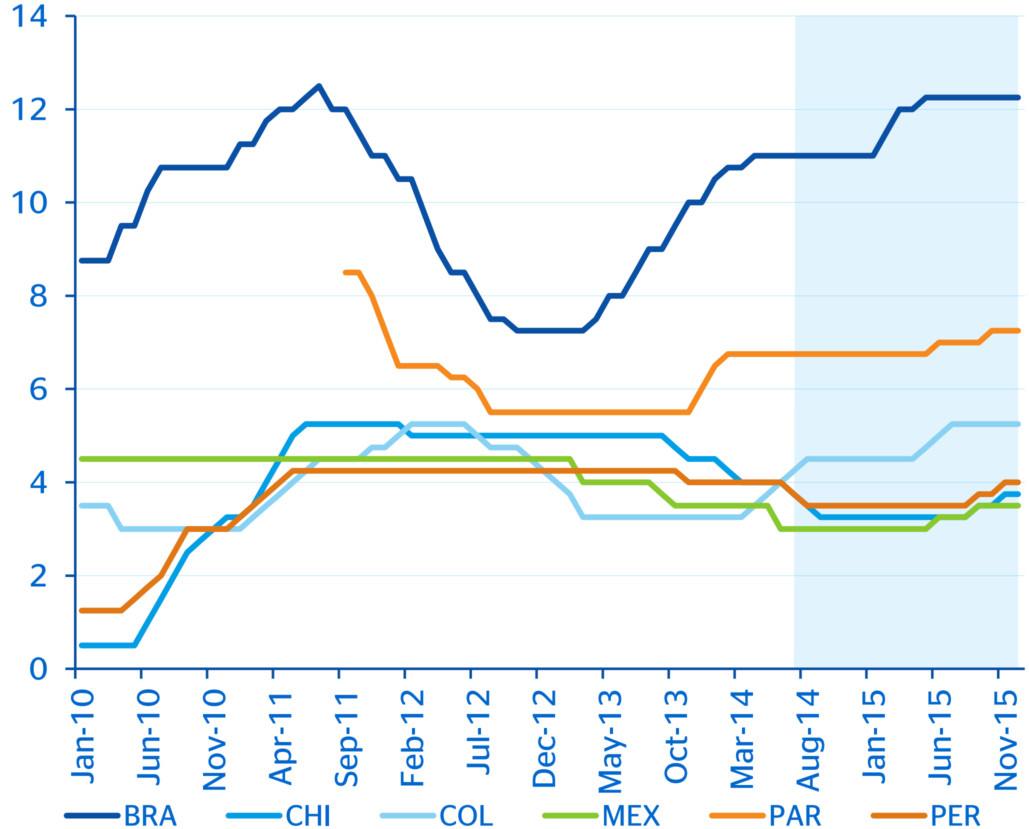
Inflation driven by shocks to food prices and exchange-rate depreciation

Inflation will stay in the upper reaches of central banks' target bands, except in Chile. Little scope for relaxing monetary policy

Weak growth has tended to bias monetary policies towards a more relaxed tone

Official interest rate in countries with inflation targets (%)

Source: BBVA Research and Haver Analytics



Inflation rates in the upper part of the target band (and hefty foreign deficits in Peru and Uruguay) appear to leave little scope for interest rate cuts

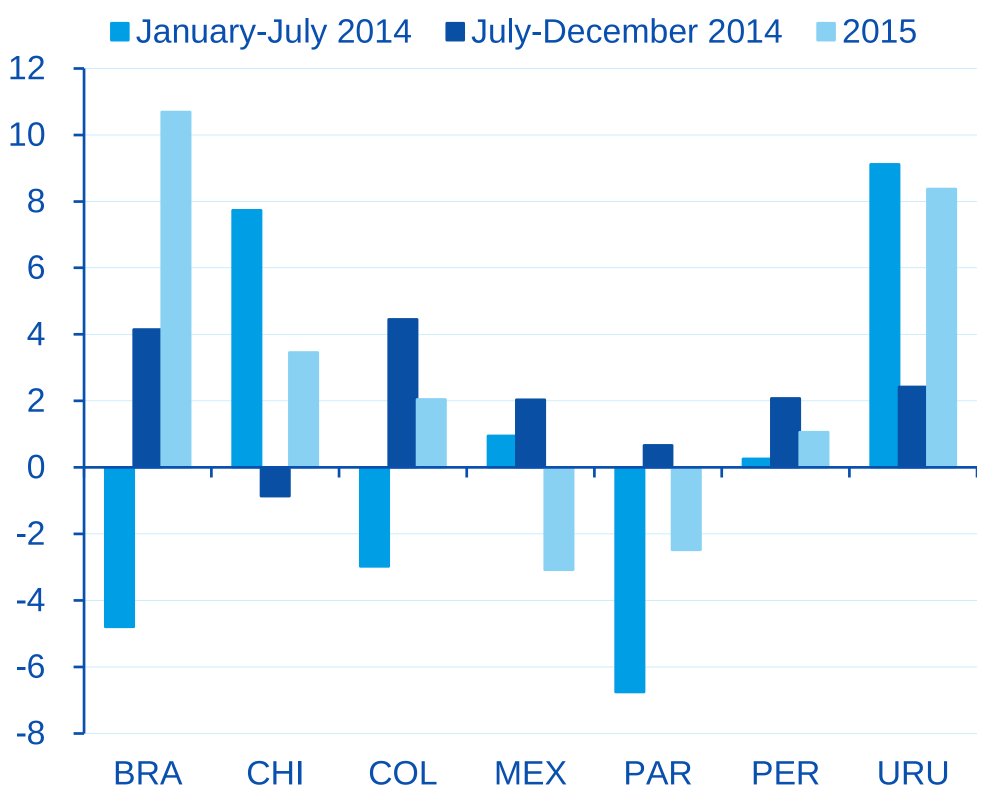
We have noticed a certain trend in supporting growth with the cuts in Chile (anticipated) and in Peru and Mexico (unexpected)

We expect further cuts in Chile and Peru, while Colombia continues to raise interest rates hand in hand with the improvement in the cycle

Increasing use of macroprudential measures, such as cuts in reserve ratios

Exchange rates will depreciate in 2014 and 2015, with very heterogeneous intensities

Variation in the exchange rate against the dollar in countries with inflation targets (%)
Source: BBVA Research and Haver Analytics



Trend towards the depreciation of the exchange rate, because of a lower relative growth, lower commodity prices and increased exchange rates by the Fed in 2015

More depreciation in countries with higher inflationary pressures (BRA, URU, ARG)…

… and in those countries showing signs of an overvalued currency (Brazil)

Key messages

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Appendix: Growth forecasts in Latin America

GDP growth (% YoY)

Source: BBVA Research. *Forecasts

	2011	2012	2013	2014*	2015*
Argentina	8.6	0.9	2.9	-1.0	0.2
Brazil	2.7	1.0	2.5	1.3	1.6
Chile	5.8	5.4	4.1	2.9	3.8
Colombia	6.6	4.0	4.7	4.9	4.8
Mexico	3.9	3.8	1.1	2.5	3.5
Paraguay	4.3	-1.2	14.4	4.9	4.3
Peru	6.5	6.0	5.8	4.1	5.9
Uruguay	7.3	3.7	4.4	2.7	2.9
Mercosur	3.5	1.3	2.4	0.4	1.2
Pacific Alliance	4.8	4.2	2.5	3.1	4.0
Latin America	4.1	2.6	2.5	1.6	2.5