BBVA | RESEARCH

# Latin America Outlook

Fourth quarter 2014
LatAm Co-ordination Unit

- Growth in LatAm will slow during 2014 and 2015. The region will grow by 0.9% and 1.8% respectively over these two years, due to a slowdown in domestic demand and a less favourable external environment. The Pacific Alliance will grow by 2.8% in 2014 and 3.8% in 2015.
- Given the greater cyclical weakness, the central banks are showing a looser approach than they were three months ago, except in the case of Brazil. Nevertheless, pressure to raise interest rates is expected in 2015, in line with the recovery and the rise in rates to be introduced by the Fed.
- Exchange rates will continue to depreciate across the region in 2015 against a backdrop of cheaper raw materials and the rise in interest rates by the Fed.
- The fiscal outlook has deteriorated, due to the slowdown in domestic demand. External deficits remain high, though they will start to fall in 2015. In general, both deficits remain sustainable.

# Table of Contents



**Closing date: 12 November 2014**

# 1 Summary

**Global growth continues to strengthen, though slowly.** The world economy continued to show moderate growth over the third quarter, pointing to global growth of 3.2% in 2014 and 3.7% in 2015. Against this backdrop, monetary policy in the majority of countries remains focused on supporting activity, while fiscal policy will assume a less restrictive approach than has been seen more recently in the US, the eurozone and even in China, which is expected to introduce additional measures to support growth. We anticipate that growth in China will fall only slightly, from 7.2% in 2014 to 7% in 2015.

**Increased tension and financial volatility in the international markets.** Against a backdrop of expectation that the Fed will make the first interest rate rises around the middle of 2015 and the divergence of monetary policy between the ECB and the Bank of Japan, there was also a sharp rise in international financial tensions in both the developed and emerging economies.

**Volatility also returned to the markets in Latin America, given the closer proximity of interest rate rises by the Fed.** Greater volatility combined with a slowdown in economic activity to generate sharp corrections in the prices of main assets (sovereign spreads, stocks and exchange rates) over the last three months. This situation of volatility and macroeconomic weakness also led to a slowdown in the receipt of short-term capital flows, though it was not enough to cause a reversal. The main exception to these losses was seen in the Mexican stock market, doubtless as a result of the greater influence of the recovering US economy.

**Volatility in the Latin American markets will most probably continue into the future.** The markets will remain highly dependent on the Fed's normalisation of its monetary policy. Despite the fact that we expect greater monetary easing in Europe, and do not expect further significant moderation in China, we believe that the effect of monetary contraction by the Fed will predominate in setting financial conditions that will be less comfortable for Latin America.

**Commodity prices have experienced a strong downward correction in recent months.** Though they remain at relatively high levels in historical terms, the prices of copper, soybean and oil have seen respective falls of 6%, 15% and 28% over the last three months. As regards the specific case of oil, there has been an unexpected increase in supply combined with a fall in demand, though the way in which the industry structures its costs will prevent any additional fall in prices and will drive a return to levels of around 100 dollars a barrel in the medium term (Box 1).

**Economic activity in the region has continued to weaken over recent quarters, particularly as the result of a slowdown in consumption and investment.** During 2014, the growth figures have consistently shown unexpected falls due to negative supply shocks, though moderation towards the middle of the year was also caused by a fall in domestic demand. Increased uncertainty (due to the external environment and, in some cases, electoral processes or economic policy measures) played an important role in this declining demand, which has hurt confidence, both in business and among the general public. The area of internal demand most affected has been investment.

**Nevertheless, looking at average figures for the region it is likely that the worst of the slowdown is behind us.** From the third quarter onwards we began to see a recovery in growth rates, driven both by an increase in worldwide growth and by greater levels of public investment, especially in countries belonging to the Pacific Alliance (Mexico, Colombia, Peru and Chile).

**Growth in the region will increase from 0.9% in 2014 to 1.8% in 2015.** These growth figures are 0.7 percentage points lower than predicted three months ago, due to an internal and external outlook that is less favourable than it was back in August. Growth will continue to rise during subsequent years to levels of around 3.5%, more in line with our estimates for the region's potential.

**Growth in the region will continue to be marked by the high level of heterogeneity, particularly among the Pacific Alliance nations.** During 2015 we expect to see notable increases in levels of growth in Peru (more than 2% higher than in 2014), Mexico and Chile (around 1% higher), along with maintenance of the strong performance seen in Paraguay and Colombia in 2014. The Pacific Alliance countries will therefore be the ones that will display the highest levels of growth in 2015, with an average of 3.8%, more than double the average for Latin America as a whole. In particular, we expect growth in 2015 to reach 4.8% in Peru and Colombia, 4.2% in Paraguay, 3.5% in Mexico and 3.1% in Chile. This contrasts with a meagre rise of just 1.3% in Brazil, during a year in which it is hoped its policies will be adjusted.

**Inflation in 2015 will remain within the meta limits set by the central banks, except in Uruguay.** The weakness of the economic cycle has eased the pressure on inflation somewhat, though it remains at, and at times above, the upper limits of the target range set by the central banks as the result of supply shocks. Going forward, convergence toward meta inflation rates will be supported to a great extent by cyclical weakness. The main exceptions will be Uruguay, where inflation will remain above the meta range, and Brazil, where it will be hard for inflation to be brought below 6%, given continuing pressure from administered prices and the weakening exchange rate.

**The central banks are showing a looser approach than three months ago, except in the case of Brazil.** Taylor rule estimates for the region support a relatively loose approach by central banks in Latin America, except in Mexico (Box 3). In line with this approach, we anticipate further interest rate cuts in Peru and Chile, and a less robust rise in rates in Colombia in 2015. Taylor rule estimates for the region also show that the Fed's programme to raise interest rates in 2015 will be a significant factor behind the increase in official interest rates that we are expecting to see across the region. The notable exception to this looser model is Brazil, where the interest rate rises that we had expected to see around the middle of 2015 will be brought forward, though this more restrictive approach will be offset, in part, by the introduction of macroprudential measures, one of the economic policy tools that is seeing increasing use in the region (Box 2).

**Exchange rates will weaken across the region with highly heterogeneous effects, driven by the rise in interest rates by the Fed and lower commodity prices.** The pressures causing currency depreciation should be more tempered in the Andean countries, and there is even a certain margin for a temporary improvement in exchange rates in Chile as the result of the potential sale of government dollar funds to finance a higher fiscal deficit. Pressure should also be more controlled in Mexico, which will benefit from the upturn in the US. However, pressure towards depreciation will be more accentuated in Brazil, Uruguay and Argentina, where inflation is significantly higher and the real exchange rate will fall seriously behind if the nominal rate does not at least keep pace with domestic prices.

**Cyclical weakness is diminishing fiscal prospects for the region, though it is improving the prospect for external balances.** Lower levels of economic activity and falling commodity prices have affected government income in the majority of countries, exacerbated by increases in public spending in some countries such as Brazil and Argentina. It is therefore expected that the fiscal accounts will show larger deficits in 2014 and 2015 than were anticipated three months ago. On the external side, the reduction in terms of trade and some problems with supply in the export sector have tended to have an adverse effect on external deficits, though these have been more than offset in Chile and Argentina by lower domestic demand. External vulnerability indicators for the region remain very low, given the levels of reserves and the proportion of long-term financing of external deficits.

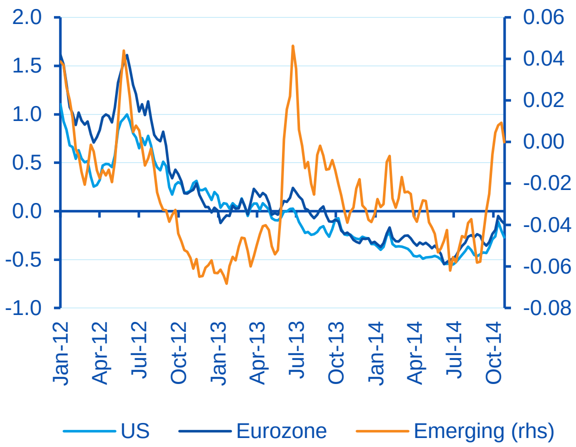
# 2 Slow global recovery with greater financial volatility

## World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

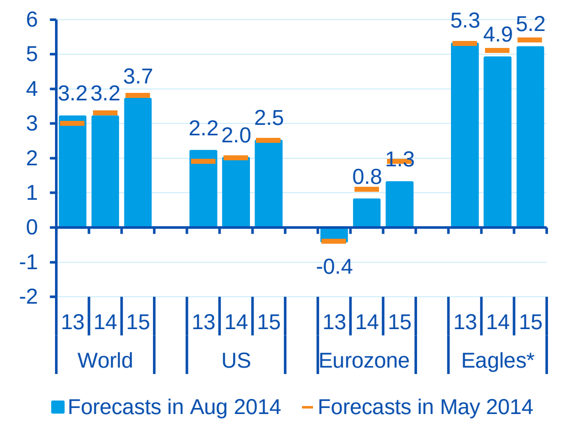
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Figure 2.1
**BBVA Research Financial Tensions Index**




Source: BBVA Research

Figure 2.2
**GDP growth forecasts (%)**




* EAGLES is the group of emerging economies which will contribute most to world GDP in the next 10 years. Group made up of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8% respectively. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations – although not for exporter countries to the extent that this is a result of a positive supply shock.

## Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the spending, employment and activity indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

## Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

## In the eurozone the recovery will be even slower than we were expecting

The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

# 3 Volatility returns to the Latin American markets

## The proximity of the Fed raising interest rates has led to increased volatility and asset price corrections in the LatAm markets

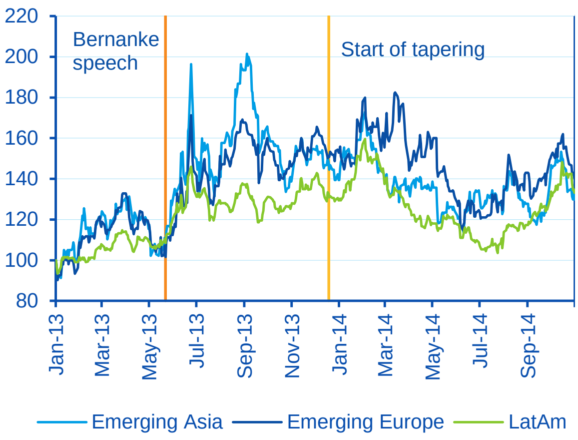
Three months ago, in the previous issue of our Latin America Economic Outlook, we stressed the optimism running through the region's financial markets at the time, which contrasted with the widespread slowdown in economic activity in the most important countries in Latin America, and we warned of the risk of a downward correction in the price of the region's main financial assets.

This correction has manifested itself in recent months, ending with the uncoupling that had previously been observed between the mood in the financial markets and levels of economic activity, which have continued to moderate in recent months.

The fall in the price of Latin American assets in recent months is due not only to the slowdown in activity, but also to a less favourable external environment, given the fall in commodity prices and the proximity of interest rate rises in the US.

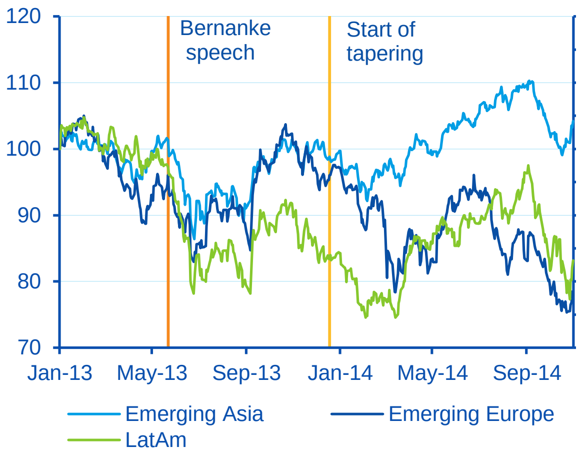
From the end of July to the end of October, the sovereign spread in Latin America rose by 75 basis points, significantly more than in Emerging Europe (+25bp) and Emerging Asia (+8bp). This correction brought an end to positive spreads in Latin America as compared with these other two emerging regions (Figure 3.1), despite the negative impact that questions over the Chinese economy are having on the Asian economies and the pernicious effect of tensions between Ukraine and Russia on countries in Eastern Europe.

Figure 3.1
**Sovereign spreads in EMs (EMBI, Index Jan 2013 = 100)**




Source: Haver Analytics and BBVA Research

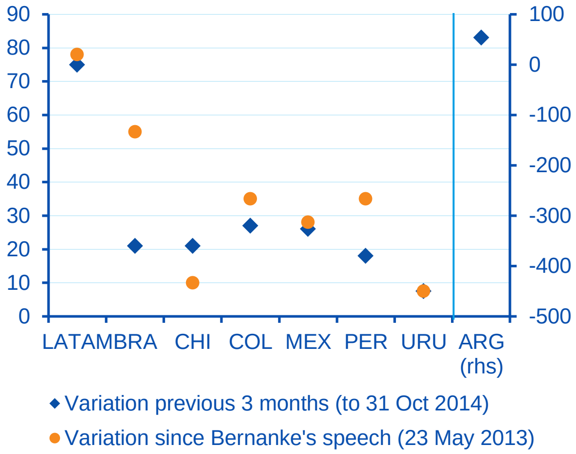
Figure 3.2
**Share prices in EMs (MSCI, Index Jan 2013 = 100)**




Source: Haver Analytics and BBVA Research

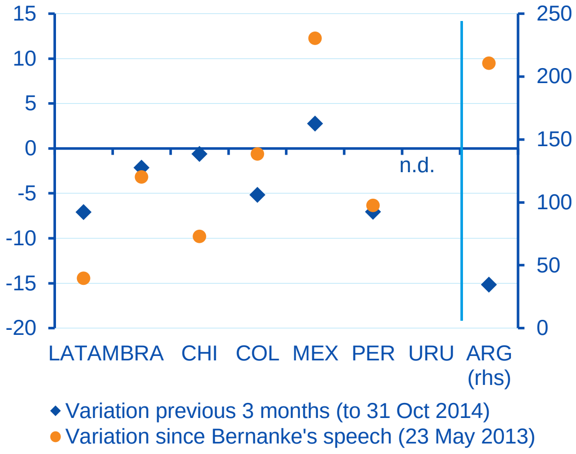
Over the same period, the MSCI stock market index in Latin America fell back 7%, a drop equivalent to the one seen in the Emerging Europe countries and more significant than the 2% fall recorded in Emerging Asia (Figure 3.2).

Figure 3.3
**Sovereign spreads in LatAm (EMBI, bp)**




Source: Haver Analytics and BBVA Research

Figure 3.4
**Share prices in LatAm (% var. in local currency)**




Source: Haver Analytics and BBVA Research

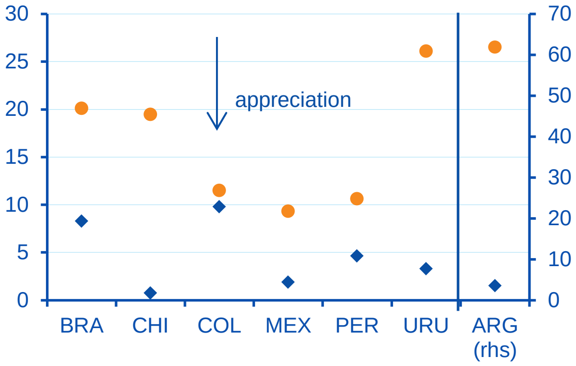
The increase in sovereign spreads and fall in stock market prices over the past three months has been widespread (Figures 3.3 and 3.4). Among the only exceptions is the Mexican stock market, which has managed a 3% rise. Despite the financial turbulence, which has meant an increase in Mexican sovereign risk, the financial recovery in the US (see section 2) has bolstered the Mexican stock market.

Furthermore, the direction and even the relative similarity of the size of the losses experienced suggest the predominance of global factors (the normalisation of monetary policy by the Fed and falls in commodity prices), though there have also been other very important factors at a regional level (the strength of the slowdown in domestic demand and the resulting economic policies) and even locally (political uncertainty due to presidential elections in Brazil and Uruguay and the effects of the failure to reach agreement on the holdouts in Argentina).

Latin American currencies have also seen a downward correction since the end of July, with losses of between 1%, in the case of Chile, and 10% in the case of Colombia (Figure 3.5). This loss of value has reduced the degree to which some currencies, such as the Brazilian real and the Peruvian new sol, were overvalued. Others have meanwhile moved or remained steady within parameters that have resulted in their slight undervaluation as compared with their par value, as is the case with the currencies of Argentina, Chile, Colombia and Mexico.

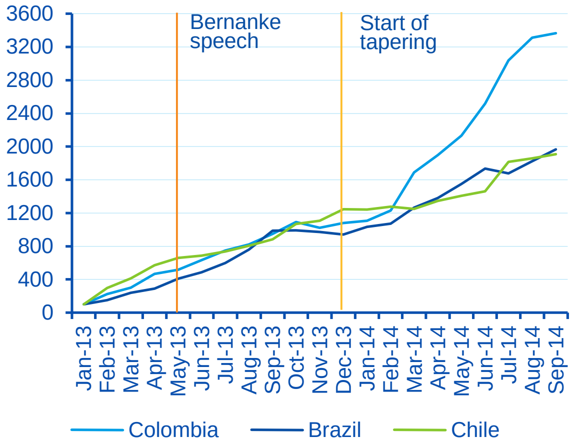
Against this backdrop it is no surprise that capital flows towards countries in the region have, in some cases, moderated (Figure 3.6). Nevertheless, Latin American countries continue to attract foreign capital, a consequence of the many opportunities for investment in these economies, particularly against a background of high levels of liquidity in the global markets.

Figure 3.5
**LatAm exchange rates (% var.)**




Source: Haver Analytics and BBVA Research

Figure 3.6
**Non-resident portfolio flows (aggregate balance of payments data, Index Jan 2013 = 100)**




Source: National Statistics and BBVA Research

With a few exceptions, such as the Mexican and Argentinian stock markets, prices of financial assets in Latin America are currently below the levels recorded in May 2013 when, following the speech by the then Chairman of the Fed, Ben Bernanke, the markets began to discount the effects of the withdrawal of monetary stimulus in the US. The gains recorded between February and June have been reversed in the past three months.

## Volatility continues against a context of a divergence in monetary policy among the main developed economies

It is difficult to discount the possibility that financial volatility may continue over the coming months, given that the markets will be waiting with bated breath for the movement towards the normalisation of monetary policy by the Fed and the resulting US business data, which will determine the speed of this process.

The markets will also remain both attentive and subject to the impact caused by the relaxation of monetary policy in the European Union and the management of the slowdown in activity in China (see section 2 for more details).

In any case, despite the fact that we expect greater monetary easing in Europe, and do not expect further significant moderation in China, we believe that the effect of monetary contraction by the Fed will predominate, meaning that, overall, international financial conditions will be less comfortable for the region in 2015 than they have been in the recent past.

Nevertheless, the perception that economic activity is showing signs of recovery, combined with the view that the prices of some assets are already below equilibrium levels, tends to limit the room for additional corrections in the future.

## Commodity prices have experienced a strong downward adjustment in recent months in a context of increased supply and weak demand

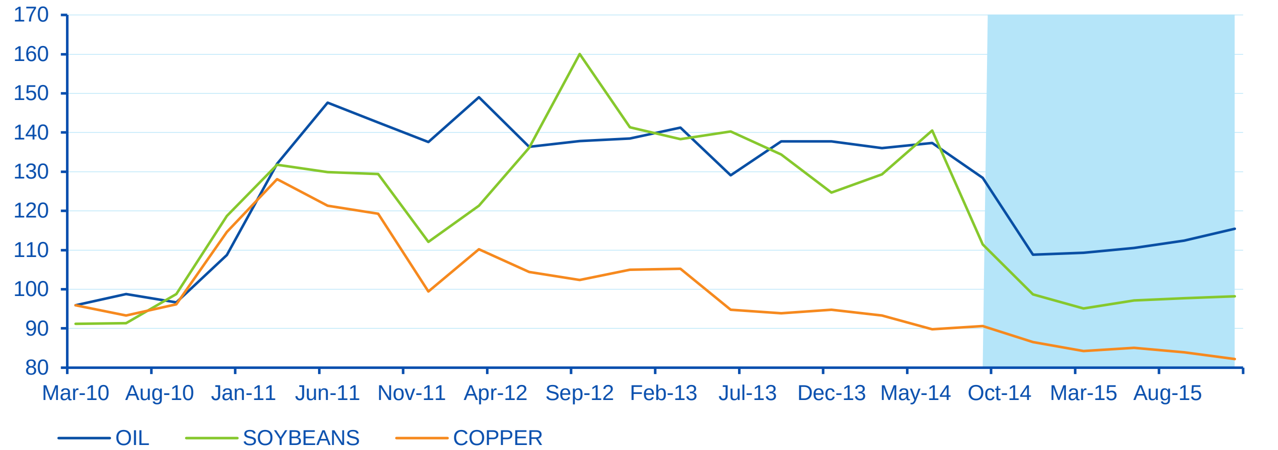
As we have already pointed out, another key factor when analysing the behaviour of assets in the region is the price of commodities. Thus, the recent corrections in Latin America's financial markets are also connected with the fall in the prices of some important commodities.

Though they remain at relatively high levels in historical terms, the current prices of copper, soybean and oil are at their lowest in recent years (Figure 3.7). Over the last three months, the prices of these commodities have seen a downward correction of 6%, 15% and 28% respectively.

In addition to a moderation in demand, the consequence in great measure of the slowdown in the Chinese economy (especially in investment, which is greater in metals and energy), the drop in the price of these products reflects the rise in the value of the dollar and an increase in supply. As regards this latter factor, we would note the exceptionally large soybean harvest in the US in 2013-14 and the forecast of good harvests in Brazil and Argentina. In the case of oil, there was an unexpected increase in output in Libya, coupled with an abundant supply of crude in the US, the latter coming from the development of non-conventional shale-oil reserves (see Box 3.1 for more details on the movement and outlook regarding the price of oil).

We expect further falls in the price of metals and soybeans in the short term. These falls will continue over the coming year in the case of copper, which will come close to the price we estimate to be its equilibrium level, while the soybean price will remain relatively stable, though still below its equilibrium level due to surplus supply, which will continue through to the coming year. On the other hand, the cost of producing oil will set a minimum price for crude at around the current level, following which we expect to see a gradual recovery to levels of around 100 dollars per barrel of Brent crude within two years. (Figure 3.7 and forecast tables at the end of this report).

Figure 3.7
**LatAm: Prices of main commodities (average index 2010 = 100)**

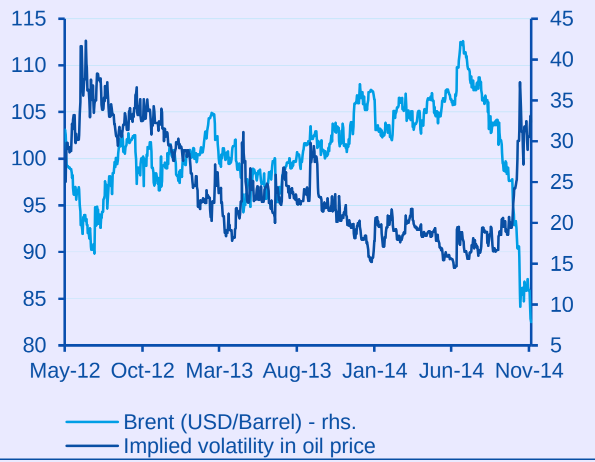



Source: BBVA Research

## Box 1. Recent movements and outlook on oil prices

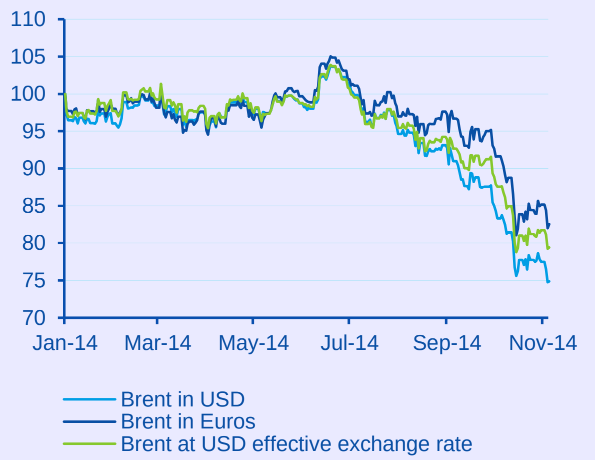
Oil prices have continued to fall since the middle of June this year, reaching a cumulative drop in price of 28% by the beginning of November (Figure B.1.1). In terms of magnitude and speed, this adjustment has only been surpassed in recent years by the fall in oil prices seen in 2008, following the start of the global financial crisis.

Figure B.1.1
**Price of Brent crude (USD/barrel) and implied volatility (OVX index)**




Source: BBVA Research and Haver Analytics

Figure B.1.2
**Price of Brent crude in various currencies (index January 2014=100)**




Source: BBVA Research and Bloomberg

**Which factors have caused the fall in oil prices in recent months?**

First, financial factors have played an important role. On the one hand, a higher dollar exchange rate (the currency in which the majority of commodities are quoted) usually tends to force prices down. However, this effect cannot explain anything beyond a fall of around 15% in the dollar price, since when measured in other currencies there has been a smaller but still substantial drop in the price of crude (Figure B.1.2). Increased volatility in the financial markets (Figure 2.1) has also contributed more recently to the drop in price, as it has with other financial assets.

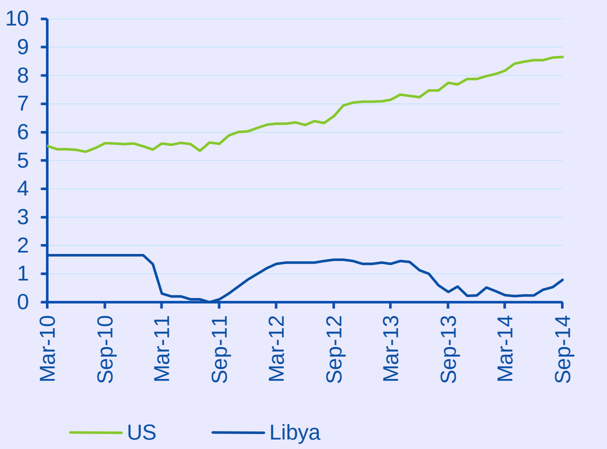
All in all, it has been supply and demand fundamentals (and expectations in this regard) that have had a marked effect on crude prices in recent months.

On the supply side, there has been a strong and, to a certain extent, unexpected increase in production. The main source has been the increased supply of non-conventional crude in the US over the past two years, which has outstripped expectations (Figure B.1.3). However, more recently there has been an increase in supply from certain countries in which geopolitical tensions have, rather surprisingly, failed to affect production. This is the case in Russia, Iraq and, in particular, Libya (Figure B.1.3). This has led to a considerable increase in the supply of crude in 2104, especially outside the OPEC nations, an increase that was not foreseen six months ago (Figure B.1.4).

This resurgence of supply comes on top of the forecasts for reduced growth in demand by the International Energy Agency (IEA), consistent with the downward review of forecasts for worldwide growth over the course of this year.

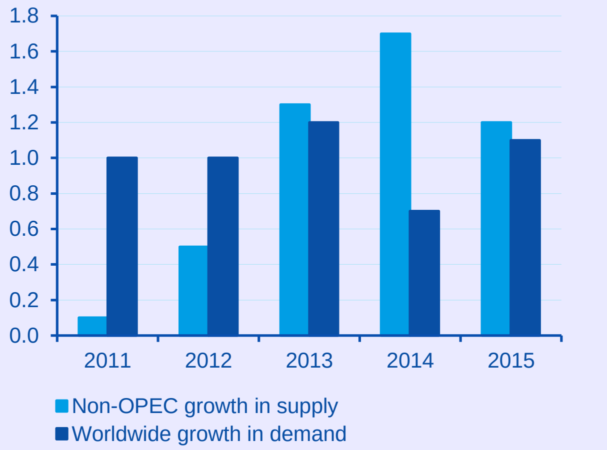
All of the above leaves an overview for 2014 in which the strong increase in production outside OPEC will vastly exceed the expected growth in demand (Figure B.1.4), thus reducing OPEC's ability to influence the price of crude.

Figure B.1.3
**Production of crude in the US and Libya (millions of barrels/day)**




Source: BBVA Research and Energy Information Administration (EIA)

Figure B.1.4
**Annual increase in non-OPEC production and worldwide demand for crude (mbd)**




Source: BBVA Research and IEA

As a result, uncertainty over the future movement of prices has also increased significantly, as demonstrated by the powerful increase in underlying volatility in oil price options (OVX index, Figure B.1.1), to an extent not seen since 2012, which at that time came in the middle of the profound uncertainty regarding the future of the European Monetary Union.

**How do current prices affect crude oil producers?**

This sharp fall in prices, and the prospect that it may persist, will remove incentives for new investment in the shale oil sector, which has been the main contributor to the increased supply of non-OPEC crude over the past four years.

Current prices still remain above (though very close to) the operational costs borne by established producers of non-conventional crude (shale oil, concentrated in the US). However, current prices will not be enough to cover the costs incurred by new operators who want to come into the market, and there will therefore be no justification for new investment in the shale oil sector. If one bears in mind that a shale oil well is drained faster than a conventional well (the rate of decline is more than 80% at the end of two years of operation, compared with 20% for a conventional well), a scenario of no new investment will mean the rapid levelling out or reduction of shale oil production in the US.

In addition, at current prices, the majority of OPEC members (including Saudi Arabia, the cartel's key producer) are unable to cover their public spending (which has expanded in recent years in order to placate the pressures exerted following the Arab spring) or pay off their external deficits. Although the majority of countries have sufficient reserves to maintain current prices for a prolonged period, this cannot be regarded as a balanced long-term position.

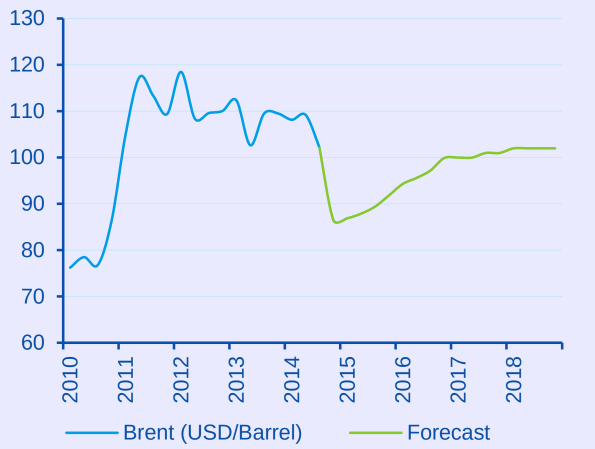
All in all, recent signs point to a lack of consensus within OPEC regarding an immediate cut in production at their meeting scheduled for the end of November this year.

**What can one expect of oil prices going forward?**

From the foregoing debate one may conclude that cost structures within the industry impose a lower limit on crude oil prices which, given the current technology, would be at around 80 dollars a barrel of Brent crude, which is the level at which prices seem to have stabilised over the last week of October and the first week of November.

Given all of the above, in the medium term, the aforementioned disincentives for investing in the shale oil sector should result in a smaller increase in non-OPEC supply and one that is more in line with the increase in global demand, which will accelerate with the recovery of worldwide growth. This is precisely what is expected from 2015 onwards (Figure B.1.4), which will mean that OPEC will regain a good proportion of the capacity to influence prices that it lost during 2014. Nevertheless, OPEC's likely failure to reach agreement on an immediate cut in production will mean that the increase in prices will be gradual, towards an equilibrium price that is not far off 100 dollars a barrel over the course of the next two years (Figure B.1.5).

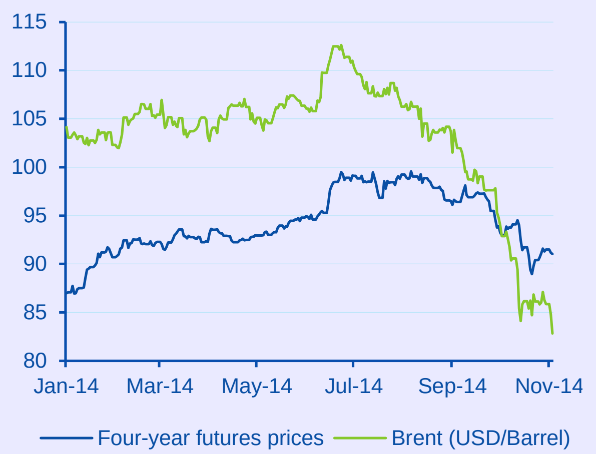
Figure B.1.5
**Forecast price of a barrel of Brent crude (USD)**




Source: BBVA Research and Bloomberg

In part, the markets will reflect this gradual return to equilibrium levels, similar to those seen prior to the recent fall. For example, it is interesting to note that, in recent months, variations in four-year futures prices have not been as substantial as those experienced by spot prices, coming in at levels of more than 90 dollars a barrel, similar to the prices seen at the start of 2014 (Figure B.1.6).

Figure B.1.6
**Dollar price of Brent crude: spot and four-year futures**



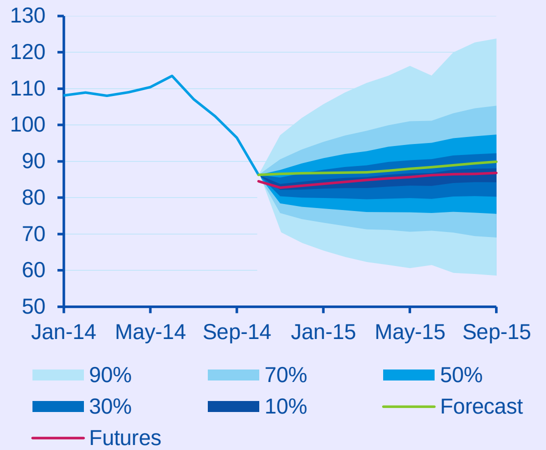

Source: BBVA Research

**Great uncertainty and balanced risk relating to our price forecasts**

One point that should be stressed is that these forecasts are subject to a great deal of uncertainty, more than usual, and this is reflected in the aforementioned increased volatility inherent in options contracts (OVX index). This therefore generates very broad confidence intervals as regards the path of futures contracts and our own forecast (Figure B.1.7).

Nevertheless, as Figure B.1.7 indicates, the risks attached to price forecasts are relatively balanced. On the one hand, there is the risk of an upturn in the prices shown in Figure B.1.5, due to the possibility that OPEC may reach an agreement to cut production by a million barrels a day at its meeting on 27 November 2014, an agreement that would cause the Brent crude price to return quickly to around 100 dollars a barrel. Another risk of an upturn in prices would come from a sharp (greater than expected) drop in investment in the shale oil sector due to reduced profitability. Finally, the surprising fact that has emerged in recent months has been that geopolitical tensions in important oil-producing areas have not translated into cuts in production.

Figure B.1.7
**Forecast for the price of Brent crude (USD) and confidence intervals***




* Confidence intervals obtained from options contracts on Brent crude as of 5 November 2014.
Source: BBVA Research

These risks of price rises are virtually offset by risks of a fall in prices. In the medium term, the risk of falling prices is centred around the possibility that an agreement may be reached to reduce or remove sanctions on Iran and that geopolitical tensions in other oil-producing areas may diminish. In the long term, the risk of downward pressure on prices centres around the possibility that technological advances will make it possible to draw on shale oil reserves profitably at less than 80 dollars a barrel.

# 4 Latin America will grow by 0.9% and 1.8% in 2014 and 2015, with high levels of heterogeneity

## Internal demand weakens in recent quarters, particularly as the result of a slowdown in consumption and investment

In recent quarters, there has been a clear moderation in domestic demand in the region: year-on-year growth fell from 2.4% in 2013 to 0.5% in the first half of 2014, falling further during the third quarter (Figure 4.1). It is important to remember that after the US recession in 2009, combined with the increase in commodity prices at the end of the 2000s and the beginning of the current decade, domestic demand was to a great extent the driver for the region's growth, with year-on-year variations in the order of 4%, while output was growing by just 2.5%. Such good times are now in the past, and 2014 has continually brought unpleasant surprises in terms of activity data, with negative supply shocks predominating, though moderation towards the middle of the year was also clearly caused by a fall in domestic demand. Supply-side factors have conditioned and delayed some key industrial projects and thus generated bottlenecks and, as we shall explain in detail below, there is some evidence that inefficiencies in the implementation of public investment have also delayed important infrastructure projects. On the whole, it would nevertheless seem probable that minimum levels of year-on-year variation were exceeded during the second quarter and that we could see higher growth figures from the third quarter onwards, driven in good measure by investment from both public and private sources.

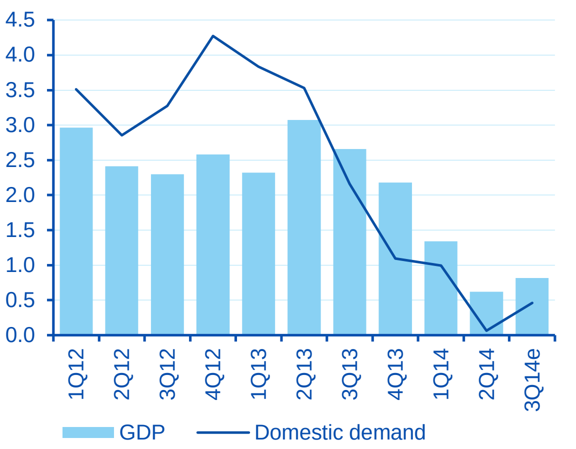
It is worth mentioning that the moderation and even fall in domestic demand was particularly significant in Argentina, Brazil and Chile, as well as, to a certain extent, in Peru. The first two of these countries have been particularly affected, with the adjustment intensifying over the course of the year, while domestic demand in Chile has shown almost zero growth in comparison with the previous year. In Peru, moderation has been widespread though the figures remain in positive territory. As regards Colombia, while this indicator has experienced some moderation there has still been growth in the order of 6% in comparison with 2013. In Uruguay the figure is 4% YoY. In Mexico and Paraguay, following a sharp downturn during the first half of the year, recent indicators point to a significant upturn during the third quarter (Figure 4.2).

This moderation in the growth of domestic demand has resulted from a combination of factors, the most important being increased uncertainty, which has led to a loss of confidence among both households and businesses, and cyclical moderations in key sectors, combined with negative supply shocks in an external context of moderation.

In the particular case of Argentina, the uncertainty attached to the resolution of the holdouts crisis generated warnings and insecurity among investors, a reaction that was also seen in relation to the elections in Brazil, where the situation was further exacerbated by problems relating to public policy management. In the case of Chile, uncertainty was linked to the announcement of tax reforms. This uncertainty led to more than a few players postponing their investment projects. In addition, we are seeing a cyclical downturn in the majority of countries (Chile, Brazil, Peru, Argentina), combined with the fact that businesses in countries like Brazil and, to a lesser extent, Chile and Mexico maintain high levels of leveraging (corporate debt stood at around 49% of GDP in the case of Brazil, which tops the list), a fact that translates into a reduced possibility of spending. Furthermore, the room for adopting counter-cyclical policies is limited in some countries. In the case of Mexico, tax reforms have meant changes to relative prices, while in Chile this has coincided with the end of the mining cycle, and both these situations have, to a certain extent, reduced the incentive for investment, something that we have also taken into account in our base scenario for Colombia for the coming year. Turning to Peru, the constant delays in bringing important projects such as the Toromocho mine into full operation have led to falls in mining output, along with mining operations in low productivity areas around

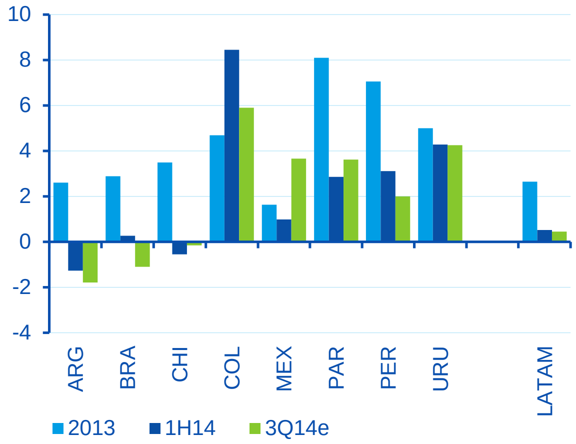
Antamina, one of the world's largest copper mines. This situation is set to continue well into 2015. On the cost side, we have also seen some delays in the implementation of budgets, particularly in Peru, Mexico, Chile and Paraguay, where full budget implementation is key to the kind of improvements forecast. In addition, it should be mentioned that the weakness of the labour market has also played an important role in the economies of countries like Mexico and Chile, where the quality of the new jobs being created tends to be low, thus suppressing overall salary levels. A similar situation can be found in countries with high levels of inflation (Argentina, Brazil and Uruguay), due to the impact on real salaries. This situation has already had an effect on the low levels of private consumption, which has tended to become widespread: so far in 2014, private consumption, which showed average growth of 3.6% across the region in 2013, has fallen to 1.6%.

Figure 4.1
**LatAm: Domestic demand and GDP (Var % YoY)**




Source: BBVA Research

Figure 4.2
**LatAm: Domestic demand (Var % YoY)**

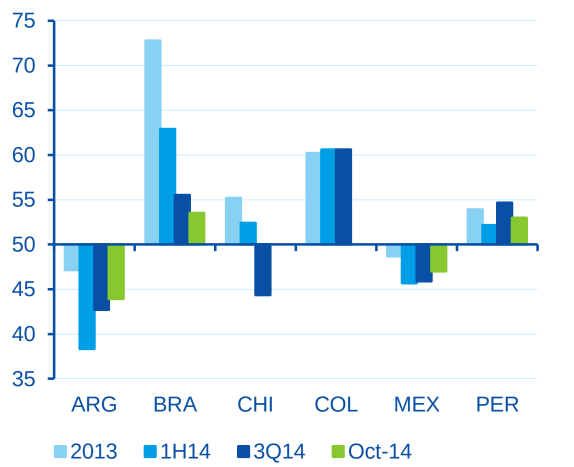



Source: BBVA Research

Confidence indicators in the region, which pointed towards a relatively optimistic outlook in 2013, have turned into negative views in the majority of countries. Attention is particularly focused on the drop in consumer confidence in Argentina, Brazil, Chile and Mexico (see Figure 4.3), where the key factor has been the fall in overall salaries, in terms of both the amounts earned (Chile) and as regards real salaries (Mexico, Argentina, Chile). It should be pointed out that in a number of these cases, Mexico and Chile in particular, but also to a lesser extent Peru, the apparently strong employment indicators (low unemployment rates, in the order of 5% in the first two countries and 6% in Chile and Peru) include levels of underemployment and employment in the informal economy (in the cases of Mexico and Peru) and self-employment in Chile. These rates are high and, in some cases, still growing, and they represent very low quality employment. In the case of Brazil, the strength of the employment figures, despite the slowdown, has more to do with the reduction in the supply of labour, and the moderation in confidence relates more to political uncertainties. Apart from Colombia and, to a lesser extent, Peru, the outlook in ordinary households is a pessimistic one.

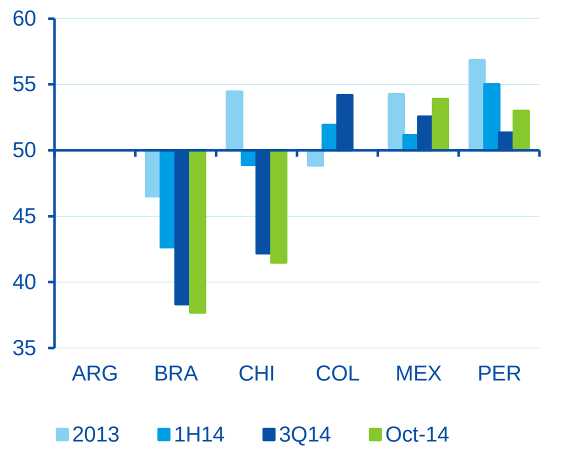
Confidence has also fallen as far as producers are concerned (Figure 4.4). Particularly notable are the cases of Brazil and Chile, where even the most recent data from October would seem to point to continuing pessimism. In the case of Brazil, as we mentioned earlier, pessimism has been linked to the electoral process, exacerbated by the issue of high interest rates, while producers and manufacturers in Chile have shown caution in respect of the regulatory framework that they will be facing in the forthcoming months. There are particular concerns regarding labour reforms, which could increase hiring and firing costs and restrict dismissals, a situation that the country shares with Brazil. Both economies have also experienced a clear moderation in the growth of credit in recent quarters. A contrasting situation of growing optimism has emerged in Colombia and Mexico, where the consolidation of growth in the US will be a key factor in increased investment and the growth of manufacturing. However, it should be mentioned that levels of violence and insecurity are, according to specialists consulted by the Bank of Mexico, the main hurdles to growth in the country.

Figure 4.3
**LatAm: Consumer confidence**




* Chile and Colombia available up to September.
Source: BBVA Research

Figure 4.4
**LatAm: Producer confidence**




* Colombia available up to September.
Source: BBVA Research

## Investment is the component that has shown the greatest slowdown, in part due to the under-execution of public investment in some countries

Investment is by far the demand-side component most responsible for the slowdown in activity in the region over recent months; this component contracted by around 2.3% year-on-year in the first half of the year, and our estimates indicate that it will continue to contract to -3.3% in the third quarter. It is worth mentioning that public investment is an important factor in this slowdown, particularly in Chile, Peru, Mexico and Paraguay. These countries show signs of problems in the areas of project saturation, high numbers of processes and insufficient personnel skills, all of which have combined to cause bottlenecks in the execution of certain investment projects.

Once again there is significant heterogeneity between countries (Figure 4.5), though levels of contraction have been particularly notable in Brazil, Chile and Peru, and there has been strong moderation in Argentina. At the other end of the scale we have Colombia and Uruguay, with growing levels of investment, and it is forecast that this component will see a sharp upturn in Mexico.

It is worth remembering that investment in infrastructure is key to our central scenario as a catalyst for future growth. Generally speaking, the region has resources and a regulatory framework that are favourable for the generation of important shared public-private works projects. According to estimates from the IMF, in a developed economy, an increase in public investment (either exclusively public or in a public-private partnership) equivalent to 1% of GDP translates into a 0.4% rise in product during the same year and up to 1.5% after four years. While the estimated effect is somewhat smaller in emerging economies (between 0.5% and 0.9% in the medium term), it has been confirmed that public investment is one of the key factors after increased productivity[1].

1: "Is it time for an infrastructure push? The macroeconomic effects of public investment": Chapter 3 of the World Economic Outlook, October 2014. Estimates among emerging economies vary according to the methodology adopted; there are three principal ones. The first examines episodes involving macroeconomic variables in the aftermath of increases in public investment, without estimating the causal effects; this approach suggests a multiplier of between 1 and 1.3 in the medium term. The second approach consists of estimating impacts on fiscal policy based on existing information and thus

Nevertheless, until now Brazil has headed up the list of countries in terms of contraction of levels of investment, both during the first part of 2014 and as regards expectations for the third quarter, mostly due to the sharp fall in confidence in the economy among business leaders. In the case of Chile, capital formation fell by 8% in real terms during the second quarter of the year, and we estimate that it will have contracted further during the third quarter (by around 4%). In this regard, the slow execution of public investment has played an important role, since the fall in investment in machinery and equipment has combined with the lower level of investment in construction, which is to a great extent linked to the slow execution of budgets.

For its part, investment in Peru has slowed, influenced in part by global phenomena (lower expected profitability due to falling commodity prices, the leveraging of large mining corporations and significant rises in energy and salary costs) and partly by more idiosyncratic factors (social unrest in the areas adjoining projects and bureaucratic obstacles to applications for exploration permits). In Mexico, the fall in investment has been marginal, though it represents a significant challenge in some sectors, notably construction, with delays of more than two years. In this regard it is worth remembering that the contribution to growth in GDP accounted for by public investment has been negative in twelve of the last thirteen quarters (taking account of year-on-year variations) and has meant a loss of 0.4 percentage points in growth during the first half of the year; this is despite the ambitious National Infrastructure Plan announced last June[2].

Colombia deserves a separate mention in all the indicators relating to domestic demand. Here the economy has experienced only a slight moderation, one that is line with its potential for growth, and the country has been characterised throughout the year by its maintenance of high levels of growth in activity, thus setting itself apart from the other Andean nations. Private consumption has led this expansion of domestic demand, which has grown by around 5.3%, slightly more than during last year. Expansion is based on a strong rise in employment, particularly in the formal jobs sector. For its part, investment grew at a year-on-year rate of 13.2% during the first part of the year, more than doubling the rate of growth seen during the previous year. In this case, investment in infrastructure has been a key factor and it is by far and away the highest in the region. Mention should be made in this regard of the ambitious “fourth generation” (4G) road infrastructure plan, which involves a historic amount of investment in the sector[3].

## Meanwhile, exports have not recovered

Turning to the external picture, the outlook is one of continuing moderation, which is in turn reflected in the fact that exports have not managed to recover, though it should be said that, as we previously mentioned, this is exacerbated in certain cases by supply-side factors (Colombia, Peru, Chile, Brazil), rather than a weakness in external demand (Figure 4.6).

Special mention should be made of the fall in commodity prices, particularly in the case of oil and soybeans, as mentioned in section 3. The lower prices of these two raw materials have translated into a fall in the value of exports for several countries in the region, notably Argentina, Colombia and Mexico.

Among the supply-side factors are issues such as lower mineral values in Peru, the closure of an important goldmine and the further postponement of the start-up of operations at the Toromocho mine. Mention should also be made of the pest- and climate-related problems affecting agricultural production (coffee and rice respectively). For its part, Colombia has particularly suffered negative supply shocks in its production of oil and coal. The case of Uruguay deserves separate mention, as the country has benefited from certain key products, such as beef exports, which have worked to offset the drop in the price of both soybeans (the commodity that remains the country’s main export) and wheat, a situation that we predict will have a

obtaining a series of exogenous shocks to public investment. The estimated effect in this case is between 0.25% in the short term, rising to 0.5% in the medium term Third, in low-income countries in which loans from international organisations finance a significant fraction of government spending, these loans are used as an instrumental variable in the measurement of flexibility; an effect estimated at around 1% in the medium term.

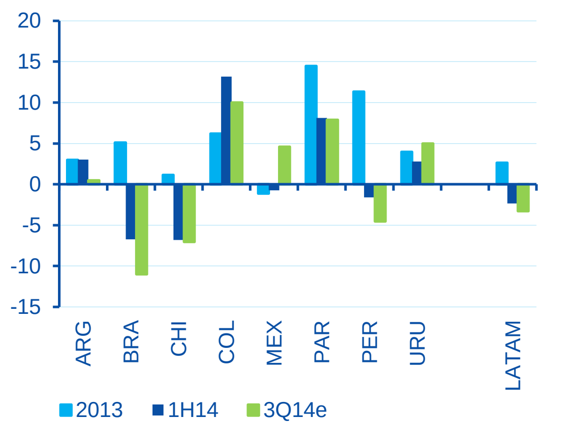
2: The most ambitious National Infrastructure Programme 2014-18. BBVA Research, June 2014

3: The 4G Plan includes around 30 publicised projects and will involve work being carried out on eight thousand kilometres of road with an investment of around USD25bn. See: Box 2, Colombia Outlook 3Q, fourth generation (4G) roads concession.

negative effect going into next year. In the case of Mexico, exports have continued to show growth. This is closely associated with the country's key sector, the automotive industry, as well as with other products such as domestic electrical appliances. It is worth remembering that around 80% of exports from Mexico are destined for the US, and that the country's geographical position and consumables costs represent its main competitive advantage.

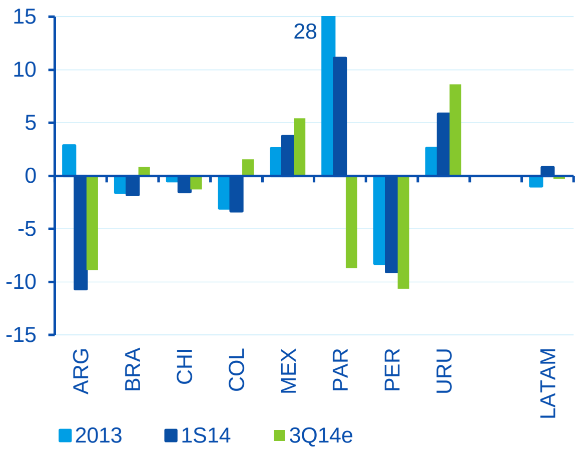
It should be said that the growth in non-traditional exports does not suggest that external moderation, though present, is the main problem affecting exports in the majority of countries. This moderation has, in general, had a secondary effect on the region, though one cannot discount the fact that its effects have been evident in, for example, the economies of Brazil and Argentina, which tend to feed off one another. In addition, the effects of moderating growth in China and the slow recovery in the US have not been inconsiderable, in the first case due to effects on the price of raw materials and, in the second, due to manufacturing demand, which had specific effects during the early months of the year.

Figure 4.5
**LatAm: investment (Var % YoY)**




Source: BBVA Research

Figure 4.6
**LatAm: exports Var % YoY (nominal amounts, in dollars)**




Source: BBVA Research

## Growth forecasts for Latin America in 2014 and 2015 have been revised downwards by 0.7%, due to an internal and external scenario that is less favourable than was expected three months ago

Given the internal and external demand factors mentioned above, it is easy to conclude that growth has seen an unexpected downturn in comparison with the variations published for the second quarter (which were in some cases accompanied by downward revisions of data previously published in the first quarter), a fact that has led us to make a further review of the growth expected for 2014 and 2015: this has fallen from growth of between 1.6% and 2.5%, to growth of just 0.9% in 2014 and 1.8% in 2015 (see Figure 4.7), except in the cases of Colombia and Uruguay mentioned above, where there has even been an unexpected upturn, and the case of Mexico, where the data observed has been in line with estimates and which was subject to an important review a month ago (from 3.5% to the current 2.5%).

As mentioned, although reviews have been made for almost all the countries in the region, particularly notable for their size in 2014 have been the cases of Peru (originally 4.1%, now 2.6%), Chile (originally 3.1%, now 1.9%), Brazil and Paraguay (the former originally 1.3% and now 0.2%, and the latter originally 4.9% and now 3.8%), while in Colombia and Mexico we maintain the estimated growth figure of three months ago (4.9% and 2.5%) and Uruguay's estimate has risen from 2.7% to 3.4%

In Peru and Chile, expected growth in 2014 displays a sharp moderation in comparison with the expansion seen in recent years: between 2010 and 2013, product grew by around 6.7% in Peru and 5.3% in Chile. This also involves a slow improvement in private consumption, with less expansion during the second quarter than in the first, with an acknowledgement that investment will be the lowest performing component: we estimate that the slowdown will be greater in Peru, while in the case of Chile improvement will only be seen towards the last quarter of the year, linked above all to the execution of the fiscal budget.

We would highlight the unexpected negative growth figures in Brazil. In addition to the revision made in the first quarter, it has now experienced falls over two consecutive quarters, which technically places the country in recession. Towards the third quarter, all the available indicators suggested that it would have come out of this phase, albeit only moderately (we refer to quarterly variation), more as a result of the sharp falls seen in previous months than being due to a genuine improvement or change of trend.

In the case of Paraguay, although it is expected that growth in 2014 will reach around 3.8%, almost one point below the initial projection, it is worth remembering that this expansion should be seen as a return to growth that is more in line with potential, following an extraordinary performance in 2013 (14.4%), and that the country has been affected by problems affecting the execution of investment and by a drop in demand from Argentina and Brazil.

For its part, Colombia will continue to see good growth in residential investment over the remainder of the year, particularly in infrastructure that will benefit from the efficient execution of public works projects, while consumption will tend to see a certain correction that is more in line with potential growth. As far as exports are concerned, these will tend to improve, and while it should be said that improvement will be slower than initially estimated, this will be offset by the growth in investment.

All in all, we can say that although the worst of the period of moderation in the region is behind us, the extent of the surprises seen during the first part of the year, coupled with the expected speed of the recovery, particularly in terms of internal demand, will not be sufficient to achieve the levels of growth forecast three months ago. In this regard, we should mention the extent to which countercyclical policies have been applied, which in the majority of cases has been scant.

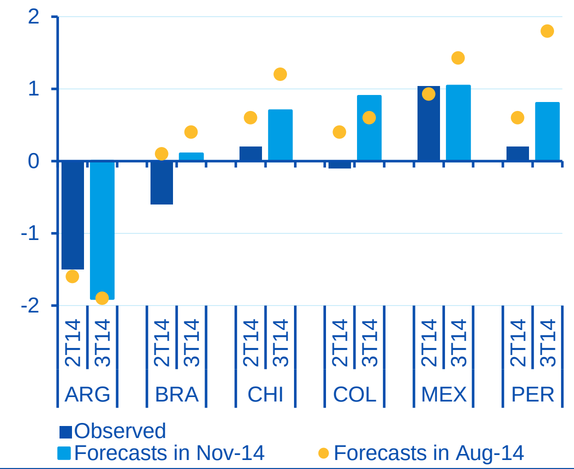
Into 2015, a key consideration in the external arena will be that, although expectations of growth in the Chinese economy have not changed, there have been changes in the composition of that growth: greater private consumption and less investment, which will have a negative effect on the region. To this, one should add the expected effects of the gradual withdrawal of quantitative easing in the US and with it the expected rise in interest rates. Despite the factors taken into consideration in our basic scenario, we still anticipate increased growth in the region, from the slump seen in 2014 to levels that are more in line with potential as we approach 2016: key factors in this regard will be, on the one hand, a boost in public investment and, on the other, the consolidation of worldwide growth against a background of lower exchange rates which will provide a stimulus for the export sector (see Figure 4.8).

The size of the correction to growth, both as the result of surprises during the first part of the year and due to the poorer prospect of recovery in the future will also involve a correction going into 2015, and this will be particularly important in the cases of Chile and Peru (from an estimate of 4.3% last quarter to a current estimate of 3.1% in the case of Chile, and from 5.9% to 4.8% in the case of Peru). Brazil and Paraguay have also seen a downward adjustment, though to a much lesser degree (3% and 1% respectively), while our prognosis for the other countries in the region remains unchanged.

It should be mentioned that, in Chile, the budget published by the government provides for significant growth (around 9.8%) in the budget for 2015, in which the priority areas are education, health and social welfare. The basic scenario takes account of a significant increase in public investment, and the negative risk in this regard would come from further delays in executing the budget. In Peru, activity in 2015 will benefit from factors such as an upturn in mining in the Antamina and Toromocho projects and the concessions recently awarded for various infrastructure projects. Brazil, on the other hand, is facing a scenario in which the recovery of activity will be slow: whatever the result of the elections, it is likely that the country will see a fiscal and monetary adjustment that will leave little room for countercyclical policies. Looking ahead to 2015 in Paraguay, the continuing slow rate of growth recorded in neighbouring Argentina and Brazil, the country's main trading partners, will mean that its own growth will be somewhat more moderate than in past years. However, notable in this case will be the growth in investment, and the driver of growth will therefore be internal demand.

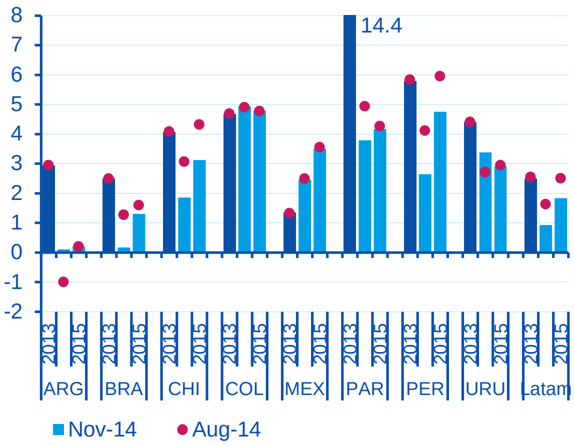
In the case of Colombia, it is worth mentioning that the outlook includes something of a moderation in investment, particularly private investment, due to the tax reforms currently going through Parliament, given that these will involve a higher tax burden for large businesses.

Figure 4.7
**LatAm: GDP growth % QoQ, expected vs. observed**




Source: BBVA Research

Figure 4.8
**LatAm: GDP growth Var % YoY**




Source: BBVA Research

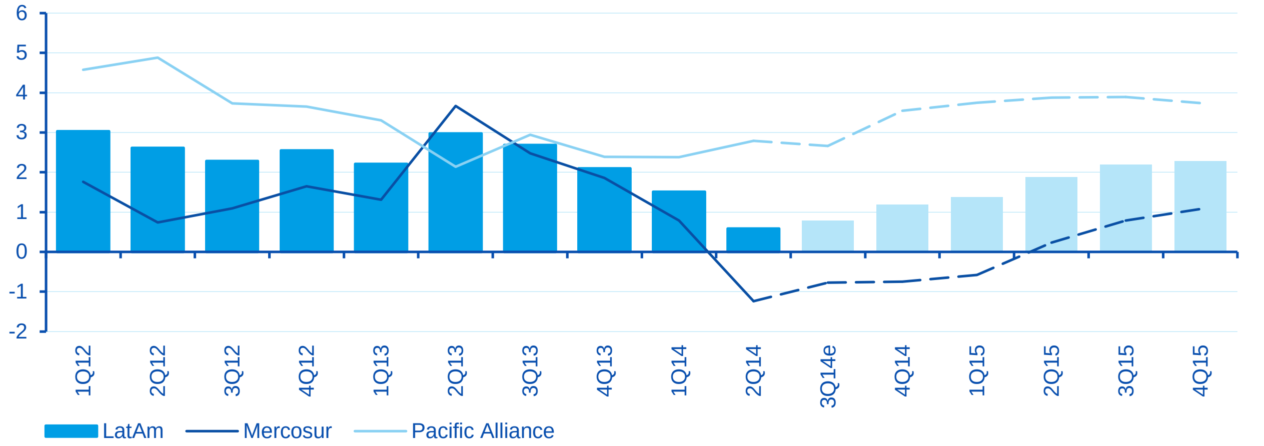
Finally, in Mexico we predict that the widespread achievement of growth in manufacturing will depend on the extent to which recovery in the US is consolidated, while the process to formalise employment continues and, with it, growth in real salaries. The outlook is also based on the fact that the recently approved structural reforms, notably the reform of the energy sector, will have to begin producing results towards the second half of 2015. Nevertheless, it is worth recalling that despite the ambitious package of reforms approved, the attainable benefits could be limited unless efforts are made to strengthen institutions and reinforce the rule of law, which would also mean working towards generating greater competition in a number of markets and seriously combatting corruption and the lack of security.

## The countries of the Pacific Alliance will continue to be the most dynamic, with growth figures in excess of the average for the region in 2014 and 2015

All in all, the economies making up the Pacific Alliance bloc will continue to achieve notable growth, in contrast to the Mercosur countries. We estimate that growth among the first group of countries will reach 2.8% and 3.8% respectively in 2014 and 2015; three-tenths of a per cent lower than estimated three months ago. For its part, the Mercosur bloc will contract by around 0.5% in 2014 and grow by 0.4% in 2015, almost one percentage point less than estimated three months ago.

Colombia, Peru and Paraguay will be the economies that show most growth in the region: particularly notable is the speed of recovery in the cases of Peru and Chile, with growth of a little above 2% in the former and an increase of 1.3% in 2015 over 2014, a reflection of their good economic fundamentals. Thus, the Andean countries once again stand out for their use of orthodox policies to achieve strength in the fundamental areas that have provided their economies with greater robustness.

Figure 4.9
**LatAm: GDP growth (% YoY)**




Source: BBVA Research

# 5 The central banks are showing a looser approach than three months ago, except in the case of Brazil

## The weakness of the economic cycle eases the pressure on inflation, though it remains at, and at times above, the upper limits of the target range set by the central banks as the result of supply factors

The moderation of economic activity and the slowdown in prices of the main commodities has helped to keep inflation under control in most of the countries in the region. Nevertheless, the recent depreciation in exchange rates, combined with other idiosyncratic factors, has prevented inflation from hitting the target set by the region's different central banks, except in Paraguay, where inflation is currently running slightly below the target rate of 5% (Figure 5.1).

Despite the fact that economic activity in Colombia has not slowed to the extent seen in other countries in the region, inflation still remains close to the central target of 3%, benefited to a certain degree by minor pressures on food prices.

In Brazil, Mexico, Chile and Peru, inflation has risen over recent months and is currently slightly above the ceilings of the respective target ranges (6.5% in Brazil, 4.0% in Mexico and Chile and 3% in Peru). In Brazil, recent pressure has come mainly from administered prices, given the small amount of fiscal room available to maintain the subsidies and controls announced in the past, and given the impact of the depreciation of exchange rates on some tradable goods. Prices in both Mexico and Chile suffered a negative impact due to the changes in tax rates implemented over the course of the first half of the year. In addition, rising inflation in Chile in recent months was also the consequence of a weakening of the country's currency. As in other countries, the pressures that recently caused inflation to rise above the target range in Peru were related more to issues of supply than demand.

Finally, inflation in Uruguay remained above the 7% target ceiling, despite the downward trend observed since the beginning of the year, when VAT was reduced on some basic staple products and certain public companies saw their rates reduced, mainly in the electricity and telecommunications sectors.

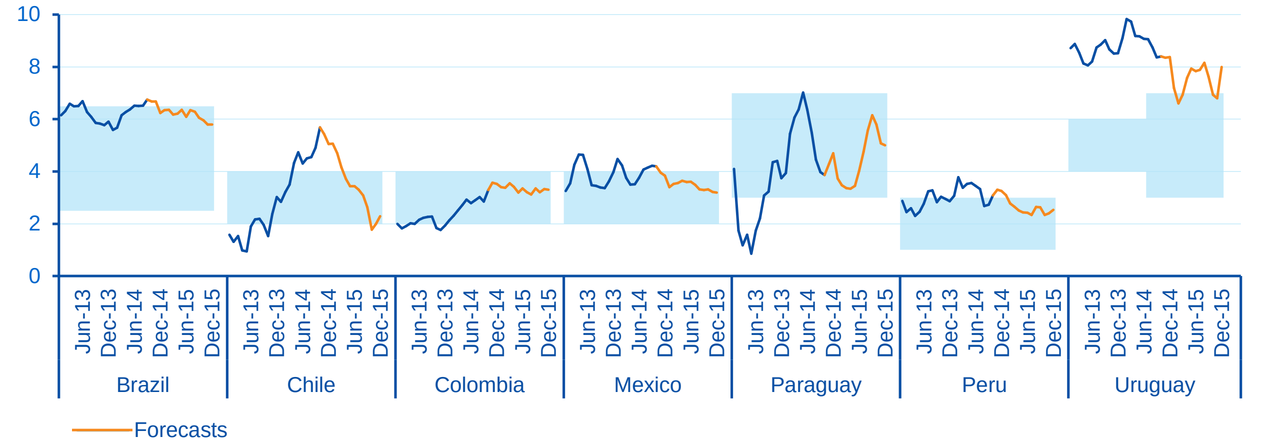
## Inflation in 2015 will remain within the meta limits set by the central banks, except in Uruguay

Despite the different starting points, rates on inflation should meet central bank targets over the coming months, with the main exception of Uruguay, where inflation should remain around 8%, above the top end of the target rate, which was recently raised to 7% (Figure 5.1).

This convergence on the target rate should be particularly marked in Chile, where inflation should end 2015 at 2.3%, towards the low end of the target range, after hitting a forecast 5.1% in December 2014. Both the moderation in activity, which in both years will grow below its potential, and a certain appreciation in the exchange rate during 2015, will be the main determining factors in this expected slowdown.

The slower rate of economic growth will also contribute to the continuing moderation of inflation in Peru, from the 3.3% figure projected for the end of this year to 2.5% at the end of 2015. The expected depreciation in the exchange rate will be offset by the fall in some important imported consumables, such as food and oil.

Figure 5.1
**LatAm: Inflation (% YoY) and central bank target ranges**




Source: BBVA Research

In Mexico, there will be a drop in inflation, despite the projected upturn in activity, in great part due to the fact that, during the coming year, the effects of tax reforms will fade, telecommunications prices will be beneficially affected by recent reforms in the sector and oil price adjustments will not be as sharp as in previous years. In addition, there are signs that there will be less pressure on agricultural and livestock prices in the short term. Inflation should therefore end the year at 3.8%, falling to 3.2% by the end of 2015.

While inflation will tend to fall in the other three countries in the Pacific Alliance from the end of this year, the view is that it will stabilise in Colombia, which is not necessarily a bad thing, given that inflation in the country is currently closer to the central target set by the monetary authorities. The forecast is that inflation will reach 3.5% and 3.3% by the end of 2014 and 2015 respectively. These estimates already take account of the lower likelihood of the occurrence of the El Niño phenomenon, which will result in a scenario that is more favourable to food prices.

Price dynamics in Brazil will be less benign than in the Pacific Alliance countries. Inflation should soon return to the broad range (2.5-6.5%), though it will not fall to levels that are significantly lower than 6% due to continuing pressure from administered prices and the effects of depreciation in the exchange rate on tradable goods In short, it should end 2014 at 6.2% and 2015 at 5.8%. For its part, Argentina will continue to see high rates of inflation in 2014 and 2015.

In comparison with our forecasts of three months ago, inflation projections for the end of 2015 have been reduced in the four Pacific Alliance countries (Chile: -0.7%, Mexico: -0.3%, Peru: -0.2% and Colombia: -0.1%). In the other Mercosur countries, the forecasts for Argentina and Uruguay have been adjusted upwards, while the forecasts for Brazil and Paraguay remain unchanged.

## The central banks are showing a looser approach than three months ago, except in the case of Brazil. Upward pressure on official interest rates is expected in 2015

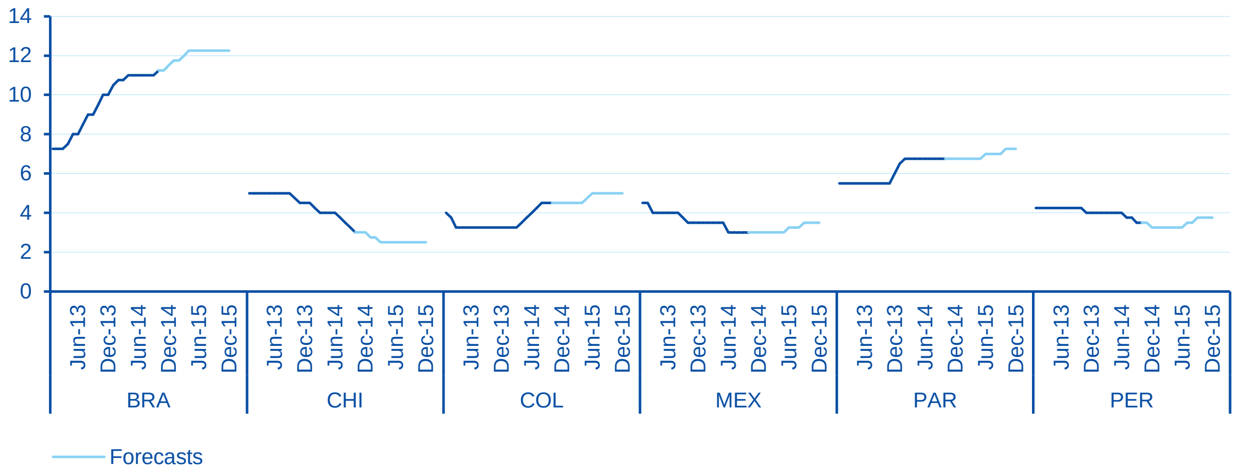
Over recent months, the gradual relaxation of monetary conditions has continued in Chile and the same process has been initiated in Peru, due in both cases to the moderation of domestic demand and the relative stability of long-term expectations. Monetary policy rates currently stand at 3% in the case of Chile and at 3.5% in Peru, in comparison with 4.5% and 4.0% respectively at the beginning of the year (Figure 5.2).

In Mexico, interest rates have remained at 3% in recent months, following the cut announced at the end of the first half of this year.

A different approach has recently been observed in Colombia, where the Bank of the Republic raised official interest rates to 4.5%, which is still below the level regarded as neutral, given the greater pressures on demand in comparison with other countries in the region. In any case, the accommodative tone in Colombia is now more obvious than before. It is therefore likely that the upward adjustment expected in the coming year, against a background of robust internal growth and the normalisation of monetary policy in the US, will be around 50 basis points, rather than the 75bp previously expected. As a result, official interest rates will end 2015 at 5.0%, with the likelihood that there will not be any increase in the event of a deterioration of external conditions (terms of trade).

Our current forecasts for other countries in the region also reflect this accommodative bias. We are therefore expecting two further cuts of 25bp in Chile, which would bring the monetary policy rate down to 2.5% by the beginning of 2015, a level that would then remain unchanged through to the end of the year. In Peru we also expect the downward cycle to continue in the coming months, with an additional cut of 25bp, bringing rates to 3.25%, a level that will be maintained until pressures associated with the rise in rates by the Fed cause interest rates to rise to 3.75% during the second half of 2015.

Figure 5.2
**LatAm: Monetary Policy Rate (%)**




Source: BBVA Research

The great exception to this looser approach is Brazil, where the monetary authorities unexpectedly raised interest rates by 25bp in October, with a further rise expected in December, which would bring interest rates to 11.50%. Despite the fact that, in this case, the tone of monetary policy has been stricter than expected, the moderation of activity continued to affect monetary decisions. In short, this has resulted in a reduction in bank reserves and capital requirements with a view to speeding up credit (for a review and discussion of the adoption of macroprudential measures in the region, see Box 5.1). In any case, the upward adjustment in interest rates should continue through the beginning of 2015, until SELIC rates reach 12.25%.

The outlook regarding the short-term stability of interest rates in Mexico remains unchanged. It is only in the second quarter of the coming year that Banxico should take a more aggressive stance and begin to raise reference rates. We forecast that they will end 2015 at 3.5%, following a cumulative adjustment of 50bp.

It is therefore expected in 2015 that local pressures resulting from the normalisation of monetary policy in the US will significantly contribute to the introduction of new cycles involving the hardening of monetary conditions in virtually all countries in the region, including Paraguay, where after a long period of rates remaining stable at 6.75%, an adjustment of 50bp is expected. In addition, in some cases, the relative weakness of activity will reduce upward pressures on interest rates (see Box 2 for more details).

## Exchange rates will weaken across the region in 2015 with highly heterogeneous effects, driven by the rise in interest rates from the Fed and lower commodity prices

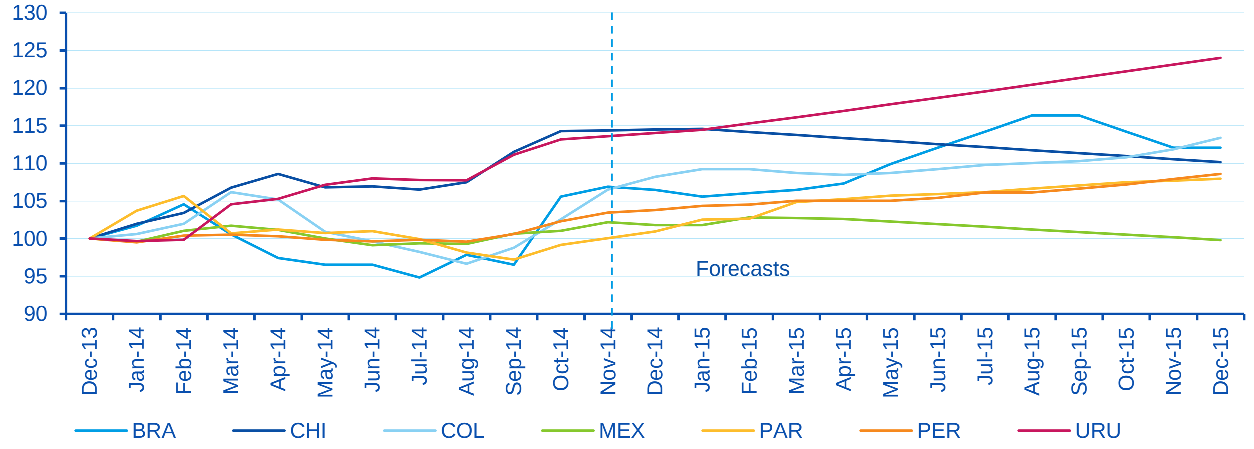
As mentioned in chapter 3, exchange rates have generally weakened throughout all the countries in the region in recent months, as a consequence of the greater strength of the dollar on the global markets and the deterioration of the terms of trade caused by the drop in commodity prices (Figure 5.3).

Looking ahead, lower levels of global liquidity, commodity price dynamics and current account deficits that remain high will maintain the downward pressure on exchange rates in the region. This pressure will be relatively light in the case of the three Andean countries, where it is expected that the exchange rate by the end of 2014 will remain close to the levels seen recently. In comparison with the value that we expect to see at the end of 2014, the exchange rate at the end of 2014 should depreciate somewhat in Peru and Colombia (4.5% and 4.8% respectively) and even appreciate (4.0%) in Chile. These forecasts are supported by the expected relative robustness of domestic demand in these countries at the end of the coming year. In addition, in the case of Chile, the potential sale of dollars by the treasury to support promised spending in the face of lower effective earnings would support forecasts of appreciation during the coming year.

In the same way as in the Andean nations, pressures associated with the normalisation of exchange rates in Mexico will tend to be weaker due to the positive effects that the recovery of US activity will have on the country, effects that will be felt more by Mexico than other countries in the region. The exchange rate should therefore end 2014 at 13.3 pesos to the dollar and reach 13.0 by the end of 2015.

A stronger depreciation is expected in the currencies of Brazil and Uruguay, which should not be surprising considering that, as in Argentina, inflation is significantly higher in these two countries. In addition, the sharp fall in Brazil’s competitiveness will require a depreciation in the exchange rate in order for economic activity to make a gradual recovery via more positive efforts in the area of exports. We expect the Brazilian real to end 2014 at 2.45 (a forecast that takes account of the limited but positive impact of the lessening of political uncertainty following the elections), reaching 2.6 in December 2015. In Uruguay, the forecast is for exchange rates of 24.40 at the end of 2014 and 26.60 at the end of 2015.

Figure 5.3
**LatAm: Exchange Rate, January Index 2012 = 100**




Source: BBVA Research

## Box 2. The use of macroprudential policies in Latin America: which ones, how and why

The Latin American countries have gradually adopted a series of macroprudential measures over recent years in order to reduce financial and macroeconomic risk in an environment in which robust domestic growth and excess liquidity in the world markets have brought pressure to bear on asset prices in the region, as well as on variable income and fixed income prices, exchange rates, etc. As well as being a reaction against external and internal turbulence, the growing use of macroprudential policies has also resulted from the fact that new regulatory recommendations have been adopted in the region, in line with the recent changes in the macroprudential framework at a global level. Finally, the interventionist bias displayed by regulators in some countries in the region has also had an influence on the frenzy that has recently been unleashed in the macroprudential arena. In short, the macro-financial environment, the updating of regulatory recommendations at a global level and, in some territories, interventionist tendencies, have been the three main and highly inter-connected factors that have shaped the adoption of macroprudential policies in Latin America. As we shall see, the importance of each of these three factors changes considerably from country to country.

Table 1 shows that the Latin American countries have used a series of macroprudential tools, divided into three groups, to facilitate analysis: “credit-related”, “liquidity-related” and “capital-related”. It also shows that there is notable heterogeneity between the different countries, both in terms of frequency and intensity and as regards the specific instruments used.

According to the information that we have collected on the main countries in Latin America, Brazil is the country in which macroprudential policies have been used with greater frequency and intensity. In our opinion, this is due to the fact that the three main factors involved in the adoption of macroprudential measures, as described above, are all applicable to the case of Brazil. Put another way, the use of this kind of policy in this case is due to i) the need to react in the face of both global and internal turbulence and manage financial and macroeconomic risk, together with the risks associated with a sharp appreciation in exchange rates, excess capital inflows, etc.; ii) the decision to implement the new set of regulatory recommendations developed at a world level, principally the Basle regulations, internally; and iii) the interventionist bias of the country’s internal regulators.

The main tools used in Brazil include reserve requirements. In recent years, these requirements have been frequently changed. They were reduced, for example, when the country was struck by the 2008-09 crisis, and more recently in the middle of 2014, as the result of the monetary authorities’ concerns about an excess moderation in local credit markets (i.e. as the result of factor i according to the structure followed in this report). Bank reserve requirements have also been used in a recurrent way because, despite the recently announced reductions, highly significant levels of bank reserves are held by the central bank (around 7% of GDP and more than 20% of deposits with financial institutions), and these therefore represent a powerful instrument for the management of internal liquidity levels. In addition to reserve requirements, the rules relating to currency mismatches and financial positions held in foreign currencies have frequently changed in recent times, in line with pressures on the Brazilian real (factor i), though also in line with the interventionist tone of the regulatory authorities (factor iii). Finally, the capital requirements driven by factors (i, ii and iii), combined with the minimum requirements to lend to certain sectors, driven by factor iii) and by factor ii), have also played an important part.

In Argentina, macroprudential policies have also set out certain minimum requirements for lending to specific sectors, such as investment projects and micro, small and medium-sized businesses. In addition, in contrast to the majority of countries in the region, it is compulsory for Argentinian banks to have an additional capital cushion of 75% over and above normal capital requirements, in order to be allowed to distribute dividends[4]. These measures have been supplemented by limits on foreign currency loans and the holding of net foreign assets by banks. Some macroprudential measures have also been driven by the need to manage financial and macroeconomic risk. In this regard we would make particular mention of bank reserve requirements. Finally, it is worth pointing out that Argentina is currently taking steps towards implementing the Basel III agreements, which will give shape to future macroprudential policies, especially those relating to capital requirements. Capital regulation in line with Basel III has already been implemented, though regulation on liquidity and leveraging will be announced shortly.

The need to manage macroeconomic and financial policies and reduce the pressures created by strong domestic growth and surplus global liquidity was probably the main factor taken into consideration when shaping the macroprudential agenda in the Andean countries (Chile, Colombia and Peru), Uruguay and Paraguay. Although the adoption of best world practices when defining internal macroprudential policies was, generally speaking, an important issue, particularly in Peru and Colombia, where the Basel III regulations on capital and liquidity are being adopted, not all countries have announced that they will be following the recommendations of the Basel III agreements.

In these countries, activism in the macroprudential arena has been less intense than in Brazil and Argentina. In the cases of Peru and Paraguay it is virtually non-existent, though in Peru and, to a lesser extent, Colombia and Uruguay, it is a little stronger. As regards Peru, regulators have concentrated on managing liquidity conditions through the use of bank reserve requirements and the establishment of counter-cyclical capital requirements. In Colombia, attention has been focused on adjusting capital requirements and limiting the degree to which banks are exposed[5]. It should be pointed out that, as well as using reserve requirements as an important liquidity management tool, the regulatory authorities in Uruguay and Paraguay have concentrated on capital-related measures, such as adjustments and capital and reserve requirements. In Chile, where the role played by macroprudential policies remains limited, the focus has been placed on policies relating to liquidity.

Finally, the macroprudential agenda in Mexico is marked above all by the implementation of the recommendations recommended on a worldwide level. In this regard, attention has been focused on the adoption of capital and liquidity requirements that are in line with Basel III, and on the implementation of institutional and governance structures for the supervision and management of systemic risk.

4: The other three countries in Latin America that place limits on the distribution of profits are Brazil, Mexico and Peru. However, in Brazil and Mexico this only occurs in exceptional circumstances, while in Peru there is a ceiling but no floor: financial institutions have to distribute at least 5% of their profits among the workers.

5: All the countries in the region, with the exception of Chile, limit the degree of banking exposure in some way (see Box B.2.1).

Regulation in Mexico has also been driven by the updating of the first framework introduced following the Tequila crisis in 1995; changes have recently been introduced in the rules on the writing down of credit (the country has abandoned a framework of underwritten losses for one based on forecast losses), and the rules governing loan-related matters (and loans to dominant parties), to mention just two issues. These interventions have had major repercussions, given the importance of banking credit within the financial system as a whole.

Another important aspect of macroprudential policy has been the establishment of a Financial System Stability Council[6], conceived as a "space" for the exchange of information between all the authorities charged with financial supervision. The purpose of this Council is to identify systemic risks in good time and coordinate measures to tackle them in accordance with the powers and responsibilities of each of its members. The Council is responsible for preparing an annual report on the country's financial stability and the actions it has taken. The most recent financial reform allows for the exchange of information between the authorities, both in the context of the Council and individually, thus creating a basis that will allow for effective monitoring of systemic risk.

In comparison with other countries in Latin America, recent economic growth in Mexico has not been especially strong, nor has it been driven by the global commodities boom; furthermore, worldwide surplus liquidity has not had a significant impact on its assets and domestic credit markets, as the inflow of foreign capital has not been channelled through the banking system. These circumstances have given rise to some concerns about the overheating of the economy, bubbles and potential exchange rate misalignments, concerns which would seem, in turn, to have encouraged the use of a variety of macroprudential tools in the rest of the region.

Finally, the non-interventionist approach by the regulatory authorities in Mexico has contributed to the comparatively less extensive use of macroprudential policies with one singular characteristic: they have opted to choose when to intervene, establishing a system of incentives instead of imposing limits and quotas.

## Conclusion

In line with what had been happening in the developed countries and in other emerging regions, the regulatory authorities in Latin America have gradually added increasing numbers of macroprudential policies to their toolbox. Nevertheless, as we pointed out earlier, there is a high level of heterogeneity between the different countries in the region, as the impact of both global and regional turbulence changes considerably from country to country. International regulations, mainly Basel III, have been adopted at different speeds, and local regulators display differing preferences as regards levels of intervention and the willingness to use macroprudential policies as a substitute for the traditional instruments of monetary policy. It is worth mentioning that, in the case of Latin America, the central banks have not proposed the use of monetary policy for macroprudential ends. We believe that this is a positive factor, bearing in mind the inflationary past of the majority of countries in the region. Furthermore, it is important to stress that macroprudential policies in Latin America have been focused on both capital and liquidity and, to a lesser extent, the credit markets, which does not mean that the regulatory authorities have not tackled the risks associated with the excessive growth of credit in recent years. Looking ahead, it is predicted that macroprudential regulation will continue to be an important alternative policy in the majority of Latin American countries over the coming years.

6: Previously known as the Financial Stability Council (established by presidential decree in 2010), the Financial System Stability Council was relaunched in the financial reforms of 2014. It comprises the Secretary of the Tax Office, the Governor of the Bank of Mexico, the chairmen of the Banking and Stock Market Commission, the Pensions Fund and the Insurance and Guarantees Commission, and the Director of the Institute for the Protection of Bank Savings.

Table B.2.1

**Macroprudential policies in Latin America: instruments used and prioritised by the regulatory authorities***

| | ARG | BRA | CHI | COL | MEX | PAR | PER | URU |
|---|---|---|---|---|---|---|---|---|
| **Credit-related** | | | | | | | | |
| Limits on exposure to the real estate sector | | | | | | | | |
| Limits on exposure to other sectors | X | | | | | | | X |
| Concentrated exposure limits | X | X | | X | X | X | X | X |
| Specific quotas for private sector loans | X | X | | | | | X | |
| Upper limit on the ratio between loan amount and asset value | | X | X | X | | | | |
| Upper limit on the ratio between debt or loan and income | | | | X | | | X | |
| Limits on the proportion of loans over deposits | X | | | | | | | |
| Ceiling on credit or growth of credit | | | | | | | | |
| Limits on loans in foreign currency | X | | | | | | | |
| **Liquidity-related** | | | | | | | | |
| Active use of reserve requirements on deposits | X | X | | | | X | X | X |
| Liquidity requirements | X | X | X | X | X | | X | X |
| Limits on the misalignment between net open currency positions and the currency | X | X | X | X | X | X | X | X |
| Limits on time period misalignments | | X | X | X | X | | X | X |
| **Capital-related** | | | | | | | | |
| Counter-cyclical capital requirements | | | | | | | X | |
| Time-varying/dynamic provisioning | | | | X | | X | X | X |
| Limits on profit distribution | X | X | | | X | | | |
| Capital and leverage ratios | X | X | X | X | X | X | X | X |

* The relevant box is marked with an "X" when the regulatory authority uses the instrument, and the box is shaded in grey when the regulatory authority has developed or used the measure more frequently.
Source: BBVA Research

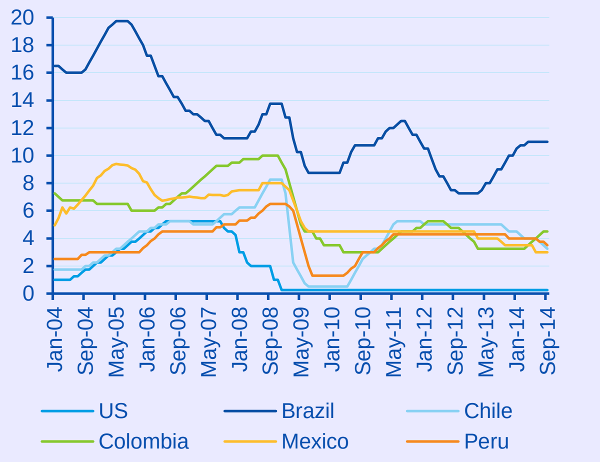
# Box 3: The Taylor rules and short-term equilibrium interest rates in Latin America

Since the year 2000, monetary policy in Latin America has to a great extent come down to an "inflation targeting" policy, characterised by the setting of a medium or long-term inflation target. Despite the fact that there have so far been few monetary cycles under these rules, they have been in operation long enough for one to attempt to provide an empirical description of the way that the monetary authorities currently behave in the face of different kinds of pressure (Figure B.3.1).

**Empirical estimate of the Taylor rules for Latin America**

Extending the traditional framework of the Taylor rules (Clarida et al., 1998[7]), we constructed linear rules to explain the official interest rates at five of the region's central banks that had set inflation targets: Brazil, Chile, Colombia, Mexico and Peru. Under these rules, interest rates respond to three macroeconomic variables: the divergence in activity (in relation to long-term production), the divergence in expectations of inflation (in relation to the inflation target) and the divergence in the US dollar exchange rate (in relation to the long-term equilibrium rate). Following the standard methodology for this type of exercise, we have included a delay in the official interest rate: in other words, we have assumed that the monetary authorities do not automatically adjust the interest rate dictated by such divergence but do this only partially, taking account of the level at which the rate currently stands. This gradualist approach to monetary policy therefore gives rise to two important parameters: a short-term equilibrium interest rate, which we will discuss in a moment and an "effective" interest rate or "partial adjustment".

Figure B.3.1
**Reference interest rates in the US, Brazil, Chile, Colombia, Mexico and Peru**




Source: Bloomberg

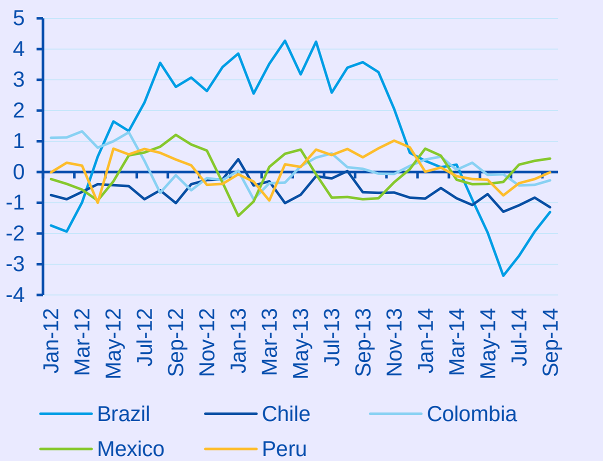
### The models support the recent relatively lax approach by central banks in Latin America, except in Mexico

Figure B.3.2 shows a monetary policy graph for the five Latin American countries mentioned above. This graph provides a picture of the divergence between the estimated short-term interest rate and the actual interest rate for each country. A positive number therefore indicates pressure to raise interest rates, while a negative number indicates pressure to lower them. It is clear that, according to our model, there is still pressure on Chile to continue lowering rates in the short term, while in Colombia the pressure is also on lowering rates though in decreasing and insignificant amounts. On the other hand, Peru clearly shows that it has reached equilibrium following a period of downward pressures, while Mexico is starting to display upward pressures, though these are as yet not significant. Brazil is also showing downward pressures, though these are decreasing according to the model.

7: Clarida, Richard, Jordi Gali, and Mark Gertler. 1998. "Monetary Policy Rules in Practice: Some International Evidence." European Economic Review 42:1033–67.

In general, the estimated models support the relatively lax approach currently adopted by the majority of countries in the region (for more details see chapter 5 of this report). In the case of Brazil, the model does not offer support for the recent hardening of monetary policy, which would suggest that its central bank may be starting to place more emphasis on inflation than on activity, in contrast to its approach in recent years (which is what is reflected in the model and, therefore, in its estimated interest rate).

Figure B.3.2
**Graph of pressure on monetary policy rates**




Source: BBVA Research

Table B.3.1 specifies the type of domestic pressure that is being felt by the central bank of each of the countries analysed, whether due to forecasts relating to inflation, activity and/or exchange rates. It also includes the kind of pressure that we forecast for the first half of 2015. We can therefore see that downward pressure in Chile is mainly caused by weak activity; pressure that we expect will fall away in the medium term (though in net terms it will be replaced by downward pressure from inflation). In Peru, despite the upward pressure relating to the depreciation of the exchange rate, the downward trend in activity should prevail. In Colombia and Mexico, we expect upward pressures to re-emerge on the activity side. Finally, in Brazil, local pressure from inflation and the exchange rate should become more significant from this point onwards, prevailing over pressures from activity.

**The empirical evidence indicates that the raising of interest rates by the Fed will force interest rates up in Latin America**

Given the imminence of the upward adjustment in interest rates in the US, we have used our models to try and capture the impact that the raising of rates by the Fed will have on local interest rates[8]. Of the five countries analysed, the Taylor rules in Brazil, Chile, Colombia and Mexico would seem to respond to US monetary policy, either to the Fed's money supply or to the "shadow" interest rates controlled by its monetary policy committee (FOMC)[9]. Thus, our models show that, in general, the impact of US monetary policy is direct; that is to say, restrictive policy by the Fed will lead to rises in local interest rates[10]. This evidence therefore supports the view that the normalisation of monetary policy by the Fed in 2015 will result in at least some of the countries in the region raising their own interest rates.

8: Over the period considered for most of these countries (2004-14), there was only one monetary cycle in the US (see Figure B.3.1), which means that caution should be applied when analysing the results of the models.
9: Given that, for a number of years, the Fed's rates have been restricted by the impossibility of applying negative rates, there are "shadow" measurements that attempt to calculate the negative interest rate equivalent to the extraordinary monetary policies that have been implemented in their place (see Wu and Xi, "Measuring the Macroeconomic Impact of Monetary Policy at the Zero Lower Bound", Working Paper, 2014).
10: This effect could be related to considerations of financial stability in the medium term (capital outflows in a global environment of greater aversion to risk that could give rise to vicious circles of still greater devaluations that cause, or are caused by, a misalignment and the impairment of bank and company balance sheets).

Table B.3.1
**Domestic sources of pressure on monetary policy**

| | Current | | | Mid-2015 | | |
|---|---|---|---|---|---|---|
| | **Inflation** | **Activity** | **Exchange Rate** | **Inflation** | **Activity** | **Exchange Rate** |
| Brazil | ++ | - - | | + | - | + |
| Chile | ++ | - - | | - | - | |
| Colombia | | | | | + | |
| Mexico | | | | | + | |
| Peru | | - | + | | - | + |

Source: BBVA Research

# 6 The prospects for fiscal balance have deteriorated, due to cyclical weakness

## The prospects for fiscal balance in the region have deteriorated in 2014, in line with less buoyant internal demand and expectations of lower prices for the principal commodities

Conditions of continuously moderating demand (except in Colombia and Uruguay) have also affected the fiscal balance in the majority of countries. On the one hand, lower levels of economic activity and falling commodity prices have negatively affected government income in the majority of countries. This combined, in the cases of Argentina and Brazil, with increased public spending, especially in respect of welfare costs (subsidies and transfers). By contrast, in the cases of Peru, Chile, Mexico and Paraguay, the net effect on fiscal balances has been softened by difficulties in the execution of budgeted public expenditure, especially the amounts set aside for public investment, though this has in turn contributed to the current slowdown, as mentioned in chapter 4. Thus, in comparison with the projections we made three months ago, it is expected that the fiscal accounts will show larger deficits in 2014 and 2015 in the majority of the countries currently experiencing a slowdown (Figure 6.1).

As far as income is concerned, Argentina is one of the economies that is most affected by lower than expected soybean prices, which, combined with the notable moderation in internal demand, will have a significant impact on tax revenues. In Brazil, given the lower levels of public revenue as a result of the moderation of the country’s economy, resources have been increased through the attraction of extraordinary income, for example, in the form of dividends from public companies and the renegotiation of tax debts.

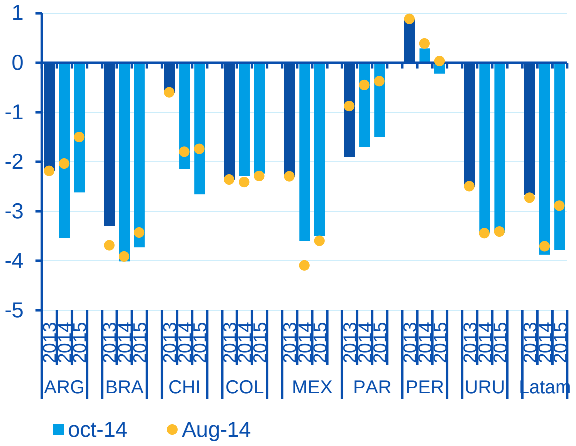
In turn, several countries in the region will, to a greater or lesser extent, feel the effects of the tax reforms that have either recently been implemented or are awaiting approval. In Chile and Mexico, revenues collected following tax reforms will be lower than initially expected, though a significant increase in revenue is expected in the case of Paraguay (with the incorporation of tax revenue from the agricultural sector and the introduction of income tax) and Colombia (with the proposed extension of the wealth tax and the transactions tax, along with an increase in income tax).

As regards spending, we have observed diverging trends in the context of the current slump in economic activity. Some countries, like Argentina, Uruguay and Colombia, have continued to support activity by using the public sector, though with differing strategies, with current spending taking precedence in the first three cases and public investment (mainly in infrastructure) being the chosen route in Colombia. For its part, Chile saw an unwelcome moderation in its public spending in the first part of the year, with under-execution of its budget, though this had begun to be corrected by the fourth quarter, and a considerable increase in spending (around 9%) is forecast for 2015. Finally, the under-execution of the budget, especially where public investment is concerned, is a more pressing problem in the cases of Peru and Paraguay (and, to a lesser extent, Mexico), which have seen only 60-70% of their budgets actually executed.

It is important to point out that this under-execution of budgeted investment is not a problem that stems from a lack of financial resources but instead is evidence of the increasing difficulties experienced by the public sector in managing an ever-increasing volume of investments. Public investment has tended, in real terms, to grow faster than product in the majority of countries, while the resources allocated to the public authorities have not sped up in the same proportion. Peru and Uruguay are particularly good examples of this (Figure 6.2). This is therefore a problem of a lack of management skills in the public sector that has led to bottlenecks and delays in viable and socially beneficial investment projects.

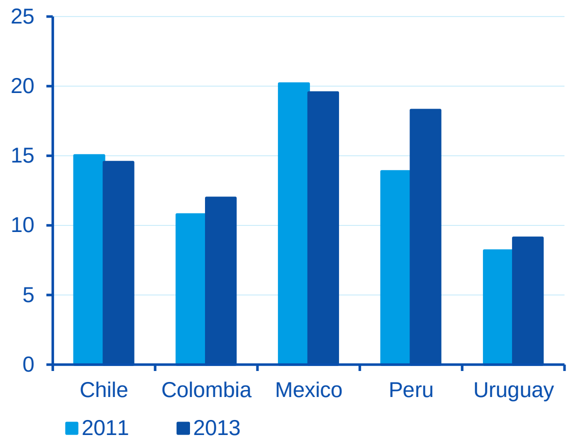
Against a background of moderation in the region, it is particularly important to warn of the potential risk of giving way to the temptation to generate a fiscal boost by implementing expansive current spending policies that would be difficult to reverse and would, by contrast, translate into increased public borrowing. In this regard it is worth mentioning the case of Mexico, where the under-execution of public spending was particularly marked in 2013. Following this, tax reforms had little effect on revenues and, adversely, had a negative impact on disposable income for both households and businesses. Following the tax reforms of 2013, public sector debt has not only failed to fall, it has in fact risen, from 40.4% of GDP to an estimated 42.3% in 2018. While, on the one hand, the ambitious "National Infrastructure Plan" presented in the middle of the year (which was supposed to involve the execution of more than twice the resources spent in the previous six months) has not yet translated into an increase in public investment, and the additional two percentage points of potential growth are still a long way from materialising[11], on the other, as mentioned in the section dealing with activity, the contribution made by public investment is negative and the input from public spending is falling.

Figure 6.1
**LatAm: Fiscal balance (% of GDP)**




Source: BBVA Research

Figure 6.2
**Ratio of public investment to public sector employees**




Source: BBVA Research

Thus, looking at the income vs. costs dynamic, we expect to see a certain degree of deterioration in our fiscal forecasts in comparison with our projections of three months ago (Figure 6.1). The main change in our forecasts centres on Argentina, Paraguay and Chile, which have been damaged by the upturn in primary costs in the case of Argentina, the inflexibility of current costs in the case of Paraguay and the effects of a greater than expected slowdown in activity in the case of Chile. In the case of Brazil, it is likely that the country will not meet its fiscal targets in 2014, though it will work hard to meet its targets for the coming year, and it will also probably make an effort to improve fiscal transparency. As regards Mexico, in order to comply with the rules for a balanced budget, the government redefined the fiscal balance by leaving out the spending of certain bodies. Despite the fact that it is estimated that the fiscal deficit will be 3.6% in 2014 (3.5% in 2015), it meets the requirements for a "balanced budget".

Colombia and Paraguay stand out for their decreasing public deficits in 2014, something that is not expected to happen in the rest of the region until 2015, insofar as the downturn is reversed. In Colombia's case, the fiscal rule (which was established in 2011 and which requires that, from 2013 onwards, the national government's structural deficit must be gradually decreased, with a maximum ceiling of 2.3% of GDP) will be

11: *Mexico Real Estate Watch*: The National Infrastructure Programme 2014-18, the most ambitious programme, will have a beneficial effect on the economy if implemented.

met as the result of the new income streams incorporated in the country's tax reforms. In Paraguay, deficit forecasts are in line with the recently approved fiscal responsibility legislation.

Peru is the only large country in the region that stands out as a result of the projected budget surplus in its fiscal accounts for 2014 (with a slight deficit in 2015). This will result, to a great extent, from increased income from the payment of taxes on capital gains earned from extraordinary transactions by non-residents, while spending levels have not increased, partly due to the under-execution of public budgets mentioned above. It is worth pointing out that public debt will continue to fall to levels of around 18% of GDP by 2018, even after the public borrowing required to finance large infrastructure items has been taken into account.

# 7 Large external deficits in LatAm, though they will start to fall from 2015

## Two opposing forces: the reduction in terms of trade and some problems with supply in the export sector have tended to have an adverse effect on external deficits, though these have been more than offset in Chile and Argentina as the result of lower domestic demand

The deterioration in terms of trade continued in the region during the third quarter, compared with the previous year. Although data are not available for every country, this deterioration was widespread during the first six months of the year, and it has continued in Brazil and Colombia, while there has been something of an improvement in Mexico and Peru (Figure 7.1). This deterioration has affected the balance of payments current account, which is expected to show a deficit of around 2.5% of GDP, virtually the same percentage as last year, and this will tend to fall towards 2015 as external conditions tend to improve.

As mentioned above in the chapter on activity, the external situation, which has been dominated by moderation in China, the slow recovery in the US and various supply-side problems, has affected the volume of goods exports in the region. This combined with supply-side factors that have led to a fall in the price of key commodities such as soybeans (due to a record crop harvest), a situation that has particularly affected Argentina, Paraguay and Uruguay. For its part, the slow US recovery has also led to a certain degree of recovery in manufacturing experts in Mexico and Colombia, while supply-side problems have had adverse effects on mining exports from Peru and Chile.

In addition, goods imports have also fallen due to the sharp moderation in internal demand. This has been partially offset by the drop in exports, to the extent that, with the exception of some cases (Chile, Uruguay), the current account balance has remained at levels that are virtually the same as they were three months ago. In Chile, the moderation in internal demand has meant a drastic drop in imports, which fell from a YoY growth figure of 0.3% in 2013 to -9.3% in 3Q14. In this case, and given the exchange rate forecasts, we estimate that the re-establishment of growth through 2014 and 2015 will be highly important, with a significant removal of emphasis on internal demand in favour of net external demand, and we have therefore adjusted our estimate for the country's current account balance from -2.3% and -2.8% of GDP respectively for 2014 and 2015 to -0.2% and -0.1% at current estimates (see Figure 7.2).

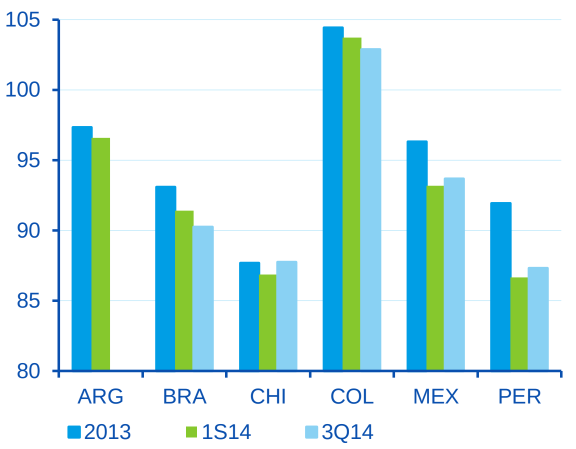
In the case of Uruguay, exports are currently enjoying a good period, and internal demand still shows a healthy level of growth, which has had an influence on the upturn in goods imports, from a slight fall of 0.2% in 2013 to 6% for the first six months of this year, which has led us slightly to revise the estimated current account deficit for 2014. Looking towards 2015, the entry into full production of the Montes de Plata cellulose plant will underpin exports. It should also be remembered that Uruguay is a net importer of oil, meaning that the downward trend in fuel prices that has been seen recently is a factor that will benefit Uruguay's balance of trade. All in all, while it is lower than it was three months ago, Uruguay's current account balance remains the highest in the region alongside Peru at around 4.5%.

By contrast, in Colombia's case the favourable dynamics of internal demand have supported an active import market, which will continue to bring pressure to bear on external balance figures, as we forecast three months ago.

Finally, particular mention should be made of the case of Brazil, which will maintain a large external deficit, despite the recent depreciation in the exchange rate. This is due to the negative effects of the slowdown in

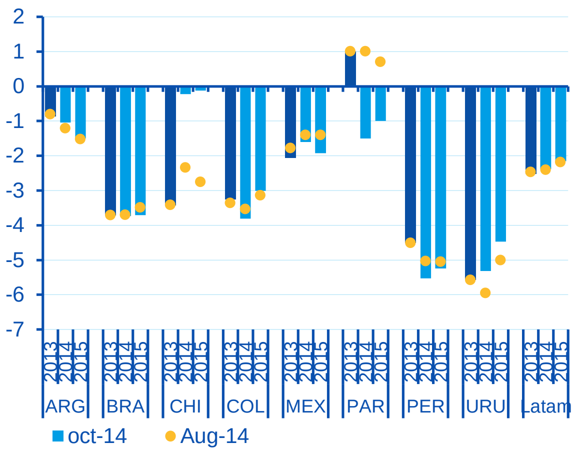
Argentina, worsening terms of trade and the problems of a continuing lack of competitiveness in the exports sector.

Figure 7.1
**LatAm: Terms of Trade (Index 1Q11 = 100)**




* Data for Argentina and Chile only available up to 2Q14; includes estimate for Chile in 3Q14
Source: BBVA Research and Haver

Figure 7.2
**LatAm: Current account balance (% GDP)**

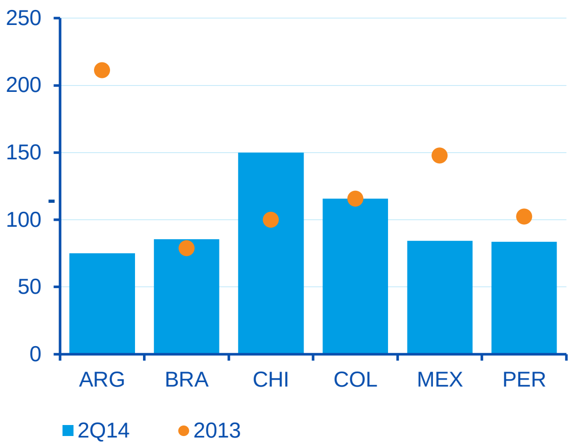



Source: BBVA Research

## The region's external vulnerability continues to be kept in check, given the relatively stable financing of external deficits and, in general, there is an adequate level of reserves

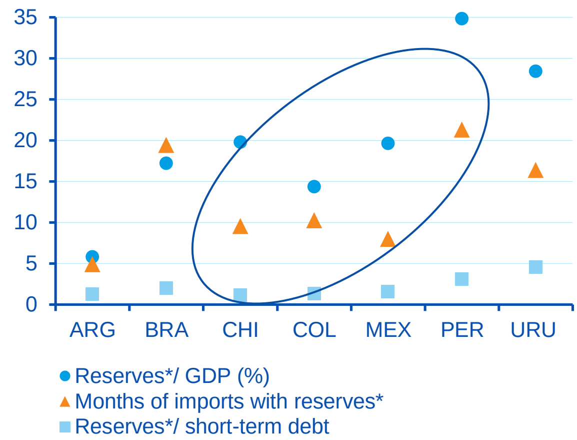
It is worth pointing out that current account deficits are still being financed by long-term foreign direct investment, even though the proportion of this investment is lower in some cases (Argentina, Mexico, Peru: see Figure 7.3) than was seen in 2013. The increase in direct investment has led to positive improvements in the level of foreign exchange reserves, which remain adequate, according to various vulnerability indicators, such as reserves for the coverage of short-term debt and months of imports covered by international reserves (Figure 7.4), this is particularly true of the Pacific Alliance countries. However, it should be mentioned that an additional deterioration in terms of trade continues to represent a risk factor that could also affect the attractiveness of the region in terms of flows of FDI.

Figure 7.3
**LatAm: % Current account deficit financed with FDI**




Source: BBVA Research

Figure 7.4
**LatAm: vulnerability indicators**




Source: BBVA Research

* International reserves include flexible credit lines from the IMF for Mexico and Colombia, and a sovereign fund in the case of Chile.

# 8 Tables

Table 1:
**GDP (% YoY)**

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | 8.6 | 0.9 | 2.9 | 0.1 | 0.2 |
| Brazil | 2.7 | 1.0 | 2.5 | 0.2 | 1.3 |
| Chile | 5.8 | 5.4 | 4.1 | 1.9 | 3.1 |
| Colombia | 6.6 | 4.0 | 4.7 | 4.9 | 4.8 |
| Mexico | 4.0 | 3.7 | 1.3 | 2.5 | 3.5 |
| Paraguay | 4.3 | -1.2 | 14.4 | 3.8 | 4.2 |
| Peru | 6.5 | 6.0 | 5.8 | 2.6 | 4.8 |
| Uruguay | 7.3 | 3.7 | 4.4 | 3.4 | 2.9 |
| Mercosur | 3.6 | 1.3 | 2.3 | -0.5 | 0.4 |
| Pacific Alliance | 5.0 | 4.2 | 2.7 | 2.8 | 3.8 |
| Latin America | 4.2 | 2.6 | 2.5 | 0.9 | 1.8 |

*Forecasts
Source: BBVA Research

Table 2
**Inflation (% YoY, avg.)**

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | 9.8 | 10.0 | 10.6 | 25.2 | 25.9 |
| Brazil | 6.6 | 5.4 | 6.2 | 6.3 | 6.1 |
| Chile | 3.3 | 3.0 | 1.8 | 4.4 | 3.3 |
| Colombia | 3.4 | 3.2 | 2.0 | 2.9 | 3.3 |
| Mexico | 3.4 | 4.1 | 3.8 | 4.0 | 3.4 |
| Paraguay | 8.3 | 3.7 | 2.7 | 5.2 | 4.5 |
| Peru | 3.4 | 3.7 | 2.8 | 3.3 | 2.6 |
| Uruguay | 8.1 | 8.1 | 8.6 | 8.9 | 7.5 |

*Forecasts
Source: BBVA Research

Table 3
**Exchange rate (against USD, average)**

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | 4.13 | 4.55 | 5.48 | 8.15 | 11.02 |
| Brazil | 1.68 | 1.96 | 2.18 | 2.34 | 2.59 |
| Chile | 484 | 486 | 495 | 569 | 581 |
| Colombia | 1,848 | 1,000 | 1,869 | 1,977 | 2,123 |
| Mexico | 12.4 | 13.2 | 12.8 | 13.2 | 13.2 |
| Paraguay | 4,188 | 4,417 | 4,312 | 4,464 | 4,717 |
| Peru | 2.75 | 2.64 | 2.70 | 2.83 | 2.98 |
| Uruguay | 19.2 | 20.2 | 20.4 | 23.2 | 25.6 |

*Forecasts
Source: BBVA Research

Table 4
**Interest Rate (%, avg.)**

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | 13.34 | 13.85 | 16.92 | 22.86 | 26.00 |
| Brazil | 11.71 | 8.46 | 8.44 | 11.00 | 12.15 |
| Chile | 4.75 | 5.02 | 4.90 | 3.69 | 2.54 |
| Colombia | 4.10 | 4.94 | 3.35 | 3.98 | 4.81 |
| Mexico | 4.50 | 4.50 | 3.94 | 3.21 | 3.23 |
| Paraguay | 8.49 | 6.00 | 5.54 | 6.73 | 6.96 |
| Peru | 4.04 | 4.25 | 4.21 | 3.77 | 3.46 |
| Uruguay | 18.95 | 18.59 | 17.70 | 21.22 | 18.66 |

*Forecasts
Source: BBVA Research

Table 5
**Current Account (% GDP, end of period)**

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | -0.8 | -0.2 | -0.9 | -1.0 | -1.5 |
| Brazil | -2.1 | -2.4 | -3.7 | -3.7 | -3.7 |
| Chile | -1.2 | -3.4 | -3.4 | -0.2 | -0.1 |
| Colombia | -2.9 | -3.1 | -3.2 | -3.8 | -3.0 |
| Mexico | -1.1 | -1.3 | -2.1 | -1.6 | -1.9 |
| Paraguay | 0.4 | -0.9 | 1.0 | -1.5 | -1.0 |
| Peru | -1.9 | -3.3 | -4.5 | -5.5 | -5.2 |
| Uruguay | -2.9 | -5.3 | -5.6 | -5.3 | -4.5 |
| Mercosur | -0.6 | -1.4 | -2.4 | -2.5 | -2.1 |
| Pacific Alliance | -1.5 | -2.0 | -2.7 | -2.2 | -2.3 |
| Latin America | -1.0 | -1.6 | -2.5 | -2.4 | -2.2 |

*Forecasts
Source: BBVA Research

Table 6
### Fiscal balance (% GDP, end of period)

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Argentina | -1.6 | -2.4 | -2.2 | -3.5 | -2.6 |
| Brazil | -2.6 | -2.5 | -3.3 | -4.0 | -3.7 |
| Chile | 1.3 | 0.6 | -0.6 | -2.1 | -2.7 |
| Colombia | -2.9 | -2.3 | -2.4 | -2.3 | -2.2 |
| Mexico | -2.5 | -2.6 | -2.3 | -3.6 | -3.5 |
| Paraguay | 0.7 | -1.7 | -1.9 | -1.7 | -1.5 |
| Peru | 2.0 | 2.3 | 0.9 | 0.3 | -0.2 |
| Uruguay | -0.9 | -2.8 | -2.5 | -3.4 | -3.4 |
| Mercosur | -2.5 | -2.9 | -3.3 | -4.7 | -4.5 |
| Pacific Alliance | -1.7 | -1.7 | -1.8 | -2.8 | -2.8 |
| Latin America | -2.1 | -2.4 | -2.7 | -3.9 | -3.8 |

*Forecasts
Source: BBVA Research

Table 7
### Commodity forecasts

| | 2011 | 2012 | 2013 | 2014* | 2015* |
|---|---|---|---|---|---|
| Oil (Brent USD/barrel) (fp) | 109.4 | 110.1 | 109.5 | 86.5 | 91.8 |
| Oil (Brent USD/barrel) (avg.) | 111.3 | 111.6 | 108.5 | 101.5 | 89.0 |
| Soy (USD/ton) (fp) | 431.6 | 544.0 | 480.0 | 380.0 | 378.0 |
| Soy (USD/ton) (avg.) | 484.2 | 537.8 | 517.5 | 462.0 | 373.5 |
| Copper (USD/lb) (fp) | 3.9 | 3.4 | 3.6 | 3.2 | 3.0 |
| Copper (USD/lb) (avg.) | 4.0 | 3.6 | 3.3 | 3.1 | 2.9 |

*Forecasts
Source: BBVA Research

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