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Latin America Outlook

First quarter 2015
LatAm Coordination Unit

- Growth in LatAm will nudge upwards, albeit slowly, held back by lower commodity prices. Activity in the region should rise from 0.8% in 2014 to 1.5% and 2.4% in 2015 and 2016, pulled up by greater growth worldwide and heavier public investment in the Andean countries. The Pacific Alliance will grow by 3.6% and 3.8% in 2015 and 2016.
- The central banks continue to show a looser bias given the cyclical weakness and could even disengage from the Fed rate hikes, apart from in Mexico. Such a move would adversely affect capital inflows to Latin America.
- The weaker commodity prices not only bode ill for fiscal and current account prospects in the region but will also have a potentially depressing impact on FDI in the primary export sector.
- All of these factors will exert pressure on LatAm exchange rates to depreciate in 2015 and 2016, yet on balance the limited currency mismatch in the private sector will mean that the exchange rate will cushion rather than spread external shocks.

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Closing date: 15 February 2015

1 Overview

World growth will continue to move upwards 2015 and 2016, albeit slowly and very unevenly. Specifically, we see it climbing from 3.3% in 2014 to 3.6% in 2015 and 3.8% in 2016. With the United States leading the way, the developed economies will lift their share of global growth, while China will continue to shift gear downwards in a controlled fashion.

One of the major developments on the economic front in recent months has been the downward correction in commodity prices, which has prompted volatility in the region's financial markets. The fall has been particularly sharp in the case of oil, and this situation is expected to persist into the next few quarters. This will have a minor adverse effect on LatAm growth as a whole but it will be very uneven from country to country and significantly inauspicious in the cases of Colombia, Mexico or Brazil (Box 1). The commodity price correction also contributed to asset price weakening in the region as well as a depreciation of exchange rates, which was also fuelled by expectations of rate hikes by the Fed in the middle of 2015. Looking ahead, we foresee volatility in financial markets continuing in a scenario of monetary policy divergence between the United States and the eurozone.

Given this less promising external context, we are downgrading forecasts for growth in Latin America, which we expect to edge upwards from 0.8% in 2014 to 1.5% in 2015 and 2.4% in 2016. This downward revision centres in particular on Brazil and Colombia. In the former case, this is due to factors such as the macroeconomic adjustment set in train by Dilma Rousseff's new government, the energy crisis and the deterioration in the terms of trade, whereas in Colombia's case it boils down to the drop in the oil price. All things considered, both stronger world growth (and the buoyancy of the United States) and the powerful public sector investment drive in the Andean countries (Colombia, Peru and Chile) will be the engines of recovery for regional growth over the next two years.

The pattern in Latin America will remain extremely mixed, with notably more growth by the Pacific Alliance (Mexico, Colombia, Peru and Chile) relative to the LatAm average. In terms of numbers, we predict that growth for the Alliance will climb from 2.6% in 2014 to 3.6% in 2015 and 3.8% in 2016, which is more in keeping with its potential rate, while increased dynamism in the Pacific Alliance could actually already have been flagged in 4Q14. This contrasts with Mercosur's virtual stagnation in 2014, which is likely to persist over 2015 and 1H16. On a country level, it will be those in the Pacific Alliance as well as Paraguay which will perform the strongest in 2015. Of particular note here is the upsurge in growth in Peru (2.4pp higher than in 2014), Mexico (up 1.4pp) and Chile (1.3pp more). On the other hand, even though growth in Colombia will be 1.2pp down on 2014, it will still be one of LatAm's most robust performers (see the country breakdowns in the forecast tables in Section 8).

The lower prices of the major export commodities pave the way for a decline in both the region's fiscal and external balances. With markedly mixed implications, the sliding oil price will hit external balances in Colombia, Brazil and Mexico, while it augurs well for Argentina, Peru, Chile, Uruguay and Paraguay. Overall, the weakening of commodity prices, especially metals, serves to exacerbate the negative impact in Brazil, while blunting the positive effect in Chile and Peru. The region's external deficits will then start to take a turn for the better in 2015 and 2016, in spite of less kind terms of trade and more restrained growth in China. Generally speaking, LatAm's vulnerability to the outside world remains limited, despite the heightening effect of lower foreign direct investment (largely due to the prospects of more modest commodity prices), which in many countries no longer manages to cover external borrowing requirements in full as it did not so long ago. On the fiscal front, both lower commodity prices and domestic demand weakness will also jar tax revenues. All in all, certain countries which have seen through tax reforms (Chile, Colombia), as well as others which could take advantage of the situation by cutting energy subsidies (Argentina) or making an across-the-board adjustment of regulated prices (Brazil), should partly offset this effect.

Inflation pressure generally in Latin America is easing in those countries where the central bank has set target levels, on account of the cyclical weakness and the oil-price fall. The big exception will be Brazil, where the fiscal adjustment in progress also entails higher regulated prices, which comes on top of the transmission to prices of the heavy depreciation of recent quarters. In Uruguay too, the inflation rate will hold above or close to the ceiling of the central bank's target range. Finally, in Colombia a degree of inflation pressure will become noticeable in the short term, as the strong depreciation of recent months feeds through to prices, although convergence towards target inflation is expected in late 2015 and 2016. Inflation expectations will in the main stay well-anchored, notably in the four Pacific Alliance member countries.

Apart from in Mexico, the central banks will feature a looser tendency in their monetary policies because of cyclical weakness and, in the Andean countries, less inflation pressure. We therefore expect further cuts in official interest rates in 2015 in Colombia, Peru and Chile, in circumstances of still timid domestic demand, unrealised output potential and meek inflation pressure. The situation is different in Brazil, where the tone of monetary policy is tighter than three months ago in a bid to restore credibility to its economic policies, although, whatever transpires there, rate hikes are not expected to keep up with the upward ratcheting by the Fed predicted in 3Q15. The only country bucking the trend of uncoupling its monetary policy from the Fed should be Mexico, where synchronisation of its economic cycle in line with the United States is likely to lead to parallel monetary adjustment.

This disengagement of monetary policy from the Fed should be one of the factors which will bring about a depreciation of LatAm exchange rates in 2015 and 2016. The Fed hikes will give rise to thinner capital inflows to the region and put LatAm exchange rates under pressure, even if this coincides with a programme of quantitative easing by the European Central Bank (Box 2). Despite this, the willingness of central banks to make a departure from the course for interest rates marked out by the Fed in 2015 is likely to be due not only to the slowdown and inflation anchoring discussed already, but also to greater openness to allowing the exchange rate to serve as the adjustment mechanism and absorber for external shocks. This development is attributable to lower feed-through of depreciation to inflation, as well as the notion that weakening the exchange rate ought not to produce excessively large losses for the non-financial corporate sector, which might have been run up from borrowing in foreign currency. On the whole, the lack of full information (especially, though not solely, in Peru and Colombia) on the level of exchange rate exposure of the non-financial corporate sector calls for some degree of caution with regard to this potential weak-point in the region (Box 3).

2 Global environment: increasing divergence between the main economic areas

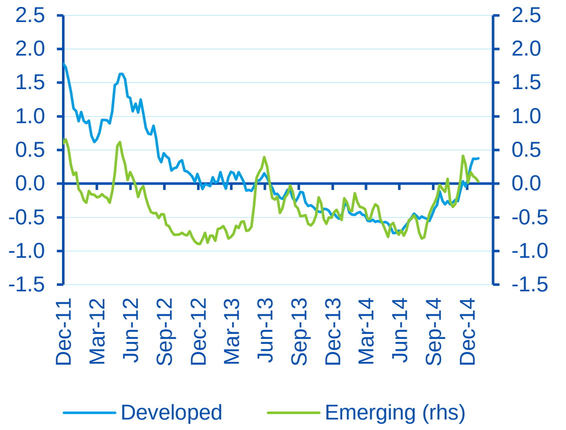
Global growth should increase to 3.6% in 2015 and 3.8% in 2016

The world economy grew in the fourth quarter of 2014 at a similar pace to the third. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the Eurozone, and the progressive deceleration of China and other emerging economies. Hence, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution over the three previous years, and the EMs continuing to decelerate.

One of the biggest pieces of news in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the Eurozone and China) offsets the reduced activity in the principal producer countries.

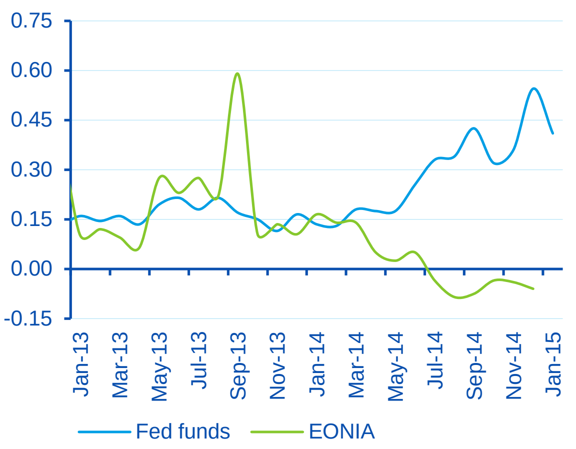
The increased volatility in financial markets, which has now reached the same level as in mid-2013, according to the BBVA Financial Tensions Index (Figure 2.1), is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors: i) doubts about the economic development of many EMs, and ii) the uncertainty around the Fed's rate-hiking cycle.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M fwd interest rates (%)



Source: BBVA Research and Bloomberg

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other (Figure 2.2)).

Thus, the improvement in global growth will continue in 2015 and 2016, by more than 3.5% on average, but there will be a significant differentiation between areas, given the asymmetric effect of falling commodity prices and monetary policy divergence in the development bloc, with these being the two effects that mark *a priori* the prospects for the global economic scenario.

All in all, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been exacerbated by those associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

The US consolidates its recovery and the Fed is ready to raise interest rates

Momentum in the US recovered over the course of 2014, based on the strength of domestic demand and also lower oil prices. Looking forward, US growth could reach 2.9% in 2015 which, together with low inflation, will accentuate the Fed's dilemma when it comes to start its monetary normalisation process. In this context, our forecast date for the first increase in the Fed funds rate remains 3Q15.

The controlled slowdown in China continues

In China, the slow deceleration in activity continued, with an estimated growth of 7.2% in the fourth quarter, the slowest since 2009 due to the loss of momentum in fixed capital investment, the deterioration in external competitiveness which was driving the Yuan's appreciation and the correction in the real estate sector.

Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the doubts about the capacity of policies to achieve a correction in the present imbalances with economic liberalisation underway. It is important to remember that the authorities have started to show more tolerance towards economic deceleration, provided that job-creation moves in line with the active population.

Finally, the downward pressures on inflation in Europe continue

Of the large economic areas, the Eurozone is the most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. In particular, an increase of 0.8% in 2014 is anticipated, which could increase up to 1.3% in 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to the ECB's actions.

Among the main focus-points of downside risks is the increased tension in Russia's sphere of influence. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the ECB's support in fostering growth. Finally, another risk is that medium-term inflation expectations will continue to fall, discouraging consumption in the short term, and leading to a negative feedback loop.

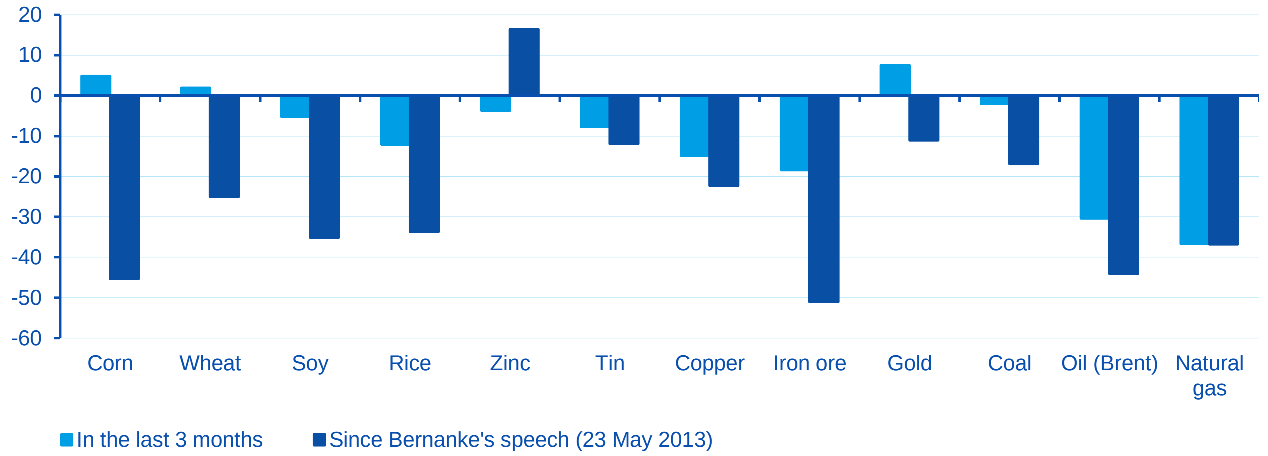
3 Commodities and the Fed are putting LatAm markets under pressure

Strong volatility and a downward price correction for the major commodities, especially oil

Commodity prices have suffered a sharp downward correction in recent months (figure 3.1). The falls in the last three months have generally been gentler for agricultural products, such as soybeans (-5%), and more pronounced for certain metals, such as copper (-15%) and iron ore (-18%), and most distinctly, natural gas (-36%) and oil (-30%).

The price revision in the last three months is especially significant, as it has been in addition to the previous drift downwards that has been accumulating since 1H13.

Figure 3.1
Commodity prices (% var.)



Source: Bloomberg

The slowdown in global growth and the resulting fall-off in the demand for commodities is one of the keys to understanding the downward price corrections for staples on world markets. Particularly relevant is the sharper-than-expected braking of growth in China, where the shift towards a less investment-led and more consumption-driven model is putting additional strain on demand (especially for metals and energy).

Commodities have also been pushed downwards by recent dollar strength through a denomination effect.

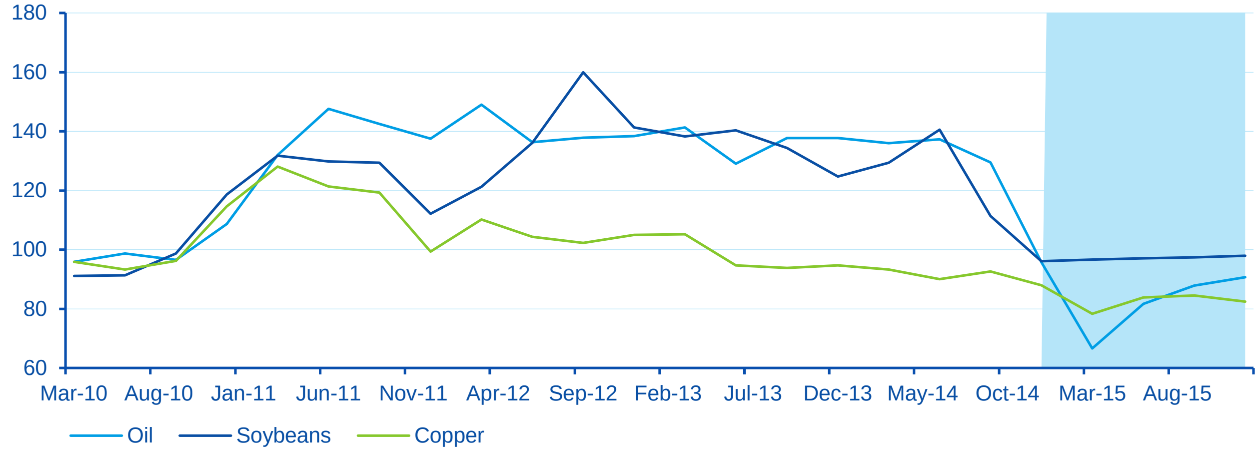
Finally, there are significant idiosyncratic factors which provide an insight into recent price movements for each commodity. In the case of oil, the slump in the price in the last few months also relates to robust growth in the supply of shale-oil in the United States and the surprisingly low elasticity of production to geo-political tensions, as well as the reluctance of Saudi Arabia to scale down output in response to falling prices.

In the case of soybeans, another of the most important items produced by LatAm countries (particularly for Argentina, Brazil, Paraguay and Uruguay), prices also reflect good past crops in the United States, Argentina and Brazil, which have contributed to the high prevailing stocks-to-use ratios.

As regards two of the most important metals for LatAm countries, copper and iron ore, the correction has to a great extent been determined by the lower Chinese demand that we have discussed, although a relatively substantial supply inherited from earlier times of high prices, as well as lower shipping costs, have also played a big part in shaping recent price movements.

Among the few commodity prices which have not lost ground in recent months is gold, one of the most important goods in the basket exported by Peru, partly because of its function as a safe-haven asset.

Figure 3.2
Key commodity prices (2010 average = 100)



Source: BBVA Research

Prospectively, the most likely script is that downward pressures will wear off and in certain cases be reversed. In the oil market the recent price fall should bring down investment in the industry and thereby allow prices to rally in the medium term. The high production costs faced by a large section of producers also lend weight to the prospects of steadily climbing prices. The upturn in the oil price in the last few weeks reinforces this outlook. Our baseline scenario for crude is of prices approaching USD70/bbl at the end of 2015 and almost USD80/bbl in late 2016. With respect to copper and soybeans, we think that the Chinese slowdown will continue to have an impact on prices in 2015 and 2016, thus prompting further down-shifts in the copper price, though milder than have been experienced of late, and a more measured convergence towards long-term levels (figure 3.2 and forecast tables in Section 8). In all three cases, particularly oil, we have downgraded our estimates on those of three months ago.

In general terms, recent commodity price movements have sketched out a more challenging landscape for LatAm countries. Although, broadly speaking, the effects of the worst-case scenario are surmountable, there is still the risk that further price weakening might hit LatAm economies harder, given their vulnerability to commodity markets (see Box 1 for more details on the specific example of the oil price).

The imminence of the opening Fed rate hikes is also depressing asset prices

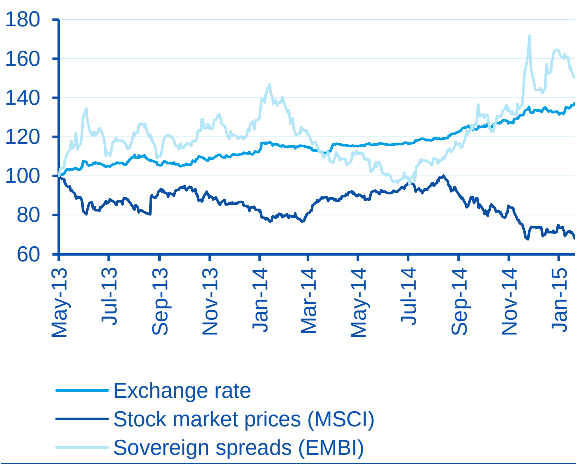
As was noted in Section 2, global financial markets have become increasingly ruffled in the last three months, following on from patterns seen in the middle of 2014.

In this climate, and bearing in mind that not only is the fall-off in activity also a widespread phenomenon in the region but that the correction in commodity prices is bad news for Latin America as well, the recently witnessed unsettled behaviour and mark-downs of LatAm assets come as no surprise (figure 3.3).

The region's sovereign spread has widened by almost 80bp in the last three months and has now opened up by over 180bp in all since May 2013 when, following the statement by the previous Fed chairman, Ben

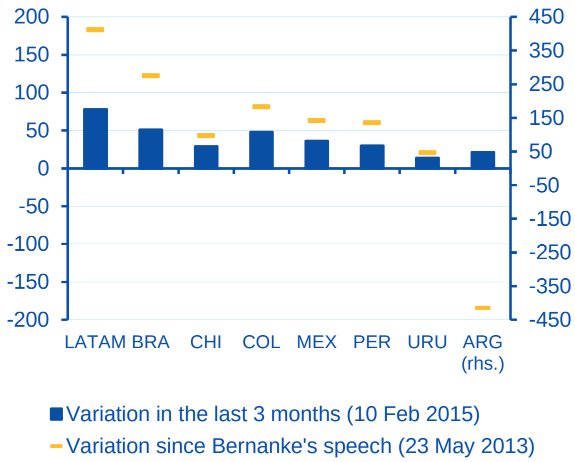
Bernanke, the markets began to price in the initiation of tapering and a return to normal monetary policy in the United States (figure 3.4).

Figure 3.3
LatAm: Stock market prices, sovereign spreads (EMBI) and exchange rates (January 2013=100)



Source: Haver Analytics and BBVA Research

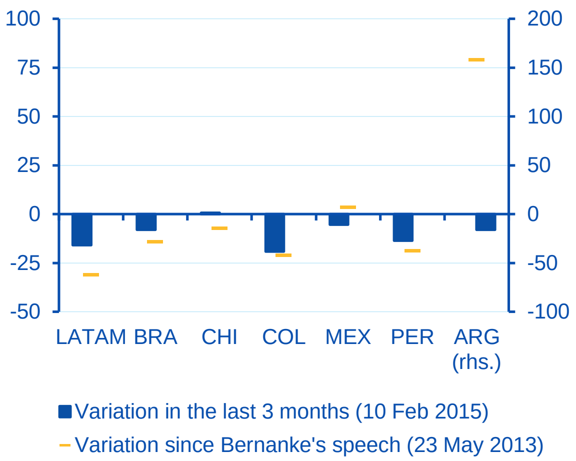
Figure 3.4
Sovereign spreads in Latin America (EMBI, bp)*



* Data for Argentina on the RH axis.
Source: Haver Analytics and BBVA Research

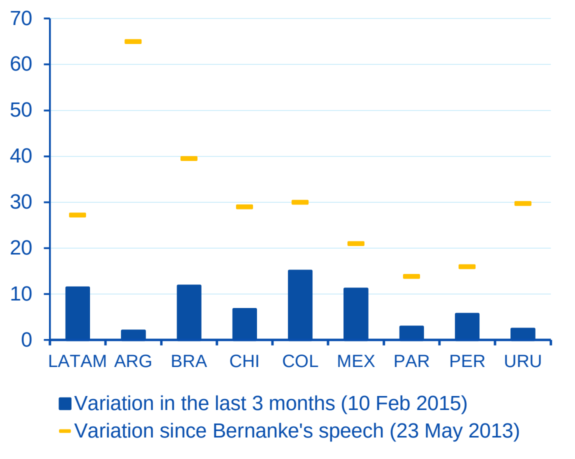
The MSCI market index for Latin America has shed 15% in the last three months, which is in addition to a fall of a similar size since May 2013 (figure 3.3). Currencies have moved in like fashion: losing 6% for the last three months on top of the slide of 28% up to then from May 2013 (figure 3.5).

Figure 3.5
Stock market movements in Latin America (% var., local currency)*



Data for Argentina on RH axis.
Source: Haver Analytics and BBVA Research

Figure 3.6
Exchange rate movements in Latin America (% var.)



Source: Haver Analytics and BBVA Research

The data by country reveals that the decline, both in the last three months and since May 2013, has been across the board, as not one country has escaped downward corrections to its asset prices. The worst hit, however, were Brazil and Colombia. In Brazil the greater openness of financial markets is a factor to take into account, since it makes the country more exposed to global disturbances. Whatever the case, the chief element behind particularly heavy falls in Brazil is the sharp deterioration in the domestic macroeconomic situation, which has been marked by stagnation and persistently high inflation, not to mention the failing health of the external and fiscal accounts. In Colombia the more dramatic adjustments are due to other factors, in particular its greater exposure to one of the commodities whose price has plunged the furthest and most sharply, namely oil (Box 1).

Conversely, although it has not been left untouched by the general downward trend, Mexico has suffered less of an impact, in all likelihood because it is the country which benefits most directly from the economic recovery underway in the United States.

Capital inflows to the region have become more subdued and in some cases even net outflows have been noted, in line with the more bearish tone betrayed by the LatAm financial markets in recent months.

Volatility will linger in a scenario of diverging monetary policies among the major developed economies

Further ahead, both the expected revival of economic activity and what are in some cases overdone downward corrections support the view of a recovery in asset prices. Nevertheless, the markets will remain on the lookout for developments in US monetary policy, and especially for activity figures, which will in the final analysis decide how fast normalising of the monetary stance takes place, and volatility is likely to remain high, or even to intensify, as the moment approaches for the Fed to hike rates, which we see happening in Q3.

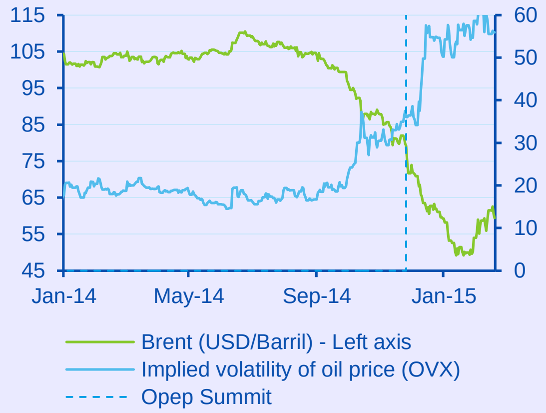
Although stimulatory measures taken by the European Central Bank could help soften the impact of the cycle of monetary tightening in the United States on the LatAm countries, forecasts indicate that they will not manage to fully offset the effect of such moves by the Fed. In particular, we predict that the Fed hikes will adversely affect capital inflows to the region (Box 2) and, by extension, asset prices in Latin America.

In conclusion, the central banks in Latin America might add to volatility in attempting to manage domestic circumstances and disengage from the Fed's rate hiking process (see Section 7 for further details regarding monetary policy in the region).

Box 1. The impact of the fall in oil prices in Latin America

The oil price has corrected by 45% since July 2014 (Figure B.1.1), due to a combination of forecast downgrades for world growth and supply-side shocks, including the sustained growth of shale oil production in the United States and the uncharacteristically minimal impact of geo-political strains on key productive zones, such as Libya, Iraq and Syria. These effects were moreover heightened by OPEC's refusal (especially on the part of Saudi Arabia) to respond to falling prices by scaling down crude production at the cartel's meeting of 27 November. Taken overall, we estimate that between a third and a quarter of the price fall is attributable to flatter global demand, whereas most of the remainder is due to surprisingly resilient supply in the sector.

Figure B.1.1
Brent oil price (USD/bbl) and implied volatility (OVX)



Source: BBVA Research and Bloomberg

More recently, the oil price has rallied slightly from the low it hit in January on initial information of a drop in investment in the industry, financial strains at shale oil companies in the United States and the closing of the short crude positions which had proliferated in late 2014.

Uncertainty over the crude price has also gathered momentum notably, which reflects significant price risks, both upside and downside. Indeed the OVX implied volatility index has not stopped rising and is holding at a high not seen since the 2008 price crash (Figure B.1.1), which points to both upside and downside uncertainty over the direction that prices will take in future (see Box 1 in the Latin America Outlook, Fourth Quarter 2014 for further details).

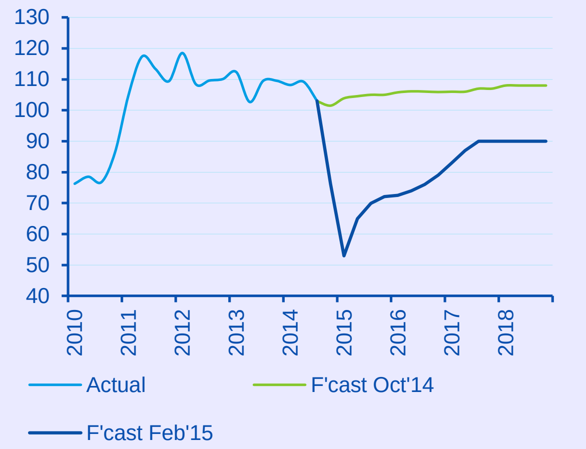
Our central forecast scenario for oil prices suggests a very gradual rise in prices as sector investment eases up and production slows down (especially regarding shale oil, with very sharp decline rates per well). We thus forecast average prices for 2015 of around USD65/bbl, rising to USD75/bbl on average for 2016 and tending towards USD90/bbl long term, in line with the industry's cost structure and factoring in a higher permanent risk premium on funding investment in the shale oil sector.

With respect to our oil-price forecast last October (stable prices of around USD105/bbl for Brent in 2015 and 2016), our new baseline scenario gives an average price almost 40% lower in 2015 and almost 30% down in 2016 (Figure B.1.2 and Table B.2.1).

The impact of the new course taken by oil prices on growth and inflation in Latin America

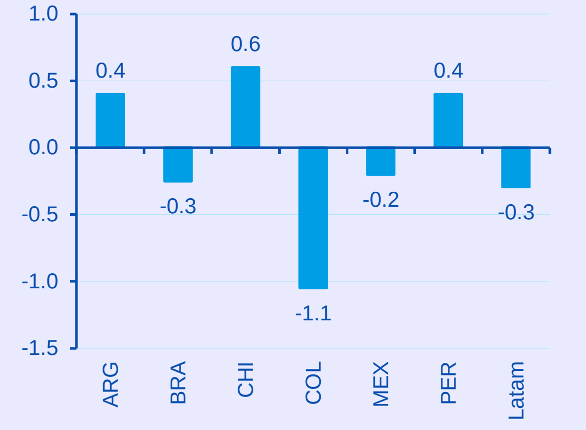
A lower oil price has a positive effect on world growth, particularly on the supply side, as it brings down costs for companies and boosts available household income, which is conducive to investment and consumption. In hard numbers, we estimate that the anticipated new direction to be taken by the price should galvanise world growth by 0.4pp in 2015 and 2016.

Figure B.1.2
BBVA Research price forecasts for Brent oil (USD/bbl, quarterly averages)



Source: BBVA Research and Haver

Figure B.1.3
Impact on growth of the revised course of oil prices: forecasts in February 2015 versus October 2014 (pp, 2015-16 average)



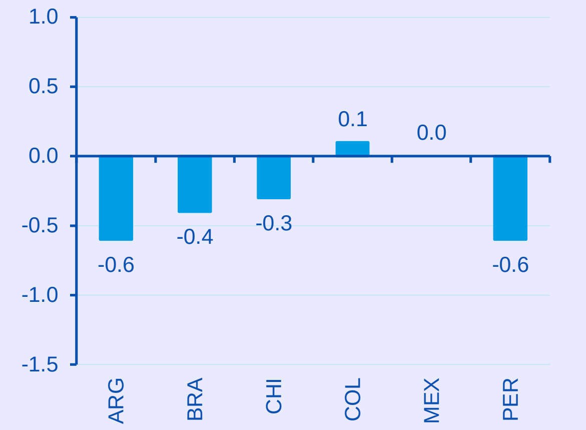
Source: BBVA Research and Haver

Table B.1.1
BBVA Research price forecasts for Brent oil (USD/bbl, annual average)

Year	October 2014 forecast	February 2015 forecast
2014	105	99
2015	105	65
2016	106	75
2017	107	88
2018	108	90

Source: BBVA Research

Figure B.1.4
Impact on inflation of the revised course of oil prices: forecasts in February 2015 versus October 2014 (pp, 2015-16 average)



Source: BBVA Research and Haver

Within Latin America we expect positive impacts in Chile and Peru, and to a lesser extent in Argentina (Figure B.1.3), which are the region's main importers of crude. For the first two, the boost for growth (around 0.5pp more on average over 2015-16) comes directly from improved terms of trade (at constant prices for other commodities). Both Chile and Peru should experience substantially trimmed inflation rates (Figure B.1.4) and less pressure on their exchange rates to weaken, which could also induce their central banks to loosen monetary policy. In Argentina the boost to growth should arise principally from a relaxing of external controls as crude imports diminish.

In any event, the fillip of a lower oil price for importing countries (such as the three mentioned before) is greater the more reliant the country is on short term flows to cover its external borrowing requirement. Thus the positive impact of cheaper crude in countries such as Peru or Chile (which cover a considerable part of their current account deficit via FDI) is less than would be felt by Turkey, for example, which imports a large volume of crude at the same time as it has a high dependence on short-term capital flows to pay for its bulging external deficit. The fall in the oil price should go a long way towards helping Turkey reduce its external vulnerability.

The larger LatAm countries (Brazil and Mexico) will have to contend with a significant negative impact from the lower oil price, which will also hit Colombia hard, where growth should be shaved by around 1pp in 2015-16 from the effect of lower exports and (from 2016) a drop in tax revenues. At the same time, the battering taken by the exchange rate will more than offset the counter-inflationary force from cheaper fuel, leaving inflation virtually unchanged on balance.

Looking to Mexico, the impact on growth is only moderately negative (-0.2pp in 2015-16) since the detrimental effects on tax revenues and FDI in the oil sector are partly offset by the greater growth in the United States (where this will rise by 0.3pp in 2015-16). At the same time, the Mexican peso should show a weakening pattern, which would spur the export sector on.

Finally, Brazil should not only suffer a terms of trade shock but investment will also be hit substantially, especially in the case of Petrobras. We therefore expect a negative effect of around 0.3pp on average on already modest growth in 2015-16.

The overall impact on the region should be slightly negative, by about 0.3pp on average in 2015-16.

An important aspect to bear in mind is that the effects described in this box only take into account the impact of a lower oil price. While it is true that this is one of the bigger shocks in the last quarter, it is not the only one. Thus the revised macroeconomic forecasts for the region incorporate this particular shock but also take others into account which have occurred in recent months, such as, for example, a drop in the price of other export commodities (copper, iron ore and soybeans, for example) and a more substantial slowdown in China. Similarly, the macroeconomic forecasts will have to add in other factors to the effects referred to in this box, including the data noted over this quarter and new policies that have been implemented (such as, for example, the fiscal stimulus measures in Peru or the tax reform in Colombia).

Box 2. Repercussions of Fed rate hikes for capital inflows to Latin America

The withdrawal of monetary stimuli by the Fed will have major implications for capital inflows to the region, given their significance in shaping global financial conditions. Fed monetary normalisation will enhance the relative appeal of US to LatAm assets, thereby reducing inflows in subsequent years. These dynamics could also lead to adjustments to the current accounts of countries in the region and currency volatility, with repercussions for growth and inflation.

Recent episodes involving US rate hikes in 1994 and 2004 are not much use when it comes to estimating the potential impact on flows into the region. Both of these found Latin America in a very different situation as regards fundamentals and financial vulnerability. In the early 90s, major imbalances persisted which, for example, led to the financial crisis in Argentina and the balance of payments predicament in Mexico. Coming into the first decade this century, however, the region was already enjoying far greater stability, with an approach incorporating inflation targets, flexible exchange policy and more prudent fiscal policies that left it better-placed to weather the rate hikes in 2004.

In circumstances where increasing levels of financial integration and depth call for a global rather than a regional analysis, we model the effects which monetary policy in the United States and the Eurozone would have on capital flows in emerging economies[1]. Additionally, account must be taken of the expected divergence between the monetary policies of the Fed, which is preparing to start withdrawing monetary stimuli around midway through this year, and the ECB, which has announced an ambitious stimulatory programme that will involve buying up sovereign bonds.

The results of the analysis suggest that the withdrawal of monetary stimuli will almost certainly lead to lower capital inflows to the emerging economies, among which Latin America stands to be the most affected. The scale will depend on market anticipation and how much risk aversion increases. Despite the ECB's historic announcement, in global terms the effect of the Fed's withdrawal of stimuli will predominate. The ECB's response will garner positive results among Europe's emerging nations, where it could to some extent counteract Fed moves, but this will not be as true in other regions such as Latin America. The outflow of capital in the scenarios where the Fed raises rates in line with expectations, or even more aggressively, should be in the range of 3.0-3.7% of cumulative GDP over three years up to 2017.

Modelling strategy

The model uses a sample from 1Q05 to 3Q14 for some 40 countries with developed and emerging nations equally represented, and the effect is measured on cumulative portfolio flows as a proportion of total assets under management. The model combines dynamic factors (DFM) with factor-augmented vector autoregressive (FAVAR) methodology to link transmission channels for flows (global, by region and idiosyncratic) with macroeconomic variables.

The model is two-stage: the initial stage (involving the Dynamic Factor Model or "DFM") is based on the hypothesis that portfolio flows have an unobservable structure of five underlying dynamic factors, viz. global, emerging, developed, safe-haven asset and idiosyncratic factors. In a second stage of estimation, these underlying factors are related to macroeconomic variables using a FAVAR, thus enabling timing dynamics between flows and the macro environment. Estimating reveals a significant relationship between factors, and measurements for global risk aversion and emerging markets (VIX and EMBI), besides a link between these and macro variables.

This model is used to analyse scenarios which propose the most likely combinations of Fed and ECB moves[2]. The scenarios considered are combinations of Fed and ECB policies and risk aversion measurements; from a gradual removal of

1: This box is based on the article: Monetary Policy in the North and portfolio flows in the South, Gonzalo de Cadenas Santiago, Alicia García Herrero, Alvaro Ortiz Vidal Abarca.
2: In the original article (August 2014) six possible scenarios were suggested, whereby in the first two the ECB adopted a reactive stance to Fed moves. For this box only those scenarios where the ECB takes a pro-active role are given.

stimuli in the United States that would involve raising the reference rate from the middle of 2015 to a scenario in which the Fed decides to put off and limit the normalisation process. The table below shows the assumptions in the scenarios; the most likely of these (central scenario) is scenario 1, where the Fed pursues an exit strategy that will mean raising the Federal Funds Rate to a level of 2% at the end of 2016 and the ECB pro-actively applies quantitative easing.

Table B.2.1
Details of simulation scenarios

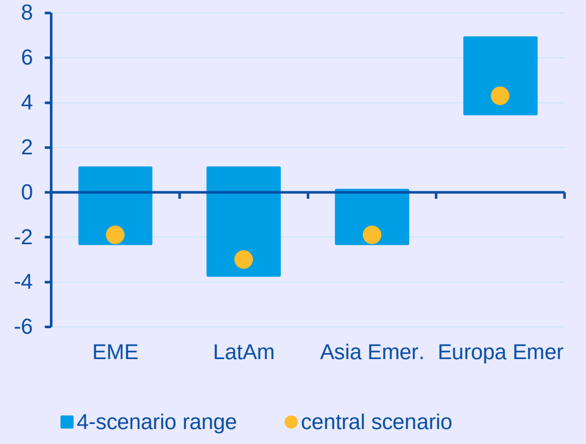
	Scenario	FED	ECB	Global risk aversion
1	Fed exit and QE by the ECB	10y + 50bp in 2014 + 50bp in 2015	10Y -20bp per quarter between 4Q14 and 2Q15	Return to long-term average
2	Over-reaction to Fed exit and QE by the ECB	10y + 150bp in two quarters	10Y -20bp per quarter between 4Q14 and I 2Q15	Spike, as with the euro crisis, which fades away one quarter later
3	Over-reaction to Fed exit and greater QE by the ECB	10y + 150bp in two quarters	10Y -50bp in two quarters	Spike as with the euro crisis, which fades away one quarter later
4	Delay in Fed exit and QE by the ECB	Half of scenario (1)	10Y -50bp in two quarters	No increase in the appetite for risk

Source: BBVA Research

Results

In all of the scenarios except for where the Fed delays making its move (scenario 4), the results point to a withdrawal of funds in emerging economies, which would range between 1.9% of cumulative GDP over three years up to 2017 and 2.3% of GDP in the worst-case situation. In those scenarios where the ECB adopts a pro-active role using quantitative easing, the negative effects on flows are partly offset, although such an impact is only detectable in Emerging Europe. On a regional level, LatAm is the most affected: in the central scenario flows would shrink by around 3.0% of GDP in cumulative terms up to 2017 (figure B.2.1].

Figure B.2.1
Cumulative effect on flows as a % of GDP, 2015-17



Source: BBVA Research

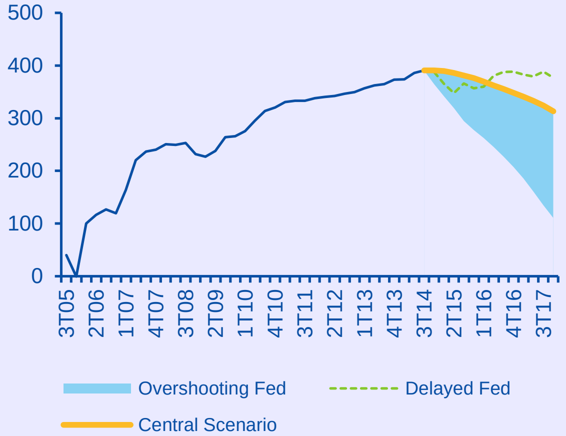
Table B.2.2
Capital flows to emerging economies, simulated scenarios. Cumulative response as a % of GDP

	EME	LatAm	Emerging Asia	Emerging Europe
1	-1.9	-3.0	-1.9	4.3
2	-2.3	-3.7	-2.3	3.5
3	-2.1	-3.4	-2.1	5.9
4	1.1	1.1	0.1	6.9

Source: BBVA Research

The unevenness in the region is striking, with some countries such as Brazil and Mexico enjoying substantial portfolio attraction; Brazil moreover is highly dependent on indexed funds, which adds in volatility and a major pro-cyclical factor. Overall, the cumulative outflow of funds from Latin America could be in the range of 3.0-3.7% of GDP although, in the scenario where the Fed delays rate hikes, there would still be a cumulative inflow equal to 1.1% of GDP (Table B.2.1 and figure B.2.2) over the next two years. The outflow would lead to weakening of the region's currencies, which would in turn place pressure on exchange rate policy management. Those countries most closely integrated with the US market and with delicate borrowing structures will be the hardest hit.

Figure B.2.2
Scenarios for capital flows to LatAm (cumulative figures since 2005, USD bn)



Source: BBVA Research

Conclusions

Monetary normalisation by the Fed will have major implications for Latin America, which should experience capital outflows of around 3.0% of GDP in the next two years.

Despite the outflows expected for the region, it should be recalled that, although to highly varying degrees, most countries are equipped with far sounder fundamentals than in the past to contend with them. The region has built up international reserves which have made it possible to absorb external shocks adequately, while the system of inflation targets and exchange rate flexibility will help to cushion the effects on growth. All in all, this analysis shows the extent to which the region will lose out on one of the tailwinds which has helped it along in recent years, and highlights the need to relaunch internal drivers for growth via structural reforms.

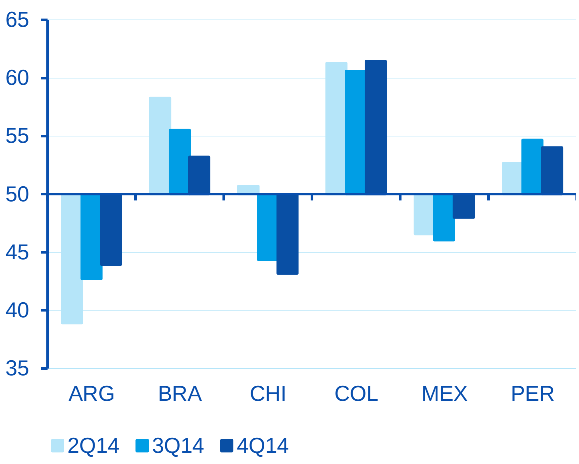
4 LatAm growth will edge upwards from 0.8% in 2014 to 2.4% in 2016

Domestic private sector demand has waned in the last few quarters, in terms of both consumption and investment

The final quarters in 2014 featured a substantial drop in consumer and producer confidence in Brazil, Chile and Mexico and stability in Colombia and Peru, though at sub-2013 levels (except in Colombia). Confidence indicators tended to settle either in pessimistic territory or near its threshold towards the end of the year (Figures 4.1 and 4.2)

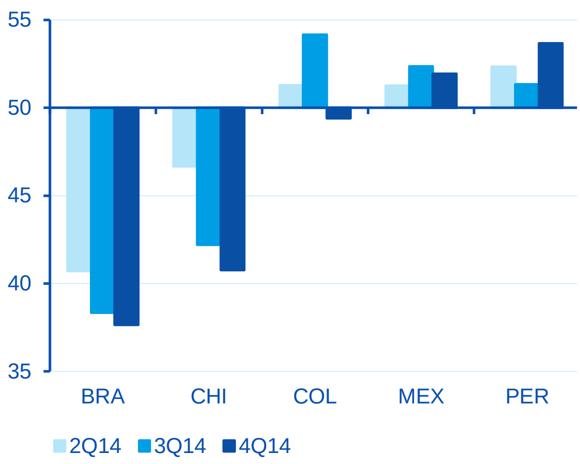
In 2014, domestic and external factors came together to bring about a downturn in growth for the region, although with differences between clusters of countries as described further on. Among these aspects causing the sharp braking of growth are political uncertainty in the cases of Argentina, Brazil and Peru; uncertainty over economic policies such as tax reform in Colombia and Chile (where labour reform is an added consideration), cyclical decline, and an external scenario of slowing growth in China and falling commodity prices, which all affect LatAm countries to different degrees and in varying directions.

Figure 4.1
LatAm: consumer confidence (values of over 50pt indicate optimism)



Source: National statistics and BBVA Research

Figure 4.2
LatAm: producer confidence (values of over 50pt indicate optimism)



Source: National statistics and BBVA Research

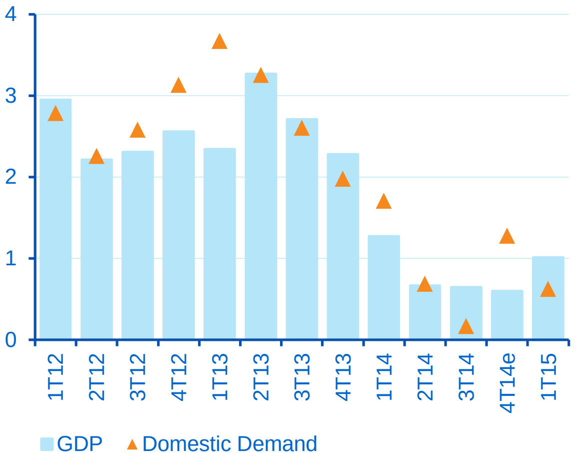
In keeping with this situation, domestic demand indicators showed a relaxation in pace for most countries over 2014. Thus, whereas annual domestic demand growth in 2013 was 2.9%, in 2014 it will have averaged 1.0%, with a decelerating pattern over the year (Figure 4.3). The drop in investment was particularly harsh, whereas consumption slowed down more sedately.

With respect to investment, there were notable falls in Brazil, Chile and Peru, whereas in Colombia and Mexico this surged ahead. In Brazil the drop was especially pronounced in machinery and equipment, while the fall in investment overall topped 6% over the year (-9.6% in 2Q14). Notable in Chile was the poor performance by the mining sector on doubts hanging over the copper price cycle, which tradable goods investment did not manage to offset[3]. Meanwhile, in Peru investment was influenced by poor and dilatory implementation of public projects in the hands of regional and local governments. Public implementation was

3: For a discussion of the dynamics of non-mining tradable goods sectors in Chile see Box 1 of Chile Economic Outlook, First Quarter 2015: “Investment in non-mining tradable goods sectors” key towards the last quarter of the year in Chile, as was the package of measures announced to boost growth in Peru, which helped to save the performance for the year from being worse. In Colombia and Mexico investment shone throughout the year. In Colombia this was influenced by the extraordinary performance by public investment with implementation at record levels, but there was also very promising private investment, while in Mexico this owed itself to a construction industry recovery which began in the latter half of the year following several years of standstill.

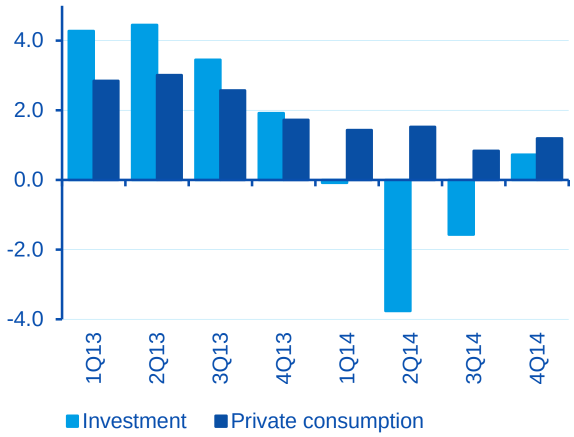
Consumption, on the other hand, was dominated by a subsiding trend in Chile and Peru, in line with a labour market that is losing vigour, while in Brazil, Argentina, Colombia and Mexico the labour market has remained resilient and continued to sustain household consumption. Towards the end of the year the drop in fuel prices served to relax inflationary pressure in the region, which has been mirrored in the improved wage bill witnessed among the Andean countries, and to a lesser extent in Brazil, Argentina and Uruguay, which are still suffering significant upward pressure on prices.

Figure 4.3
GDP and domestic demand (% var. YoY)



Source: National statistics and BBVA Research

Figure 4.4
Investment and private consumption (% var. YoY)



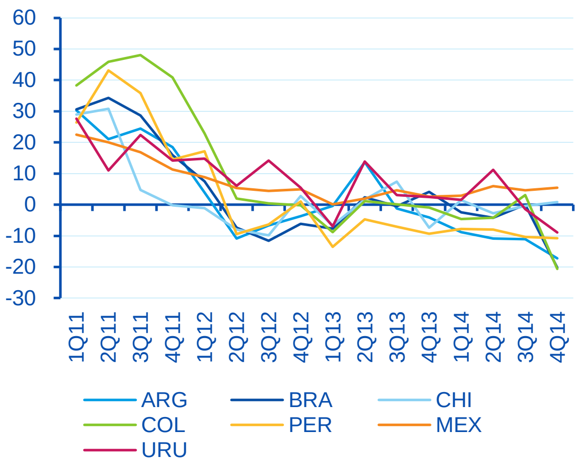
Source: National statistics and BBVA Research

Exports are suffering from commodity price weakness, although some supply shocks still persist

Export indicators have remained shy and in some cases fallen back over the year. This trend intensified towards the last quarter, influenced by the fall in commodity prices, which mainly affected Colombia and Peru. In these two countries the oil price slide has been accompanied by supply shocks in coal-mining and, less severely, the oil industry in Colombia, and the delay in full implementation of the Toromocho and Antamina mining projects (Figure 4.5). The slowdown in exports of non-traditional goods appears to be due more to the commodity price effect rather than particularly marked weakness abroad, although for the time being there has been no major surge in US demand. The exception worth mentioning is the upturn in Mexican exports, especially in the auto industry, with annual growth of 14% in H2. This contrasts with the onset of recession in Brazil coming into the new year, as well as the decline in Argentina's growth, which were factors that have sustained each other and served to exacerbate external sector weakness in both countries.

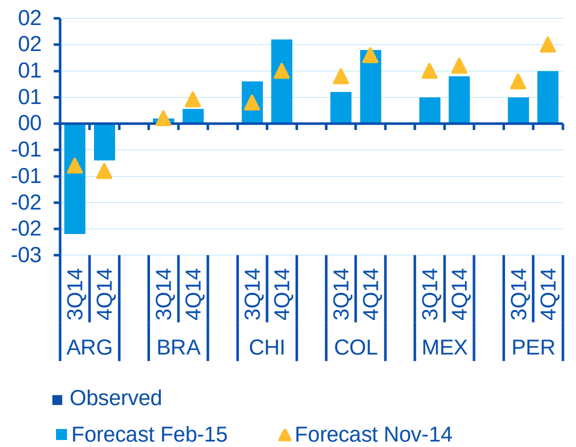
The flatter demand than was initially foreseen in both its domestic and external components has brought unwelcome surprises in relation to growth predicted in Q3 and prompted a revision of the 4Q14 forecasts (Figure 4.6).

Figure 4.5
Exports (% var. YoY)



Source: National statistics and BBVA Research

Figure 4.6
Forecast GDP variation: November 2014 and February 2015 (% QoQ)



Source: National statistics and BBVA Research

The growth forecasts for Latin America in 2015 and 2016 are being revised downwards, mainly on lower prices of key export commodities

Worse-than-expected figures, though chiefly the prospect of lower export commodity prices for extended periods[4] and, to a lesser extent, domestic factors, have led to a downgrade of growth forecasts for 2015 and 2016 for all countries in the region. It should be remembered here that in the baseline scenario export commodity prices will persist below historical levels in the next few years, on top of which there are internal factors such as the likelihood of lower domestic demand in the Andean countries, uncertainty as regards reform processes and more severe adjustment programmes than expected in Brazil. On the other hand it should be noted that, with respect to Argentina, for which upward revisions have been made in 2015 (from 0.2% expected a quarter ago to the current level of 1%), these have been greatly influenced by the change of base year used in the national accounts[5], while the brighter outlook due to cheaper oil is also a factor (Figure 4.8).

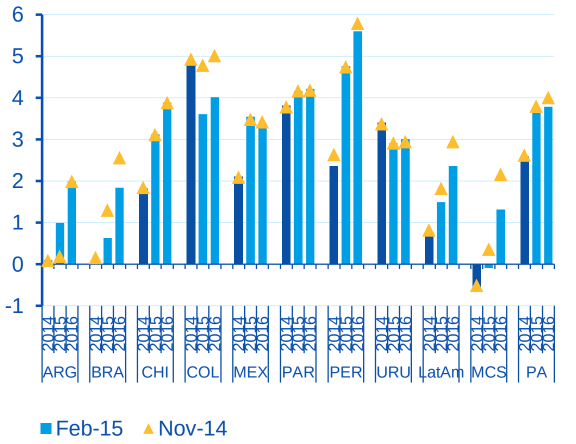
All things considered, we still expect growth in the region to rise over 2015 and 2016, from the stagnation observed in 2014, with a level of 0.8% to 1.5% in 2015 and 2.4% in 2016. For recovery to really get off the ground, it is vital for consumer and producer expectations to be rekindled, and in this sense lower energy prices are very significant. It will also be crucial, particularly in the Andean countries, for the stimulus of the public sector component in demand to be sustained (remember that this could provide half of the growth in countries such as Chile), while the supply shocks will have to play out too - which have hampered projects such as those at the Toromocho and Antamina mines in Peru. Critical, too, will be the pull from global growth, underpinned by better progress in the United States, in a context of weaker exchange rates, which should particularly benefit manufacturing exports by Mexico and Colombia, and go some way to counteracting the depressed oil price.

4: See the simulation in Box 1, “The impact of the fall in oil prices in Latin America”, in this same note.
5: The base year used in formulating the Argentine national accounts was changed from 1993 to 2004, the annual growth variations were adjusted to reflect the new base year, and there were substantial changes. Nominal GDP shows a level higher by around 25% in the new data series. The new figures mean that the agricultural, mining and manufacturing sectors now account for a greater share, whereas the other sectors lose out with the new base year.

The Pacific Alliance countries will continue to perform the most dynamically and approach their potential in 2015 and 2016, with the exception of Colombia, held back by oil price weakness.

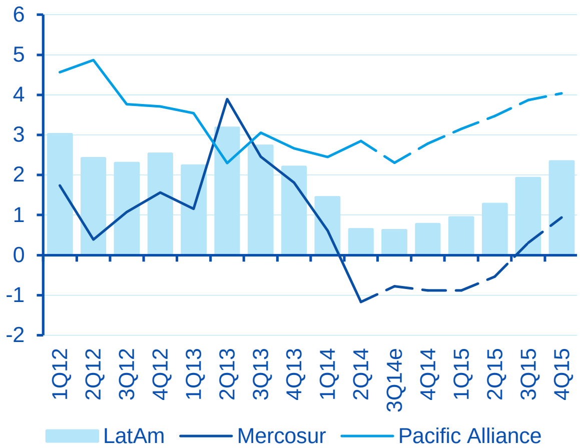
2015 will continue to show up the difference in growth between the countries in the Pacific Alliance (3.6%, close to its potential) and those in Mercosur (-0.1%), but then after 2015 the gap will narrow, although there will still be a considerable divergence. By country, those growing most notably in 2015 will be Peru (4.8%), Paraguay (4.2%), Colombia (3.6%) and Mexico (3.5%). The upturn in growth relative to 2014 will be particularly substantial in Peru (over 2pp), Mexico (1.4pp) and Chile (1.3pp), whereas the correction will mean there is -1.3pp less in Colombia than in 2014, but even so, it will still be among those LatAm countries which grow the most.

Figure 4.7
GDP by country, 2014, 2015 and 2016 (% var. YoY)



Source: National statistics and BBVA Research

Figure 4.8
GDP: LatAm and blocs (% var. YoY)



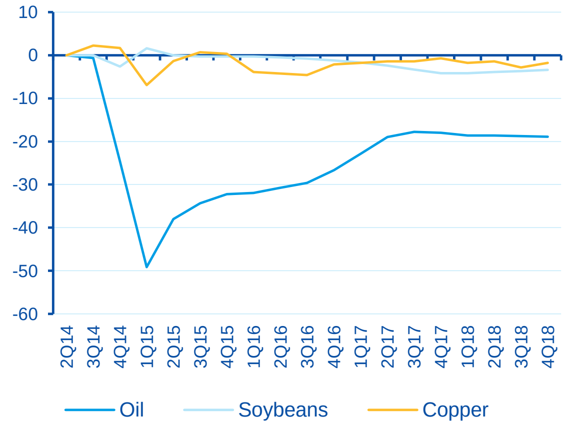
Source: National statistics and BBVA Research

5 The fall in commodity prices is widening high external deficits in LatAm

In very different ways, the fall in commodity prices brings negative repercussions to the region

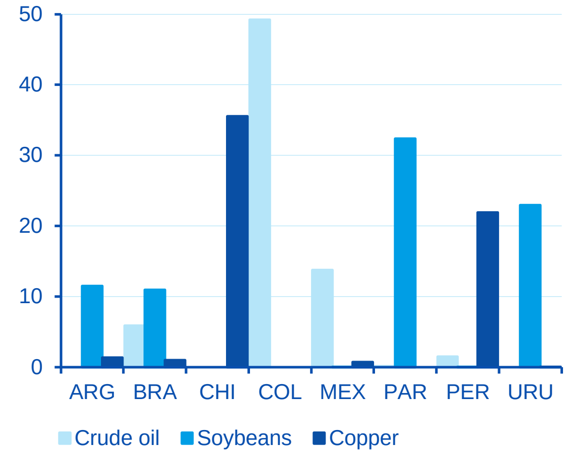
On the one hand, the nose-dive taken by the oil price compared to what was expected in October (Figure 5.1) adversely affects the trade balances of countries with high oil exports, such as Colombia, Brazil and Mexico (Figure 5.2), while it benefits net importers such as Argentina, Chile and Peru. On the other hand, the drop in the price of other commodities such as soybeans, copper and iron ore impact negatively on Brazil, Chile, Peru, Paraguay and Argentina.

Figure 5.1
Commodity prices: % divergence from the trajectory forecast in October 2014



Source: National statistics and BBVA Research

Figure 5.2
Commodity exports as a % of the overall figure

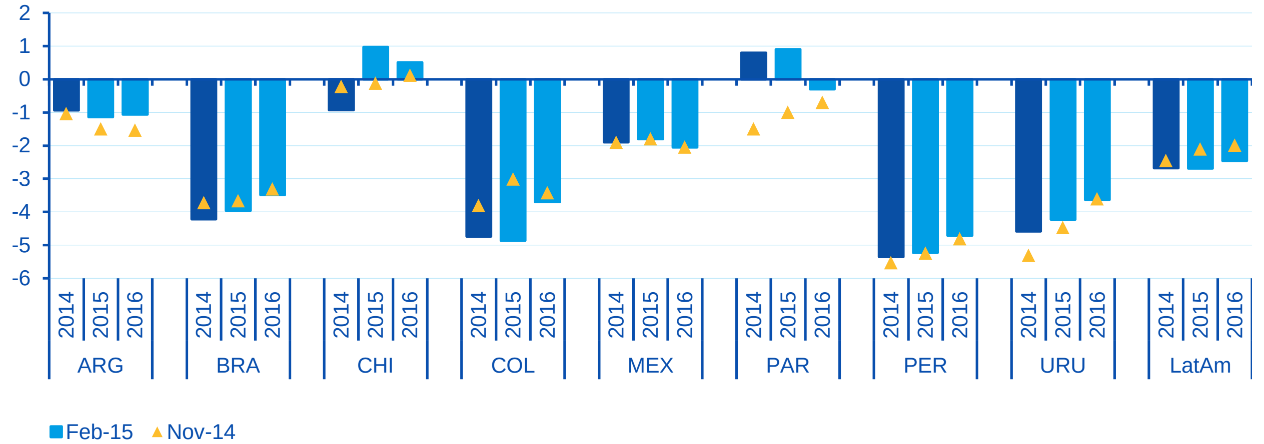


Source: National statistics and BBVA Research

Overall, the net effect on the external balance is slightly negative for the region (Figure 5.3), with revisions tending to a lower deficit in Argentina, Uruguay and particularly Chile and Paraguay. In these countries the lower oil price will more than offset the setback from lower copper and soybean prices. On the other hand, the expected improvement in world growth and exchange rate depreciation will mean that exports continue to provide a spur for growth. In Colombia, though, the greater exports of non-traditional goods do not make up for the effect of the oil price slide, and the foreign deficit will widen in 2015, whereas Mexico is notable in that the drop in oil exports will be offset by manufacturing exports as it benefits from rallying growth in the United States. For Peru we are standing by our current account estimate as the impact of the lower oil price will be compensated by weaker copper and gold prices.

The foreign deficits will begin to improve in 2015, in spite of the poorer terms of trade and more restrained growth in China. It is worth noting that in certain cases such as Peru and Uruguay, although their current account balances show a pattern of becoming smaller, they will still remain a source of vulnerability in the next few years, even if they are kept in check.

Figure 5.3
Current account as a % of GDP



Source: National statistics and BBVA Research

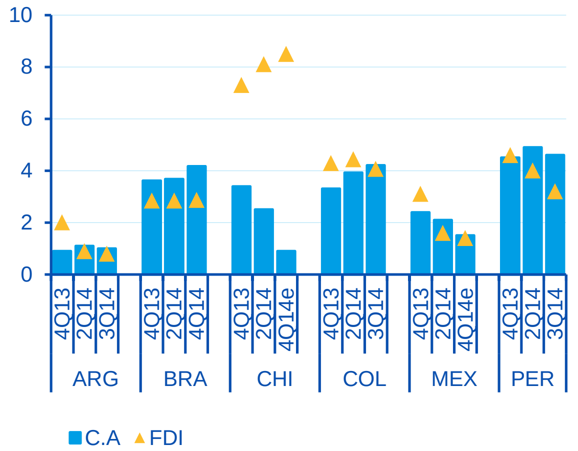
The region's external vulnerability remains limited, despite being slightly augmented by lower FDI

Even though the region's level of vulnerability is still low, the recent foreign deficits of most LatAm countries (Argentina, Brazil, Colombia, Mexico and Peru) have not been fully financed by Foreign Direct Investment (Figure 5.4). Given the prevailing external conditions, this is likely to remain the case in 2015, where the outstanding amount will be funded by using portfolio capital and borrowing, or by calling upon foreign reserves built up over recent years. It should be remembered that the current account deficits of recent years have been a consequence of raising capital for productive investment projects, such as in Colombia, Peru and Uruguay, where there have been infrastructure projects in the former case and mining ventures in the other two, which enhance the productive capacity of these countries and will be key to the forecast improvement in foreign deficits from 2016.

Nonetheless, the low prices in the primary export sector do not bode well for livelier foreign direct investment in the next few years. Furthermore, as has been mentioned in Box 2 on Fed rate hikes and capital inflows to Latin America, the region will be affected by lower portfolio flows in the coming quarters. The risk of lower inflows thus still looms as a source of vulnerability.

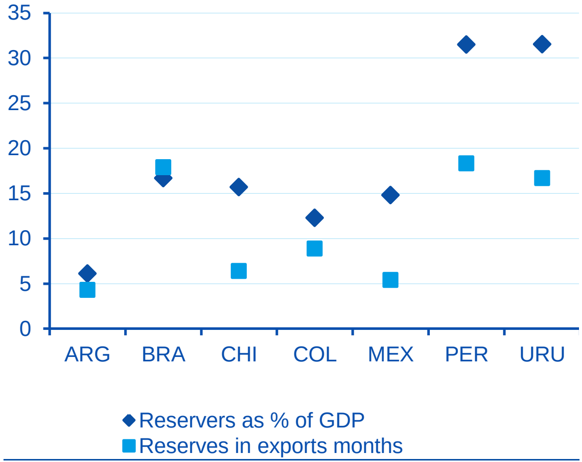
Taken together, the LatAm countries are well-placed to withstand any outflows of foreign reserves, so expected depletion of these should not prove too unsettling for the economy. They stand at acceptable levels according to various methods of measuring them (Figure 5.5), representing approximately 15% of GDP and in all cases equating to over four months of imports. Moreover, foreign reserves are also supplemented in certain cases by flexible lines of credit from the IMF (Colombia and Mexico) and sovereign funds (Chile and Peru).

Figure 5.4
LatAm: FDI and current account



Source: National statistics and BBVA Research

Figure 5.5
Foreign reserves in LatAm: adequacy indicators



Source: National statistics and BBVA Research

6 Flatter domestic demand and commodity price correction are threatening fiscal balances in some countries

The prospects for the region's fiscal balances from 2016 are looking gloomier in line with lower-than-expected commodity prices

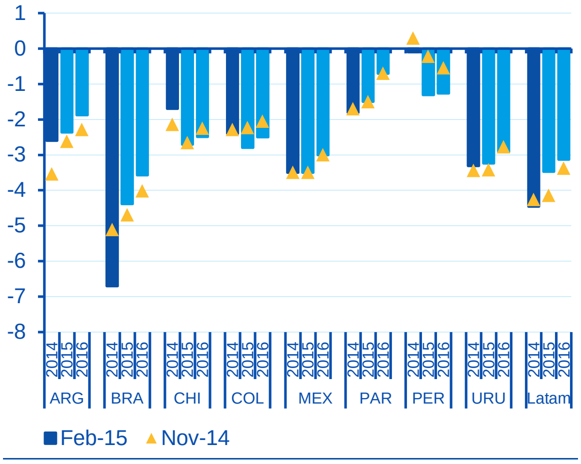
Forecast commodity prices will also affect estimates for fiscal balances in the region, yet governments are standing by their commitment to economic growth, which will mean that fiscal balances come under further pressure in the medium term (Figure 6.1).

For the year just ended, we see a pronounced deterioration in the primary balance in 2014 in Argentina and Brazil. For Argentina, though, the drop in the oil price will impact positively, as it implies less of a need for funds to subsidise gas and fuel imports. On the other hand, a programme of fiscal adjustment has been announced in Brazil which will entail a gradual recovery of the primary balance at the expense of side-effects which hinder activity.

Further into 2015 there will be less revenue from the commodity export sector, which will affect Chile, Colombia and Mexico, where the latter two countries will feel the effects in 2016. This year the tax revenues arising from domestic demand will be lower as it grows less briskly than was expected a quarter ago. In Peru, lower tax revenues are predicted following the measures to boost the economy which were announced in late 2014 (lower tax rates, accelerated depreciation, etc.), while in Chile tax receipts were up in 4Q14, in line with government projections and we estimate that tax collected for 2015 of approximately 1%, which is not without associated risks, as a large slice of the higher revenues will come from lower levels of tax evasion and the plugging of loopholes. In Colombia, lower revenues from commodities will be offset by greater inflows after the tax reform at the end of 2014, and in Mexico the tax effects of lower oil prices will be mitigated by the government's hedging strategy.

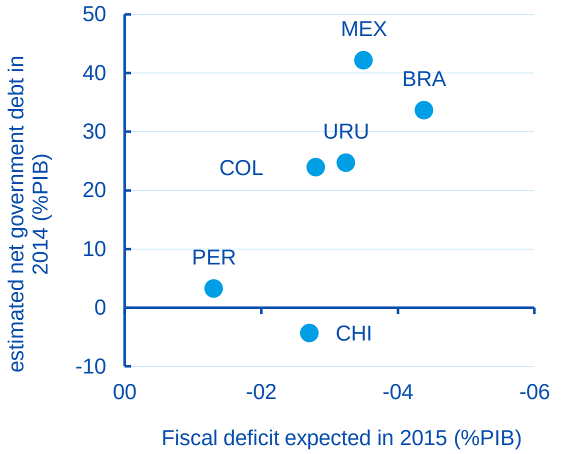
Public investment programmes (and public-private partnership ventures) will be one of the mainstays of growth, especially in the Andean countries. Peru announced a major fiscal stimulus initiative at the end of 2014, Chile managed to speed up budget implementation late last year, and Colombia will follow suit with the commitment to keep public spending high by backing, among others, infrastructure programmes. Together with commodity prices stuck below levels estimated a month ago, this commitment will put public finances in the region under heavy pressure from 2016 (partly allayed by an upturn in global activity). Additional measures are likely to be called for, such as public spending cut-backs (Mexico), further tax reforms (Colombia), or a potential relaxation of structural fiscal rules (Peru). It should be recalled that public borrowing is holding at levels which do not impinge on the sustainability of government finances in the coming years, and there is some elbow-room to implement counter-cyclical policies, should this be required (Figure 6.2).

Figure 6.1
Fiscal balances (% of GDP)



Source: National statistics and BBVA Research

Figure 6.2
Fiscal deficit expected in 2015 and estimated net government debt in 2014 (% of GDP)



Source: National statistics and BBVA Research

7 Central banks are exhibiting a looser tendency and could uncouple from the Fed in 2015, though not in Mexico

Inflationary pressure is easing in general on cyclical weakness and the oil price fall, whereas it is rising in Brazil in spite of poor demand

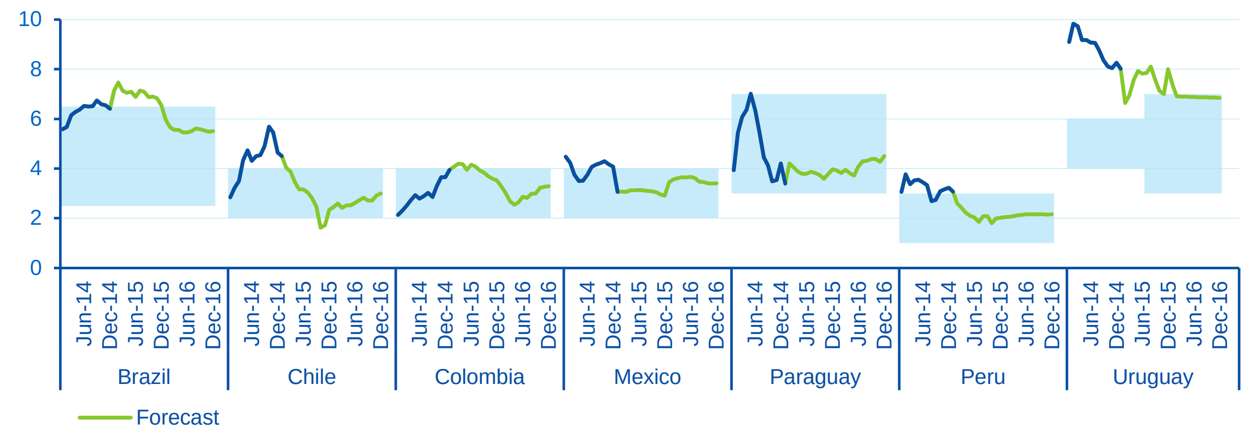
While the sharp downward correction of commodity prices has held back economic growth, it has also helped to bridle inflationary pressure. As is pointed out in Box 1, the fall in the oil price has a downward effect on domestic prices, which will be magnified by the receding prices of other commodities that are important for LatAm countries, especially agricultural and livestock goods.

Another helpful factor as regards inflation in the region is the slowdown in economic activity, as demand pressure has now abated somewhat, even though the labour market is still strong in certain cases.

These two factors, namely lower commodities prices and slower growth, have allowed inflation forecasts to be lowered in most LatAm countries compared to those we ventured three months ago. The most recent inflation figures, however, point to the existence of certain upward pressures, generally unrelated to demand aspects. The best example of this is from exchange rate depreciation, which is something that has been observed in virtually all of the LatAm economies. In most countries, however, such as, for example, Mexico and Chile, these pressures from depreciation have not stopped inflation from subsiding in recent months (figure 7.1).

The most notable exceptions to this downward trend in the last few months have been Colombia and Brazil. In both cases the sharp exchange rate depreciation was heavier than in the region's other countries (figure 3.4) and has played a major role in the recent deterioration. In Brazil, the main culprit behind the spike in inflation has been the adjustments in government-regulated prices, in an environment where the fiscal restrictions stop prices from being held down artificially low.

Figure 7.1
LatAm: inflation (% YoY) and target range for central banks



Source: BBVA Research

Inflation will gradually converge towards central bank targets

Following the trends described above, inflation as we commence 2015 stands above the target band for the central banks in Chile, Peru, Brazil and Uruguay. In the first two cases, though, not only is the gap with the ceiling of the target band narrower, but this upper limit is far lower (4% in Chile and 3% in Peru, against 6.5% in Brazil and 7.0% in Uruguay).

In contrast, in Colombia, Mexico and Paraguay inflation is currently within the target ranges. In all three countries the most recent figures show inflation of around 3.5%.

In general, we expect inflation to move towards the targets set by the respective monetary authorities in the medium term (figure 7.1). In Mexico, convergence of this kind will be helped by the reduction in telephone charges following recent regulatory changes, while in Colombia this should occur in spite of the fact that in the short term inflation will top 4%, the upper limit of its target range. In Brazil and Uruguay, although there is greater tolerance regarding inflation, given their wider target ranges, convergence will be gradual and limited, as in these two countries the central targets (of 4.5% in Brazil and 5% in Uruguay) will not be achieved, and inflation will remain either at the upper end of the target range or above it.

Our current forecasts (see figure 7.1 and forecast tables in Section 8) are in general a fraction lower than they were three months ago, which reflects a kinder environment as regards inflation. Only in two countries, Brazil and Colombia, have we not either held our inflation forecast practically unchanged or lowered it. In line with what we were saying before, the upward revisions for Brazil and Colombia, which are concentrated in 2015 (from 5.8% to 6.5% for the close of the year in Brazil, and from 3.3% to 3.5% for the same period in Colombia), relate to the sharp exchange rate depreciation as well as, in Brazil, the considerable pressure from regulated prices.

Therefore inflation will generally remain under control and inflation expectations will stay well-anchored in the Pacific Alliance countries and in Paraguay. Despite the prospects of falling, in Brazil and Uruguay inflation will continue at a high level and achieving a greater anchoring of expectations will remain a challenge for the authorities in economies

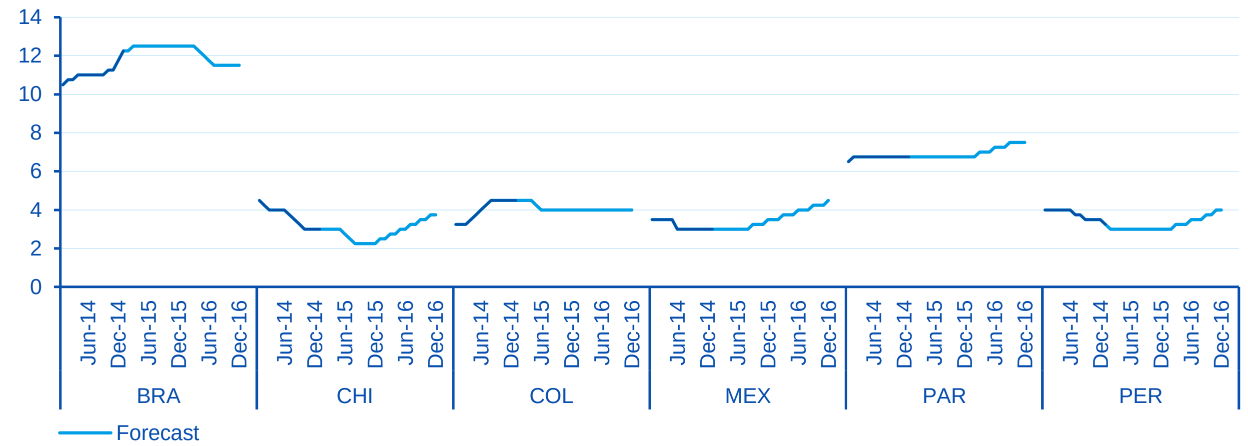
The region’s central banks are showing a looser bias despite the impending Fed rate rises

Interest rates stand at levels below those of a year ago and also six months back in most countries (figure 7.2). The main exceptions are Colombia and Brazil, not just because of the upward path being traced by inflation in both cases, but also due to the greater resilience of economic activity to current circumstances in Colombia and the need for credibility to be restored to monetary policy in Brazil.

The slowdown of economic activity and the more inflation-friendly environment are taking pressure off the region’s central banks, so monetary policy has now taken on a more relaxed hue.

The more expansive tone adopted by the region’s central banks should mean further cutting of interest rates over 2015 in Peru and Chile. Specifically, we expect reference rates in Peru to be trimmed by 25bp to 3.0% in the short term, while we predict that, after three 25bp cuts in the course of the year in Chile, interest rates there will reach 2.25%.

Figure 7.2
LatAm: Monetary Policy Rate (%)



Source: BBVA Research

Colombia should soon join the set of countries in which monetary policy will become more expansive over the year in response to concerns over a slowdown of activity, in Q2 to be exact. We expect two cuts of 25bp and interest rates at 4.0% for a long while from then on.

Our current forecasts are thus for rates of 2.25% in Chile, 3.0% in Peru and 4.0% in Colombia at the close of 2015, which are respectively 25bp, 75bp and 100bp below what we were estimating three months ago. The three Andean countries should therefore, at least in 2015, buck the trend of a potential wave of hikes prompted by the raising of rates in the United States in Q3.

Similarly, in Paraguay we foresee rates holding stable at 6.75% throughout the year. As with the Andean countries, Paraguay should steer clear of embarking on a monetary tightening policy immediately following the rate hikes in the United States.

The situation is otherwise in Brazil. The tone is now more restrictive than it was three months ago. Benchmark rates should reach at least 12.50%, which is 25bp above our previous estimate, although there ought not to be any shift in monetary policy immediately following the start of the monetary normalisation process in the United States.

Mexico will be the exception among the countries in the region pursuing target inflation rates, and we do not expect it to disengage from US monetary policy. We are standing by our view that a gradual adjustment set in train after the policy move in the United States will take the Mexican reference rate to 3.50%.

The short-term unhitching of monetary policy from that in the United States which is anticipated in most of the LatAm countries should be possible, not only thanks to the economic slowdown, reduced pressure from domestic prices and the backing of monetary policy in Europe, but also to an apparent softening of aversion to adjustment working through via the mechanism of exchange rates. Instrumental to this phenomenon is the perception that any impact of a depreciation on prices should be minimal, especially in an environment of growth short of its potential and the view that currency weakness should not produce losses that are too significant for the corporate sector (see Box 3 for further clarification on this subject).

Whatever transpires, as growth starts to gather momentum and the process of monetary policy normalisation in the United States goes ahead and discussion turns to tapering monetary stimuli in Europe, interest rates should come under increasing pressure to rise. Given this likely environment in 2016, we forecast further rate hikes in Mexico (up to 4.50%) and the initiation of a new round of monetary tightening in Chile (up to 3.75%) and Peru (reaching 4.0%), although this will be less extreme than previously predicted. In contrast, dampening of inflation and salvaged credibility for economic policy should mean that rates can be cut to levels approaching equilibrium in Brazil in 2016.

Exchange rates will languish at weaker levels looking ahead

As was noted in Section 3, exchange rates have come back a very long way in recent months. In almost all of the LatAm countries, currencies are close to lows since the 2008-09 Lehman Brothers crisis.

In the present situation, several forces are at work which would depress the region's currencies, among them the normalisation of monetary policy in the United States and the appreciation of the dollar on world markets, expansive monetary policy, the drop in commodity prices and widening current account deficits.

The significance of each of these factors varies from country to country, which endows them with differing patterns of currency depreciation; both those actually observed and those that one might expect.

In part of the region, the improved economic activity indicators should tend towards some of the depreciation over recent months being reversed in the course of 2015 and 2016 (figure 7.3 and forecast tables in Section 8). This would be true of Colombia, Mexico and Chile. In this last country, the powerful current account correction, which should lead to a surplus as early as this year, as well as potential dollar sell-offs by the Treasury to finance pledged public spending, lends weight to forecasts of forthcoming peso appreciation.

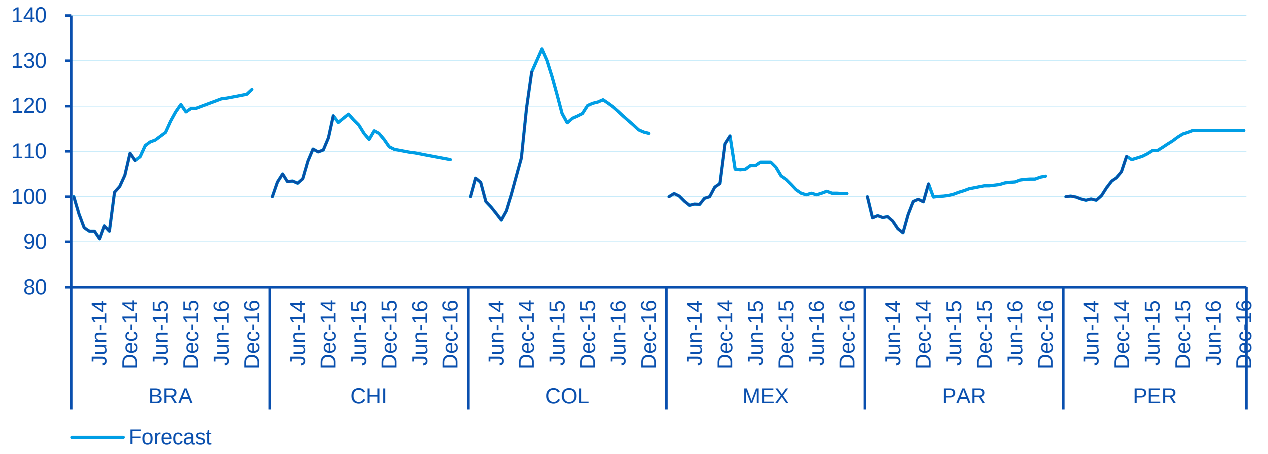
Elsewhere in the region, in Peru, Brazil and Uruguay currencies should continue to weaken. In Peru, the apparently reduced reluctance to countenance any further depreciation of the PEN should lend itself to a gradual fall in the currency this year as well as the next. In the two other countries, exchange rate depreciation is the more likely owing to greater domestic inflation, besides the need to restore lost competitiveness.

In Paraguay, the exchange rate will move in a way which differs from the basic patterns described above. In the short term we expect the PYG to strengthen, which would cancel out part of its recent slide. The currency should, however, go on to take a steadily weakening course.

Despite the different trajectories forecast from here, in 2015 and 2016 exchange rates will remain at stronger levels than they have in the past in all the countries under review, in line with the new local and global economic situation. Compared to 2014, the exchange rate will on average be 15-20% weaker in Brazil, Colombia and Peru, and around 5-10% weaker in the other countries.

In spite of the cost in inflation terms and the impact on economic agents with borrowings in foreign currency, exchange rate depreciation should boost economic recovery in Latin America by enhancing its competitiveness abroad.

Figure 7.3
LatAm: Exchange rates (January 2012 = 100)



Source: BBVA Research

Box 3. Limited risk of currency mismatches in the corporate sector in Latin America

In a scenario of exchange rate strength and copious liquidity in the international market in the wake of the 2008 financial crisis, the emerging nations, and among them those in Latin America, stepped up fund-raising in overseas markets, especially in the non-financial corporate sector[6].

The risk, and consequently concern, regarding a potential currency mismatch in the corporate sector is greater at times such as now[7,8], when the weakening of commodity prices and the prospect of monetary normalisation in the United States place mounting pressure on the exchange rates of LatAm countries. Compounding this is the fact that there is far less information available on the financial position and exposure to foreign currency of the non-corporate private sector than there is, for example, as regards either the state or the financial system.

It should in any case be pointed out that there are four factors which should diminish the currency depreciation effect: i) unlike what happened in 2008, the current weakening has been evident for some time now, which has allowed companies to ready themselves for it; ii) the countries have been able to learn from the 2008 experience and in certain cases, particularly in Mexico and Brazil, where the corporate sector took a notable battering from the Lehman Brothers fall-out owing to their foreign currency exposure, regulatory changes have been brought in to curtail the risk of a major currency mismatch; iii) the region's economies have considerable foreign currency liquidity from building up reserves in recent years, which could be channelled into the private sector if required (as was done in certain countries in 2008-09 and is even now taking place); and iv) some companies which have issued bonds in foreign currencies could have natural cover if their revenues are linked to the exchange rate, for example by being exporters or direct suppliers to the export sector.

To what extent is the non-financial corporate sector in Latin America exposed to exchange rate fluctuations? This box describes the findings from studies conducted by the region's central banks, which have examined the degree of currency mismatch of non-financial companies, thus affording us an overview of the situation in the region.

Argentina

After the traumatic collapse of the currency board in late 2001 and early 2002, and the subsequent learning process regarding the risk of currency mismatches, the Argentine private sector's external debt was steadily brought down to 12.4% of GDP in 2Q14 from 31% at the close of 2001. This figure is not only low but additionally: i) 50.3% of this debt involves companies in various tradable goods sectors (industry, mining and agriculture, among others) that have a large portion of their revenues in foreign currency, which provides them with natural cover; ii) 43% of the private sector's external debt is with companies in the same group, which would manage to refinance themselves without too much trouble in the event of an episode of currency depreciation. On this basis, only a small fraction of the private external debt in foreign currency is exposed to a significant risk of a currency mismatch. With respect to the dollar debt within the local financial system, this was also reduced from 13.9% at the end of 2002 to 0.7% of GDP in 2Q14, with the additional qualification to note that loans of this kind in foreign currency are arranged for export firms (under a regulatory change made by the central bank after the currency board

6: For further details on this process of rising fund-raising abroad, see, for example, the 2014 Latin America and the Caribbean Macroeconomic Report, IDB. "Global recovery and monetary normalisation".
7: See, for example, Global Financial Stability Report, 2014. International Monetary Fund
8: See, for example, Bank for International Settlements, "Chapter IV - Debt and the financial cycle: domestic and global", 84th BIS Annual Report, 2013/2014.

crisis), which means that the risk of a currency mismatch is even less.

Brazil

According to a study recently published by the central bank[9] using data on access to bank credit, external debt, credit instruments and currency derivatives, total corporate debt was 49.2% of GDP in 2014. Of this amount, 17.1% of GDP was foreign currency denominated, of which 6.1% of GDP was accounted for by export companies (which have natural currency cover, as we have mentioned earlier), 3.0% had currency cover in local markets, 5.1% was where the company's parent or part of its assets were abroad, and only 2.9% of GDP had no known kind of currency hedging. The study thus supports the contention that the currency mismatch problem is limited in Brazil. Although funds raised by subsidiaries of Brazilian companies abroad are not included in the central bank figures, the monetary authority argues that these are not significant volumes. Finally, all the requirements for greater information on the holding of currency derivatives, that were established after the problems that arose with the exchange rate depreciation in 2008, such as the central bank's currency swap selling programme which began in 2013, among other measures, are factors which mitigate the potential impact of exchange rate depreciation.

Chile

In Chile, a central bank study[10] highlights the sound position of Chilean companies with regard to any depreciation. According to the data provided, the currency mismatch as measured by dollar liabilities less dollar assets, less the net derivatives position, as a percentage of total assets (asset-weighted average) came down from 1.8 to 0.8 between 2009 and 2013. Similarly, the proportion of company assets with a mismatch percentage of over 10%, measured as a percentage of overall assets, dropped by 60% in 2008-13. Even though companies have been stepping up external bond issues to the detriment of local bonds since the middle of 2013, they have generally gone hand-in-hand with currency hedging. Chile's currency mismatch risk is thus limited.

Colombia

In Colombia, a recently published central bank study[11] notes that currency mismatch levels rose in 2005-12. On average, 28% of foreign debt in this time was currency-hedged, although this figure could be underestimated as no information is available on hedging by Colombian companies with foreign counterparties. On the other hand, 84% of the debt in foreign currency is in companies with foreign capital, so they could be less affected by exchange rate fluctuations. It should also be noted that the information used in this study does not address the universe of companies with foreign currency debt, and the figures provided are the average for 2005-12 and do not necessarily represent the true current situation.

Mexico

A central bank study[12] draws on information on all of the companies listed on the Mexican Stock Exchange which publish their financial statements quarterly. These companies have issued around 88% of the sum total of bonds placed abroad, so this is therefore highly representative of the universe in question. The study concludes that, on aggregate, losses would be limited given a 30% currency depreciation, as they would equate to little more than 15% of equity, or only around 5% if we take into account the hedging that companies have made. The comparatively small impact of such a depreciation relates to the significant reduction in exposure using FX options since 2008. On top of this, issues have been placed with long terms and at fixed rates, so companies do not appear to have taken on sizable refinancing and interest rate risks. Notable too are the regulatory changes brought in over recent years in connection with the derivatives

9: Box "Performance of non-financial corporate borrowing following the 2008 international crisis", from the central bank's September 2014 Financial Stability Report.
10: Box III.1 "Currency mismatch in the non-financial corporate sector" from the central bank Financial Stability Report, Second Half of 2014
11: Angel, S., Niño J., Montes "Currency mismatches of non-financial firms in Colombia". Economics Notes 805-2014
12: Report on the Financial System. Central bank. October 2014. pp: 52-56

market, both domestically and internationally, which have helped to limit risks.

Peru

In Peru, a study[13] by the central bank of non-financial companies examines a set of 84 companies (listed on the Lima stock exchange) from March 2011 to December 2013. To measure mismatch risk they use gains or losses produced by exchange rate fluctuations as a proxy. The results indicate that these companies showed considerable and rising losses in 2013, due to higher dollar borrowings which entailed high exchange rate losses. With respect to progress in the regulatory environment, at the end of 2012 the banking and insurance watchdog (SBS) established higher capital requirements for currency credit risk exposure and more demanding (i.e. lower) benchmark loan-to-value ratios for dollar mortgage loans. Moreover, in 2013 the central bank stipulated an additional reserve requirement for financial institutions which exceed a limit set on dollar-denominated vehicle and mortgage loans. Here it should be mentioned that in early 2015 the central bank toughened up the previous measure by imposing a further reserve requirement that will apply to those financial institutions that do not comply with the obligation to cut down the balance of their dollar loans (excluding foreign trade lending) by 5% as of June and 10% up to December this year.

Conclusion

The information on the degree of exchange rate exposure in the non-financial corporate sector is very thin in Latin America, as it is in the other emerging economies. Based on sparse studies by the region’s central banks, it could be concluded that the individual corporate sectors are in most cases prepared to face up to the costs of a sharp depreciation in the exchange rate, as the increase in external liabilities in the last few years has been accompanied by a rise in foreign assets and currency hedging.

This said, we should be mindful that the lack of information, especially in certain countries, such as Peru and Colombia, rules out making a more emphatic and widely applicable conclusion. We therefore think that the central banks and supervisory authorities should pursue efforts to gather and disclose data conducive to more ample analysis, which would remove uncertainty over the risks attaching to any depreciation of LatAm currencies.

13: Box 2 “Currency risk at non-financial companies” Central bank Financial Stability Report. May 2014

8 Tables

Table 1:
GDP (% YoY)

	2012	2013	2014*	2015*	2016*
Argentina	0.8	2.9	0.1	1.0	2.0
Brazil	1.0	2.5	0.1	0.6	1.8
Chile	5.4	4.1	1.8	3.1	3.9
Colombia	4.0	4.7	4.9	3.6	4.0
Mexico	3.8	1.7	2.1	3.5	3.4
Paraguay	-1.2	14.4	3.8	4.2	4.2
Peru	6.0	5.8	2.4	4.8	5.6
Uruguay	3.7	4.4	3.4	2.9	3.0
Mercosur	1.2	2.4	-0.6	-0.1	1.3
Pacific Alliance	4.2	2.9	2.6	3.6	3.8
Latin America	2.5	2.6	0.8	1.5	2.4

*Forecasts
Source: BBVA Research

Table 2
Inflation (% YoY, avg.)

	2012	2013	2014*	2015*	2016*
Argentina	10.0	10.6	20.9	20.6	24.1
Brazil	5.4	6.2	6.3	6.8	5.6
Chile	3.0	1.8	4.4	3.0	2.7
Colombia	3.2	2.0	2.9	3.9	3.0
Mexico	4.1	3.8	4.0	3.1	3.5
Paraguay	3.7	2.7	5.0	3.9	4.1
Peru	3.7	2.8	3.2	2.2	2.1
Uruguay	8.1	8.6	8.9	7.5	6.9

*Forecasts
Source: BBVA Research

Table 3
Exchange rate (against USD, average)

	2012	2013	2014*	2015*	2016*
Argentina	4.55	5.48	8.12	10.22	14.59
Brazil	1.96	2.18	2.36	2.78	2.95
Chile	486	495	570	617	587
Colombia	1798	1869	2001	2414	2313
Mexico	13.2	12.8	13.3	14.1	13.3
Paraguay	4417	4312	4514	4731	4848
Peru	2.64	2.70	2.84	3.10	3.22
Uruguay	20.2	20.4	23.2	25.8	28.1

*Forecasts
Source: BBVA Research

Table 4
Interest Rate (%, avg.)

	2012	2013	2014*	2015*	2016*
Argentina	13.85	16.92	22.55	19.76	20.77
Brazil	8.46	8.44	11.02	12.46	11.88
Chile	5.02	4.90	3.69	2.63	3.13
Colombia	4.94	3.35	3.98	4.19	4.00
Mexico	4.50	3.94	3.21	3.10	3.96
Paraguay	6.00	5.54	6.73	6.75	7.19
Peru	4.25	4.21	3.79	3.02	3.48
Uruguay	18.59	17.70	21.36	18.71	18.17

*Forecasts
Source: BBVA Research

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

	2012	2013	2014*	2015*	2016*
Argentina	-0.2	-0.8	-0.9	-1.1	-1.1
Brazil	-2.4	-3.7	-4.2	-4.0	-3.5
Chile	-3.4	-3.4	-0.9	1.0	0.5
Colombia	-3.1	-3.2	-4.7	-4.9	-3.7
Mexico	-1.3	-2.1	-1.9	-1.8	-2.0
Paraguay	-0.9	2.3	0.8	0.9	-0.3
Peru	-3.3	-4.5	-5.4	-5.2	-4.7
Uruguay	-5.3	-5.6	-4.6	-4.2	-3.6
Mercosur	-1.4	-2.3	-2.7	-2.9	-2.6
Pacific Alliance	-2.0	-2.7	-2.6	-2.4	-2.3
Latin America	-1.6	-2.5	-2.7	-2.7	-2.5

*Forecasts
Source: BBVA Research

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

	2012	2013	2014*	2015*	2016*
Argentina	-2.5	-2.3	-2.6	-2.3	-1.9
Brazil	-2.5	-3.3	-6.7	-4.4	-3.6
Chile	0.6	-0.6	-1.7	-2.7	-2.5
Colombia	-2.3	-2.4	-2.4	-2.8	-2.5
Mexico	-2.6	-2.3	-3.5	-3.5	-3.0
Paraguay	-1.8	-1.9	-1.8	-1.5	-0.7
Peru	2.3	0.9	-0.1	-1.3	-1.3
Uruguay	-2.8	-2.5	-3.3	-3.2	-2.9
Mercosur	-2.8	-3.0	-5.7	-3.8	-3.5
Pacific Alliance	-1.7	-1.8	-2.7	-3.1	-2.7
Latin America	-2.3	-2.5	-4.5	-3.5	-3.1

*Forecasts
Source: BBVA Research

Table 7
Commodity forecasts

	2012	2013	2014	2015*	2016*
Oil (Brent USD/Barrell) (average)	111.6	108.5	99.1	65.0	75.4
Soybeans (USD/ton) (average)	537.8	517.5	459.5	374.5	390.5
Copper (USD/pound) (average)	3.6	3.3	3.1	2.8	2.7

*Forecasts
Source: BBVA Research

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