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# Latin America Economic Outlook

Second quarter 2015
LatAm Coordination Unit

- LatAm growth will remain low in 2015 and will slowly pick up in 2016, though still below the region's potential level. Unevenness will continue in the region, with Brazil in recession and the Pacific Alliance growing at around 3%.
- The recession in Brazil in 2015 will spill over into Argentina, Uruguay and Paraguay and have a very minor effect on the other countries in Latin America.
- Except in the case of Mexico, inflation has stayed above forecasts in those countries with inflation targets, partly due to currency depreciation, but particularly on account of idiosyncratic fiscal and weather-related shocks.
- The window for monetary stimulus in the Andean countries is closing, despite the cyclical weakness. Surprises on the high side in inflation (and in Peru, the exchange-rate volatility) are discouraging central banks from cutting interest rates, which should remain stable in 2015 in Colombia, Peru and Chile.

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**Closing date: 29 May 2015**

# 1 Overview

**We have revised our world growth forecast for 2015 to 3.5%, 0.1pp less than predicted in February, whereas we have raised our estimate for 2016 a shade to 3.9%.** The downward revision for 2015 is to a large extent because of the slowdown in world growth in 1Q, the brief slowdown in the United States, and the decline in activity in certain key emerging markets. In a scenario of gradual, trend slowdown in China, the emerging economies should reverse their current deceleration thanks to the pull effect from the developed economies, the slow but sure rise in commodity prices, and a potentially more restrained rate hike than in previous Fed normalisation processes.

**The volatility in the region's financial markets continued, strongly influenced by the revisions to forecasts regarding the start of the Fed's rate hike.** Prices of the major financial assets and interest rates continued to weaken until mid-March, when they began to tick up again (without fully making up the lost ground) as the belief took hold that the Fed's rate adjustment would be later and more gradual than was anticipated coming into the year. Looking ahead, the volatility in financial markets will continue as activity and employment figures in the United States go on altering expectations concerning the beginning of the Fed rate hikes.

**Meanwhile, commodity prices have stayed at modest levels, with one or two upturns in oil and copper.** Part of the price rises related to supply fundamentals, but they were also influenced by a bit of dollar depreciation at the start of 2Q, in line with the other financial assets in the region.

**In a context of virtually general weakness in the confidence indicators, we have revised our growth forecasts for Latin America downwards, to 0.6% in 2015 and 2.1% in 2016.** The downward revision has been brought about by i) lower-than-expected growth in 4Q14 and 1Q15; ii) the decline in household and business confidence, caused by an escalation of political ructions and uncertainty over the economic policies in a number of the region's economies, which has weighed on private-sector consumption and investment, and iii) the fall in public expenditure in certain major economies in the region, such as Brazil, Mexico, Colombia and Peru. The increase in LatAm growth in 2016 should be driven by i) dynamic external demand in step with the increase in world growth; ii) the boosting of public investment, especially among the Andean economies, and iii) a milder macroeconomic adjustment in larger economies such as Brazil.

**By countries, the downward revision to 2015 growth forecasts is concentrated in particular among Brazil, Mexico and Peru, although it affects almost all of the region's economies.** In Brazil, the lower growth forecast (-1.3pp in 2015, to -0.7%) arises due to a stronger-than-expected macroeconomic adjustment, higher inflation and uncertainty overshadowing the crisis affecting Petrobras. The sharp shift in Brazil's growth should have a significant spill-over effect, basically on Argentina, Paraguay and Uruguay, although this will be minimal in relation to the other economies in the region (Box 1). Besides Brazil, the downward revisions to forecasts are also very substantial for Mexico (-1pp, to 2.5%, partly from the oil price slide, the weak 1Q growth in the United States, and the public expenditure adjustment) and Peru (-1.7pp to 3.1%, hindered by low confidence and delays in public investment).

**Unevenness will continue to prevail in the region and it will still be the Andean countries and Paraguay which grow the most in 2015 and 2016.** The Pacific Alliance will carry on growing at 2.7% in 2015, much as it did the previous year, and growth will then increase to 3.2% in 2016, above the regional average, although below its potential, which we estimate to be slightly over 4%. Notable above other cases will be the surge in growth in Peru and Chile over 2014-16, at rates of 2.2pp and 1.6pp respectively (see the tables of forecasts in section 9).

**Inflation rose in the region in spite of the cyclical weakness, but it should come back to central bank target levels at the end of 2015 or 2016, except in Brazil and Uruguay (although it will be within the target range in Brazil).** With the exception of Mexico, inflation at the end of 1Q was above our estimate of one year ago and also three months back, due to the currency depreciation (especially in Peru and Chile) as well as idiosyncratic factors, which include tax hikes (Chile, Brazil), the rise in administered prices (Brazil), food price shocks (Peru and Colombia) and inertia-related factors (Uruguay and Brazil).

**Despite the cyclical weakness, the window of opportunity is closing up for a cut in interest rates by the Andean central banks given the persistence of inflation (and in Peru, the exchange-rate volatility).** This means that instead of the interest rate cuts in the Andean countries which we were counting on three months ago, the most likely occurrence if that rates will be kept at current levels until at least mid-2016. With respect to Brazil, the inflation shocks and the need to restore the credibility of monetary policy will force a larger-than-expected rate hike. In conclusion, given the synchronisation of activity in Mexico and the United States we still anticipate a rise in Mexican rates that shadows the course taken by the Fed very closely.

**On the other hand, the depreciation pressure on the currencies will continue due to the uncoupling of the Fed rate with hikes and still sizeable external deficits.** The recent currency depreciation in the region (only slightly corrected by dollar weakness since April) has arisen in spite of exchange rate intervention by some economies in the region (Peru). Looking ahead, currency markets will continue to be very much conditioned by the Fed's monetary policy normalisation strategy and movements in commodity prices, which suggests to us that further spells of volatility are highly likely. Despite some occasional currency appreciation in certain countries (mainly in Chile and Colombia), partly due to greater support from copper and oil prices, in many cases currency depreciation will persist over the forecast horizon, particularly in Brazil, Peru and Paraguay.

**The low prices of the main export commodities will keep external deficits at high levels in the region.** External balances will continue to show deficits (except for Chile and Paraguay), although there will be a certain narrowing of deficits in Peru, Uruguay and Brazil due to currency depreciation and domestic demand weakness. Even so, these factors in Colombia and Mexico ought not to be enough to counteract the effect of the fall in the oil price. In spite of the lower weight of foreign direct investment (FDI) as a source of financing to plug the external deficit, in general the region's vulnerability to the world outside remains limited.

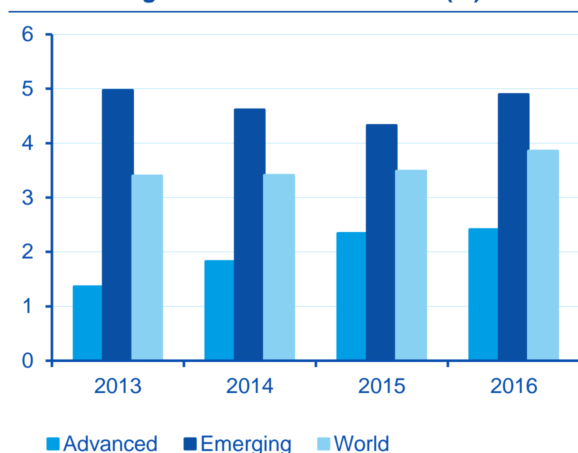
**Prospects for fiscal balances are still unchanged with respect to the situation three months ago, except as regards Brazil, where the public deficit is likely to be significantly larger than expected**. The increase in the forecast for the public deficit in Brazil in 2015 (from an estimated -4.4% in January to -5.6%) is despite the bigger macroeconomic correction underway and partly because of the deterioration in forecast growth as well as the rise in interest rates on debt.

# 2 World growth is suffering from the slowdown in the emerging economies

## World growth came off the pace in 1Q15

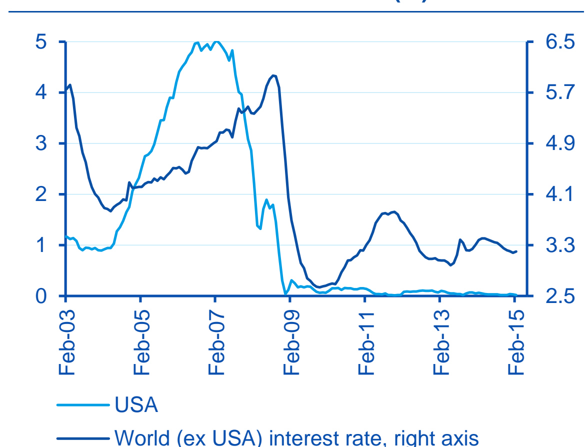
The slowdown in world growth in Q1 was produced by the slowdown in the US economy, less drive in the Chinese economy and the drop in activity in some of the most prominent emerging countries (such as Russia and Brazil). The consolidation of growth in the block of developed countries contrasts with the broad flagging trend among the emerging economies, which was more pronounced in Asia and Latin America than in Eastern Europe.

Figure 2.1
**World GDP growth: 2015-16 forecasts (%)**




Source: BBVA Research

Figure 2.2
**Short term nominal interest rates (%)**




Source: BBVA Research

We are therefore revising our world growth forecast for 2015 down to 3.5%, which is 0.1pp below the estimate from January and only 0.1pp above the figure for 2014 (see Figure 2.1). For 2016, world growth should show average growth of 3.9%, partly as a result of expansionary monetary policies in the developed countries, which ought to record their best rates since 2010. In a scenario of gradual trend deceleration in China, the emerging economies should reverse the current slowdown thanks to the pull effect from the developed economies, the gradual climb in commodity prices and a potentially more restrained rise of interest rates than in other historical episodes of Fed normalisation.

The progressive rise in commodity prices in line with our forecasts and the reinforcement of loose monetary policies worldwide have been two of the more prominent elements on the economic landscape in recent months. Central Banks have in fact been more proactive, in both developed and emerging economies, and, even if the Fed decides on a strategy of gradual monetary tightening, the emerging economies have chosen to give priority to reactivating domestic demand by looking to cut interest rates (see Figure 2.2), in some cases at the cost of both taking on greater local currency volatility and discouraging inward and continued flows of foreign capital.

Despite this, and the fact that economic policies will continue to be accommodative, the downside risks for world growth persist. The biggest threats are the extent of the slowdown in China and the fallout from the start of Fed interest rate normalisation. The deflationary pressure associated with the drop in the oil price,

geo-political tensions and the potential for failure by the ECB to relaunch inflation expectations in the eurozone are risks which, despite appearing less likely and to entail less of an impact than predicted some months ago, cannot be ruled out. Finally, a risk which remains latent is the lack of any agreement between the Greek government and the European institutions and the IMF over the refinancing of its debt.

## Growth slowed down in the United States in Q1…

The United States has begun 2015 with a significant slowdown in its growth rate to an annualised quarterly rate of 0.2%, from an increase of 1% on average in the three preceding quarters. The unusual severity of the weather conditions accounts for some of this deceleration, to which one might add the oil price fall and its impact on the energy sector and the beginnings of the effect of the stronger USD on exports. Even so, the robustness which the labour market continues to exhibit should continue to sustain household incomes and private consumption. Annual US growth could therefore reach 2.9% in 2015 and stay at rates of around 3% in 2016 too.

The Fed's interpretation of whether the slower growth in Q1 was temporary or longer-lasting will define how it reacts from now on. The most likely outcome is that the first policy rate hike will take place in September 2015, followed by a gradual rise to no further than 1.5% by the end of 2016.

## … as it did in China too

In China the economic slowdown has taken a firmer grip in the last few months, with growth for 1Q15 registering 7% YoY and featuring an adjustment in industrial production and investment, although there was a brighter relative showing from private consumption. The slowdown is attributable to the correction playing out in the real estate market, political uncertainty ahead of the National People's Congress in March, the decline in competitiveness caused by the worldwide appreciation of the CNY, and finally the effects of the fiscal consolidation of local authorities which began in 2014.

The structural character of the factors mentioned lends weight to the prediction that China will grow less in the medium term and experience greater volatility. The annual growth target of 7% for 2015 laid down by the Chinese authorities is based on the implementation of new stimulus measures, of both a monetary and a fiscal nature. Subsequently in 2016, growth will continue to adjust at 6.6%.

## The eurozone showed the biggest recovery these past few months

Of the developed economies, it was the eurozone which put in the best relative performance going into 2015. GDP could have grown at the highest pace since mid-2011, with Germany and Spain heading up growth in the area as a whole. The recovery has been driven by the better financing conditions and the euro's depreciation, both prompted by the ECB's quantitative easing programme, together with the drop in the oil price. The less restrictive fiscal policy and containment of the fall in nominal wages in the periphery countries are also helping to relaunch growth. This means that GDP should advance by 1.6% in 2015, which should rise to 2.2% in 2016.

# 3 Volatility continues in LatAm markets as they watch out for the timing of rate hikes in the United States

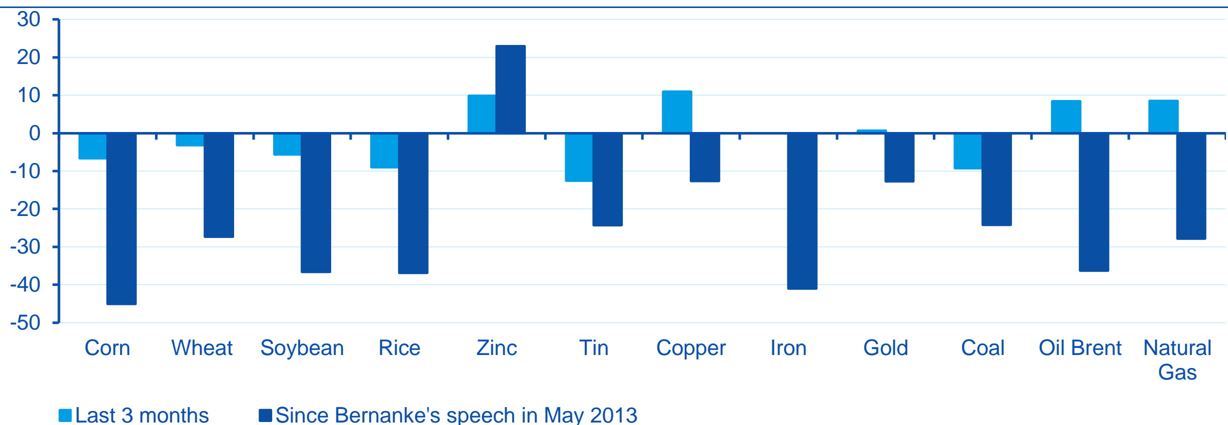
## Commodity prices are still flat, as expected three months ago.

Commodity prices have not performed evenly in the past three months. Whereas the oil price and that of some metals such as copper have risen by around 10%, agricultural commodity prices have shifted downwards over this period and those of gold and iron ore have remained practically unchanged (Figure 3.1).

The oil price rise, which is a little less than we were expecting three months ago, was associated with the fall-off in crude inventories (which are nonetheless still at high levels) and movements in world financial markets, especially the depreciation of the USD and the lower volatility seen since March.

The loss in value of the USD in world markets and the toning down of financial upheavals, which partly reversed the movements in the opposite direction which had been observed at the beginning of the year, also provided support for another of the most important commodities for LatAm countries, namely copper. The rally in the price of this metal was in line with our forecasts of three months ago.

Figure 3.1
**Commodity prices (% var.)**

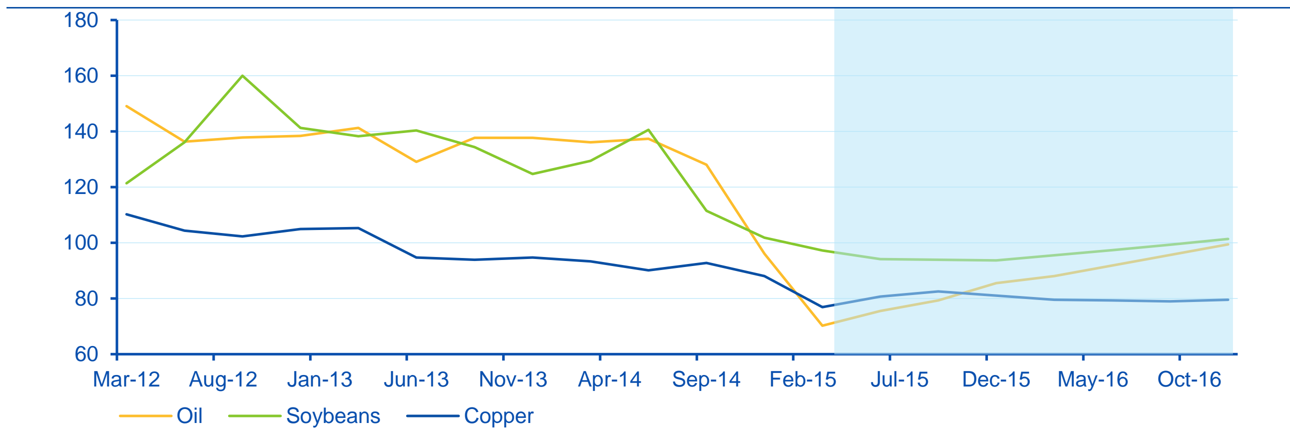



Source: Bloomberg

In spite of the boost which financial factors also gave to agricultural commodity prices, within this group of commodities it was effects relating to their fundamentals which predominated. Specifically, the additional fall in the soybean price in recent months reflects the impact on supply of the bumper harvests in the United States, as well as Argentina and Brazil. The downward correction in the soybean price contrasts with our predictions of three months ago that prices would remain stable.

Whatever the case, prices are still low, far below those of two years ago when markets started to price in the beginning of tapering and monetary policy normalisation in the United States after the speech made by the former chair of the Federal Reserve (Fed), Ben Bernanke. At the same time, the gradual slowdown of the Chinese economy on top of the absence of a stronger pull from demand from the developed countries has helped to keep commodity prices depressed in recent years.

Figure 3.2
**Prices of the major commodities (average index value, 2010=100)**




Source: BBVA Research

Bearing in mind movements in commodity markets over the past three months and the downward revision of our forecasts for world growth in 2015, we have revised our forecasts for the short-term prices of oil, copper and soybeans down a little. Meanwhile, we are still waiting for prices to converge gradually until the close of 2016 towards their long term equilibrium levels. In other words, we expect the oil price to continue to adjust upwards, moving towards USD70/bbl (Brent) at the end of 2015 and USD80/bbl at the close of 2016 as world demand picks up and the supply responds to the relatively low prices observed in the last few months. With regard to soybeans and copper, we estimate that current prices are not significantly far from their long-term levels (Figure 3.2).

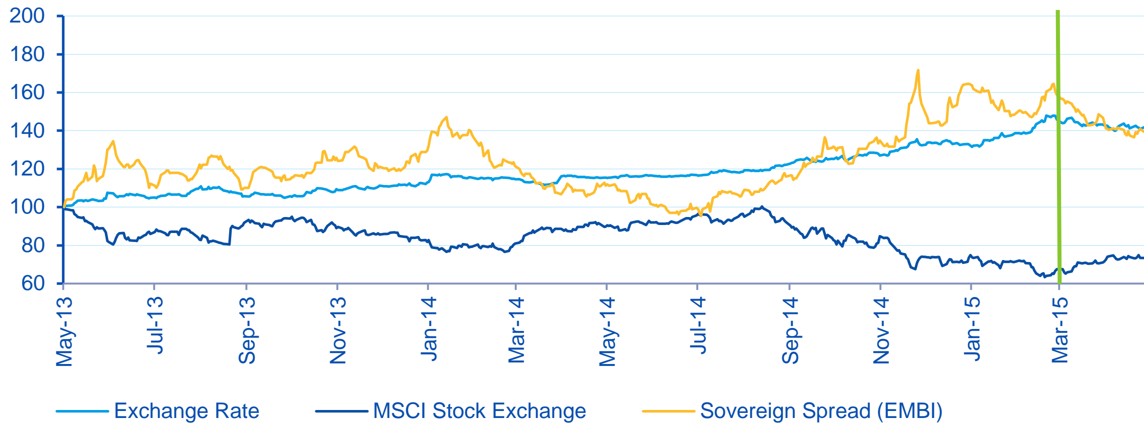
## The shift in views on the start date and pace of the Fed rate hikes has moved LatAm markets.

As with the commodity markets, prices of Latin American financial assets have also reacted over the past three months to the outlook for the normalisation of monetary policy in the United States. In fact, Latin American markets fell back up to mid-March and began to rally again from then onwards as the idea took hold that the Fed's rate adjustment would be slower in coming and take longer than was expected at the outset of the year and, as a result, the USD backtracked on its strengthening trend.

As can be seen in Figure 3.3, the sovereign spread (the LatAm EMBI), the MSCI stock market index and the average LatAm exchange rate stopped declining and began to improve again from mid-March. This rally has allowed the region's sovereign spread to narrow by 31 points in the past three months and both the MSCI stock market index and the region's average exchange rate to regain all the ground they have recently lost.

Meanwhile, the slowdown in the region and the weakening of commodity prices continued to weigh on LatAm asset prices, which has stopped there being a more marked upturn since March.

Figure 3.3
**LatAm: stock market prices, spreads and exchange rates (23 May 2013=100)**

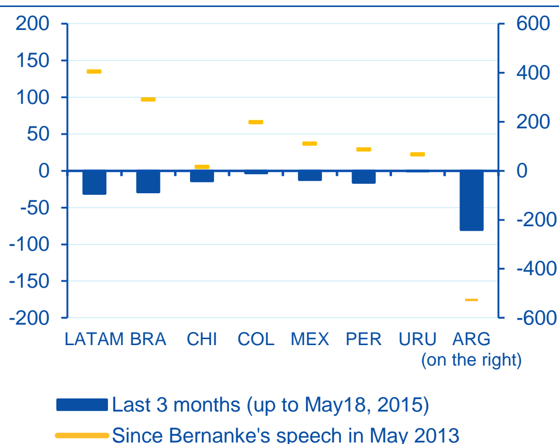



Sources: BBVA Research

With few exceptions, recent regional trends have repeated themselves relatively uniformly across the financial markets of each country, suggesting that global factors have been more influential on local markets than idiosyncratic aspects.

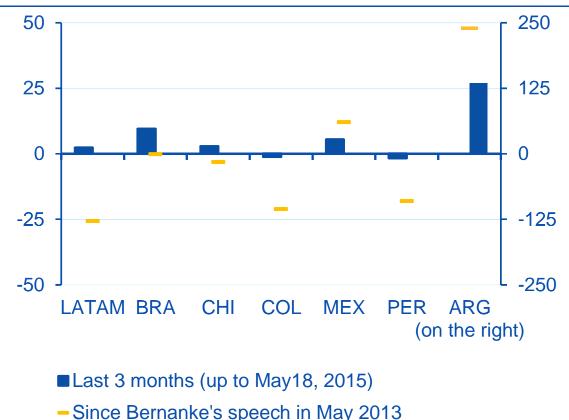
The sovereign spread has corrected itself in a pattern of reduction over the last three months in all the countries under review (Figure 3.4), more sharply so in Argentina (-80bp) and Brazil (-29bp). In the case of Argentina, one of the factors which have helped narrow the sovereign spread has been optimism about the outlook for the country after the October elections. On the other hand, with Brazil we should bear in mind that the earlier decline was worse there than for the rest of the region, as events in the Petrobras crisis and expectations over the economic adjustment underway amplified global movements (i.e. there was a deterioration up to March, followed by a mild improvement from then onwards).

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




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

Figure 3.5
**Stock market performances in Latin America (%, in local currency)***



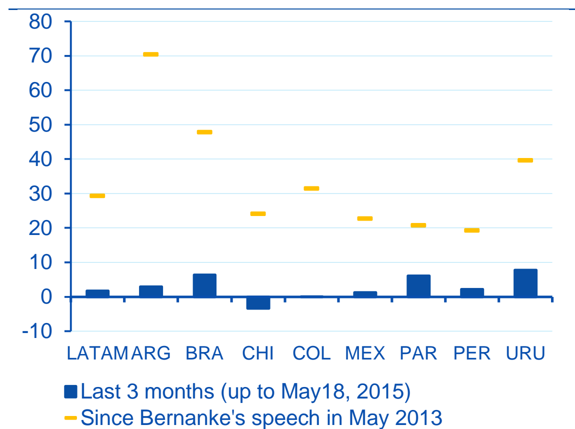

* Data on Argentina on the RH axis.
Source: Haver Analytics and BBVA Research

Although stock markets have been more weighed down by the slowdown in activity and other local factors, in the last three months there have generally been rises, especially in Argentina and Brazil, for the reasons cited earlier (Figure 3.5).

Turning to the FX markets, despite the reversal of the depreciating trend from March, exchange rates in mid-May were still somewhat weaker than they had been three months earlier (Figure 3.6). This phenomenon was more pronounced in the Mercosur countries, where inflation is higher (and requires a more swingeing currency depreciation to head off a loss of competitiveness), and the major commodity markets (agricultural products) have proved a bigger handicap to these countries than to the Andean economies or Mexico in recent months (Figure 3.1). On top of this there might have been some degree of spill-over into the other countries within the block of countries from the depreciation in Brazil (see Box 1). On the other hand, in the Pacific Alliance countries the depreciation was very minor (2% in Peru and 1% in Mexico), or even non-existent (0% in Colombia and -3% in Chile), partly due to the rally of roughly 10% in the copper price and oil over the period, added to which currency market intervention was a factor in Peru's case.

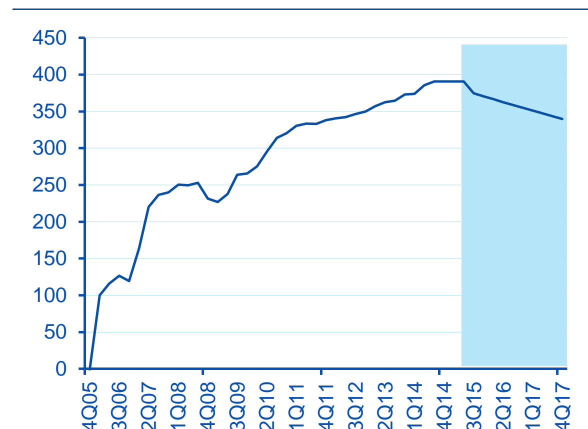
Thus, with the notable exception of Argentine sovereign risk and the stock markets in Mexico and Argentina, prices of the region's financial assets have remained significantly below the levels of two years ago, when the tightening of monetary liquidity in the United States had not yet been discounted, and commodity markets admitted far higher levels of economic activity than there are now.

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




Source: Haver Analytics and BBVA Research

Figure 3.7
**Capital inflows to LatAm (portfolio flows, USD mn)**




Source: IFS and BBVA Research

## Volatility will continue further ahead, to the extent that any hiking of the Fed rate hike will US data-dependent

Given that the decision on the timing and scale of the rate hike in the United States basically hinges on the country's economic activity data, it is highly likely that any positive or negative surprises in these indicators will give rise to fresh adjustments in expectations, and therefore an upturn in volatility in global and Latin American financial markets further down the line.

The central banks of LatAm countries may add to this volatility (especially as regards the exchange rate) if there is any uncoupling (albeit only partial) from the Fed rate hike in the course of addressing local conditions marked by weak growth.

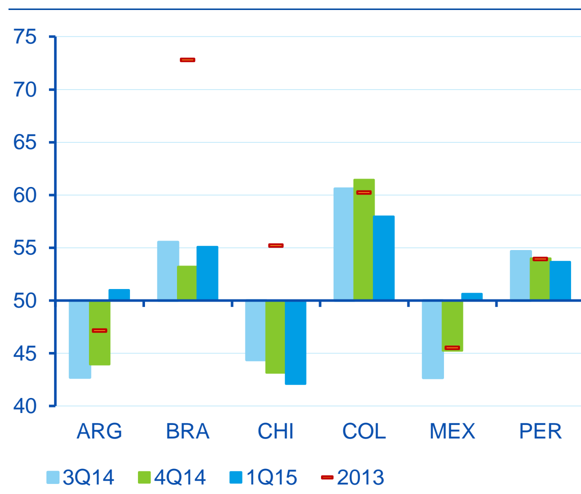
Thus, even though the gradual recovery of growth in activity in the region's countries ought to lend support to LatAm asset prices, the most likely scenario is that global conditions will not be as helpful as they have been. Looking at this more closely, we predict that capital inflows into the region will fall off in the coming years. In our baseline scenario, which features world growth of the order of 3.5% in 2015 and 3.9% in 2016, with the United States embarking on its monetary normalisation process in 3Q this year and global risk aversion gradually wearing off, a net outflow of capital of non-residents should arise, which should build up to an amount equalling 2% of regional GDP in the next two years (Figure 3.7), which is a bit less than we were forecasting before (see Box 2 of our LatAm Outlook, 1Q15). This would then imply a continuation of the easing of flows into the region that we have observed since mid-2014.

# 4 Latin America's growth will remain low in 2015 and pick up in 2016, yet it will still remain below potential

## Private-sector domestic demand continues to flag, dogged by poor confidence indicators

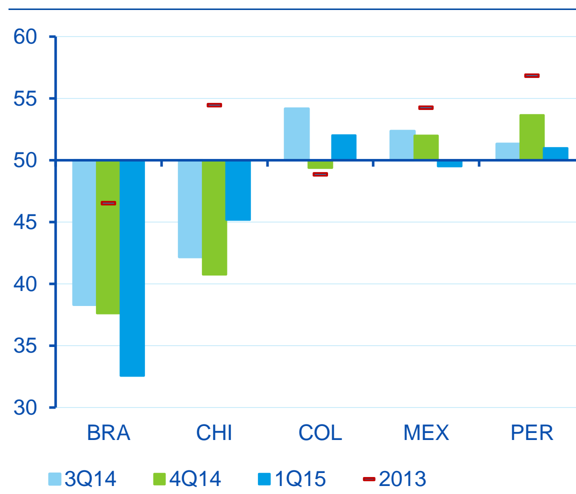
The region's confidence indicators continued to point to pessimism over the first quarter of the year, particularly from the standpoint of producers. In Brazil, Mexico and Peru, producer confidence took a notable turn for the worse coming into the year, while in Chile, Colombia and Peru this happened too among households (see Figures 4.1 and 4.2). Among the factors behind such gloomy sentiment are i) the increase in political ructions in certain countries, ii) uncertainty with regard to economic policies, including reform processes in some economies, and iii) the cyclical decline, with an impact on the prospects for disposable income and returns on investment, which are to a large extent influenced by a less bright external environment, where a key factor has been the drop in commodity prices. On the other hand, it is worth mentioning the cases of Argentina and Mexico at this point, where consumer confidence has improved considerably in recent quarters (and even significantly since 2013 in Argentina), and Brazil, where it is holding relatively unchanged, though far below the levels of 2013. Looking at business confidence, this has improved in Colombia, and although it has in Chile too, it is still in pessimistic territory.

Figure 4.1
**LatAm: consumer confidence (levels over 50pts indicate optimism)**




Source: BBVA Research and national statistics

Figure 4.2
**LatAm: producer confidence (levels over 50pts indicate optimism)**



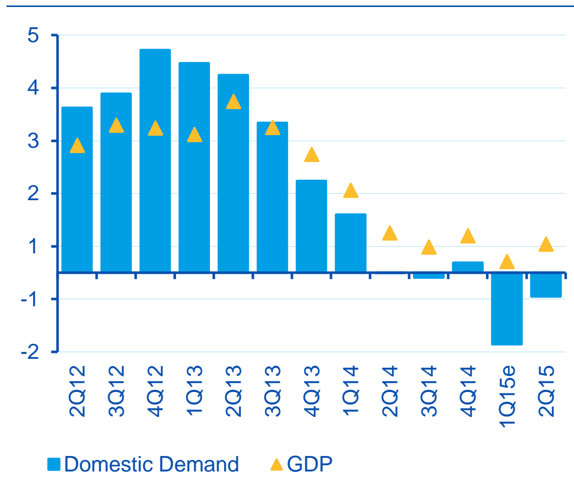

Source: BBVA Research and national statistics

On the other hand, there was a notable YoY contraction of domestic demand in 1Q, which is something that has been influential in the substantial slowdown in GDP: from YoY growth of 1% for domestic demand in the region in 4Q14, we estimate that this has sunk to -0.1% in 1Q15 (see Figure 4.3).

This slowdown in domestic demand has been particularly significant in investment (see Figure 4.4), a component which strayed from its path of recovery in early 2015, as a result of the sluggishness at large, especially in the Andean countries and Mexico. In Chile the waning investment there has been associated with transitory factors linked to the stormy weather in the north of the country in March, as well as lower private investment, partly on account of the uncertainty surrounding the process of approving the reforms.

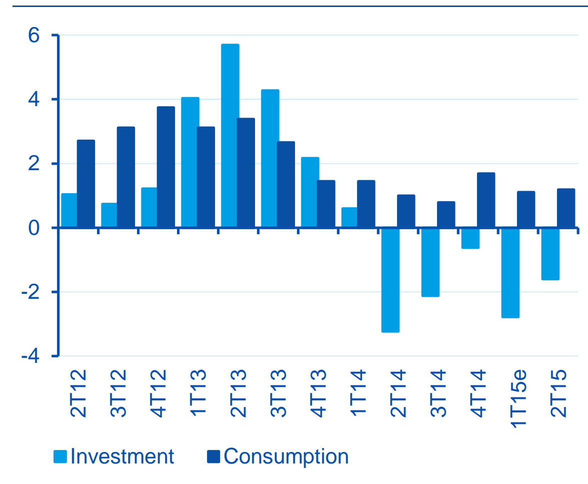
Furthermore, the slowdown in the mining cycle associated with the lower copper price, among other factors, has not been made up for by the increased investment in other tradable sectors. In Colombia, Mexico and Peru the main problem has been the poor level of execution of public investment in addition to the lethargic recovery of industry in spite of currency depreciation. In Peru's case, as with Chile, the correction of the copper price has also slowed the mining investment cycle. In terms of private investment, certain economic agents are likely to have brought forward a portion of the investment planned for 2015 to 4Q14, thereby avoiding higher future costs of imported assets. With respect to public investment Peru stands out, as this item contracted by around 25% YoY in the first quarter of the year, while private investment dropped 3.9%, which marked the fourth quarter in a row of setbacks.

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




Source: BBVA Research and national statistics

Figure 4.4
**LatAm: investment and private consumption (% var. YoY)**




Source: BBVA Research and national statistics

Meanwhile private consumption has kept up modest growth in recent quarters, showing 1.2% in 2014, which was below the average of 2.7% for the region in 2013, plagued by the lower confidence levels (Brazil, Chile) and labour market weakness (Brazil, Chile, Mexico), which, in combination with the high inflation level in Brazil, have undermined household disposable income.

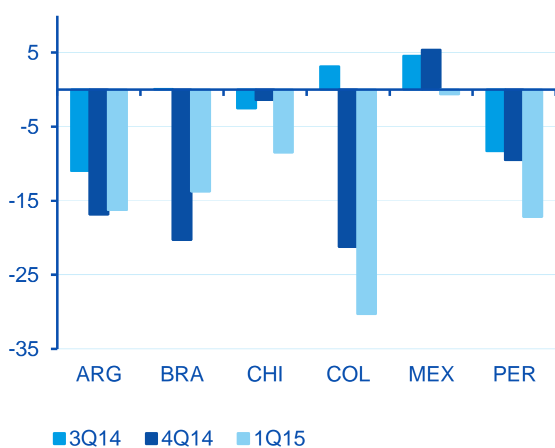
There are, however, major differences among the regions, which has been the consistent factor in the last few quarters: whereas for the Pacific Alliance countries domestic demand will show growth of about 1.6% YoY for 1Q15, for the Mercosur economies this will be a fall of around 2.3% YoY. This difference for the domestic demand indicators is a determining factor in expected GDP growth for 1Q, which we estimate was 0.2% for the region on aggregate, -1.7% in the Mercosur block (although there was growth in Uruguay and Paraguay) and 2.5% in the block comprising the Pacific Alliance countries (see Figure 4.8).

## Exports have suffered from the impact of the fall in commodity prices, although one or two supply-side shocks still persist as well

Export indicators continued to slip back in 1Q15 with respect to the previous year, to a large extent caused by the lower prices of key exports, especially commodities (see section 3). This trend was intensified in Chile, Peru and, conspicuously, Colombia, while in Mexico manufacturing exports failed to offset the nosedive in oil exports, which made the overall variation for exports slightly negative (see Figure 4.5). Colombia, Mexico and Brazil were especially hit by the 1Q deterioration in their terms of trade. With respect to Brazil, foreign sector weakness fuels the same situation in Argentina, and vice versa successively, despite the depreciation in their currencies.

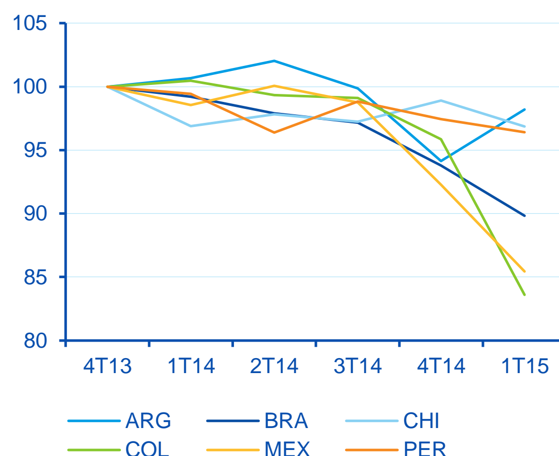
In Peru and Chile, supply-side problems which began in 2014 continued to blight their extractive sectors mostly, in a situation that was exacerbated by the lower commodity prices. Here it should be recalled (see Section 2) that commodity prices have been somewhat slower than expected in recovering, which has hit Colombia and Mexico particularly hard given the importance of oil in their export mix (50% and 10% of exports respectively).

Figure 4.5
**Exports**
**(% var. YoY, 3-month moving average, USD)**




Source: BBVA Research and national statistics

Figure 4.6
**Terms of trade (1Q13=100)**




Source: BBVA Research and national statistics

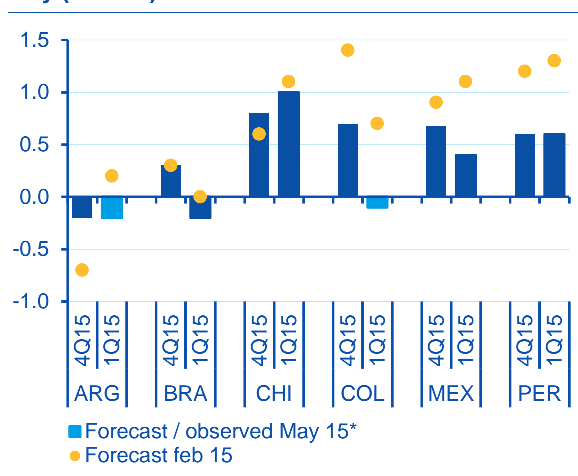
## We have revised our growth forecasts for LatAm in 2015 and 2016 to 0.6% and 2.1%, mainly on domestic demand weakness and a larger-than-expected impact of Brazil's economic policy correction.

The performances of domestic demand and the export sector led to negative surprises as regards the growth forecast for 4Q (except for in Argentina and Chile) and have prompted us to revise our 1Q forecasts downwards, in some cases significantly. Based on data published as of 1Q for Brazil, Chile, Mexico and Peru, our seasonally adjusted analysis (which allows a quarter vs. previous quarter comparison) throws up results which are far below those anticipated for the last two of these countries (Figure 4.7). We have thus revised our growth estimates for 2015 downwards, and in some cases those for 2016 as well. Besides the knock-on effect from the lower growth in 1Q, this revision arises due to i) the greater impact of the macroeconomic policy correction in Brazil, which will also have a sizeable effect on Mercosur countries, as is examined in Box 1; ii) the weak private sector growth, where the drop in investment mentioned in the

previous section will take a little more time to be restored, to which we should add the expected effect on consumption which is foreseeable given the loss of optimism in several economies; iii) the political ructions and uncertainty surrounding certain reform processes in Andean countries, and iv) the public spending cuts in Mexico and Colombia to abide by their fiscal rules.

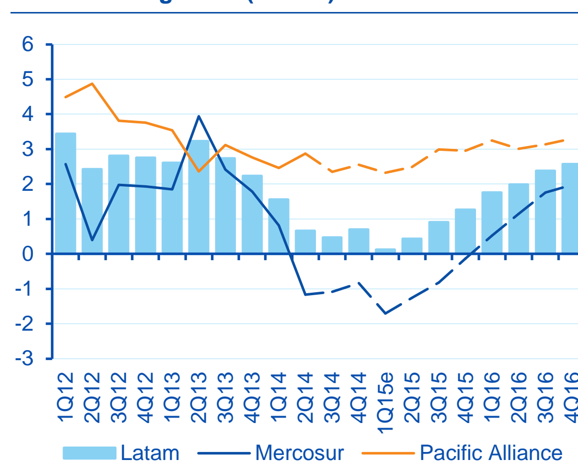
We have revised downwards our growth forecasts for 2015 for all countries except Paraguay. These are particularly significant cuts for Peru (-1.7pp), Brazil (-1.3pp), Mexico (-1.0pp) and Colombia (-0.5pp), and more discreet for Argentina and Uruguay. For 2016 we have also trimmed our growth forecasts for Peru (-1.0pp), Mexico (-0.7pp) and Colombia and Chile (-0.4pp). Growth for the region as a whole in 2015 would therefore come down from 1.5% estimated a quarter ago to a forecast of 0.6% now, while for 2016 estimated growth is reduced from 2.4% in February to 2.1% now.

Figure 4.7
**LatAm: GDP growth estimated in January and May (% QoQ)**




*Dark blue indicates an observed figure
Source: BBVA Research and national statistics

Figure 4.8
**LatAm: GDP growth (% YoY)**




Source: BBVA Research and national statistics

For Peru the revision of its growth forecasts comes after the sharp contraction in investment (particularly in the public sector) as well as the slowdown in household consumption. Among the sectors most affected are construction and non-primary manufacturing, by the weakness of domestic demand. Towards 2016 private spending weakness will persist in a climate where the implementation of counter-cyclical public policies has run up against problems, which has hampered growth.

For Brazil we have brought down forecast growth for 2015 from 0.6% three months ago to our current level of -0.7%. Among the factors behind this are i) the deterioration in the terms of trade; ii) more restrictive fiscal and monetary policy than we anticipated three months ago; iii) the large rise in inflation and its effect on real wages and production costs; and iv) the Petrobras crisis and its impact on investment and sentiment. As for Mexico, we are downgrading our growth estimate for 2015 from 3.5% previously to 2.5%, as a result of i) the deterioration in the oil price and production platform; ii) a poor 1Q performance by the US economy, partly associated with a harsher-than-expected winter; iii) the weakness of the domestic market, with a slow recovery in the construction sector, and iv) the public spending cuts and the delay in the bidding process for contracts within the energy reform[1].

1: Up to now the National Hydrocarbons Commission (the CNH) has issued the bidding guidelines for three out of the five stages which make up Round 1 of the energy reform. The two other stages concern deep water fields and unconventional resources. In both cases the date for invitations to tender has still not been set and indication has been given that the tenders have been postponed owing to the low oil price.

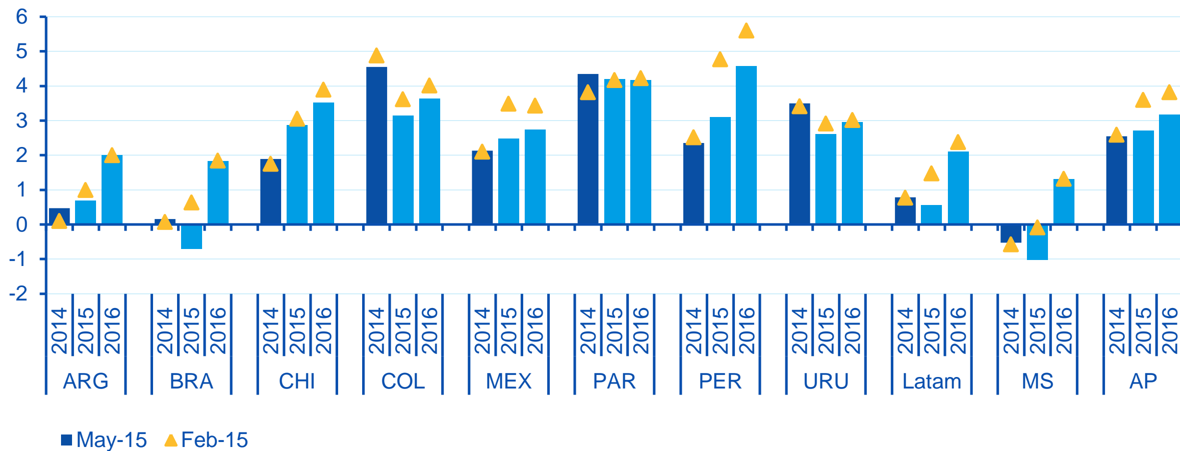
In Colombia and Chile, as with Peru, the revision is linked to the prospect of lower investment, which will take a bit more time to recover, and the half-heartedness of private consumption, to which should be added, on the one hand, the adverse effect on consumption that will come from the loss of optimism, and on the other hand, the political ructions and uncertainty emerging from certain reform processes.

## The Pacific Alliance countries will continue to be the most dynamic, though still below their potential in 2015 and 2016.

Even so, the Pacific Alliance countries will be the most active by a long way. The end of 2014 and the start of 2015 will be the floor for growth but this will continue to be positive and show a rising trend, albeit below their potential. By way of contrast, the countries in the Mercosur block will remain in the downturn that began in 2Q14 and which we predict will continue over the rest of the year (see Figure 4.8).

By individual country, Paraguay, Peru, Chile and Colombia will stand out as those showing the most growth in the region over 2015-2016, while Chile (1pp), Peru (0.7pp) and Mexico (0.4 pp) are notable for rallying with respect to 2014. On the other hand, in Colombia the correction with respect to 2014 will be the most significant (1.4 pp), followed by Brazil (0.9pp), but even so, Colombia will still be one of the countries with the most growth in the region.

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




Source: BBVA Research

## Box 1. What impact does Brazil have on Latin America's economy?

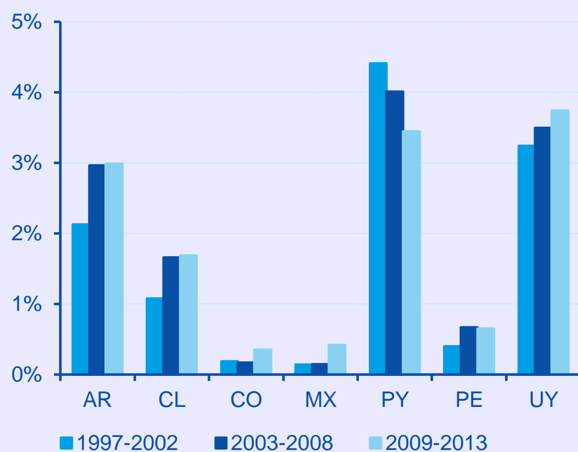
The sharp deceleration in the Brazilian economy and concern about potential spill-over into other LatAm countries have prompted us to examine to what extent and through what channels any movements in the Brazilian economy are passed on to that of each of its regional neighbours. Thus in this box we analyse the key transmission channels and present quantitative exercises to gauge the impact of shocks originating from Brazil on each of its principal neighbours in the region.

### The trade channel (goods)

Over the past decade Brazil's imports have held at around 9% of its GDP, with manufactures accounting for 75% of these, while the rest are commodities. On the other hand, of total purchases made by Brazil, 15% originates from Latin America, with virtually the same distribution by categories as for those from the rest of the world.

By country, Argentina's share in Brazil's overall imports is notable (around 6% in recent years, followed by Chile and Mexico (with roughly 2% each).

Figure B.1.1
**Size of exports to Brazil (in % of GDP for each exporter country)**

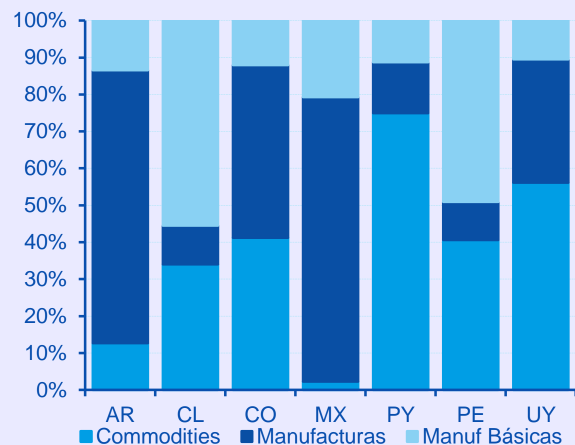



Source: Base Alice and WTO

When observing sales to Brazil as a proportion of the GDP of each country, it becomes possible to stylise three cases of exposure (Figure B.1.1) The most potentially vulnerable situation is that of the original Mercosur partners (Argentina, Paraguay and Uruguay), followed by that of Chile, and last of all, that of the other countries (Peru, Colombia and Mexico).

From a qualitative standpoint, which emerges from analysing those items which make up each invoice paid by Brazil to its trading partners in Latin America, a certain unevenness between countries is also observable, as there are marked differences in the goods mix depending on the country of origin (Figure B.1.2). Argentina and Mexico would be the countries worst hit by any sudden drop in Brazil's demand for goods imports, given the high content of manufactures in their sales, but the low share of Brazilian buying in Mexico's trade substantially allays the risk which Brazil poses for it. Contingent risk of the same nature, though on a smaller scale, affects Colombia, and, to a lesser extent, Uruguay. Among the other countries within the sample, the most heavily traded goods are commodities and basic manufactures.

Figure B.1.2
**Exports to Brazil by group of goods (%, annual average over 2008–13)**




Source: Base Alice and WTO

Argentina is thus the partner which would be most affected in the event of a drop-off in demand from Brazil. Notable within the significant trading relationship among the major Mercosur economies is the auto sector agreement which has

strengthened trading ties via the installation of auto final assembly plants in both countries. Boosted by the Mercosur trade agreement, Brazil has been Argentina's foremost trading partner since the early 1990s, both as regards imports and exports. In 2012-13, Brazil accounted for 21% of Argentine exports, representing 2.8% of the country's GDP. Argentina is therefore highly vulnerable given that the volume of trade is substantial and includes a high proportion of manufactures, basically cars and auto-parts, and in 2013 vehicle exports comprised 49% of exports to Brazil (43.6% in 2009-13). Trade in goods within these categories presents significant rigidities, both due to technical and legal specifications in the destination market and product turnover cycles, as well as marketing characteristics. Events in 2014 provide a perfect illustration of this risk, as when the Brazilian economy braked sharply, Argentine industrial exports to the country fell-off by 16%, while those of vehicles dropped by 18%.

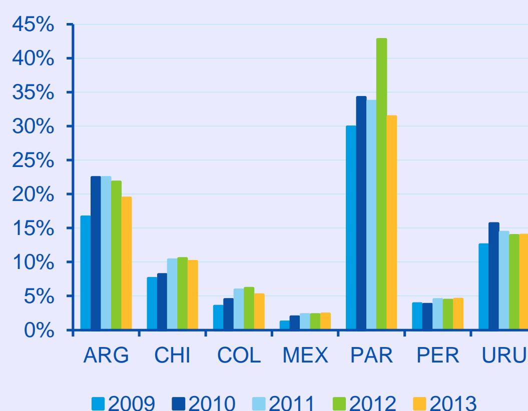
The other original members of Mercosur have a sales profile that is quite a lot less exposed to Brazil. Even though for Uruguay exports to Brazil are 22% of its overall international sales and in the case of Paraguay these are 12%, according to the breakdown of trade in both countries there is a high proportion of agricultural commodities, which serves to mitigate reliance on Brazil as these are basic goods which are relatively easy to place in international markets. With respect to Paraguay, if electricity exports are included, the proportion of exports to Brazil within the country's total exports amounted to 36% in 2009-13. Although the demand for electricity is relatively inelastic, this illustrates how high exposure to the Brazilian economy is.

## The services channel - tourism[2]

Notable within this segment is the flow of Brazilian tourists out of the overall number of visitors to Mercosur countries, especially Paraguay (Figure B.1.3).

Nonetheless, despite its importance within the total flow of tourists, Brazilian tourism has a very small weight in terms of the economy of these countries, representing 0.5% of GDP for Uruguay, with like figures of 0.3% in Paraguay and 0.2% in Argentina. In none of these cases does it therefore suppose any risk beyond what it implies for certain niches or specific locations.

Figure B.1.3
**Brazilian tourists out of the total (%)**



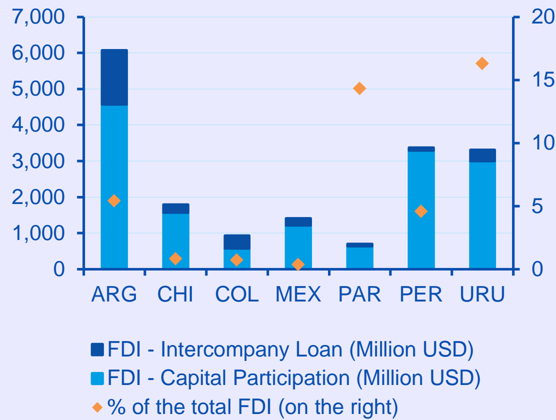

Source: National statistics and BBVA Research

## The FDI channel

The flow of Brazilian FDI to countries in the region has surged in recent years, taking the stock of FDI in Latin America's principal countries in 2013 to USD19.7bn, with almost one third accounted for by Argentina (Figure B.1.4). In terms of the total stock of FDI in each country, Brazil's weight is very substantial in Uruguay and Paraguay (16% and 14%) and significant in Argentina and Peru (approximately 5%). The stock of Brazilian FDI has a weight of roughly 6% of Uruguay's GDP, with corresponding figures of around 2% for Paraguay and Peru and 1% in Argentina, while this is under 1% in the other countries examined[3].

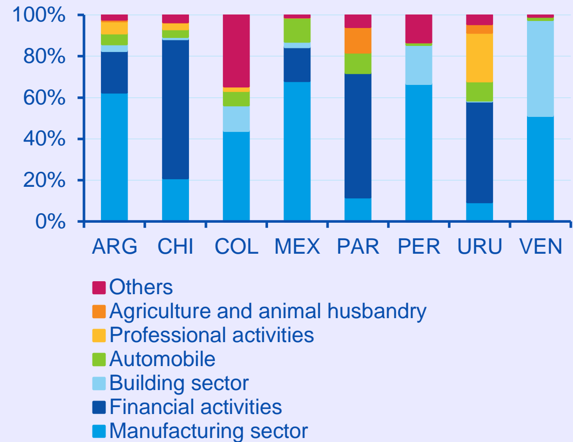
2: Unlike the situation as regards goods trade, not much information is available on services trade among Latin American countries. Here we examine a generally important sub-sector within the services sector for which there is greater data availability: tourism.
3: The figures used in this section are from the Central Bank of Brazil's census of Brazilian capital abroad. In some cases they differ significantly from those published by other sources, for which reason we advise caution when giving them consideration.

Figure B.1.4
**Foreign Direct Investment originating from Brazil (stock in 2013: USD mn, % of total stock)***




* Foreign Direct Investment (FDI) is broken down, according to the methodology used by the BCB, into equity holdings and inter-company loans.
Source: BCB, WTO

Figure B.1.5
**FDI originating from Brazil by sector (stock in 2013, % of country's total Brazilian FDI)***

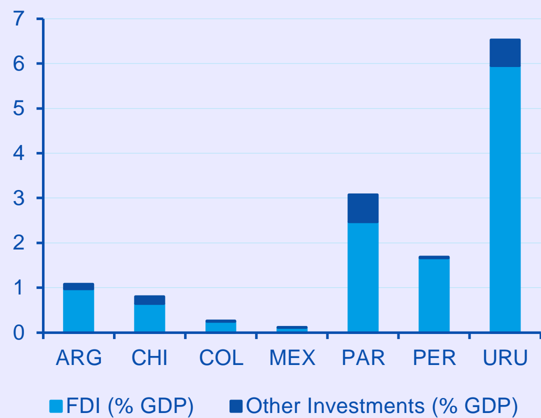



* Only FDI – Equity holdings. Does not include FDI – Inter-company loans.
Source: BCB

The sector breakdown shows that generally speaking it is manufacturing industry and financial activities which account for a large part of the stock of Brazilian FDI (Figure B.1.5). Despite the lack of data, the available evidence suggests that a substantial portion of the manufacturing sector FDI of certain countries is attributable to investments by Petrobras.

This breakdown helps to show that, beyond a potential macro-economic effect, there are sectors which are especially sensitive to any curtailment of flows of Brazilian FDI. In particular, given the recent corruption scandal involving Petrobras and several of Brazil's major construction companies, mention should be made of the risk of certain of the region's countries being hit by the financial problems which both the oil company and the construction sector face. In this respect, manufacturing and construction sector FDI, which serves as a proxy representing each country's degree of exposure to this factor, equates to 1.4% of Peru's GDP (USD2.8bn)[4], around 0.5% of GDP for Argentina and Uruguay, 0.3% for Paraguay and roughly 0.1% of GDP for the other countries.

Figure B.1.6
**Weight of Brazilian investments in GDP (stock in 2013, %)**




* Only FDI – Equity holdings. Does not include FDI – Inter-company loans.
Source: BCB, IMF

## The portfolio investment channel

The stock of portfolio and real estate investments is largest in Argentina and Chile: USD0.6bn and USD0.4bn respectively. In both of these countries equity investment has the most considerable relative weight, while in the region's other countries, holdings of currency and deposits are the most sizeable, as well as those of real estate.

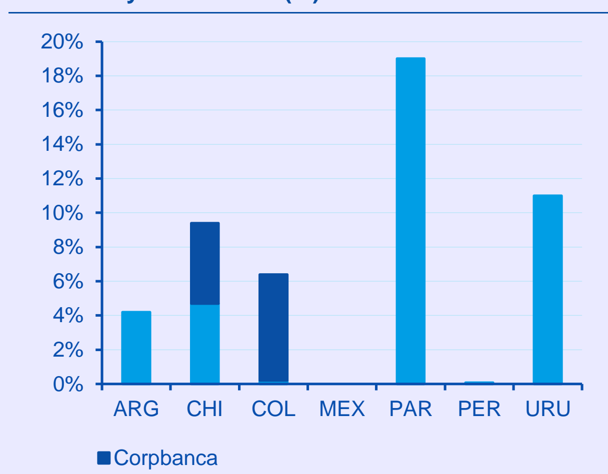
4: At the end of 2013 Petrobras sold off its operations in Peru for approximately USD2.6bn, which contributed to a marked reduction in the stock of Brazilian FDI in the country.

In all cases, however, Brazilian investments other than in FDI are not all that significant, and only account for 0.6% of GDP in Uruguay and Paraguay, and no more than 0.1% of GDP in the other countries (Figure B.1.6).

## The banking channel

Brazilian-controlled banks represent a little less than 20% of the Paraguayan banking market, while this figure is a shade over 10% for Uruguay (Figure B.1.7). If the recent M&A activity involving banking assets is given the go-ahead by the competition authorities, the presence of Brazilian banks in Colombia and Chile will also become significant, at around 6%. In Argentina the weight of Brazilian banks amounts to roughly 4%, whereas in Mexico and Peru is almost negligible.

Figure B.1.7
**Interest of Brazilian-controlled banks out of total financial system assets (%)***




* The Corpbanca / Itaú merger was being reviewed by the local authorities as of the date this Outlook was filed.
Source: BBVA Research, national statistics

Even though the significant presence of Brazilian banks in certain of the region's countries points to a risk of spill-over, the predominance of the branch model over that of subsidiaries helps to provide insulation from the effects of shocks originating from Brazil on the countries in the region.

## The "regional financial indexes" channel

A portion of financial investments in Latin America are made via regional financial indexes which represent a portfolio of assets from several of the countries in the region. Although markets of this kind account for only a small part of total financial investments, the inclusion of Brazil among them means that decisions by financial investors in Latin American assets are influenced by how Brazilian securities perform. This in turn means that any sharp downward correction by Brazilian financial assets could end up prompting a similar downward correction in the prices of the financial assets of other countries in the region, probably only temporarily, unless events in Brazil have undermined the fundamentals for other countries.

Distortion of this kind becomes greater when Brazilian assets have an overly high weight in regional financial indexes, which is something that tends to happen, chiefly in the case of stock market indexes. In many financial indexes of this type, Brazilian assets represent over 50%, which is higher than the share accounted for by Brazil's GDP within the regional GDP figure (around 38%)[5].

## Quantifying Brazil's impact on the LatAm countries

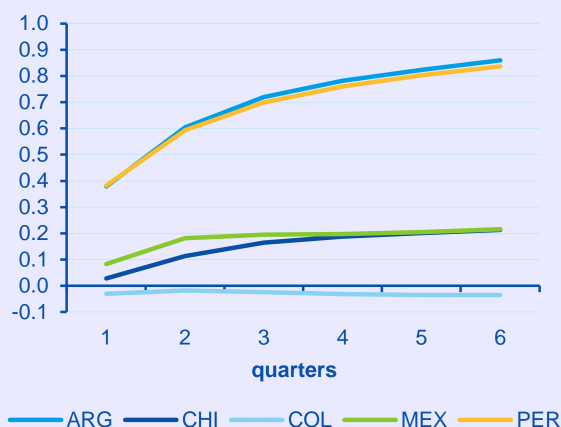
To gauge the impact of a shock in Brazil on the other countries, we estimate two econometric models.

The first of these is a VAR in which we include a set of global factors (world GDP, international financial conditions and commodity prices), as well as the GDPs of Brazil and the rest of Latin America. This analysis suggests that among the

5: For example, 48% in the S&P Latin America 40; 51% in the MSCI Latin America, and 53% in the FTSE Emerging Latin America.

Mercosur members it is Argentina which suffers most given problems in Brazil, although all the countries in the block are significantly affected too. The cumulative impact after six quarters of a shock of one standard deviation with respect to Brazil's GDP (2.5pp) is approximately 0.8pp in Argentina, a little over 0.6pp in Uruguay and around 0.4pp in Paraguay. As regards the Andean countries, only in Peru is there a strong effect, which is comparable to that on the Mercosur countries[6]. For the other economies the effects are almost negligible.

Figure B.1.8
**Impulse-response (GVAR), cumulative impact of one standard deviation wrt Brazil's GDP on the LatAm countries**




Source: BBVA Research

A second exercise involves estimation of a Global VAR (GVAR) model[7]. Unlike the VAR, the GVAR isolates the effect of an idiosyncratic shock from Brazil from the effect which it might have on the region's other economies. The results for this model tend in the same direction as the earlier exercise: the effects of a shock of one percentage point on Brazil's GDP are stronger for the Mercosur countries, principally Argentina and Peru. In Mexico, Chile and Colombia the impact is far less (Figure B.1.8).

## Conclusions

Our analysis shows that within the region, it is Argentina, Uruguay and Paraguay which are the countries that have most exposure to Brazil. These three countries have considerable relations with Brazil in practically all of the spill-over channels. Among these, Argentina is the country which would be most affected by a shock to its neighbour, mainly on account of the magnitude of its exports of manufactures to Brazil.

The region's other countries would in any event also be affected to a certain degree, albeit less than Argentina, Paraguay and Uruguay, by problems originating from Brazil. In this regard, we would highlight bank channels in Colombia and Chile, and FDI in Peru. In the case of Mexico, the country least exposed to the Brazilian economy among those analysed, the main linkage comes from trade flows of manufactured products.

Likewise shocks of the same magnitude in Brazil can be passed on in different ways to the region's countries, depending on their source (real, banks, financial ...).

Finally, although the Brazilian economy affects those of its regional neighbours, it should be noted that the impact of an adverse shock in Brazil is not generally strong enough to suck the region's other countries into a crisis, although it could contribute to this in certain specific situations.

6: The results for Peru are striking given that trade and financial relations between these countries are not particularly significant. This is likely to be indicative of a specification problem for the model, such as leaving out some influential common factor, for which reason further investigation into these results is called for. It should be added that a similar problem can be found in the "Intra-Regional Spillovers in South America: Is Brazil Systemic after All?" by G. Adler & S. Sosa, which was published as a Working Paper by the IMF in June 2012.
7: Due to a lack of data, Paraguay and Uruguay were not included in the GVAR estimation.

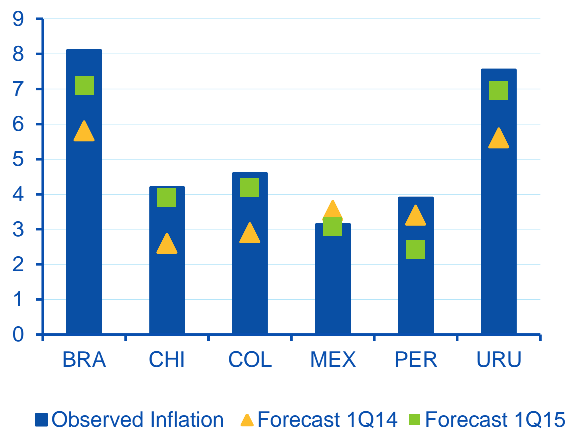
# 5 Inflation in the region has increased, but it should be back to target levels by the end of 2015 or early 2016

## Inflation pressure is being sustained in those countries with inflation targets, despite the cyclical weakness

Inflation has surprised on the high side across a broad section of Latin American countries in recent months. Specifically, annual inflation at the close of 1Q15 was higher than expected a year ago and even more than what we were predicting three months ago for all the countries with inflation targets, with the exception of Mexico (Figure 5.1).

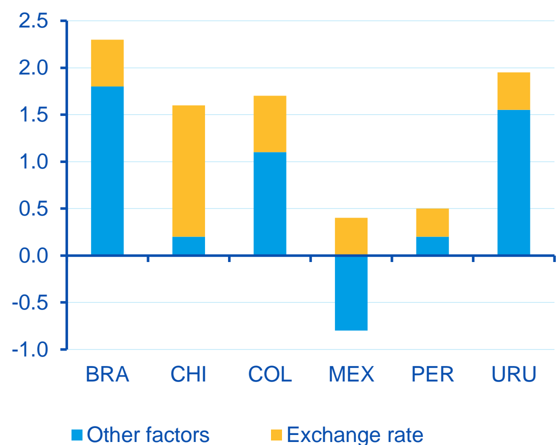
There are clear idiosyncratic factors which have contributed to the greater pressure on domestic prices in recent months: tax hikes (Chile, Brazil), the effect of supply shocks on food prices (Colombia, Peru), realignment of government-administered prices (Brazil), reforms and regulatory changes (Mexico) and inertia-related factors (Uruguay, Brazil). Nonetheless, the sharp currency depreciation generally observed in the past few months (despite the appreciation noted in recent weeks) has also been an explanatory factor behind recent deviations of inflation from prior estimates.

Figure 5.1
**Observed inflation at the close of 1Q15 and that forecast for the same period both in 114Q and at the start of 1Q15 (% YoY)**




Source: BBVA Research

Figure 5.2
**Breakdown of explanatory factors for the difference between observed inflation at the close of 1Q15 and that forecast for the period in 114Q (pp)**



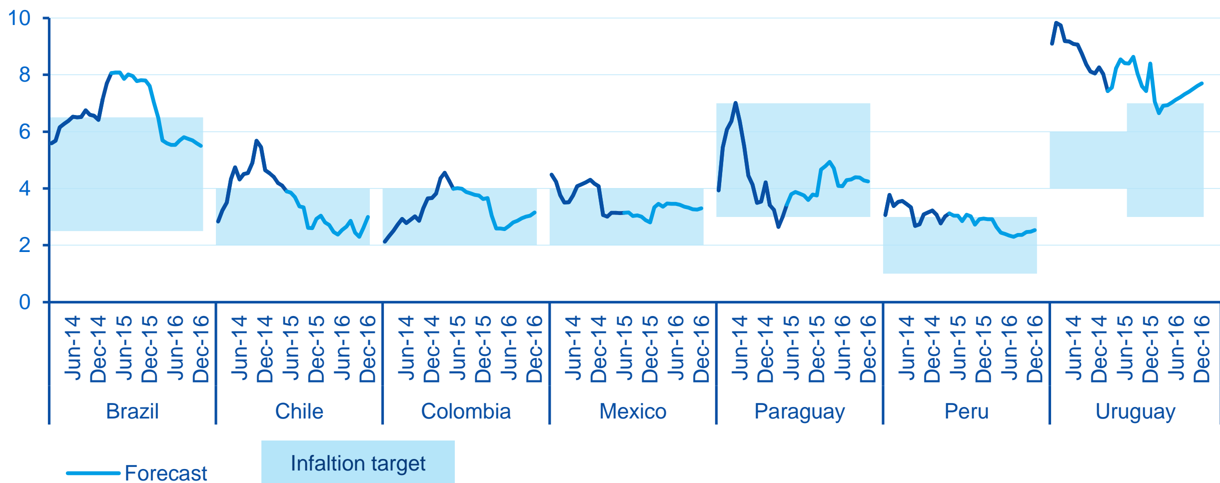

Source: BBVA Research

Our estimates suggest that the gap between inflation observed at the close of 1Q15 and that forecast in 1Q14 is in general mostly explained by idiosyncratic factors other than the exchange rate, although this is also a significant factor (Figure 5.2). Even so, in Peru, and principally in Chile, the currency depreciation by an amount above what we were predicting one year ago is the main driver behind the departure of inflation from what we were forecasting.

Similarly, following the recent surprises, inflation is very close to or above the upper limit of the target band set by each central bank (especially in the cases of Brazil and Uruguay, as can be appreciated from Figure 5.3). This is happening despite the fact that the weakness of economic activity is generally helping to keep demand pressure on prices from being very significant.

In Mexico and Paraguay inflation pressure is weaker. In Mexico inflation is close to its central target level (3%). That is due to i) the cyclical weakness ii) the effects of the reforms implemented with respect to telecoms and electricity prices iii) a smaller rise in petrol and gas prices, and iv) the more volatile among the prices within the consumption basket eased. With regard to Paraguay, inflation stands at 2% below the new target band of 2.5% to 6.5% (2014: 3% to 7%), basically because of lower food and oil prices.

Figure 5.3
**LatAm: inflation (% YoY) and target band of central banks**




Source: BBVA Research

## Inflation will converge towards central bank targets in 2015-16.

We have revised our inflation expectations for the close of 2015 in the light of the recent surprises: upwards for most countries and downwards for Mexico and Paraguay. With respect to our 2016 forecasts, these are practically unchanged, with the exception of Peru, which we have revised upwards a touch, by 0.3pp to 2.5% due to greater anticipated currency depreciation.

We also expect inflation pressure to ease off over our forecast horizon as the impact of more moderate demand and commodity markets outweighs factors tending upwards, particularly the impact of a weaker exchange rate (Figure 5.3). This outlook is supported by the fact that most of the recent shocks mentioned earlier are of a transient nature, although the central banks will have to be watchful as regards second round effects on prices.

The greater credibility of the region’s central banks and the anchoring of long-term expectations should contribute to the process of taking pressure off prices and help set inflation on course to converge towards the central value of the respective target bands.

In Brazil and Uruguay, where inflation has remained above the central target level of late, and long-term expectations are not so well-anchored, a more restrictive tone to fiscal and monetary policies will contribute to the moderation expected in the coming months, while the effect on inflation of hikes in indirect tax in Brazil is wearing off. Whatever happens, in both countries inflation will still lurk in the upper part of the target band.

# 6 The window of opportunity for cutting interest rates in LatAm is closing

## Despite the cyclical weakness, the window of opportunity for cutting interest rates is closing due to the persistence of inflation (and in Peru, because of exchange rate volatility)

The recent inflation-related surprises discussed in the previous section have ended up shaping tougher-than-forecast monetary policy in several of the region's countries. Thus, instead of interest rate cuts in the Andean countries, which we were expecting to see three months ago, the most likely scenario is that interest rates will be held at current levels, i.e. 3.25% in Peru, 3% in Chile and 4.5% in Colombia, for a long time, at least until mid-2016 (Figure 6.1), when the lift-off of economic activity will call for an upward shift.

In Peru, besides the greater inflation pressure, the decision not to cut interest rates arises from concern that a more expansive monetary policy could put more pressure on the exchange rate to depreciate in a highly dollarised economy. In Colombia, aside from the inflation pressure and in spite of a slowdown in activity, the decision not to cut interest rates is also based on the high current account deficit, good progress being made in credit portfolio growth and the risk of high inflation tainting expectations. In Chile, the monetary authorities remain focussed on inflation pressures and the persistence of them, and they have ruled out a monetary policy rate cut within the "foreseeable future". They have also hinted at a small upward adjustment at the end of the year, which is something that we do not believe will ultimately happen, due to inflation remitting as we go forward.

In Brazil, inflation surprises (as well as the need to restore credibility for its economic policy) are forcing a bigger-than-expected hike in interest rates. Instead of concluding the process of toughening monetary policy with a Selic rate of 12.50%, the Brazilian monetary authorities raised rates to 13.25% in April and should hike them to 13.75% at their next meeting in June, which is a level at which they ought to remain until 1Q16, when falling inflation warrants some degree of monetary loosening.

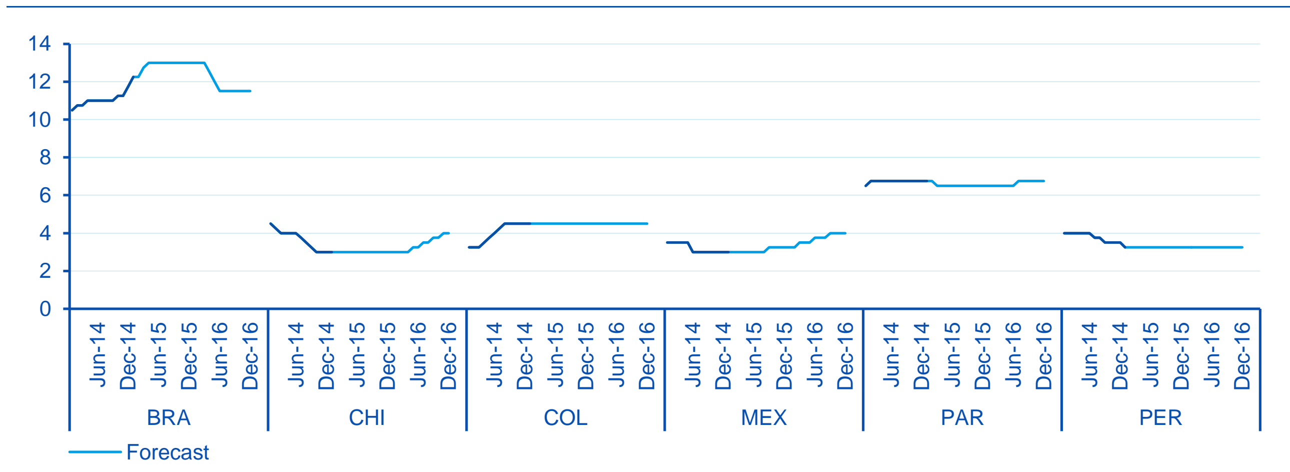
In Mexico and Paraguay, the recent inflation surprises were in a downward direction, which leaves the central banks with room to manoeuvre. In this regard, statements from Mexico's central bank show a willingness to synchronise their monetary adjustment cycle with that of the United States. We therefore expect rates in Mexico to begin rising in September and to reach 3.25% and 4.0% by year-end 2015 and 2016, respectively.

In Paraguay, the central bank has lowered the policy rate to 6.25% in recent months instead of holding it at 6.75% as expected. As with other countries in the region, we are not expecting further cuts ahead since inflation should start to rise and growth will remain relatively robust. We forecast that rates will stay at their current level until mid-2016.

Thus, given the widespread view that the problems experienced by businesses which are associated with a currency mismatch are limited[8], the most likely course of events is that monetary policy will uncouple from the Fed, at least in the short term. The main exception is likely to be Mexico, which should remain in step with US monetary policy due to the fact that its economy is closely intertwined with that of its northern neighbour.

8: See the box on this subject in our Latin America Economic Outlook, 1Q15.

Figure 6.1
**LatAm: Monetary Policy Rate, %**




Source: BBVA Research

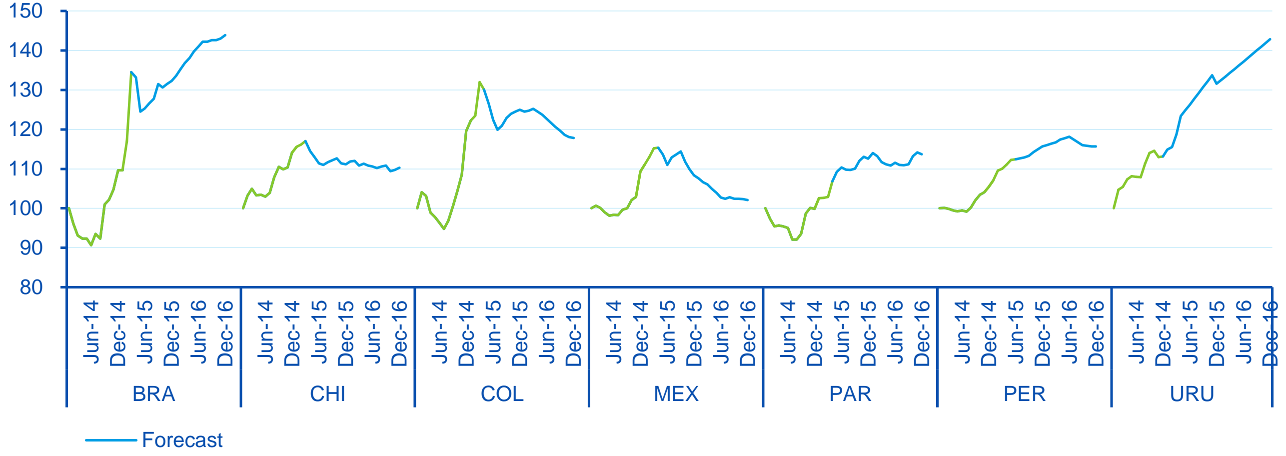
## Curencies will remain under depreciation pressure due to central banks uncoupling from the Fed rate hike and still-hefty external deficits

As was examined in Section 3, the appreciation of LatAm currencies since mid-March has wiped out a portion (albeit a small one) of the depreciation that had been observed previously. In all of the region's countries the currency is palpably weaker than it has been in the past two years (Figures 3.6 and 6.2). In certain cases this has arisen in spite of exchange rate intervention by the monetary authorities. This is what has happened in Peru, and to a lesser extent Brazil, where the central bank broke off from its programme of daily injections of dollar liquidity using currency swaps at the end of March.

From now on movements on FX markets will be very much dictated by the Fed's normalisation strategy as well as commodity price trends, which suggests to us that fresh bouts of volatility are highly likely. Moreover, the uncoupling of monetary policy of most countries in the region from that in the United States will imply pressure on their currencies to depreciate. Lastly, unwieldy current account deficits and the prospects of a slackening of capital inflows into the region should also contribute to currencies remaining at relatively weakened levels (for further details see Section 7 and our forecasts concerning how capital inflows to the region will behave in Section 3).

In spite of one or two minor downscaling revisions for certain countries, primarily Chile and Colombia, partly due to greater support from copper and oil, in many cases the currency depreciation will continue over our forecast horizon, particularly in Brazil, Peru and Paraguay (Figure 6.2).

Figure 6.2
**LatAm: Exchange rate (January 2012=100*)**




* Local currency to the dollar.
Source: BBVA Research

# 7 External deficits in LatAm will linger on the high side yet remain sustainable

## External deficits in the region will still be marked by the low prices of certain key export commodities

External accounts will continue to show deficits in almost all of the region's countries (except Chile and Paraguay), hit by the fall in commodity prices in the region. Specifically, we estimate that the external deficit will widen in Argentina and Colombia in 2015 (and Argentina again in 2016). What prompts this forecast of a higher deficit is, in Argentina's case, the implicit scenario of exchange controls being partly removed, leading to a surge of imports. With regard to Colombia and Mexico, as was mentioned in Section 4, they will be especially affected by the lower oil price, which will not be successfully offset by the rise in non-traditional exports in Colombia, or manufacturing exports in Mexico, even within the context of currency depreciation. Meanwhile we expect a lower deficit in Peru, Uruguay and Brazil[9] (see Figure 4.6). This smaller expected deficit is associated with the expected depreciation of their currencies and the lower level of economic activity, which will imply lower imports over the year, and, in Peru's case, also factors-in the anticipated increase in mining production from 2Q. The only country in the region where we are standing by our forecast of a current account surplus is Chile, where it will be around 1%, and in this case, even though a slowdown in activity will lead to less imports, this effect will also be offset by lower copper prices.

These current account deficits will still be considerable in Colombia, Peru, Uruguay and Brazil in 2015, but they will have to begin to come down towards 2016, particularly in Colombia and Brazil. For the region as a whole it will be somewhat larger than in 2014, but then start to close up from 2016 as key projects come on-stream (such as the mines in Peru and those associated with the energy reform in Mexico) and world demand picks up, with the impact this will have on the regions products, even taking into account the fact that the slowdown in growth in China will persist.

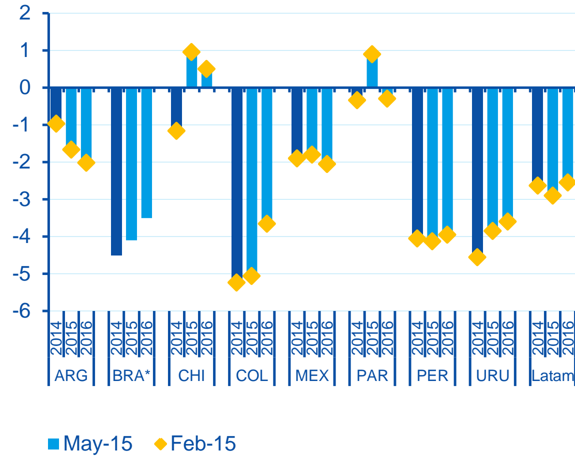
## The region's vulnerability to the exterior remains limited, although there is a greater reliance on short-term funding

In spite of everything the region's level of vulnerability is still low: deficit financing continues to come mainly from FDI, although this is less ample than it was a few years ago. In 2012 and 2013 FDI was enough (with the exceptions of Mexico in 2012 and Brazil in 2013) to cover external deficits, even though, according to the latest available data, this has not been the case in Chile (see Figure 4.8). This lower proportion of FDI is associated with both the lower growth expected for the region and lower commodity prices, which accounted for a substantial part of FDI in the exporter countries.

For 2015 we estimate that this trend will continue in most countries. The lower proportion financed from FDI implies that it is now short-term capital which is financing the bulk of the deficit, which could represent a weak point in the medium term in any scenario of a sudden exit of capital. For the time being though, this vulnerability is manageable.

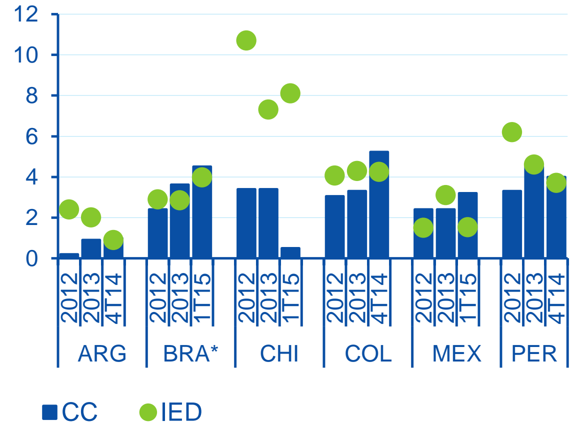
9: Here it is worth noting the situation in Brazil, where methodology has been revised, meaning that it is not possible to compare the previous series with the new set, nor, by extension, prior estimates with new ones either.

Figure 7.1
**Current account (% of GDP)**




* Change of series on account of a shift in methodology by the BCB: the new series is not comparable with the previous set.
Source: BBVA Research

Figure 7.2
**Current account deficit and FDI, (cumulative % of GDP over past four quarters)**




Data available for 1Q15 for Brazil, Chile and Mexico. The statistics for Brazil for 2015 are not comparable with previous figures, given the change of methodology by the BCB.
Source: BBVA Research and national statistics.

# 8 Unchanged prospects for fiscal deficits, except in Brazil and Argentina, where they have taken a considerable turn for the worse

## The outlook for fiscal balances in Brazil in 2015 has deteriorated, in spite of the fiscal policy correction

The fiscal outlook is now gloomier in Brazil and slightly better in Argentina, while in the other countries there are no meaningful changes with respect to estimates a quarter ago (see Figure 4.9). In Brazil the government is carrying out a major fiscal adjustment aimed at checking the deterioration in the public finances. The correction entails cutting public spending and hiking taxes in certain sectors, such as specific manufactures and fuels. Although the fiscal correction was necessary, it is also the reason behind the downward revision in the outlook for growth, as was mentioned in Section 4. Despite these significant measures, the fiscal situation looking ahead is substantially bleaker now than it was a quarter ago (fiscal balance of -5.6% of GDP now, while it was -4.4% in January), which serves to illustrate the scale of the fiscal effort that is called for.

Meanwhile, for the Andean countries we are basically keeping the fiscal outlook unchanged for 2015. For Chile this already factors in the eventuality of lower tax collection, which will be compensated by budget execution of over 100%. In Colombia, the fiscal accounts have deteriorated with respect to the scenario in January, with the consequent cuts in spending needed to preserve the fiscal rule intact. A key factor in the poor results for tax revenues has been the bad set of results from Ecopetrol on the slide in the oil price, which has meant that government revenues are likely to have fallen away drastically, thus implying a need to slash spending. It is not, however, merely a question of oil revenues, as the 2012 tax reform could have upset the government's revenue-generating capacity on a permanent basis. This worse situation will mean that there is a need for a reform towards 2016 which will involve tax hikes and spending cuts. Finally, in Peru, the fiscal deficit forecast which is being held unchanged takes account of the permanent cut in tax rates (a lasting decrease in fiscal revenues), as well as heavier investment spending associated with infrastructure projects. Even so, the estimated public finance deficits will be at manageable levels and do not compromise long term sustainability.

In Mexico the spending cuts announced at the beginning of the year will have a particular impact towards 2016 (oil-related revenues for 2015 are partly covered via hedging and petrol imports). In this regard the government has announced zero-based budgeting, whereby it intends to effect a wholesale revision of public expenditure for 2016; our new estimates have built in the effect of this.

Finally, we are not expecting significant changes for this year in the handling of Argentine fiscal policy, although these will be required in the future and will have to entail reductions to energy and transport subsidies.

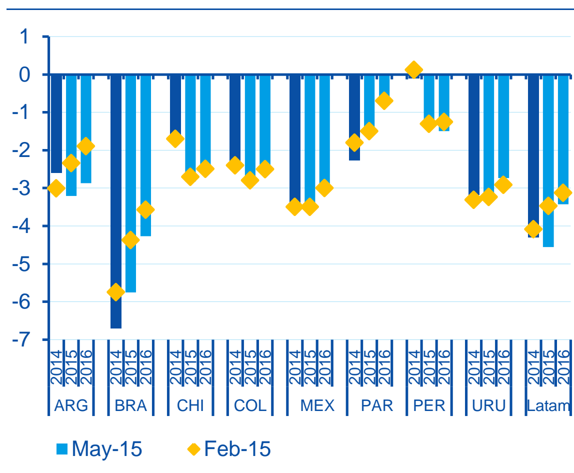
## Public investment programmes will nevertheless be one of the drivers for growth, especially in the Andean countries

Public investment programmes will be key, particularly among the Andean countries: in Chile the government has shown ability in executing all of the budgeted public expenditure, unlike in the previous year. Such ability to execute is not entirely free of risks relating to red tape to cut through, although we forecast a substantial investment expenditure component. Meanwhile in Colombia, despite the predicted cut in public investment programmes, these funds will continue to underpin growth significantly, and on top of this

account should be taken of the resources which were not executed from the 2013-2014 biennial budget, which will represent a major source of additional revenue for 2015-2016. It should be noted that Colombia recently announced a growth reactivation plan (PIPEII) which does not involve more spending but rather swifter prioritisation and execution of approved projects. In Peru implementation of the fiscal stimulus measures which were announced at the end of last year as high priority infrastructure investment projects will take effect. The impact of this on growth will also be positive given the basis for comparison effect (remember that in 2014 public investment fell 2.4%).

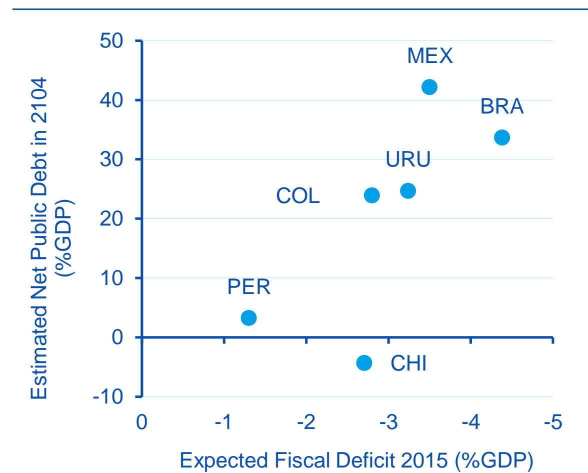
The adjustments required in Brazil and Mexico could conversely lead to less buoyant public investment. For Mexico, numerous projects have already been delayed due to choking of revenues due to the fall in the oil price which began last year. This hold-up will have to be resolved over the course of this year and certain projects will be re-channelled via public-private partnerships, although we lean more to the conservative side regarding the contribution of public investment this year. In Brazil cuts will have to be applied to funding for an entire raft of public expenditure projects, including spending on welfare and transfers.

Figure 8.1
**Fiscal balances (% of GDP)**




Source: BBVA Research *

Figure 8.2
**Estimated fiscal deficit in 2015 and estimated net public debt in 2014 (% of GDP)**




Source: BBVA Research and the IMF World Economic Outlook, April 2015.

# 9 Tables

Table 1
**GDP (% YoY)**

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 0.8 | 2.9 | 0.5 | 0.7 | 2.0 |
| Brazil | 1.8 | 2.7 | 0.2 | -0.7 | 1.8 |
| Chile | 5.5 | 4.2 | 1.9 | 2.9 | 3.5 |
| Colombia | 4.0 | 4.9 | 4.6 | 3.1 | 3.6 |
| Mexico | 3.8 | 1.7 | 2.1 | 2.5 | 2.7 |
| Paraguay | -1.2 | 14.2 | 4.4 | 4.2 | 4.2 |
| Peru | 6.0 | 5.8 | 2.4 | 3.1 | 4.6 |
| Uruguay | 3.3 | 5.1 | 3.5 | 2.6 | 3.0 |
| Mercosur | 1.7 | 2.5 | -0.5 | -1.0 | 1.3 |
| Pacific Alliance | 5.0 | 4.2 | 3.0 | 2.6 | 2.7 |
| Latin America | 2.8 | 2.7 | 0.8 | 0.6 | 2.1 |

*Forecasts
Source: BBVA Research

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

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 10.0 | 10.6 | 20.6 | 18.2 | 23.3 |
| Brazil | 5.4 | 6.2 | 6.3 | 7.9 | 5.8 |
| Chile | 3.0 | 1.8 | 4.4 | 3.6 | 2.6 |
| Colombia | 3.2 | 2.0 | 2.9 | 4.0 | 2.9 |
| Mexico | 4.1 | 3.8 | 4.0 | 3.0 | 3.4 |
| Paraguay | 3.7 | 2.7 | 5.0 | 3.5 | 4.4 |
| Peru | 3.7 | 2.8 | 3.2 | 3.0 | 2.5 |
| Uruguay | 8.1 | 8.6 | 8.9 | 8.1 | 7.2 |

*Forecasts
Source: BBVA Research

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

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 4.55 | 5.48 | 8.12 | 9.26 | 12.5 |
| Brazil | 1.96 | 2.18 | 2.36 | 3.08 | 3.40 |
| Chile | 486 | 495 | 570 | 608 | 595 |
| Colombia | 1798 | 1869 | 2001 | 2.440 | 2.388 |
| Mexico | 13.2 | 12.8 | 13.3 | 14.9 | 13.7 |
| Paraguay | 4417 | 4312 | 4514 | 4.766 | 4.862 |
| Peru | 2.64 | 2.70 | 2.84 | 3.15 | 3.28 |
| Uruguay | 20.2 | 20.4 | 23.2 | 26.8 | 29.3 |

*Forecasts
Source: BBVA Research

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

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 13.85 | 16.92 | 22.55 | 21.64 | 30.90 |
| Brazil | 8.46 | 8.44 | 11.02 | 13.33 | 12.21 |
| Chile | 5.02 | 4.90 | 3.69 | 3.00 | 3.42 |
| Colombia | 4.94 | 3.35 | 3.98 | 4.50 | 4.50 |
| Mexico | 4.50 | 3.94 | 3.21 | 3.08 | 3.69 |
| Paraguay | 6.00 | 5.54 | 6.73 | 6.35 | 6.38 |
| Peru | 4.25 | 4.21 | 3.79 | 3.25 | 3.25 |
| Uruguay | 18.59 | 17.70 | 21.52 | 19.23 | 18.22 |

*Forecasts
Source: BBVA Research

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

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | -0.2 | -0.8 | -1.0 | -1.7 | -2.0 |
| Brasil[1] | -2.4 | -3.4 | -4.5 | -4.2 | -3.6 |
| Chile | -3.6 | -3.7 | -1.2 | 1.0 | 0.5 |
| Colombia | -3.1 | -3.2 | -5.2 | -5.1 | -3.7 |
| México | -1.3 | -2.1 | -1.9 | -1.8 | -2.0 |
| Paraguay | -2.0 | 1.7 | -0.3 | 0.9 | -0.3 |
| Perú | -3.3 | -4.5 | -4.1 | -4.1 | -4.0 |
| Uruguay | -5.3 | -5.4 | -4.6 | -3.9 | -3.6 |
| Mercosur | -1.4 | -2.2 | -2.6 | -3.3 | -2.8 |
| Alianza del Pacífico | -2.1 | -2.7 | -2.6 | -2.3 | -2.2 |
| América Latina | -1.7 | -2.4 | -2.6 | -2.9 | -2.5 |

*Forecasts
[1] 2012 and 2013 current account data are not comparable with data from 2014 on due to methodological changes.
Source: BBVA Research

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

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | -2.5 | -2.3 | -2.6 | -3.2 | -2.9 |
| Brazil | -2.5 | -3.1 | -6.7 | -5.8 | -4.3 |
| Chile | 0.6 | -0.6 | -1.6 | -2.8 | -2.5 |
| Colombia | -2.3 | -2.4 | -2.4 | -2.9 | -2.6 |
| Mexico | -2.6 | -2.3 | -3.5 | -3.5 | -3.0 |
| Paraguay | -1.8 | -2.0 | -2.3 | -1.5 | -0.7 |
| Peru | 2.3 | 0.9 | -0.1 | -1.3 | -1.5 |
| Uruguay | -2.7 | -2.4 | -3.2 | -3.1 | -2.7 |
| Mercosur | -2.8 | -2.8 | -5.5 | -5.6 | -4.0 |
| Pacific Alliance | -1.7 | -1.8 | -2.7 | -3.1 | -2.7 |
| Latin America | -2.3 | -2.4 | -4.3 | -4.6 | -3.4 |

*Forecasts
Source: BBVA Research

Table 7
### Commodity forecasts

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Oil (Brent USD/barrel) (avg.) | 111.6 | 108.5 | 98.9 | 61.7 | 74.5 |
| Soy (USD/ton) (avg.) | 537.8 | 517.5 | 465.0 | 364.6 | 378.7 |
| Copper (USD/lb) (avg.) | 3.6 | 3.1 | 2.7 | 2.7 | 2.8 |

*Forecasts
Source: BBVA Research

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