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Latin America Economic Outlook

Third quarter 2015
LatAm Coordination Unit

- Growth will be low in LatAm in 2015 and 2016, at 0.2% and 1.1% respectively. Confidence indicators are still weak, which is holding back private sector consumption and investment. Paraguay, Peru and Colombia will be countries that lead growth in 2015-16.
- We are revising our estimate for potential growth down to 2.7% for 2016-20, primarily due to the smaller boost for South America from China and commodities, while we are revising Mexico's potential growth upwards from 2.8% to 3.4% for 2016-20.
- Inflation is holding up, above central bank targets, in particular due to fiscal idiosyncratic and weather-related shocks. Greater exchange rate depreciation of LatAm currencies has also been influential, even though the level of pass-through to domestic prices has not intensified.
- Growing dilemmas for central banks, except in Mexico. They face increased cyclical weakness but at the same time there is above-target inflation and greater currency depreciation. Mexico will remain in step with the Federal Reserve, as forecast three months ago, but Brazil and the Andean countries will disengage from it.

Contents

Closing date: 3 August 2015

1 Overview

World growth in 2015 is being revised downwards to 3.4%. This should recover to 3.8% in 2016. The block of developed economies continues to share encouraging growth prospects, which helps to limit the impact that the slowdown among the emerging heavyweights is having on activity and trade worldwide. The global setting in the last quarter has also been marked by the powerful stock market correction in China, which will dampen growth there in the coming quarters. Due to this, we are revising growth forecasts for China down to 6.7% and 6.2% in 2015 and 2016. On the other hand, the rough patch that growth went through in the first half in the United States also warrants a downward revision of forecasts for it in 2015, to 2.5%, although we are standing by our prediction of an initial rate hike by the Fed in September.

Industrial commodity prices have been hit by the volatility in financial markets in China, but above all the correction was brought about by supply shocks, particularly as regards oil. The oil price has been greatly influenced by the increase in OPEC production (by Saudi Arabia and Iraq), productivity gains in the shale oil sector in the United States and the nuclear deal with Iran, while the soybean price has been driven by weather-related problems in the United States.

The Fed, China and cyclical weakness have weighed upon LatAm financial markets in the past three months. Prices of the major financial assets and exchange rates have continued to sag between April and August, burdened by concern over China's economy, the correction in commodity prices (especially copper and oil) and the impending start of rate hikes by the Fed. Added to these factors is the element of the region's own cyclical weakness, which has borne down on market prices to detrimental effect. Further ahead, jitters will persist in blighting financial markets, as activity and employment figures in the United States continue to confirm an imminent Fed rate hike.

Confidence indicators have continued to flag in the region, sapping the strength from domestic demand and justifying a downward revision of growth forecasts for Latin America to 0.2% in 2015 and 1.1% in 2016. The two dominant factors behind this change of take are, first, the ongoing deterioration in household and business confidence, which has been provoked by both political ructions and uncertainty over economic policies in several of the region's economies. This has hampered private sector investment considerably, as well as (on top of labour market weakness) consumption. The second factor is the less rosy external climate, given the corrections to both growth in China and key commodity prices. The upturn in growth, which should gradually transpire from 2016, ought to be driven by: i) the pull from external demand following on from a rise in world growth; ii) the impetus provided by public sector investment, especially in the Andean economies and Mexico, and iii) the less restrictive tone of economic policies in Brazil.

All things considered, growth rates in the region will gradually converge towards the potential level, which we estimate at approximately 2.7% for 2016-20 (Box 1). The potential growth level is being brought down with respect to the forecast made one year ago (of 3.0%), mainly on account of the downward correction in South America given a less benign external environment, which will not be wholly neutralised by the higher level of potential growth that is forecast for Mexico.

The Pacific Alliance will grow by 2.6% and 2.9% in 2015-16, which is ahead of the regional average, although short of the potential rate which we put at 3.8%. The countries that will grow the most in the region in the next two years will be Paraguay (3.7% on average for 2015-16), Peru (3.2%) and Colombia (3.1%). (See table of forecasts in Section 9).

Inflation is still holding above the targets of the region's central banks, despite the cyclical weakness, and should edge towards the central bank targets more slowly than anticipated, partly because of stronger than expected depreciation. With the exception of Mexico, at the end of Q2 inflation stood above the level we were predicting a year ago, primarily due to exchange rate depreciation (especially in Peru, Colombia and Chile), rather than any rise in the amount of exchange rate pass-through to prices, which has not increased significantly in the region over the past year (Box 2). Inflation in the region has also surprised on the high side, owing to idiosyncratic reasons, among which may be cited tax hikes (Chile, Brazil), higher administered prices (Brazil), food-price shocks (Peru, Colombia) and inertia-related factors (Uruguay, Brazil).

In a context of greater cyclical weakness and simultaneous high-side surprises regarding inflation, monetary policy dilemmas across South America are becoming more critical, given the looming Fed rate hike. The response to such a dilemma varies in South America and partly depends on the margin of credibility that monetary policy has. In Brazil, the expected course of official interest rates is more restrictive than it was three months ago, with an additional hike in July and postponement of the initial rate cut expected in 2016. On the other hand, the path for interest rates in Chile is now more accommodative than we were anticipating three months ago, with a 50bp cut in the rate at the end of this year. Finally, in Colombia and Peru, we are standing by our view of stable rates for the remainder of this year and 2016. Conversely, as we did three months ago, we still expect Mexico to continue to tie in its monetary policy with that of the Federal Reserve, given how closely aligned the countries' economic cycles are.

With the uncoupling from the Fed by central banks (except in Mexico) and a less encouraging external environment, the pattern of exchange rate depreciation among the region's currencies will continue. The recent weakening of exchange rates came about in a context of cyclical slowdown, lower commodity prices and doubts over growth in China. Going forward, new bouts of volatility are likely in anticipation of the opening US rate hikes. In countries such as Mexico, Chile and Colombia, after sinking to a low point after the initial Fed hike, the exchange rate for their currencies is likely to appreciate a bit from the end of 2015 as growth recovers and oil and copper prices also tick up gently.

The modest prices of the key export commodities will keep deficits on the high side in the region. External balances will continue to show a deficit (except in Chile), although there will be a certain narrowing of deficits in 2016 in almost all countries, due to exchange rate depreciation, domestic demand weakness and something of a recovery in the terms of trade. The region's external vulnerability remains contained, despite the smaller weight of foreign direct investment (FDI) as a source of financing for the external deficit.

The outlook for fiscal balances is becoming bleaker, especially in Argentina and Brazil. In most countries the slowdown has had an adverse impact on tax revenue forecasts and, to compound this, in certain cases there is an acceleration of spending. The standout cases of a decline in fiscal prospects are Argentina, on account of a bigger spending drive in 2015, and Brazil, where the serious economic and political problems in achieving surplus targets have brought about downward revisions for them, which will call for a greater effort in 2016. The main exception to such practically across-the-board impairment of public finances is Mexico, where deficit forecasts remain stable compared to those of three months ago.

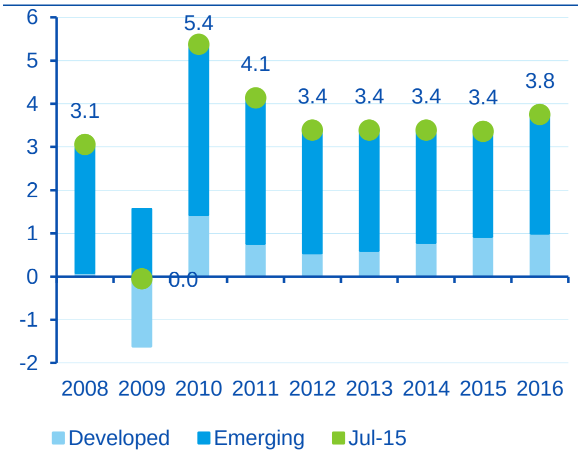
2 Global environment: moderation in world growth and a marked deceleration in the emerging economies

We have revised our forecast for 2015 world growth downwards, to 3.4%. This will recover to 3.8% in 2016

After a poor first quarter, world growth appears to be more dynamic in 2Q15, on the back of the recovery in the US (after the stagnation in GDP observed in the first few months of the year), euro area strength and GDP growth in China of 7% YoY, the same reading as in the first quarter. Despite this, world GDP is likely to have grown at under 3% YoY in the first half of the year, thus justifying our downward revision of growth for 2015 as a whole (to 3.4%, which is 0.1pp below what we were predicting in April). Looking to 2016, the world economy could pick up pace and attain growth of 3.8%.

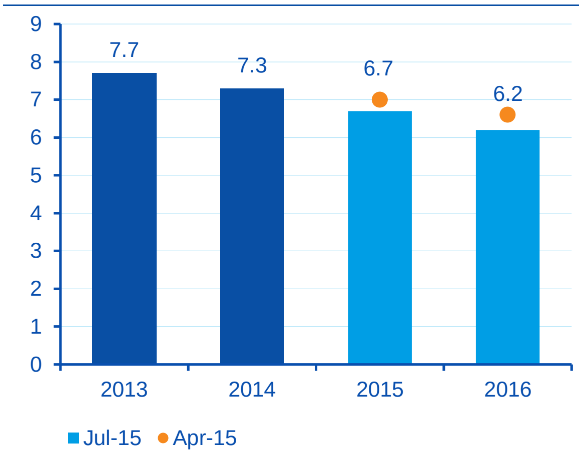
The developed economies continue to share encouraging growth prospects, which will contribute to mitigate the impact on world activity and trade of the current slowdown among the key emerging economies. Specifically, while in 2015 the developed nations have the potential to grow at their fastest pace since 2010, at a shade over 2% YoY, the major emerging markets could see weaker growth again for the fifth year in succession.

Figure 2.1
World growth: annual growth (%). 2015-16 forecasts



Source: BBVA Research

Figure 2.2
China: economic growth, % annual change



Source: BBVA Research

Besides the downward revision of growth forecasts for the world economy, a hallmark of the global context in the last quarter has been the manifestation of some of the risk events that we singled out three months ago and, if they take a turn for the worse, this could bring the global economic recovery to a halt. The first of these involves the bout of financial instability in China. This was brought about by the sharp correction of its stock market, within a situation of trend deceleration in growth, which has drawn on substantial borrowing, and a process of financial liberalisation still underway. The second, which is equally significant, is the Greek crisis, and the constrains to reach an agreement that ensures that the country will face its financial commitments in the short term, as well as the sustainability of its debt via reforms to enhance the economy's capacity to grow in the long term.

The combination of these two risk events, together with the approach of the Fed's first rate, has heightened financial disruption the world over, particularly in the form of greater volatility in stock and currency markets, with a heavier impact on the euro area and Asia.

The disappointing growth in the first half of the year justifies our downward revision for growth in the US in 2015 …

In the US, GDP growth contracted in the first quarter, followed by modest growth in the second, judging by the available indicator readings for activity and confidence. This justifies our downward revision for growth for 2015 as a whole, which we think could reach 2.5%, or some 0.4pp below the level we forecast in April. The uncertainty over how the economic cycle will perform in the coming quarters has now been heightened bearing in mind the impact of the persistent dollar appreciation on exports, the weakness of private investment and the deterioration in the global situation. Even so, US GDP could grow by 2.8% in 2016.

… while the financial volatility in China has also led us to revise our growth forecasts for 2015 and 2016

In China, the pace of economic growth is likely to slow owing to the impact of the recent bout of financial tensions. Besides the negative effect on the confidence of the private sector, there might also potentially be some reversal of consumption decisions as a result of the drop in households' financial wealth. More than anything though, there is likely to be a deterioration in financing conditions for corporates, which is associated with both the suspension of new placements and the loss of value of collateral backing bank loans. These are the factors responsible for the downward revision in the growth forecast for China in 2015 and 2016 to 6.7% and 6.2% respectively (0.3pp and 0.4pp lower than in our April scenario, see Figure 2.2). The battery of stimulus measures implemented by the country's authorities to stave off the possibility of even worse contagion to the economic activity cycle is the reason why we do not expect a more intense correction to the rate of economic growth.

Economic growth in the euro area continues to recover despite the Greek crisis

The pattern in the euro area is still one of sustained recovery, with quarterly GDP growth rates in the order of 0.4% in the first two quarters of the year. The improved dynamics in France and Italy are combining with the strength of Germany and Spanish GDP growth, which is advancing at a quarterly pace of close to 1%. The emergence of certain risk hotspots with differing impacts on the region could slightly reduce estimated growth for 2015 and 2016 but, even so, the forecasts are still positive (+1.4% in 2015 and +1.9% in 2016, 0.1pp and 0.3pp below those we forecast in April). Altogether, without a doubt the most significant challenge is to try and dispel any scepticism about the irreversibility of the monetary union project.

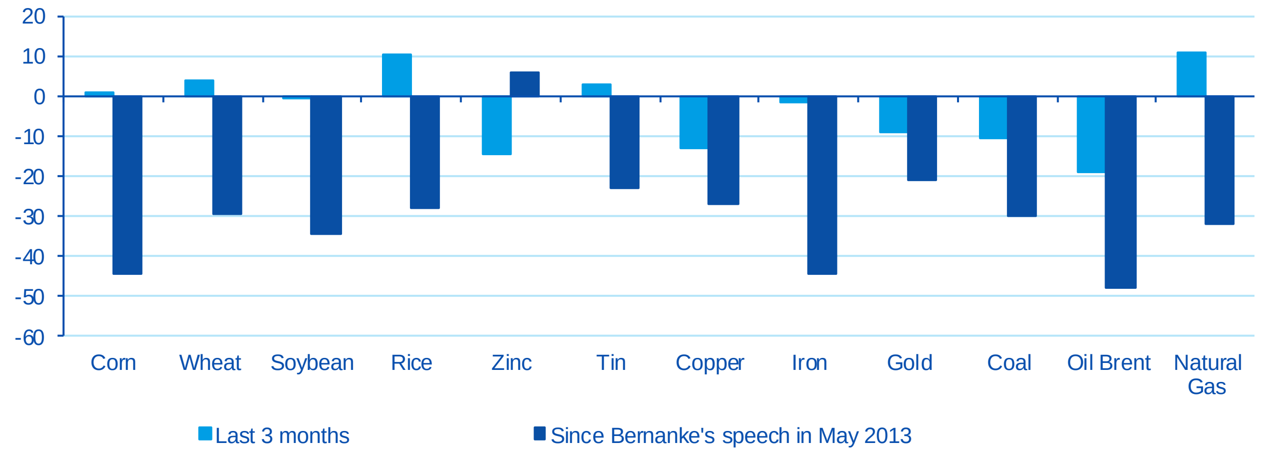
3 The Fed, China and cyclical weakness are depressing Latin American markets

Key commodity prices are enduring the impact of financial market upheaval in China, although the correction has mainly been from supply shocks

In the past three months, the prices of most commodities have drifted (Figure 3.1). This is partly due to the economic slowdown and the recent financial turmoil in China, but above all to supply shocks in certain specific markets and renewed dollar strength (which has an impact on prices via a denomination effect).

Among the goods most affected by the downward corrections of the past few months, copper (-13%) and oil (-19%) are conspicuous. These two markets have been afflicted (as have others) by both the Chinese economy's situation, given the country's substantial share of global demand, and the financial impact of the dollar's appreciation. Even so, the prime factors which have had a bearing on the recent plunge in the oil price have originated from the supply side with, first, the increase in OPEC production (especially in Saudi Arabia and Iraq), second, shale oil's maintained production and productivity gains in the United States and, finally, the nuclear deal between the latter and Iran, which could increase the oil supply in an already overflowing crude market. The oil price has additionally factored in the increase in inventories among the OECD countries and a weaker appetite for investing in the crude market on the part of pension funds.

Figure 3.1
Commodity prices (% var.)



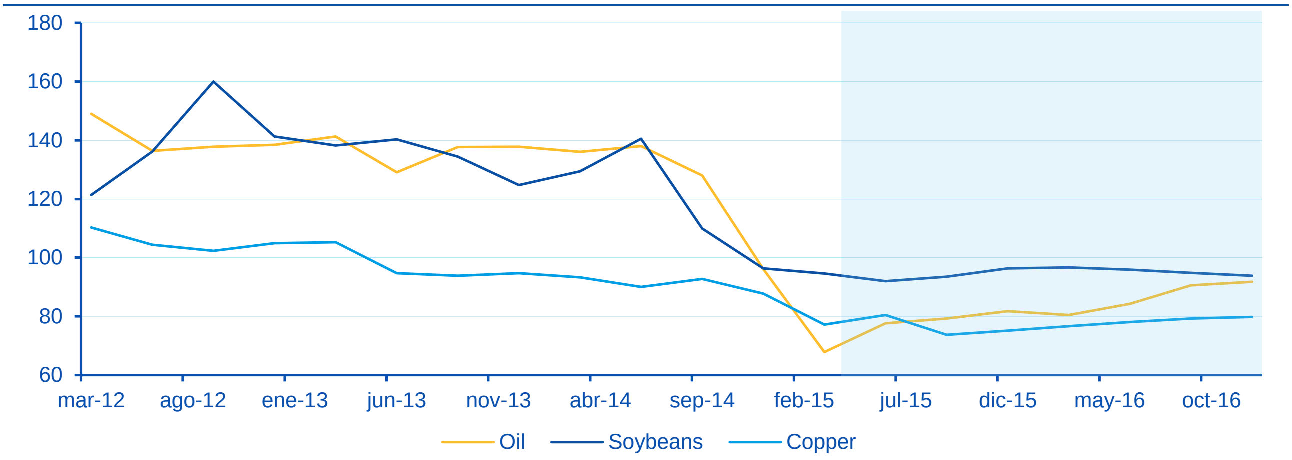
Source: Bloomberg

In our opinion, the factors which have affected the oil price in the last few months, particularly those of a more structural nature, such as shale oil productivity gains, will also dampen the rally in the crude price over the forecast horizon. We have therefore revised down our forecasts for the Brent price and expect this to average USD61/bbl and USD69/bbl respectively in 2015 and 2016, compared to the estimates of USD62/bbl and USD75/bbl which we ventured three months ago (Figure 3.2).

We have likewise moved down our forecasts for the average price of copper, to USD2.62/lb and USD2.68/lb respectively for 2015 and 2016, from USD2.71/lb for both years three months ago. The principal determining factor behind this revision has been the poorer outlook for growth in China. In any event, we still expect the copper price to revive, given expectations of a fall in inventories arising from reduced supply.

Movements in the soybean price, as well as those of other agricultural commodities, have been different from those above. This is, on the one hand, because it is less responsive than metals and oil to financial impacts and the slowdown of China's economy (among other reasons, because the deceleration of China's growth is taking place at the same time as a reorientation towards consumption (more agricultural commodity intensive) to the detriment of investment (more metals and oil intensive). On the other hand, the soybean price has benefited from the dulling effect of excess rainfall on output prospects in the United States. We expect these factors to go on pushing up the soybean price over the rest of the year and that a normalisation of supply, with a promising outlook for production in the southern hemisphere, will drag prices gently down in 2016.

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



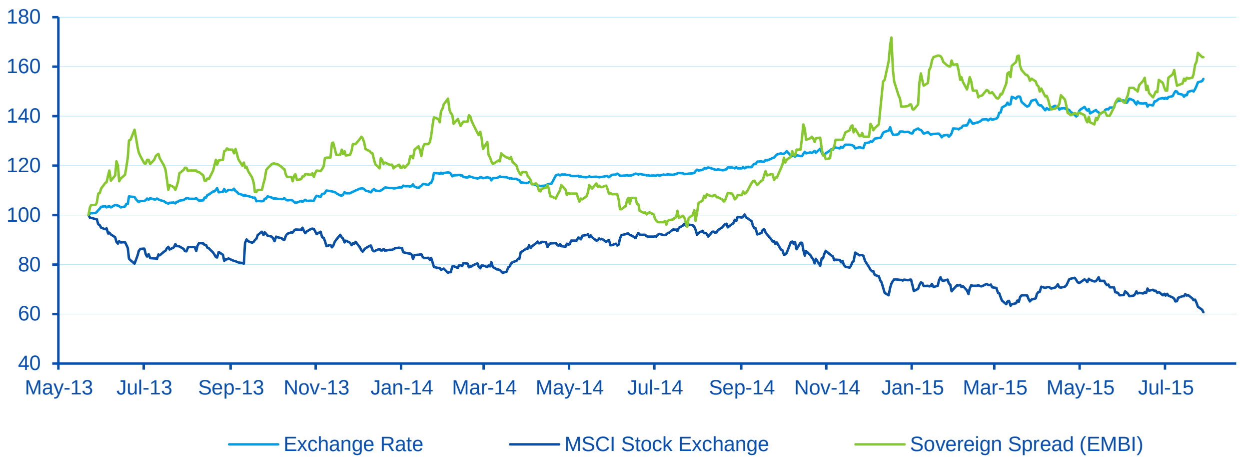
Source: BBVA Research

Significant downward corrections to LatAm financial asset prices in recent months

After a mild upturn in part of March and April, prices of LatAm financial assets have displayed a downward trend again over the past three months (Figure 3.3). As we have been pointing out in our reports, a large part of the weakness and volatility of late is associated with the prospect of monetary policy normalisation by the Fed. Since the decision-making process as regards the timing and magnitude of the rate rise in the United States essentially depends on the country's activity figures, positive or negative surprises in connection with these indicators give rise to shifts in expectations and, consequently, increased volatility in financial markets both globally and in the region. By the same token, the resurrection of the perception that the Fed will hike rates in Q3 is one of the factors that explains the recent falls in Latin American financial markets.

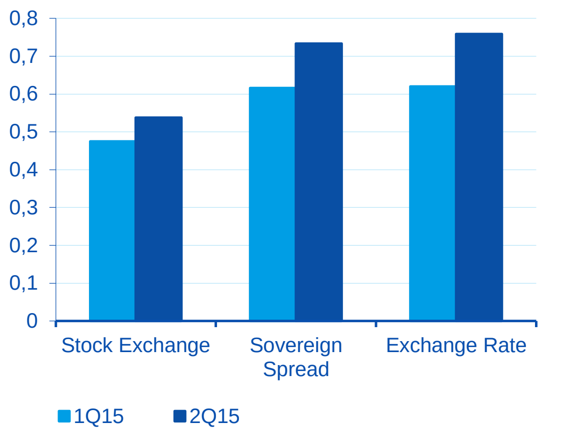
Whatever the case, growing concern over China's economy, and the subsidence in commodity markets which ensued, have also hit financial asset markets in Latin America. Indeed, the significance of these factors for the region's financial markets is likely to have been greater in the past three months than at the beginning of the year, not only with the escalation of concern over China and heftier corrections to commodity prices, but also because of the closer correlation between the price trends for the principal primary products exported by the region's countries and the performance of their financial assets (Figure 3.4).

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



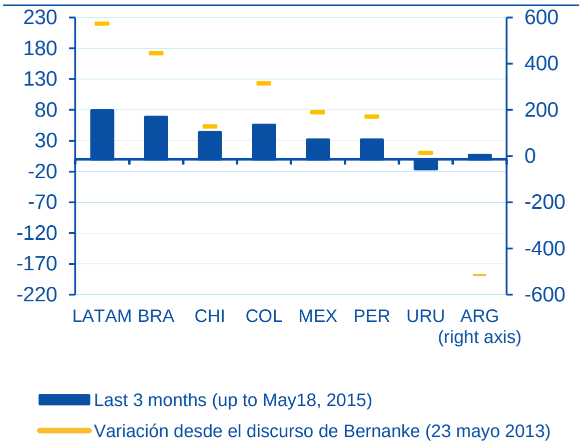
Source: BBVA Research

Figure 3.4
Correlation between the commodities index and the stock market, the sovereign spread and the exchange rate in LatAm*



* Absolute value of the correlation in each quarter between the various indexes. Commodity index: CRB, Stock market: MSCI, Sovereign spread: EMBI Latam; Exchange rate: average exchange rate for the region's principal countries.
Source: CRB, Haver Analytics and BBVA Research

Figure 3.5
Sovereign spread trends in Latin America (EMBI, basis points)*



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

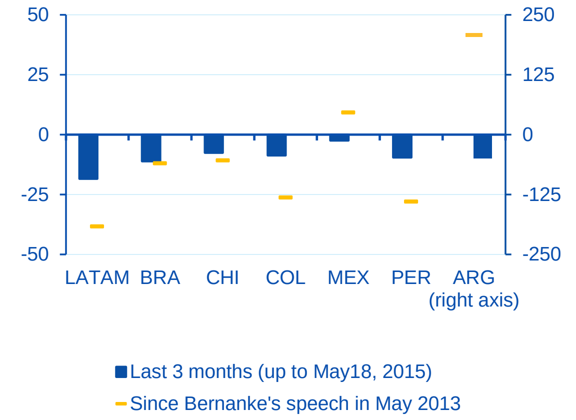
Finally, another of the chief factors behind the falls in Latin American markets has been the cyclical weakness of the region's economies: generally, growth has eased up, inflation pressure has not intensified and, in at least some cases, external and fiscal balances have deteriorated (see the sections which follow for further details on macroeconomic developments in Latin America). One example of the significance of idiosyncratic factors for financial markets is Brazil, where the recent downturn (more accentuated than in other countries) has prompted mounting concern over a potential loss of investment grade status for its sovereign debt, mainly after S&P, which maintains the country's rating as borderline investment grade, revised the outlook in its appraisal for the country in July from "stable" to "negative".

Within this environment, recent evidence points to a slowdown of capital inflows to the region's countries. In some of these, such as Colombia and Brazil, portfolio flows turned negative in June. This phenomenon was to some extent predictable, given the impending normalisation of monetary policy by the Fed, and is a process which is expected to continue into the future. Our forecast is that net capital outflows will amount to approximately 2% of regional GDP in the next two years.

Turning to sovereign spreads, the EMBI Latam aggregate indicator has shown an 80bp upturn over the past three months. Within this market, the sharpest corrections have been felt in Brazil and Colombia, although also in Chile, Peru, Mexico and Argentina. The exception has been Uruguay, where the sovereign spread has narrowed slightly in the last three months (Figure 3.5).

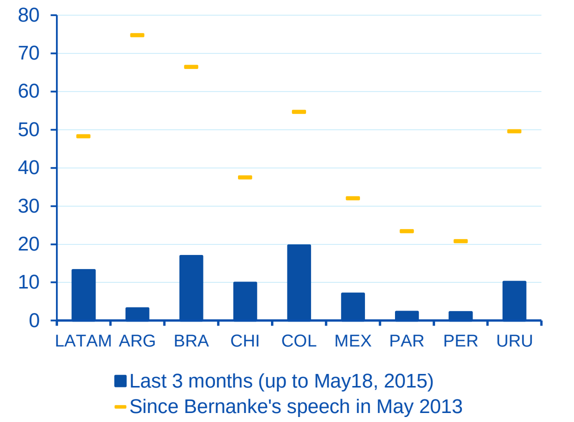
Lost ground has also been observed in stock and currency markets. In these two cases, there have been no exceptions to the widespread downward trend. As with sovereign spreads, Brazil and Colombia are the countries which have experienced the most substantial corrections. In Brazil this has been due to the more marked economic decline (leaving aside the greater liquidity in its financial markets), and in Colombia this owed itself to its dependence on oil, a commodity which has suffered the heaviest downward price corrections in the past three months (Figure 3.1).

Figure 3.6
Stock market performances in Latin America (% var. in local currency)*



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

Figure 3.7
Exchange rate movements in Latin America (% var.)



Source: Haver Analytics and BBVA Research

Volatility is set to linger as the opening Fed rate hike draws near

After the recent corrections, financial markets have notably magnified their cumulative falls since May 2013, when former Fed Chair Ben Bernanke gave the markets cause to start factoring in the beginning of tapering and the monetary policy normalisation process in the United States (Figures 3.5 to 3.7).

Looking ahead, we predict that volatility in Latin American financial markets will persist and intensify as we approach the possible date of the commencement of rate hikes by the Fed, and South America's central banks disengage still more from US monetary policy, which is something that could particularly affect currency markets (see Section 6). Expectations that China's economy will continue to slow down over the coming years also lend weight to this perception of a bleak setting for the region's assets (see Section 2).

In spite of this, we also predict a rally in the prices of certain key commodities, such as oil and copper, from current depressed levels, which should provide support for markets that are strongly bound in with them, such as Colombia, Peru and Chile. Added to this, the gradual recovery of economic activity should steadily bring greater relief from the downward pressures assailing Latin America's financial markets.

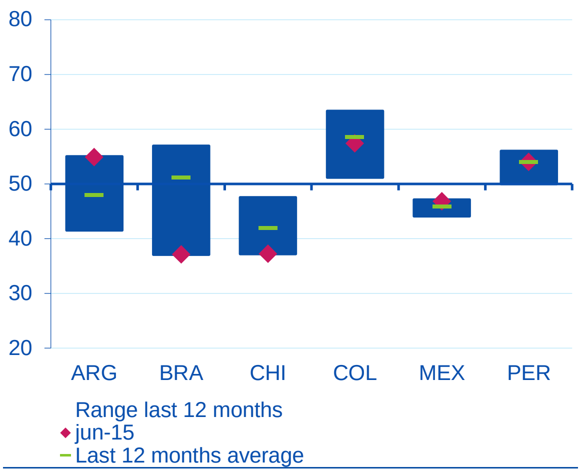
4 Growth will stay low in Latin America in 2015 and 2016

Family and business confidence indicators remain at a low ebb, which is weighing down on domestic demand

Consumer and producer confidence levels deteriorated in Q2 and this appears to be due to: i) political factors; ii) uncertainty over economic policy, including reform processes (Chile and Colombia); iii) cyclical decline, including less buoyant labour markets (Brazil, Chile, Peru) and gloomier prospects for producers, and iv) a less encouraging external environment, where the effects of lower expected growth in China still apply, on top of the fact that commodity prices are not managing to make up lost ground. Consequently, the confidence indicators in most countries remained in pessimistic territory in June (Figures 4.1 and 4.2).

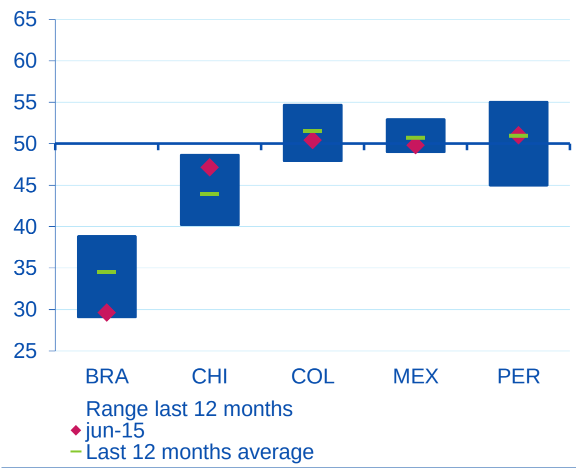
Idiosyncratic factors headed the list of the contrasting changes in confidence indicators in the neighbouring countries of Argentina and Brazil. On the one hand, Argentine consumers suggested greater confidence given the coming elections as well as the greater currency stability and the slowdown in inflation. On the other hand, in Brazil the political crisis is biting harder, with the government in a more awkward position, which is compounded by the higher inflation readings and a labour market in increasingly dire straits. Chilean consumers have also reacted badly to inflation shocks and intensifying political ructions, while Colombian consumers have indicated bullishness, given a brighter employment scenario. In Mexico the extremely sluggish return of confidence soldiers on, and in Peru consumer confidence was practically unchanged on average, compared to one quarter earlier.

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



Source: BBVA Research and national statistics

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

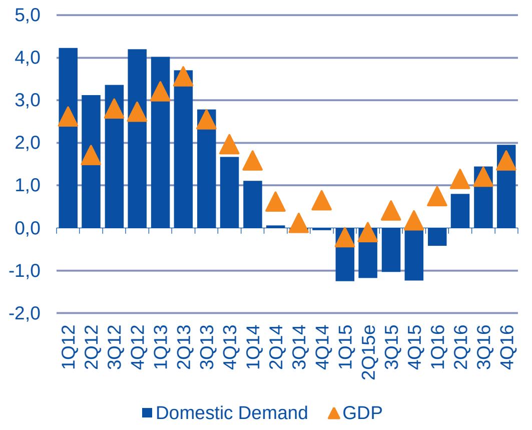


Source: BBVA Research and national statistics

Among producers, the Brazilian business community continued to indicate falls in confidence, although it does seem that the worst is over. In Colombia the expected improvement in non-traditional exports failed to materialise, which was reflected in a drop in confidence. The Chileans were the only people whose confidence level rose on average compared to the first three months of the year, as Chilean producers reported a mild recovery in the cycle, even though the debate over reforms resurfaced and political ructions rattled on in 2Q, while Peruvian producers indicated an upturn in confidence in June. Finally, in Mexico producer confidence was virtually unchanged compared to the previous quarter.

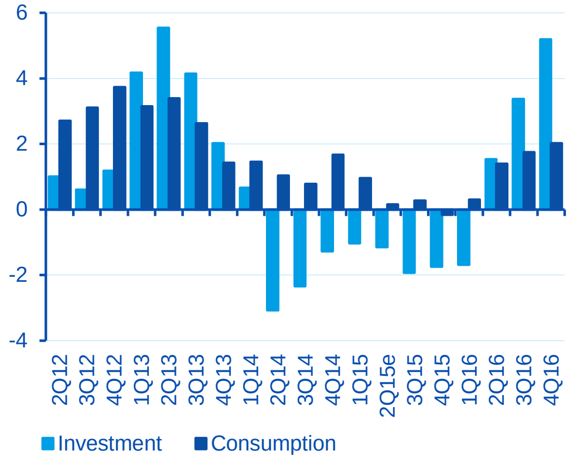
Along with the poorer producer confidence readings, investment has continued to fall off sharply. In the past few months, there have been notable drops in the investment component in national accounts, particularly in Brazil (-7.7% YoY) and Chile (-1.7% YoY), whereas in Peru investment barely increased at all (0.1% YoY). We have seen good results in Colombia, owing to a pick-up in civil engineering work, and in Mexico, which was influenced by a base effect. Consumption has also felt the effects of lower household confidence, with falls in Brazil (-0.9% YoY in Q1) and a deceleration in the rest of the region. Domestic demand in the region has moved from growing at an average of 0.2% YoY in 2014 to slipping back by 1.2% YoY in 1Q15 (Figure 4.3).

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



Source: BBVA Research and national statistics

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



Source: BBVA Research and national statistics

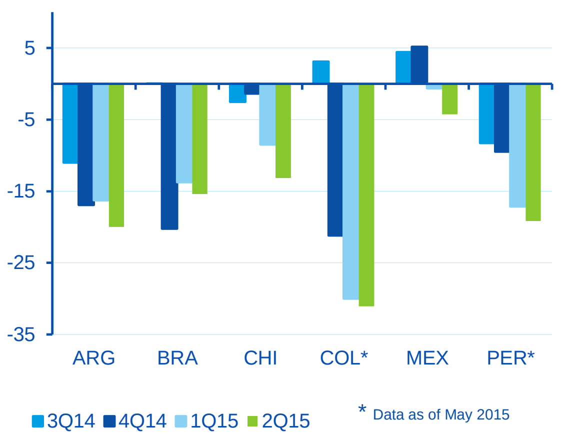
Confidence is expected to languish at low levels to the extent that the lower commodity prices as well as both the slowdown and financial volatility in China add to the above-mentioned domestic factors. We therefore foresee fairly discouraging developments in most economies. In this sense, investment will remain depressed in Argentina, Brazil, Chile and Peru, while Brazil will be the country where the investment correction is the sharpest, both on the public sector side, due to the fiscal adjustment process, and on the private front, owing to the downturn in confidence and the outlook ahead. Meanwhile, in Chile, in spite of the recent rise in producer confidence, there have been major delays in executing public sector investment, which even implies that the full amount of the budget for the year might not be implemented. On the other hand, the end of the mining cycle and the uncertainty associated with the process of fiscal reform have meant cutbacks in private investment. Similar problems of slow budget implementation are being experienced in Peru and Paraguay, particularly in local and regional governments and on account of poor weather conditions in Paraguay. On the other hand, in Colombia, Mexico and Uruguay the situation is quite a lot more benign and one of stability as regards investment projects, and the Colombian government is going to bring forward 4G project work, which will partly offset the adverse impact on investment projects of lower oil prices. In Mexico, the greater buoyancy in the US economy should imply positive spillover into investment, particularly in the private sector, which will tend towards compensating for the spending cuts announced at the beginning of the year.

On the consumption side, we expect there to be slackening in Colombia, Chile and Peru, and a fall in Brazil in the next few quarters. Consumption will be hit by the upturn in inflation in the opening months of the year, which has fed through into lower real wages, a cyclical deterioration in the labour market, more subdued credit in certain cases (Brazil and Chile) and, overall, lower consumer confidence. By way of contrast, we foresee an improvement in consumption in Argentina and Mexico: in Argentina thanks to a greater fiscal stimulus, as well as the conclusion of wage bargaining, increased retirements and pre-election public works projects, while in Mexico this is because of rising earned incomes, where the increase will be noted in both formal employment levels and real wages (Figure 4.4).

Exports continue to feel the impact of the drop in commodity prices

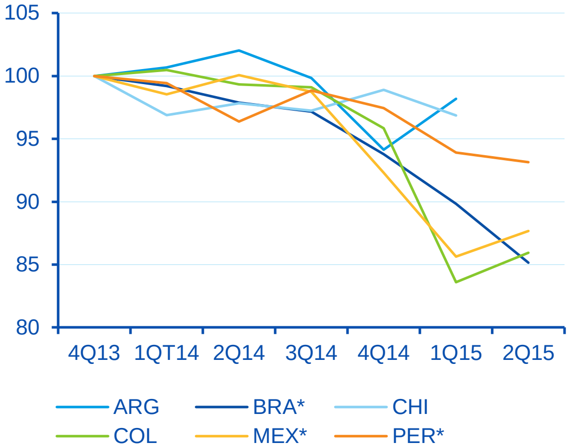
The value of exports continues to smart from lower commodity prices, which have had an effect on all economies (Figure 4.5). Terms of trade have continued to move against most countries, although they have improved in some cases (Mexico, Colombia), and relative prices in foreign trade are still far inferior to the levels observed one year ago (Figure 4.6). Moreover, the recession in Brazil has had a very negative effect on Argentine and Uruguayan exports, added to which in Argentina there have been supply shocks such as the vegetable oil workers' strike in May. The fall in the crude oil price has had harmful effects, particularly in Colombia and Mexico, both of which are net exporters, in a situation which has not been compensated by other exports. In Mexico, the automotive industry has been performing well, but the other manufacturing activities have looked flat, despite the currency depreciation. In Peru, the slide in exports also continued and became more acute, as they dropped back by more than expected in the first few months of the year.

Figure 4.5
LatAm: Exports (% var. YoY)



Source: BBVA Research and national statistics.
*Country data up to May.

Figure 4.6
LatAm: Terms of trade



Source: BBVA Research and national statistics.
*Country data up to May.

The growth forecasts for Latin America in 2015 are being revised downwards, mainly due to the weakness of domestic demand in the region. The forecasts for 2016 are moreover affected by a less benign environment than expected

In the first quarter, Argentina and Colombia grew ahead of forecasts and Brazil lost less momentum than predicted (Figure 4.7). The most growth came from consumption in Argentina, the improvement in net exports and inventory accumulation in Brazil, and from the positive surprise from civil construction projects in Colombia. Meanwhile, the variation stayed in line with expectations in Chile and Paraguay, and almost in line in Mexico and Peru.

Indicators for the second quarter suggest that the deceleration will have continued or become more pronounced, thereby reversing the positive surprises in Q1 (Brazil and Colombia), which means that growth will come in below estimates. Nonetheless, for Argentina we now expect a bit more growth in 2015 than one quarter ago, which will primarily derive from higher public spending.

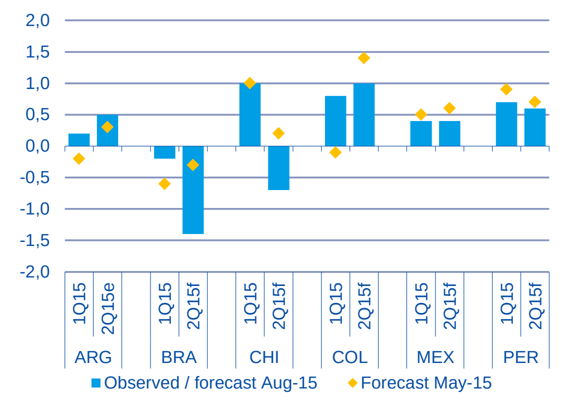
The anticipated drop-off in investment is the stand-out factor behind the expected slowdown in GDP in 2Q15. Notable here are Brazil, where the fall in GDP will be substantially heftier than was predicted one quarter ago (-0.3% QoQ in April, -1.4% QoQ now), and Chile, where we now forecast that GDP will come down, as opposed to the growth we were expecting beforehand (0.2% QoQ in April, -0.7% QoQ now). For Colombia, Mexico and Peru the new estimates are slightly down on those of three months ago (Figure 4.5).

For the rest of the year, the adverse conditions that have implied a downward revision to the region's growth forecasts will predominate, namely: i) the greater deterioration of confidence in Brazil; ii) muted private sector demand in the Andean countries and in Brazil, and iii) political ructions and uncertainty surrounding some reform processes (especially in the Andean countries).

These factors have implied a reduction in expected growth for 2015, down to 0.2% YoY against 0.6% YoY three months ago. This forecast revision already takes into account a growth recovery in the second part of the year which - for Peru, Chile and Mexico - will not be enough to make up for the slackening in the first half. We are less optimistic for the rest of the year with respect to Brazil, Colombia, Paraguay and Uruguay, where we estimate that the pattern of dampening growth will accentuate in H2. In this respect, Brazil is worth noting, where the announcement of a more gradual fiscal adjustment means a blow to confidence in an environment that has already taken a considerable turn for the worse. Here we predict a slump of around -1.5% YoY this year (instead of the previous -0.7%) from which it will slowly emerge in around 2016 (0.5% YoY, from 1.8% previously). Thus the most significant revisions to growth in 2015 are for Brazil (0.8pp), Chile and Peru (0.6pp). In contrast, the revision is positive for Argentina 0.6pp, while there is no change for Mexico or Uruguay.

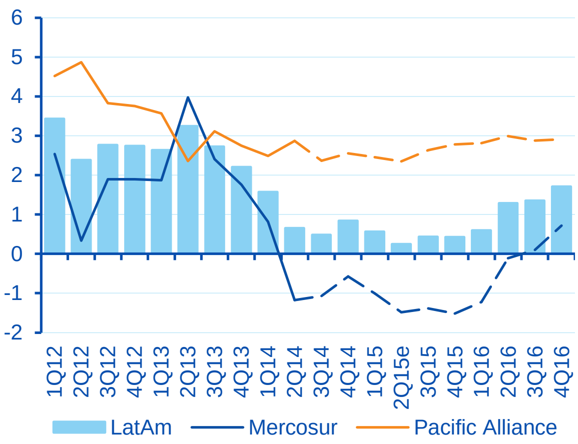
In 2016, we expect the worst of the correction to have passed, although domestic demand will still be subdued and the external outlook will remain less encouraging than was predicted a few months ago. In this regard, there will be an impact from the smaller-than-expected growth in China and Brazil. On the positive side there will be a degree of stimulus from the central banks (such as in Brazil), while business confidence will rally as it gains support from the reallocation of public spending and the boost from public sector investment, particularly in the Andean countries. These factors will bring about a recovery for the course of growth, although at levels far below potential growth rates (see Box 1 for an update on estimated potential growth rates). Looking to 2016, the downward revision of growth in Brazil (1.3pp) is notably greater than for all other geographical areas, followed at some distance by Chile (0.8pp) and Peru (0.7pp). All this means that in 2016 we now expect growth for the region of 1.1% YoY, compared to the figure of 2.1% YoY which we were expecting one quarter ago.

Figure 4.7
LatAm: Observed and estimated growth (% var. QoQ)



Source: BBVA Research and national statistics

Figure 4.8
LatAm: GDP (% var. YoY)

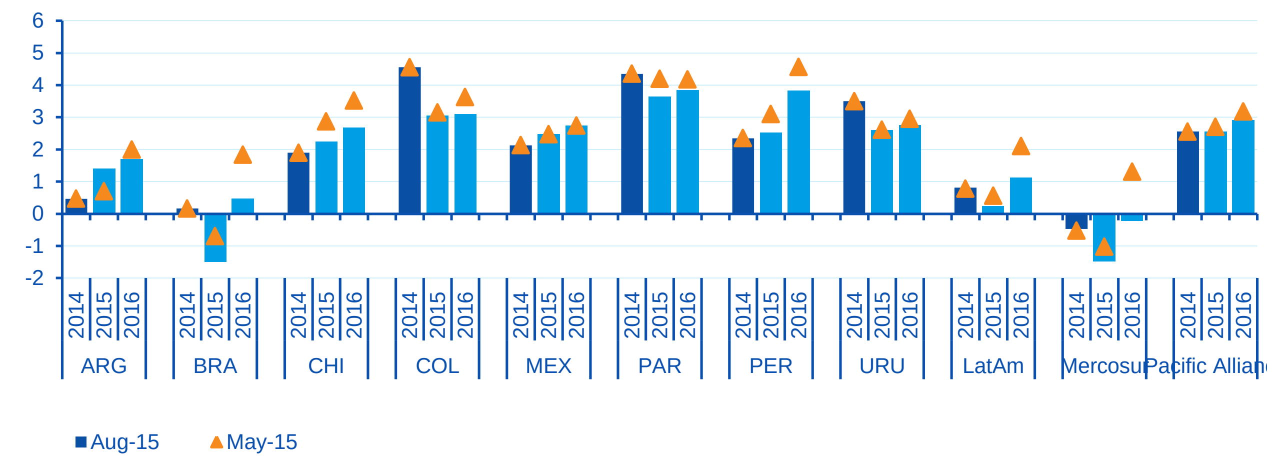


Source: BBVA Research and national statistics

The countries in the Pacific Alliance will go on growing at above the regional average, yet still below their potential rates in 2015 and 2016.

The region's growth rate will continue to advance at two very different speeds: on the one hand, there are the southern countries, grouped here into Mercosur (although one should assume that Uruguay and Paraguay will continue to progress at a relatively good pace), and on the other hand the Pacific Alliance countries (Figure 4.8). For the first group we estimate a contraction of GDP this year of -1.5% YoY, followed by -0.2% in 2016. For the second group we forecast growth of 2.6% and 2.9% respectively. Growth will at all events briefly drift away from its potential rate. Paraguay, Peru and Colombia will stand out, despite the revisions for growth in the 2015-16 two-year period, with variations of 3.7%, 3.2% and 3.1% (Figure 4.9).

Figure 4.9
LatAm countries: GDP growth (% YoY)



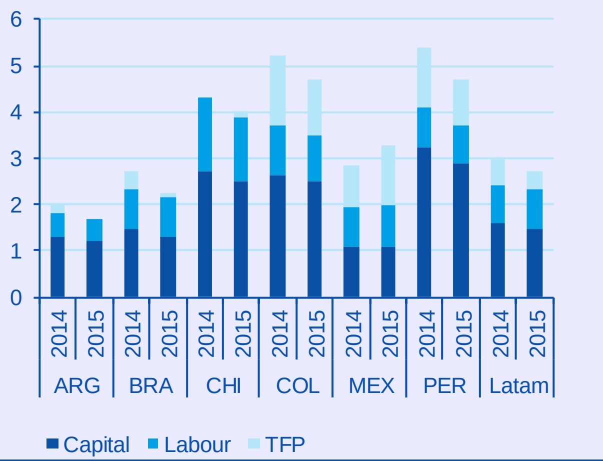
Source: BBVA Research

Box 1. Latin America's growth potential is being brought down to 2.7%, despite the markedly higher revision for Mexico

As in previous years, we have revised our estimates for long-term potential growth and the factor contributions of capital and labour to productivity for the key economies in Latin America[1 2].

The results point to long-term potential GDP (defined here as average potential GDP over 2016-20) of 2.7% for Latin America, which is below the 3.0% estimate ventured one year ago (Figure B.1.1).

Figure B.1.1
Long-term potential growth (%, current estimate vs. February 2014 for the 2016-20 annual average)



Source: BBVA Research

We are revising our estimates down for long–term potential GDP in all of the countries in South America that have been taken into account: Argentina, Brazil, Chile, Colombia and Peru. By way of contrast, for Mexico we have revised our estimate upwards, from 2.8% to 3.4%.

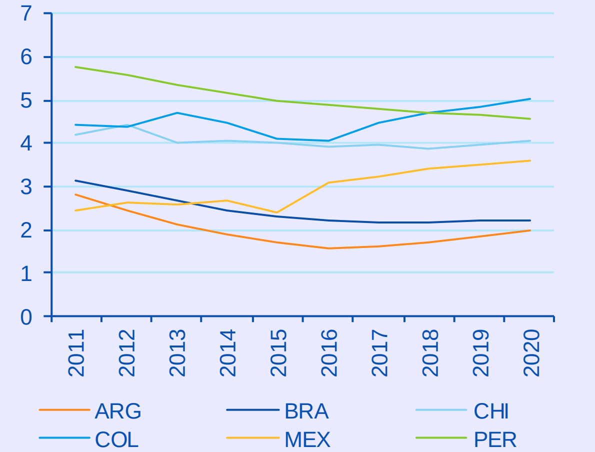
Generally speaking, growth potential is lower now than was previously estimated in South America, due to a less benign external environment and the little progress made in the boom years in implementing reforms and other measures to lift capital accumulation and productivity. In other words, the downward revisions for growth potential in South American countries relate to the impact of lower commodity prices and internal economic and political problems in prioritising and speeding up fixed capital investments and productivity[3]. We likewise note that, in terms of components of potential GDP, the main determinant of the downward revision for the potential GDP of South American countries has been the poorer outlook with respect to developments in TFP, and in a secondary sense, the lower expected contribution from capital[4 5].

In Mexico the situation is otherwise though, for two reasons. First, the country is implementing a battery of economic reforms which should allow its TFP to increase in the coming years. Second, the energy reform will mean the arrival of capital which lifts private investment and, indirectly, public investment too, through the increase in government revenues from the rise in oil income. Besides this, Mexico will stand to benefit more than its regional neighbours from the recovery of economic activity in the United States[6].

1: For the previous revisions, in 2013 and 2014, see our publications Latin America Economic Outlook, third quarter, 2013 and Latin America Economic Outlook, third quarter, 2014.
2: To evaluate long-term growth potential, i.e. potential GDP, we use the estimation method for a production function where the output generated by each economy depends on the accumulated capital stock, the available labour force, the non-accelerating inflation rate of unemployment (NAIRU) and Total Factor Productivity (TFP), which can be understood as the efficiency with which capital and labour are combined.
3: Since 3Q14, we have revised our long-term forecasts down for oil, soybeans and copper by 31%, 13% and 4% respectively. For further details regarding our forecasts and recent commodity price movements see Section 3.
4: Chile differs from the other South American countries to some extent, as the key driver of the revision of potential GDP is capital. In this case, TFP was revised very slightly upwards, although it is still at a very low level.
5: For further details concerning the correlation between TFP and the economic reforms, see the Box on this subject in our Latin America Economic Outlook, third quarter, 2013.
6: According to our most recent estimates, the potential GDP of the United States will rise from 2.3% in 2011-15 to 2.7% in 2016-20.

Beyond the revisions carried out, long-term potential GDP is still highest in Peru (4.7%), Colombia (4.6%) and Chile (3.9%). After the recent progress made, Mexico is drawing near to the Andean countries. These four countries together, which form the Pacific Alliance, present a potential GDP of 3.8%, which is even larger than was forecast one year ago (3.7%).

Figure B.1.2
Annual growth of potential GDP between 2011 and 2020 (%)

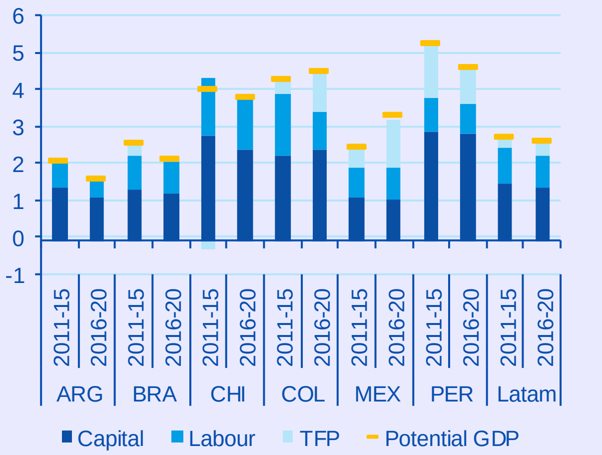


Source: BBVA Research

Finally, growth expectations remain lowest in Brazil (2.2%) and Argentina (1.8%). In these two countries, the contribution of each of the three components of potential GDP (capital, labour and productivity) is lower than the average of the respective contributions in the Pacific Alliance countries. Our annual estimates show that potential growth will rise gradually in the coming years, not only in Mexico but also in Argentina and, chiefly, Colombia (Figure B.1.2). In Argentina the expected progress should neutralise part of the recently-observed deterioration. As regards Colombia, in 2020 it will become the country in the region with the best growth prospects.

Our results also show that potential GDP should stay relatively constant in the next few years in Brazil and Chile, while it will shift downward in Peru, where it will nonetheless remain at levels ahead of those in most of the region's countries.

Figure B.1.3
Average annual growth of potential GDP in 2011-15 and 2016-20 (%)



Source: BBVA Research

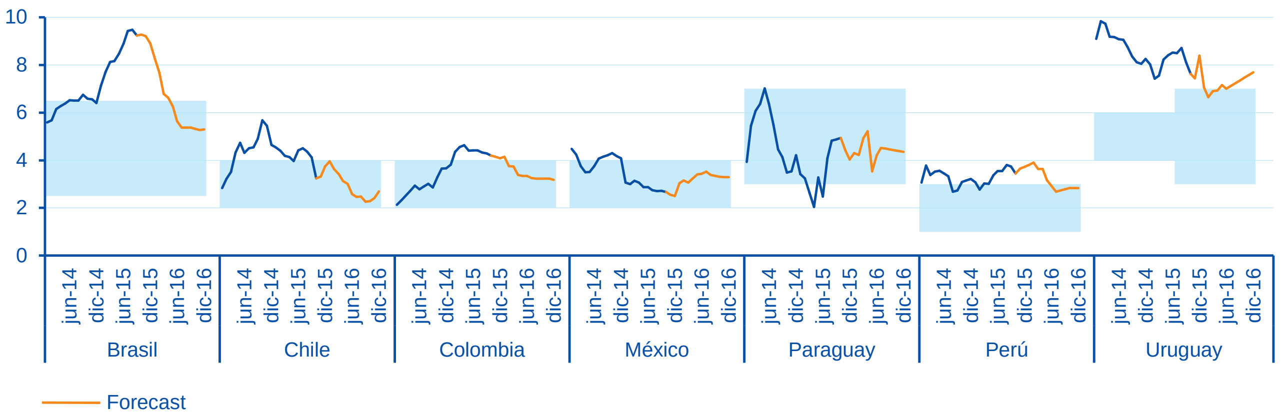
Similarly, the momentum of Mexico and Colombia in the next few years should mean that the region's potential GDP will remain practically unchanged in 2016-20 compared to the previous five years (Figure B.1.3). In any event, the region should not resign itself to growth potential of this magnitude. As the examples of Mexico and Colombia illustrate, committing to a reform agenda which allows the contribution of capital to be lifted and productivity to be raised is key to offsetting the slump in commodity prices.

5 Inflation is on the rise in the region, due to exchange rate depreciation and supply shocks

Inflationary pressures remain high in the countries with inflation targets, despite cyclical weakness

Inflation continued to surprise on the high side in most Latin American countries in Q2, in a prolongation of the trend already observed in Q1 this year. Heftier than expected pressures on prices produced inflation of 8.9% YoY in Brazil in June (which was far above the target of 4.5% YoY) and 4.4% in both Chile and Colombia (target: 3%), 3.5% in Peru (target: 2%) and 8.5% in Uruguay (target: 5%). In none of these cases were overshoots in comparison with expected levels due to demand factors, as in all four countries the growth rate is currently below potential, and has even surprised on the low side in the last few months (see Section 4 and Box 1 for further details on this point). Among the main drivers behind the surprising robustness of inflation in these countries are: i) depreciation of their currencies, in most cases on account of the great magnitude of this since, as is highlighted in Box 2, there is generally no evidence of a relatively high pass-through coefficient (i.e. of any currency depreciation being passed on to prices to a large degree); ii) the impact of certain supply shocks, principally on the prices of food products, which tend to have a very large weight in the consumption baskets of countries in the region; iii) the bigger-than-expected revision of regulated prices by the Brazilian government in an environment in which the fiscal correction underway limits the scope for providing subsidies via lower prices.

Figure 5.1
LatAm: inflation (% YoY) and target bands of the central banks



Source: BBVA Research

Contrary to what happened in Brazil, Uruguay and the Andean countries, inflation was surprisingly low in Paraguay, standing at 2.5% at the close of the first half, and in Mexico, where it recently sank to a historical low of 2.9%.

Generally speaking, after the aforementioned performance of the last few months, inflation is currently above the upper limit of the bands set by the economic policy makers, with the exceptions of Mexico and Paraguay. There is a notable distance between current inflation and the target band in Brazil and Uruguay, where the second round and inertia effects are a source of concern for the monetary authorities. In Mexico and Paraguay inflation is not only within the respective target bands, but in the lower part of these ranges. In Mexico this is due not only to cyclical weakness, but also to the impact of the reforms on the telecommunications and energy sectors, as well as the moderate pass-through to prices of the depreciation of the Mexican peso.

Inflation will converge on central bank targets more slowly than expected in 2015-16

Recent inflation trends have shaped our forecasts for the second half of the year. We have thus, on the one hand, raised our estimates for those countries where inflation has recently surprised on the high side, while we have cut our forecast back for Mexico, where inflation was surprisingly low, by 0.3pp to 2.5%. Although Paraguay also saw lower-than-expected inflation, we have revised our year-end forecast for it slightly upwards, to 4.0% against our figure three months ago of 3.8%, due to greater depreciation of its currency (for current forecasts see Figure 5.1 and the tables at the end of this report).

We foresee inflation continuing to run quite a way above its target levels at the close of 2015 in Brazil (8.9%) and Uruguay (8.4%), a shade above the upper limit of its target range in Colombia (4.1%) and Peru (3.7%), and within the established band in the other countries. Moreover, we estimate that over 2016 inflation will go on closing in on the respective central targets, which implies moderating in most countries and tracing an upward path in Paraguay and Mexico.

We have also revised our forecasts for next year slightly downwards for most countries, largely because of the downward revisions to their growth rates, while in Mexico this is due to the recent sharp drop in inflation there. Nonetheless, for Peru we have moved this slightly upwards, given the more dramatic depreciation in the PEN and the effect on prices of a more severe El Niño weather phenomenon (which also contributed to the upward revision in 2015).

Significantly, despite the anticipated slowdown up to the close in 2016, inflation in Brazil, and especially in Uruguay, will not only remain at a substantially higher level than in the other countries, but actually above the central target of 4.5% in Brazil and above the upper limit of the target band in Uruguay. The high level of inertia and greater tolerance with respect to inflation exhibited in the past will make swifter convergence on the respective targets less likely, despite the measures taken by the monetary authorities in both countries. In any event, the contraction of domestic demand, the restrictive tone of monetary policy and the end of the process of an across-the-board revision of administered prices will all be conducive towards a significant reduction of inflation in Brazil, from 8.9% at the close of 2015 to 5.3% at the end of 2016.

Box 2. Has exchange rate pass-through to prices increased in Latin America?

Inflation has surprised on the high side in LatAm countries in recent months. To be precise, annual inflation at the close of 1Q15 was higher than expected in 1Q14 in all of the countries with inflation targets, with the exception of Mexico.

In certain cases, there are clear idiosyncratic factors which have contributed to increased pressures on domestic prices in the past few months: tax hikes (Chile, Brazil), supply shocks hitting food prices (Colombia, Peru), realignment of administered prices by the government (Brazil), reforms and regulatory changes (Mexico), and wage inertia forces (Uruguay and Brazil). Nonetheless, the powerful (bigger-than-expected) exchange rate depreciation observed in general in the past few months has been a major factor in explaining recent deviations by inflation relative to previous estimates. Even so, besides this greater exchange rate depreciation, the doubt remains over whether the higher inflation has also been caused by a higher level of pass-through to domestic prices from a given level of exchange rate depreciation[7].

The aim of this box, therefore, is to examine what the exchange rate's contribution is to the recent inflation surprises and to check for empirical evidence of any recent increase in the pass-through coefficient that might have occurred.

For this purpose we first estimate a homogeneous VAR model for the countries reviewed in this box. After this preliminary comparative exercise, the results for the estimated models are explored on a separate basis for each country, taking into account the unique features of each economy.

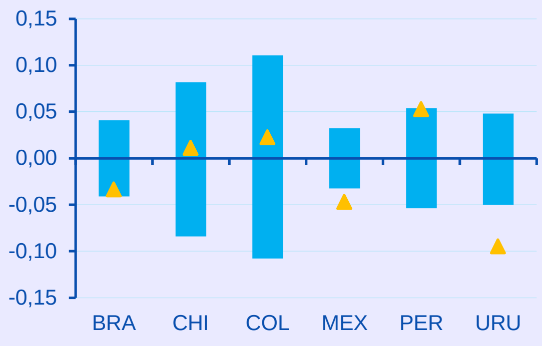
Preliminary analysis via a homogeneous VAR model for all the countries

A time-varying coefficient VAR (TVC-VAR) exercise is proposed for the period from January 2000 to May 2015 using monthly data[8]. The estimates using data to May 2015 are compared with the estimation from a year beforehand, to May 2014. What concerns us is to find out whether the pass-through effect is higher or lower now than it was a year ago, and if this difference is statistically significant.

We find that the response by annual inflation to depreciation has risen (though not significantly) in the last year in Chile, Colombia and Peru, whereas it has diminished in Brazil, Mexico and Uruguay (Figure B.2.1). The current estimate is within the confidence interval for estimation made using data from a year ago, except in Uruguay and Mexico. In both cases, however, the lower bound of the confidence interval in the previous estimation is within the upper bound in the present estimation.

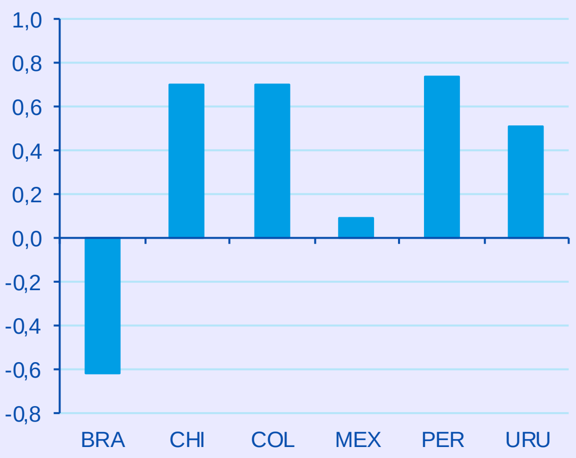
7: The academic literature tends to make the point that the pass-through coefficient is greater in periods of greater currency depreciation and at times when exchange rate weakness is not perceived as a transient phenomenon, which is a picture that matches the situation in several of the region's economies.
8: Included as endogenous variables are an economic activity index, the benchmark interest rate, the local currency's exchange rate against the dollar, and the general price index. Included as exogenous variables are the US industrial production indicator, the Fed rate, the US consumer price index, and the commodity price index. The reason for estimating using a Time-Varying Coefficient VAR (TVC-VAR) is that this method estimates those coefficients at each moment in time which are most appropriate for the model rather than a sample average as in a traditional VAR. The TVC-VAR allows estimated coefficients to vary over time. The thinking underlying this estimation method is that economies carry out changes which affect the structural relationship of the series. The pass-through effect is calculated as the cumulative response in the first year of inflation to a 1% variation in the NER.

Figure B.2.1
Difference in the cumulative pass-through coefficient over 12 months (for a 1% depreciation): May 2015 compared to May 2014



Source: BBVA Research

Figure B.2.2
Coefficient of correlation between the cumulative pass-through over 12 months and exchange rate depreciation (January 10 – May 15)



Source: BBVA Research

We likewise find a positive relationship between the pass-through coefficients and the scale of the exchange rate depreciation over the period, which suggests asymmetry in the exchange rate pass-through to prices (greater at times of depreciation than when there is appreciation of the exchange rate). The only exceptions are Brazil and Mexico. In Brazil, the result could relate to periods when strong appreciation took place when there was high inflation in the past, and also to the dynamics of administered prices, which do not always reflect market factors. In Mexico, the low coefficient could be associated with the direct response effect on prices of imported goods rather than inflation generally (Figure B.2.2).

Analysis based on idiosyncratic models for each country

In this section we take a look at the pass-through estimation using models specific to each country, even though the results are not directly comparable with each other.

Brazil

A model is estimated in which market price inflation (i.e. excluding prices that are administered by the government) is determined by past inflation, prospective inflation, the output gap, commodity prices, certain variables to control for supply shocks and the exchange rate (USD/BRL) via the two-stage least squares method, using quarterly data from 1Q99 to 2Q15. The result found is of pass-through to inflation that is practically identical to that found in estimation using data up to 1Q14, which suggests that there has been no change in the pass-through coefficient in the last year and that this therefore remains at around 5%. Even though there are certain factors which could be instrumental in reducing the pass-through coefficient at the moment (in its 1Q15 inflation report the central bank, the BCB, made reference to some of these, such as the weak performance by economic activity, the restrictive tone of monetary policy and the smaller depreciation of the multilateral effective exchange rate compared to the bilateral USD/BRL rate), the stability of the pass-through coefficient found in our models implies that there are other factors at work in the opposite direction (and among the prime candidates are the large scale of the exchange rate depreciation and the perception that this is no temporary phenomenon). Similarly, bearing in mind the results from our model, the recent inflation surprises in Brazil can be largely explained by factors outside exchange rate depreciation and pass-through, such as the sharp correction in prices administered by the government.

Chile

The isolated estimate of the pass-through coefficient made in 1Q14, using a model where annual inflation is estimated on the basis of an annual depreciation of the exchange rate and following a linear trend, was 10.1% with a standard deviation of 2.5% (see our Economic Watch on this). Extending calculation of this kind to April 2015, we observe a rise in the pass-through coefficient to 14.3%, with a standard deviation of 2.2%. The result does not differ greatly from the estimation carried out by the central bank (BCCh) using VAR methodology. In the study published in February 2015, a pass-through coefficient of around 14% was estimated, with a range of 10% to 20%. Among the reasons that could explain the rise in the exchange rate pass-through in Chile, besides the scale of the depreciation, is the observed increase in the share of manufactured consumer goods in the successive changes in the CPI basket. Be this as it may, in 2Q14 we were projecting inflation of 2.1% over 12 months and this turned out to be 4.4%. On the other hand, the effective depreciation of the exchange rate was 11.5%, compared with a projected level of 1.5% (+10%). Added to this, the pass-through coefficient rose from 10% to 14%. Taking a pass-through rate of 14% and the effective depreciation of the exchange rate, our inflation estimate would have been 1.4pp greater, leaving a difference of 0.9pp still to be accounted for, which should primarily be due to the unexpected effects of the Tax Reform passed at the end of 2014. (Figure B.2.4).

Colombia

In estimating the pass-through in Colombia a VAR model is used featuring the exchange rate, the index of imported product prices, the total producer price index and the consumer price index. Estimation using data up to 1Q15 shows that the pass-through for a 10% depreciation of the Colombian peso to domestic prices is not significantly different from the estimate made in 1Q14, in other words, of approximately 5% in 12 months (see our Economic Watch published in April 2014, which also includes a review of the relevant literature for the country). Although the pass-through coefficient has held virtually constant according to our model, the exchange rate has depreciated far more than had been expected in the last year, mainly from 4Q14, which has had an estimated impact of 0.8pp on observed annual inflation in June 2015. Nevertheless, the principal factor behind the recent inflation surprises has been the impact of domestic supply shocks on food prices (Figure B.2.4).

Mexico

Pass-through of exchange rate variations to prices in Mexico seems to have decreased in the last few years. The coefficient in our inflation model (a mark-up model which considers inflation as a cost-push phenomenon) has diminished over the years. For example, if we restrict the sample to ending in 2005, the estimated pass-through is 6.8%, whereas if we use a sample up to 1Q14, the coefficient would drop to 4.2%, while up to 1Q15 it would come down further, to 4%. Nonetheless, if we use 36-month rolling windows for the same estimation, we find that the pass-through elasticity of exchange rate movements to the general level of consumer prices is close to 0%, which is consistent with recent estimates by the central bank (Banxico). This could be due to the fact that both the price stability in recent years and the improved credibility of the central bank which are associated with this encouraging performance might have largely eliminated the indirect effect of exchange rate movements on inflation (i.e. their indirect influence, through the changing of inflation expectations). Given this phenomenon, now movements of this kind appear to affect inflation only directly, by raising import prices (a weight of 19.7% in the general consumer price index). The greater goods inflation which is associated, to a large extent, with the pass-through has had an impact of around 0.13pp on headline inflation. We think that in the next few months the prices of this component will continue to rise and that the impact could ultimately be between 0.3pp and 0.4pp. Even so, the impact on headline inflation of the above-mentioned cyclical weakness, together with the telecommunications reform which has brought about falls in telephony prices, a smaller increase in petrol prices, the helpful effect of lower natural gas prices and of the energy reform on electricity prices, and a very encouraging start to the year for the more volatile among prices, has translated into lower inflation than we were anticipating a year ago, despite the peso's depreciation (Figure B.2.3).

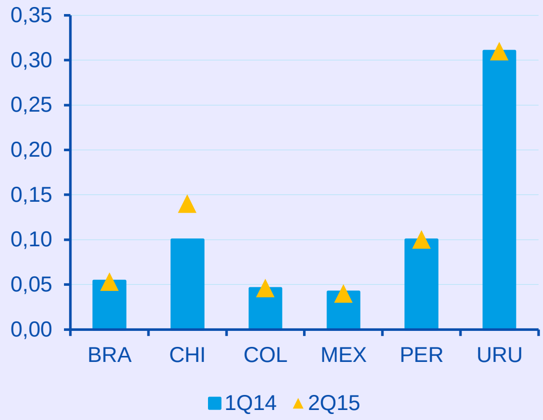
Peru

In 1Q14 the pass-through effect of an exchange rate depreciation to domestic prices was estimated at 10% using confidence bands of +/-4pp. The coefficients were estimated using a VAR between January 2004 and December 2013[9]. An update of this estimate, using information available as of March 2015, finds that the coefficient holds at around 10%. On the other hand, using our quarterly inflation model, we find that the difference between the inflation observed at the close of 2Q15 and that forecast one year ago is 0.8pp. Regarding this difference, 1.1pp is explained by the deviation of the observed exchange rate from the expected level (13.2% compared to 2.5% initially forecast). The rest (-0.3pp) is accounted for by the cyclical weakness of the economy and the effect of the lower oil price, which is partly offset by the combined impact of higher prices for locally produced foods and greater inertia owing to inflation expectations which have remained relatively high (close to the upper limit of the target range). (Figure B.2.3).

Uruguay

The current estimates for Uruguay reveal a coefficient for exchange rate pass-through to inflation of a cumulative 31% over 12 months[10], which is a similar value to that observed using data up to 2Q15. Estimation was made using a single-equation quarterly model (1947:1-2015:1) which estimates the relationship between inflation and the exchange rate, controlling for two lags of inflation itself to capture inflation inertia. This coefficient is relatively high in comparison with the region's other countries (Figure B.2.3). One explanation for this is the Uruguayan economy's high dollarisation, which lifts the pass-through from a devaluation to inflation. Moreover, unlike Peru, where there is also a high degree of dollarisation, inflation's persistence at levels of over the central bank's target range has undermined the credibility of the monetary authority and given rise to strong inertia in price rises. It is also important to underline the significance of the goods import quota in ample segments of supply. As in most of the region's other countries, the recent inflation surprises are not in the main associated with the recent exchange rate depreciation, and in Uruguay price dynamics are basically driven by wage inertia.

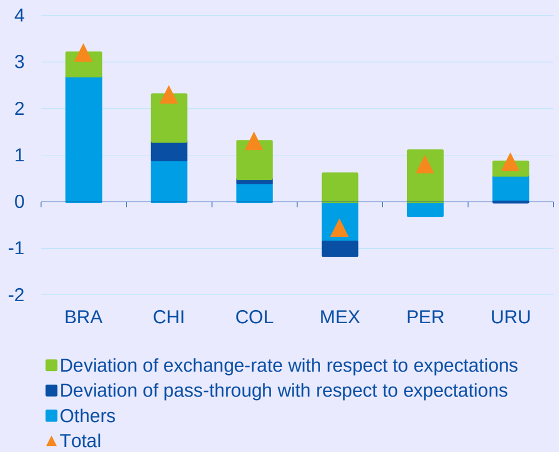
Figure B.2.3
Cumulative pass-through over 12 months given a 1% exchange rate depreciation, according to the models customised for each country



Source: BBVA Research

9: McCarthy (1999): Pass-Through of Exchange Rate and Import Prices to Domestic Inflation in Some Industrialized Economies", BIS Working Paper No. 79, Bank for International Settlements. This same article is what Winkelried (2012) bases himself on in "Exchange rate pass-through and inflation targeting in Peru". *Revista de Estudios Económicos N° 23,9-2.* Central Reserve Bank of Peru. This paper, which is the most recent work of this kind on Peru, shows that adopting an inflation targeting regime should have helped significantly in reducing the pass-through effect, from 60% in the 90s to close to 10% at the end of the sample period (2011).
10: An IMF estimate (2008), "Pass-Through, Dollarization, and Credibility in Uruguay", in Country Report No. 08/46, calculated a value of 450bp for this same coefficient, using data from 1990-2005, and finds that the value of the coefficient fell over time. Part of the explanation for our differences compared to the IMF (2008) could be due to the fact that our sample includes more recent data (up to 1Q15).

Figure B.2.4
Breakdown of the explanatory factors behind the difference between observed inflation at the close of 2Q15 and that forecast for the period in 2Q14 by BBVA Research (pp)



Source: BBVA Research

Conclusion: little evidence of an increase in pass-through in Latin America

Both the exercise based on the VAR model estimated homogeneously for the countries examined and the models developed to take account of the idiosyncrasies of each economy show that in general there is no evidence of any significant rise in pass-through recently in Latin America, beyond what could have happened in other episodes of exchange rate depreciation (given the apparent asymmetry in pass-through with respect to the direction of exchange rate movements). Thus, the inflation surprises observed in the opening months of 2015 were not brought about by any increase in exchange rate pass-through to prices (Figure B.2.4), with the exception of Chile where this factor has in fact contributed to inflation straying from previous forecasts, albeit in a supporting role. The fact that exchange rates have depreciated by more than had been expected at the start of 2015 has actually contributed to recent inflation surprises, yet in most countries these shocks have been determined by other factors away from exchange rates. There is some evidence in the sense of the uneven response in the channel from the exchange rate to prices in the Andean countries and Uruguay, where it has been verified that the pass-through of the shock is greater in periods of depreciation than in times of appreciation.

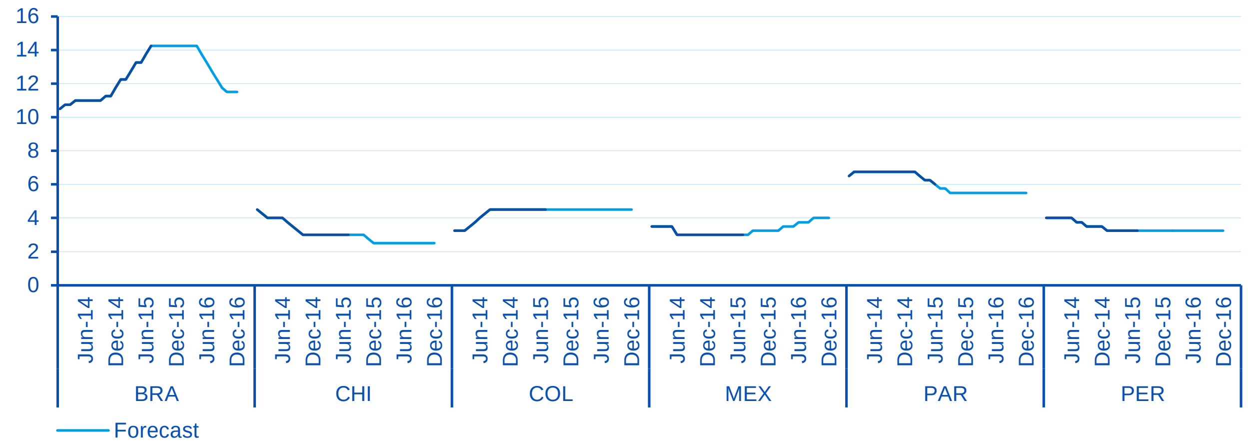
6 Bigger monetary policy dilemmas in South America, while Mexico synchronises with the Fed

Rate decisions should mean cuts in Brazil, Chile and Paraguay, stability in Peru and Colombia and hikes in Mexico from now until the end of 2016

The region's countries currently face the dilemma of either raising rates, to minimise the second round effects of the recent upturn in inflation and ensure that expectations are anchored, or lowering them, to facilitate the recovery of economic activity, which is currently growing at below its potential rate. The imminent rate hike by the Fed in the United States adds complexity to the situation, as uncoupling local monetary policies should exacerbate pressures on currencies, which would not only have an impact on inflation, but would also entail a cost for economic agents who are running debts in dollars.

Given this dilemma, most central banks in Latin American countries have opted to hold interest rates steady so far this year. Specifically, the MPR has been held unchanged since the beginning of the year in Chile (3.0%), Colombia (4.5%), Peru (3.25%) and Mexico (3.0%). By way of contrast, in Paraguay the monetary authority has cut rates by 100bp in recent months to 5.75%, and Brazil has raised them to 14.25%. In Paraguay the monetary loosening went hand-in-hand with the downward trend in inflation, whereas in Brazil policy was in response to the acceleration of prices and an attempt to restore credibility for monetary policy and anchor expectations.

Figure 6.1
LatAm: The Monetary Policy Rate, %



Source: BBVA Research

As to the future, we foresee greater diversity in the strategies of the region's central banks (Figure 6.1). Disengagement from the Fed, which we expect to make a start in September on raising interest rates gradually, will happen in different ways among the countries in South America. We think that in Colombia and Peru the MPR will continue at current rates for a considerable time. To be precise, in both cases our forecast is one of stability at present levels until the end of 2016, although in Peru, where concern over excessive volatility in currency markets is particularly great on account of the high levels of dollarisation in its economy, changes to monetary policy could continue to be brought into play using other instruments. In Brazil, the central bank's communication strategy suggests that the upward cycle has finally come to an end.

Still in Brazil, we expect interest rates to be held steady for a long time, although for less than in Peru and Colombia. A cycle of monetary loosening, which will be less aggressive than those seen on previous occasions, might commence in the middle of next year to accompany a moderation of inflation. In Chile, our prognosis is that the downward shift ought to come before it does in Brazil, although still in 2015, due to the weakening of domestic demand. Finally, in Paraguay, an additional cut of 25bp should be announced in the coming months, after which interest rates are likely to stay at 5.5% until at least the end of 2016.

While we forecast an uncoupling of monetary policies in South America from that in the United States, on the other hand we estimate that Mexican monetary policy will remain in step with its northern neighbour. In this respect, recent central bank statements have already made it clear that the chief determinant moulding its decisions will be Fed monetary policy. This means that, given our forecast that the Fed will begin its rate hikes in September, Banxico should also raise its reference rate in September, from the current level of 3.0%, at which it has stood since June 2014, to 3.25%, and then hike it up further until it reaches 4.0% in 2016.

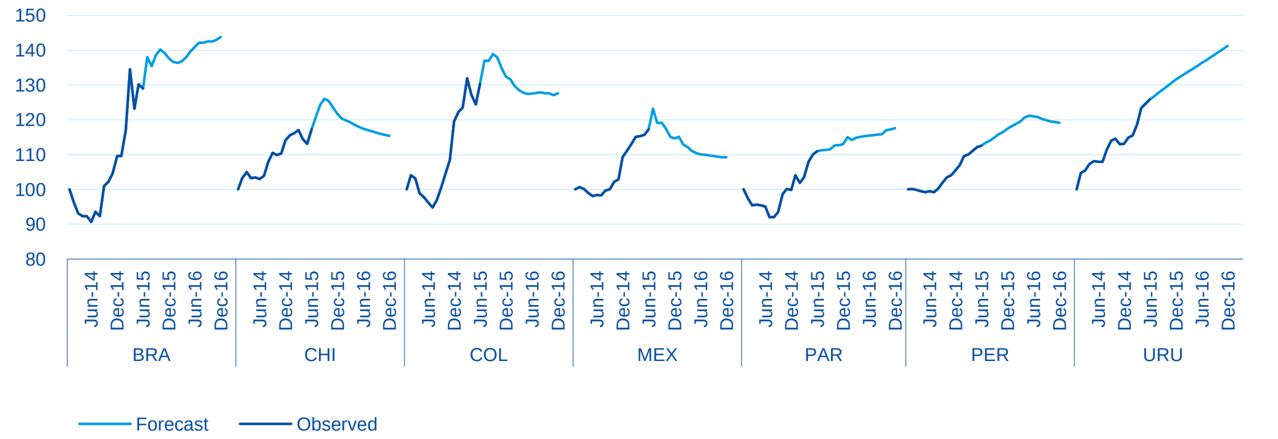
Exchange rates in the region will remain weakened going forward, under pressure on account of the uncoupling from the Fed rate hike by the central banks and a less encouraging external environment

As was commented in Section 3, Latin American currencies have been subject to a blanket depreciation in the past three months, having been influenced by domestic factors, such as the likely disengagement of local monetary policy from that of the Fed and the slowdown in growth, as well as external factors, especially the US dollar’s appreciation in global markets, the recent financial upheaval in China and the setback for key commodity prices.

The volatility in currency markets should generally continue in the coming months, as the Fed gradually defines its monetary policy normalisation process.

Even though exchange rates should in no case exhibit the same kind of strength as they did some years ago in countries such as Mexico, Chile and Colombia, currencies are likely to appreciate from the last quarter, after bottoming out immediately after the first Fed hike, as a result of the progressive recovery of economic activity and greater support in Mexico and Colombia from the oil price and, in Chile, from the copper price (Figure 6.2 and Annex).

Figure 6.2
LatAm: Exchange rate, January 2014=100 (local currency to the dollar)



Source: BBVA Research

In the other countries examined, the depreciation should go on beyond 2015. In Peru, besides the less benign external scenario, factors weighing in favour of greater weakness of its currency are the poorer growth prospects, the worsening outlook for the external and fiscal accounts, and the faltering resilience of the economic policy-making authorities, due to the fact that credit dollarisation is falling faster than expected. In Brazil, the further currency depreciation is also likely to be in response to the country's need to regain competitiveness in its manufacturing sector and the risk of Brazil finally losing its investment grade status.

It should likewise be noted that the high degree of volatility could ultimately bring about greater currency market intervention, as has happened recently in Mexico, where the volume of dollars up for auction has been lifted from USD52mn to USD200mn daily.

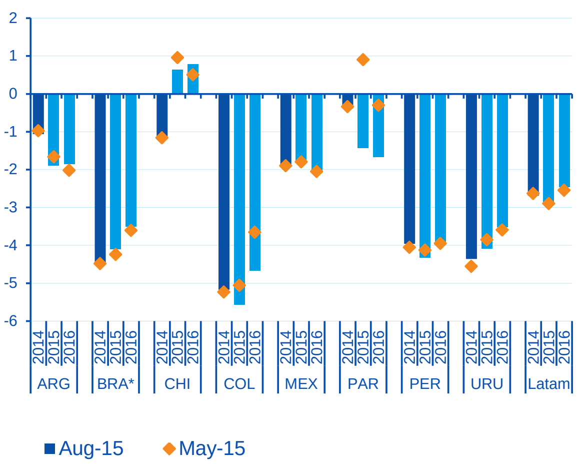
7 External deficits will remain high, though still manageable, in LatAm

The region's external deficits will continue to be hampered by the modest prices of key export commodities

The outlook for the current account for 2015 has taken a slight turn for the worse in almost all of the economies. Exports continue to suffer from the fall in commodity prices and the lower growth of major trading partners, which has not yet been offset by non-traditional exports. The exception will be Chile, for which we still forecast a current account surplus in 2015, albeit a smaller one than was being predicted three months ago. The lull in activity will also imply a mild adjustment to external accounts (Figure 7.1).

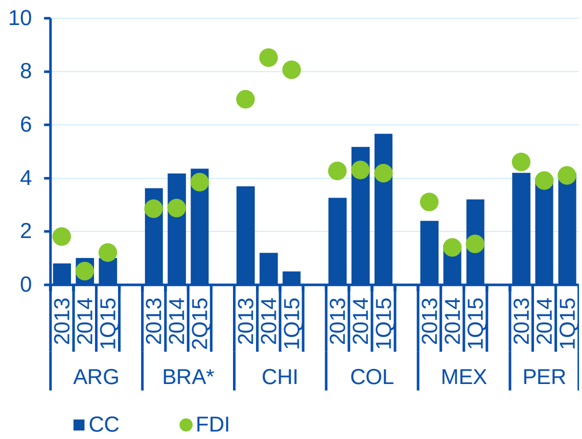
For 2016, the outlook for exports will brighten with the stabilisation of commodities and the maturing of investment projects now underway (mining ventures in Peru and Chile, plus the energy reform in Mexico), as well as the boost from non-traditional exports (Colombia, and manufactures other than in the automotive industry in Mexico), which, together with the predicted adjustment of domestic demand, should help to narrow the external deficit. We should be mindful, though, of the fact that the lower expected growth for China represents a major challenge for the countries in the region, and the correction could be more severe than was anticipated one quarter ago.

Figure 7.1
Current account as a % of GDP



* Change in methodology used by the central bank. Previous and current forecasts are not comparable
Source: BBVA Research

Figure 7.2
Current account deficit and FDI as a % of GDP



* Change in methodology used by the central bank. Previous and current forecasts are not comparable. Last figure: 2Q15.
Source: BBVA Research and national statistics

The region's external vulnerability is still limited, but there is a greater reliance on short-term funding

The financing of deficits by means of short-term flows has been stepped up since three months ago. Measures of the region's vulnerability suggest that the risks it faces are still limited.

Here a warning is in order with regard to the increase in the proportion of the external deficit that is being financed with short-term capital. In 2013 there was enough FDI to cover the external deficit in all of the countries except Brazil, whereas in 2014 and early 2015 this was only true of Chile and, to a lesser extent, Argentina (Figure 7.2).

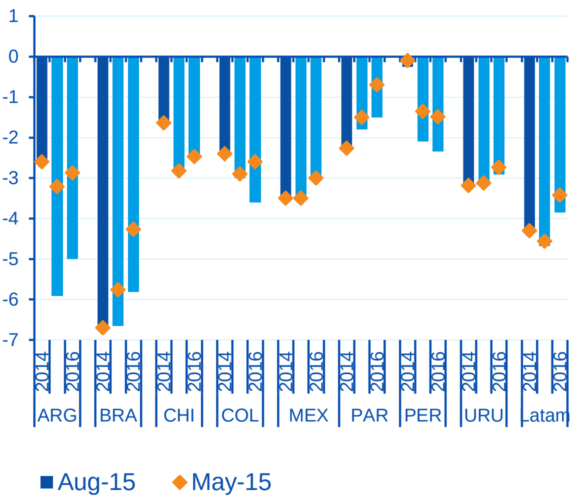
8 The outlook for fiscal balances has worsened, especially in Brazil and Argentina

Prospects for fiscal balances in 2015 have deteriorated in Brazil owing to the cyclical decline and smaller fiscal adjustment

There is an outlook of a major deterioration in the public finances in the countries in South America, due to lower revenues from a slowdown in activity, causing a drop in tax collection levels (Chile, Brazil, Colombia, Peru and Paraguay), in some cases accompanied by an acceleration of expenditure (Argentina, Peru and Paraguay). Conversely the public finances in Mexico show greater stability.

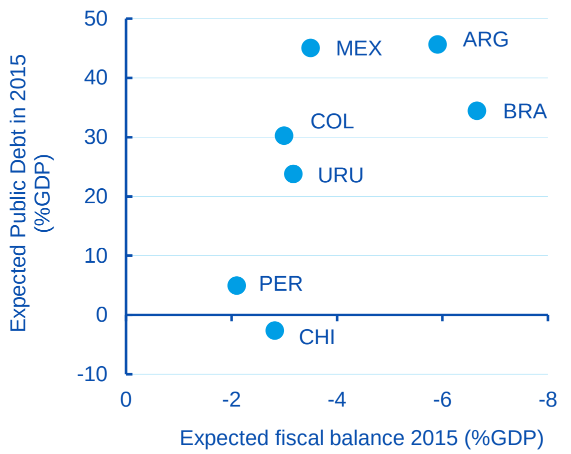
The fiscal accounts have deteriorated sharply in Argentina (Figure 8.1 and 8.2), and will continue to do so over 2015 as a result of a policy of increased government spending, which could begin to be reversed some time in 2016. The primary surplus in Brazil will be smaller than predicted, not just because of the effect of the contraction in domestic demand on revenues, but also due to the political problems which unleashing a more potent fiscal correction entails. The recent announcement of a lowering of primary surplus targets from 1.1% of GDP in 2015 and 2.0% in 2016 and 2017 to 0.15% in 2015, 0.7% in 2016 and 1.3% in 2017 illustrates the fact that the fiscal correction, which is still provoking a great deal of uncertainty, will be more gradual than expected. On top of this, the greater expenditure on servicing interest, owing to a higher monetary policy rate and the cost of holding a stock of currency swaps (with a value of approximately USD100bn), will also be a burden on Brazil's fiscal balance. In the Andean countries and Paraguay, the mainly public sector investment projects via improving infrastructure will be among the key drivers of growth, although to a lesser extent than was anticipated one quarter ago. In Colombia, the fiscal deficit will gather momentum in 2015 and 2016, given the lower oil income and the larger deficit allowed under the fiscal rule. In Chile, convergence towards a structural balance in 2018 is beginning to look under threat, as the scope for government spending will diminish from 2016. In Peru the primary driver of growth in the second half of the year will be the commencement of major infrastructure work (the metro, a gas pipeline and the Talara refinery).

Figure 8.1
Fiscal balances as a % of GDP



Source: BBVA Research and national statistics

Figure 8.2
Expected fiscal deficit in 2015 and estimated net government debt in 2015 (% of GDP)



Source: BBVA Research, IMF WEO and national statistics

9 Tables

Table 9.1
GDP (% YoY)

	2012	2013	2014	2015*	2016*
Argentina	0.8	2.9	0.5	1.4	1.7
Brazil	1.8	2.7	0.2	-1.5	0.5
Chile	5.5	4.2	1.9	2.2	2.7
Colombia	4.0	4.9	4.6	3.1	3.1
Mexico	3.9	1.5	2.1	2.5	2.7
Paraguay	-1.2	14.2	4.4	3.6	3.9
Peru	6.0	5.8	2.4	2.5	3.8
Uruguay	3.3	5.1	3.5	2.6	2.8
Mercosur	1.7	2.5	-0.5	-1.5	-0.2
Pacific Alliance	4.9	4.3	2.9	2.6	2.6
LatAm	2.8	2.7	0.8	0.2	1.1

Source: BBVA Research. *Forecast

Table 9.2
Inflation (% YoY, average)

	2012	2013	2014	2015*	2016*
Argentina	10.0	10.6	20.6	16.9	20.8
Brazil	5.4	6.2	6.3	8.7	6.1
Chile	3.0	1.8	4.4	4.1	2.9
Colombia	3.2	2.0	2.9	4.3	3.4
Mexico	4.1	3.8	4.0	2.8	3.3
Paraguay	3.7	2.7	5.0	3.7	4.4
Peru	3.7	2.8	3.2	3.4	3.1
Uruguay	8.1	8.6	8.9	8.1	7.2

Source: BBVA Research. *Forecast

Table 9.3
Exchange rate (vs. USD, average)

	2012	2013	2014	2015*	2016*
Argentina	4.55	5.48	8.12	9.26	12.47
Brazil	1.96	2.18	2.36	3.18	3.41
Chile	486	495	570	642	631
Colombia	1798	1869	2001	2,578	2,513
Mexico	13.17	12.77	13.29	15.36	14.62
Paraguay	4417	4312	4514	5,064	5,366
Peru	2.64	2.70	2.84	3.17	3.37
Uruguay	20.23	20.40	23.20	26.59	29.12

Source: BBVA Research. *Forecast

Table 9.4
Interest rate (%, average)

	2012	2013	2014	2015*	2016*
Argentina	13.85	16.92	22.55	21.19	21.90
Brazil	8.46	8.44	11.02	13.58	12.94
Chile	5.02	4.90	3.69	2.94	2.50
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	6.00	5.50
Peru	4.25	4.21	3.79	3.25	3.25
Uruguay	18.59	17.70	21.52	20.23	18.54

Source: BBVA Research. *Forecast

Table 9.5
Current Account (% GDP, end of period)

	2012	2013	2014	2015*	2016*
Argentina	-0.2	-0.8	-1.1	-1.9	-1.8
Brazil	-2.4	-3.4	-4.5	-3.9	-3.1
Chile	-3.6	-3.7	-1.2	0.7	0.8
Colombia	-3.1	-3.3	-5.2	-5.6	-4.7
Mexico	-1.3	-2.1	-1.9	-2.2	-2.0
Paraguay	-2.0	1.7	-0.4	-1.4	-1.7
Peru	-2.7	-4.2	-4.0	-4.3	-4.0
Uruguay	-5.3	-4.9	-4.4	-4.1	-3.5
Mercosur	-1.4	-2.3	-2.8	-3.3	-2.5
Pacific Alliance	-2.0	-2.7	-2.6	-2.7	-2.4
LatAm	-1.6	-2.5	-2.7	-3.0	-2.4

Source: BBVA Research. *Forecast

Table 9.6
Fiscal balance (% GDP, end of period)

	2012	2013	2014	2015*	2016*
Argentina	-2.5	-2.3	-2.6	-5.9	-5.0
Brazil	-2.5	-3.1	-6.7	-6.7	-5.8
Chile	0.6	-0.6	-1.6	-2.8	-2.6
Colombia	-4.1	-3.9	-2.4	-3.0	-3.6
Mexico	-2.6	-2.3	-3.5	-3.5	-3.0
Paraguay	-1.8	-2.0	-2.3	-1.8	-1.5
Peru	2.3	0.9	-0.3	-2.1	-2.3
Uruguay	-2.7	-2.4	-3.2	-3.2	-2.9
Mercosur	-2.8	-2.8	-5.5	-5.8	-4.5
Pacific Alliance	-2.0	-2.0	-2.8	-3.2	-3.0
LatAm	-2.4	-2.5	-4.3	-4.7	-3.9

Source: BBVA Research. *Forecast

Table 9.7
Commodities forecast

	2012	2013	2014	2015*	2016*
Oil (Brent USD/Barrel) (average)	111.6	108.5	98.9	60.9	69.0
Soybean (USD/ton) (average)	537.8	517.5	458.3	362.3	366.8
Copper (USD/pound) (average)	3.61	3.32	3.11	2.62	2.68

Source: BBVA Research. *Forecast

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This report has been produced by the LatAm Unit

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