

# Latin America: a two-speed slowdown

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## Main takeaways

- 1 Global growth continues to pick up, although less strongly, with weakness in emerging markets.** Uncertainty about Chinese long-term prospects remains (which effected an increase in market volatility in July-August) and the Fed's liftoff is pushed back to December, with a slower tightening path in 2016.
- 2 Latam slows down at two different speeds.** Pacific Alliance countries will grow at 2,4% in 2015-16, while Brazil will suffer a deep recession in both years. Activity in Latam as a whole will remain flat in 2015-16 (-0.3% and 0.3%).
- 3 Inflation remains above Central Banks' targets (except Mexico),** especially due to a strong depreciation of the exchange rate. Andean countries tighten their monetary policies. Mexico will synchronize with the Fed's liftoff, at least initially.
- 4 A risk scenario with a deeper slowdown in China would have a significant effect in South America.** Further drops in commodity prices and (especially energy and metals) and the increase in global risk aversion would have a stronger negative effect on countries with weaker fundamentals and smaller policy space (fiscal and/or monetary) to cushion the shock.

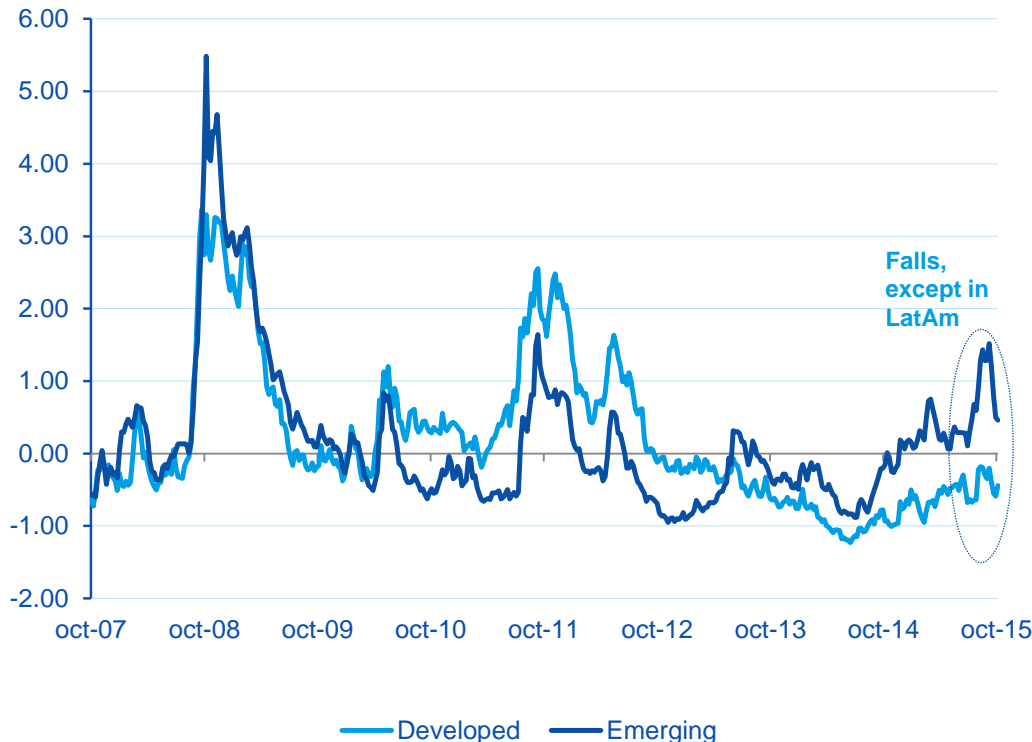
## Outline

- 1 A more subdued global recovery, with less dynamic emerging markets
- 2 Latam: a two-speed slowdown
- 3 Box 1: The fallout from a deeper Chinese slowdown

# Financial markets reacted strongly in the previous quarter

## BBVA Research Financial Stress Index

Source: BBVA Research



Possible overshooting in some markets

Strong FX depreciation and, in general, sharp correction of risky assets, such as those of emerging economies.

- What's the source of this shock?
1. Commodity prices
  2. Doubts about China
  3. Waiting for the Fed's liftoff

# Including a sharp fall in commodity prices

**Brent oil: (USD/b)**

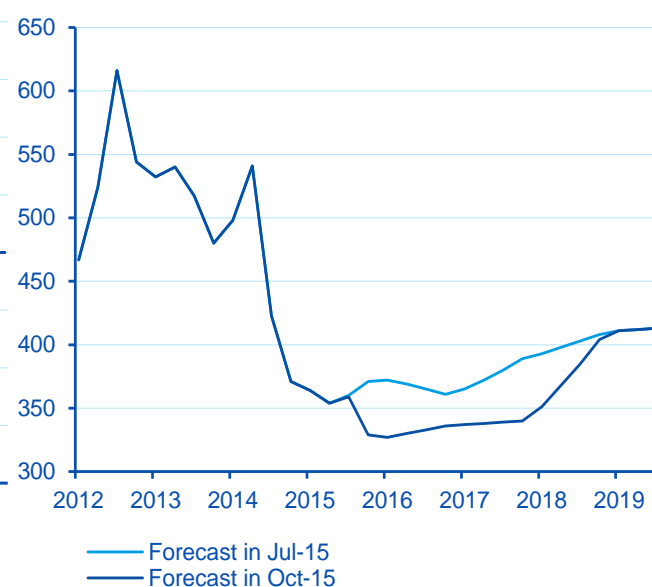
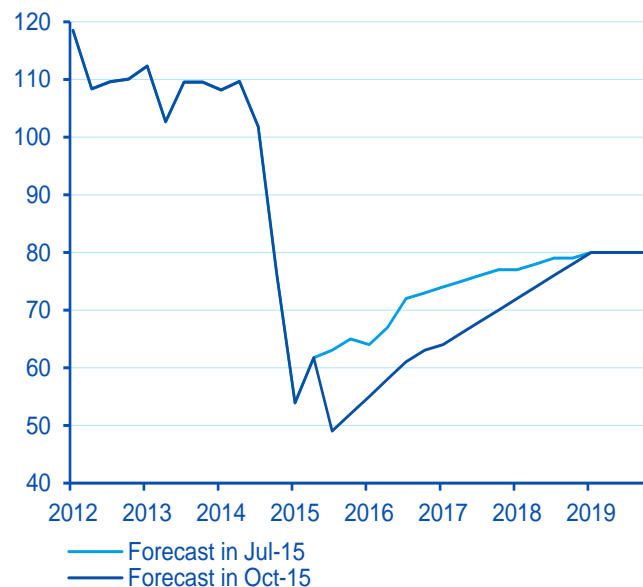
Source: BBVA Research and Bloomberg

**Soybeans: (USD/mt)**

Source: BBVA Research and Bloomberg

**Copper: (USD/lb)**

Source: BBVA Research and Bloomberg



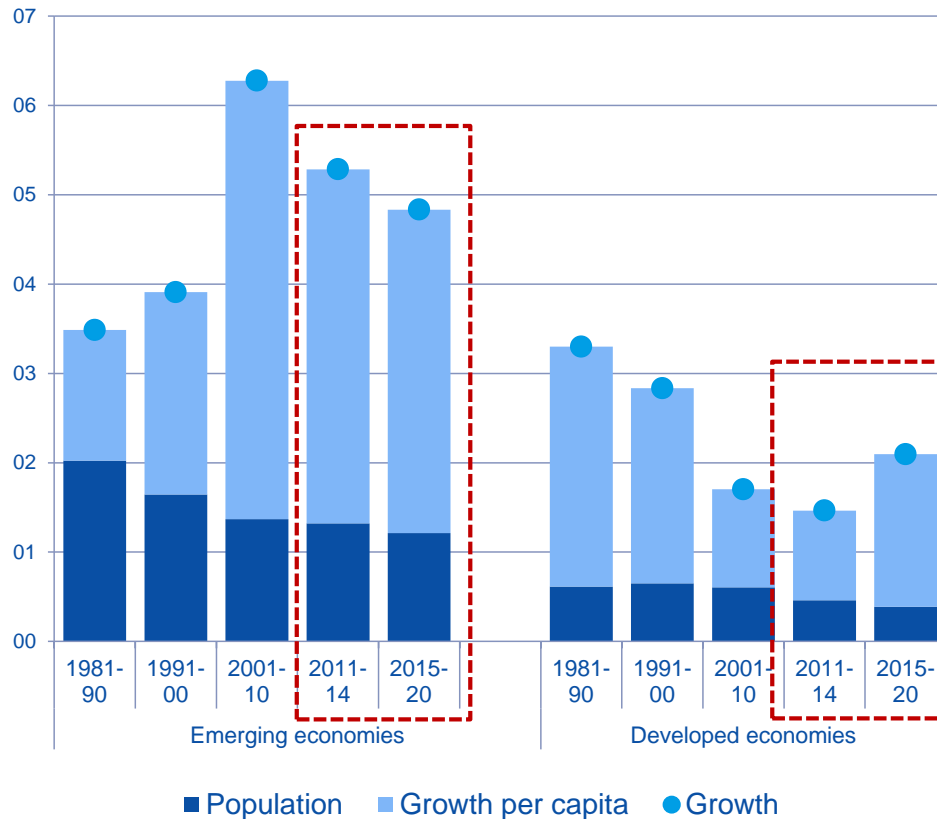
Oil prices reflected in part an unexpected resilience on the supply side...

... but also increasing doubts about Chinese growth, which hit other commodities as well.

# Increase in global growth will be driven by developed economies.

## GDP Growth, population growth and per-capita GDP growth

Source: BBVA Research, IMF and World Bank



2011-14 has been the first 5-year period since the 80s in which both emerging and developed economies have slowed down simultaneously

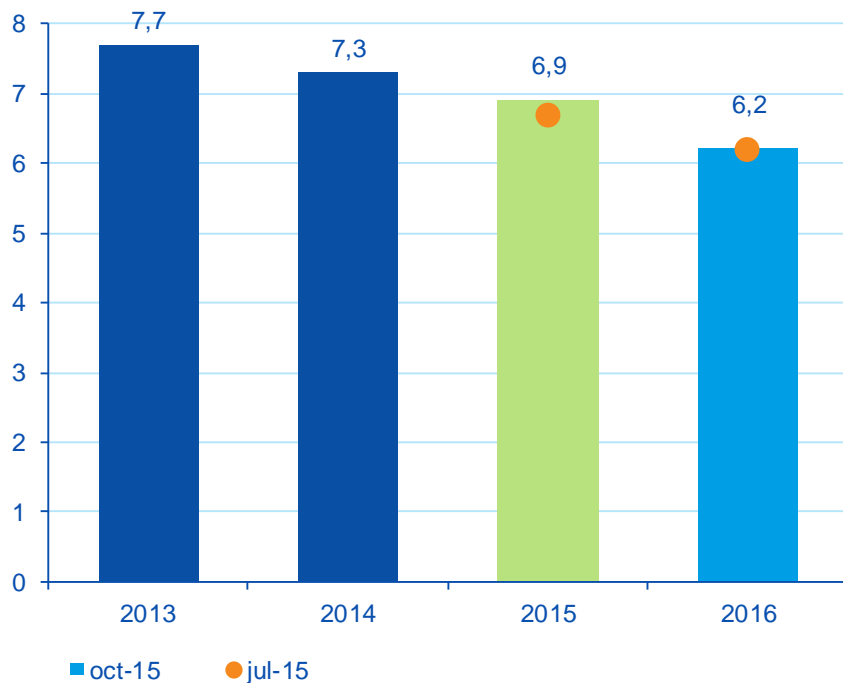
Rebalancing in China, slowdown in globalization and slower population growth drag down global growth

Stronger growth will come about from increase in per-capita growth and, thus, productivity, especially in developed countries

# China: lingering doubts about medium-term prospects

## China: GDP growth (%)

Source : BBVA Research



Alternative indicators of economic activity decelerate faster than official GDP figures ...

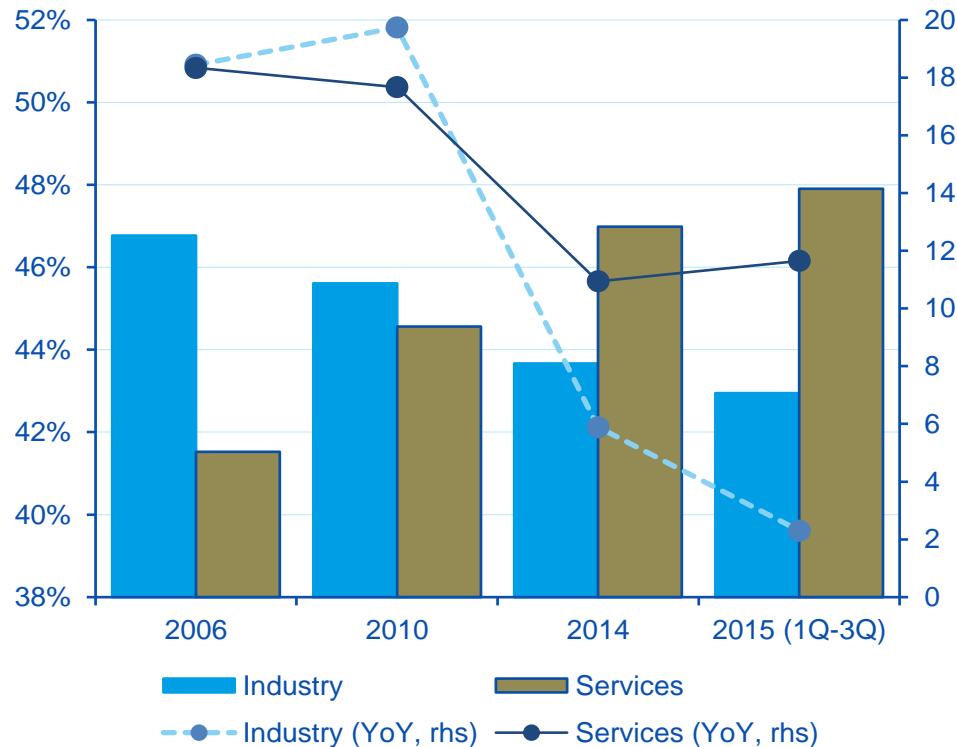
... but may be overestimating the importance of manufacturing, given growing importance of services

Greater support from fiscal and monetary policies. Financial sector reforms continue

# China: Rebalancing towards services, consumption and urban employment continues

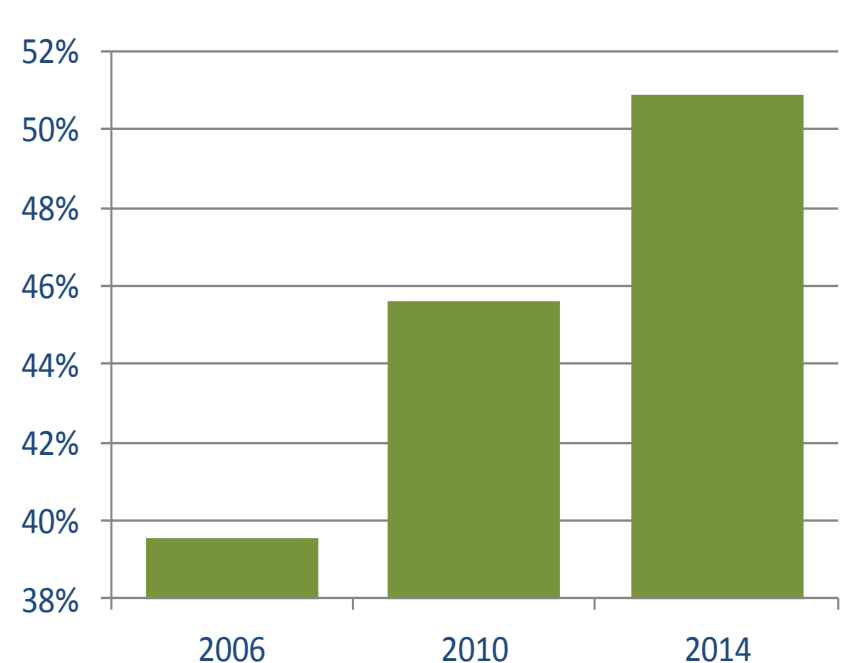
**China: GDP by sectors (% of GDP and growth rate)**

Source: BBVA Research



**China: urban employment, % of total**

Source: BBVA Research



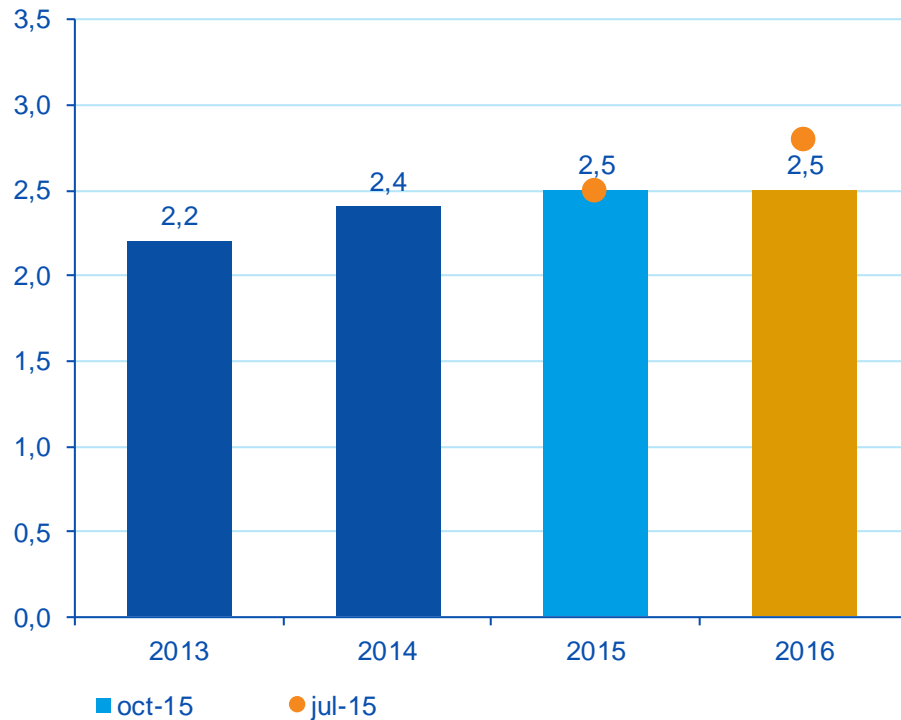
Risks are tilted to the downside as challenges are sizable: reduce indebtedness and ensure the efficiency of investment.



# US: slightly less robust growth than anticipated, on weaker export and energy sector

## US: GDP growth (%)

Source: BBVA Research, BEA



A strong US dollar, lower external demand and weak investment in energy sector have dragged GDP. Consumption is strong but cannot fully offset these two effects

Additional growth may come from a pick-up in credit after clean-up of banking sector and deleveraging of the private sector

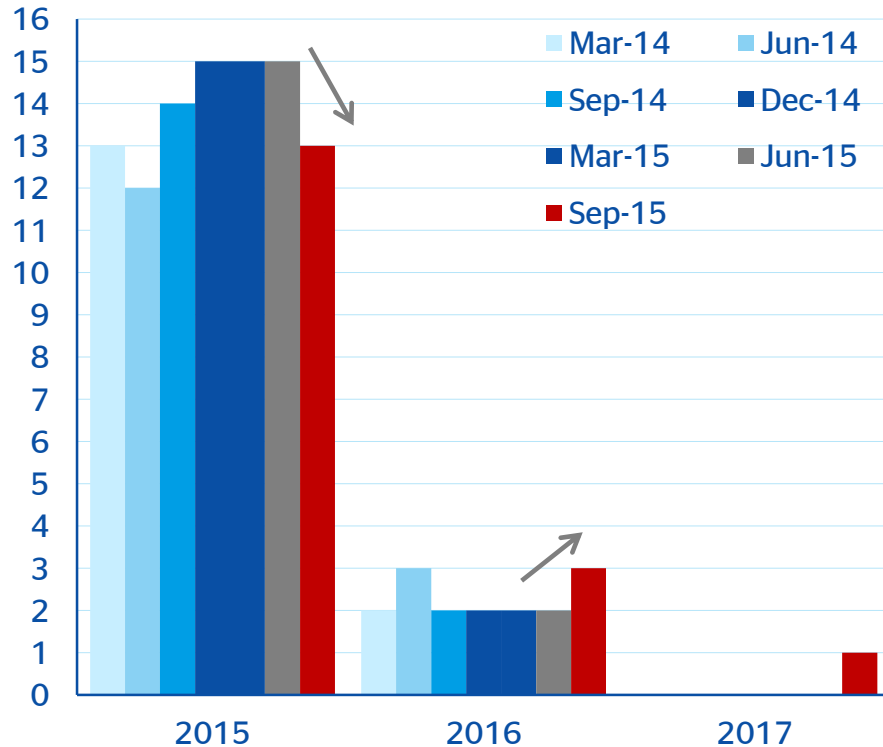
Fed rate rise in December is still uncertain and further rises would be slower than previously anticipated.

# Fed delays beginning of lift-off and points to a slower rate of increases in 2016

## Fed: FOMC assesment of the best time to raise rates

Number of FOMC members

Source: Fed, BBVA Research



Fed delays lift-off on uncertainty about global economy and scant inflationary pressures

FOMC points that they may let unemployment fall below the stated target if spare capacity is to be reduced...

... and there are lingering doubts about the convergence of inflation to its target going forward

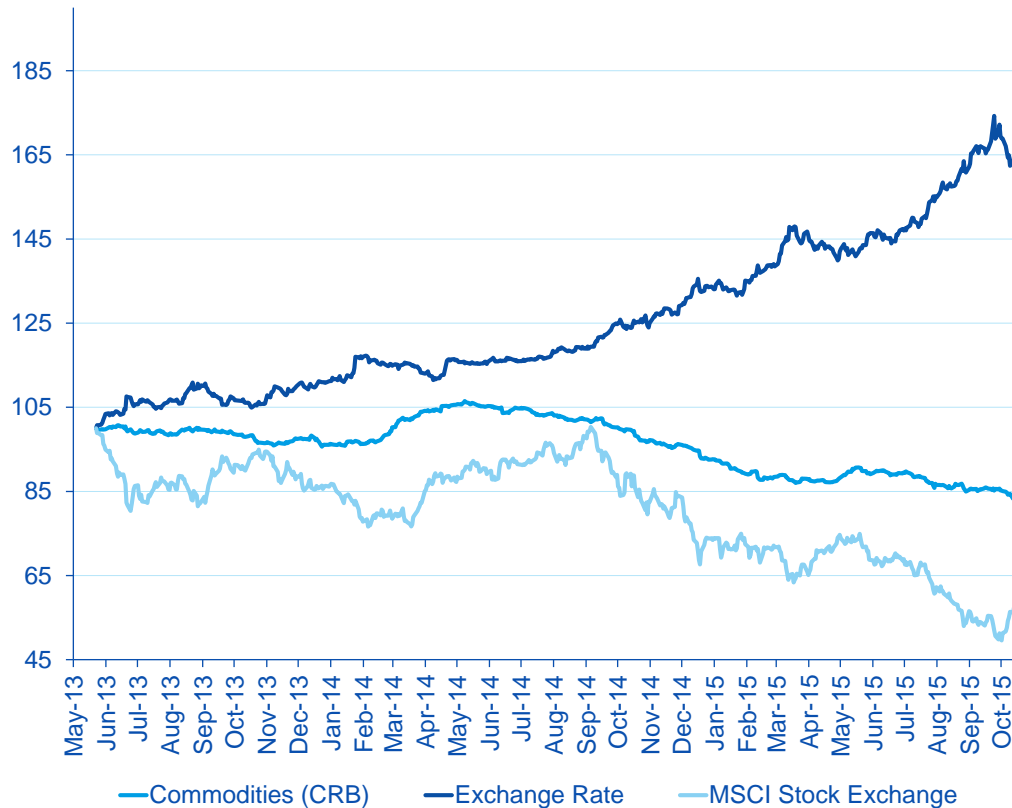
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# Fed, China and a weak cycle have dragged financial markets in Latam

**Main Latam asset prices  
(index May 2013=100)**

Source: BBVA Research and Haver



Prices of the main Latam financial assets and exchange rates continued to weaken, especially in July and August...

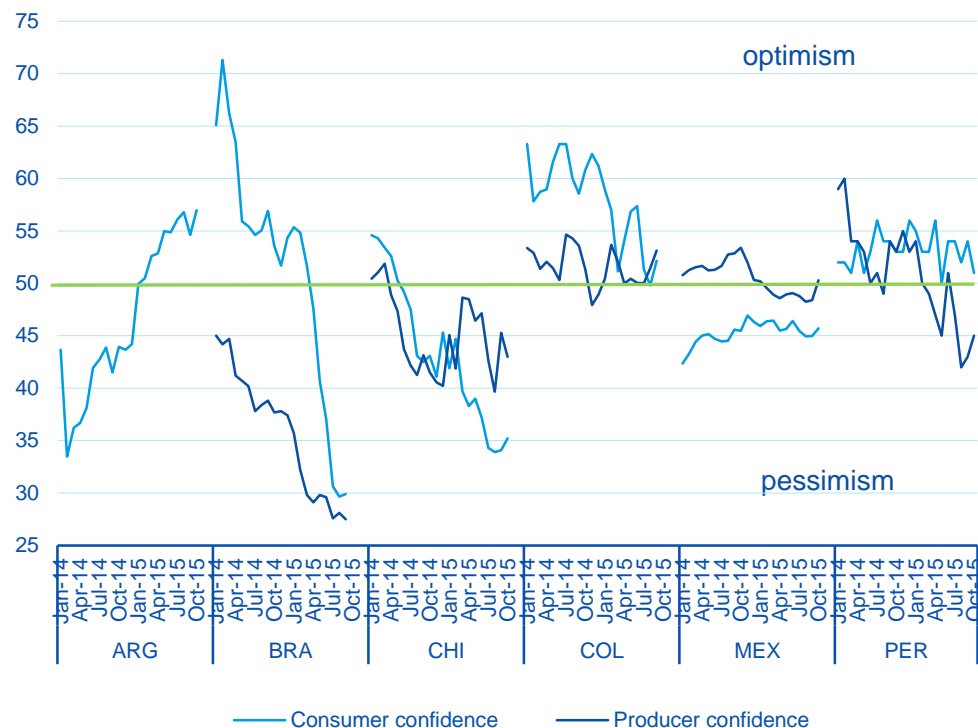
... dragged by concerns about Chinese growth, lower commodity prices and the impending Fed's liftoff

These factors are multiplied by cyclical weakness in the region

# Confidence indicators continued to weaken, dragging domestic demand

## Latam: Household and firm indexes (values over 50 indicate optimism)

Source: BBVA Research and Haver



Weaker confidence in the region due to political noise and policy uncertainty in some countries...

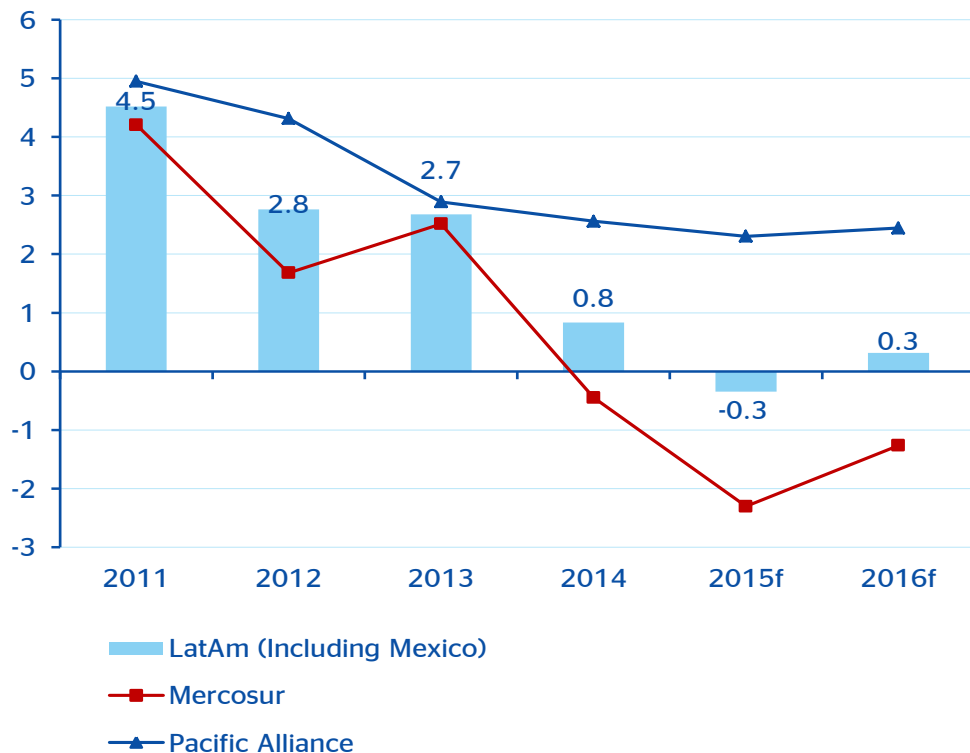
...in addition, a weak external sector, weak labor markets and high inflation also dent consumer confidence

... all this, in turn, has dragged private consumption and investment

# Latam: a two-speed slowdown in 2015-16

**Latam\*: GDP growth (%yoy)**

Fuente: BBVA Research



Weak consumption and investment dragged by falling confidence indicators

A less favorable external environment (China, commodities)

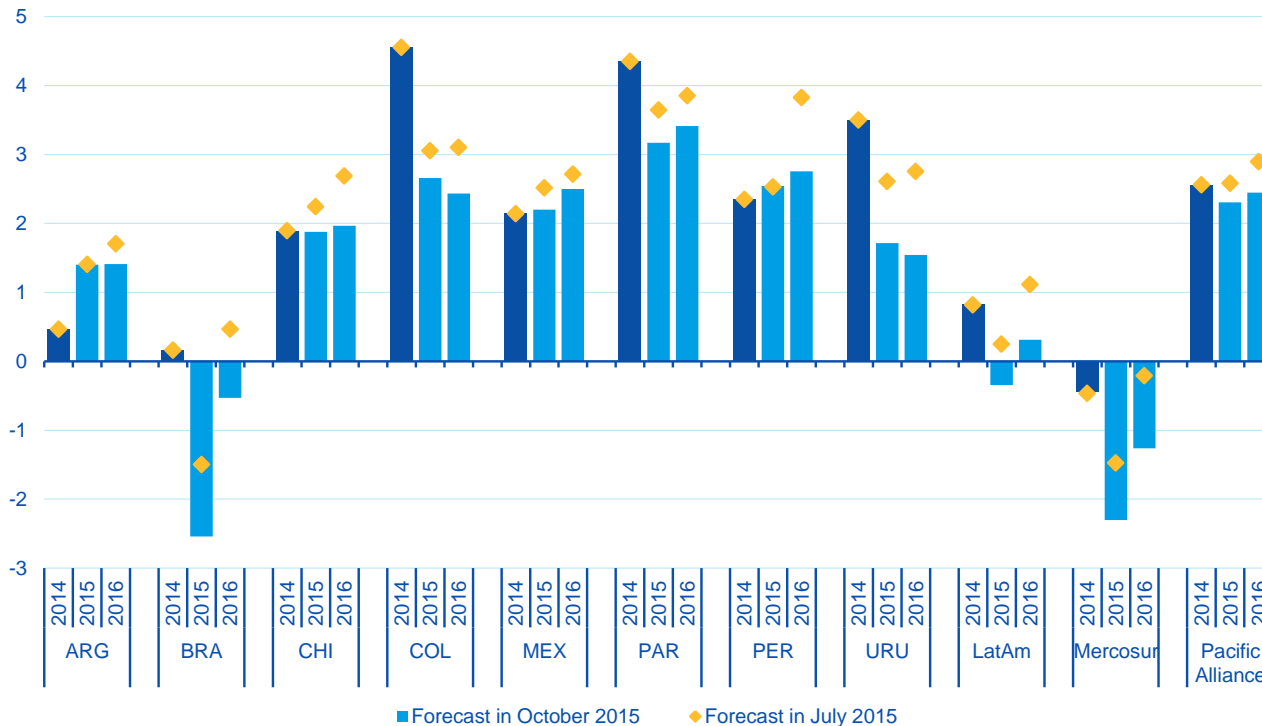
Higher growth in 2016 on:  
 (i) increase in global demand;  
 (ii) public investment in Andeans  
 (iii) Shallower recession in Brazil

Weighted average for Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú, México, Uruguay and Venezuela

# Heterogeneous growth in Latam, Andeans and Paraguay to grow above the rest

## Latam countries: GDP growth (%)

Source: BBVA Research



Growth forecasts marked down in all countries, except ARG

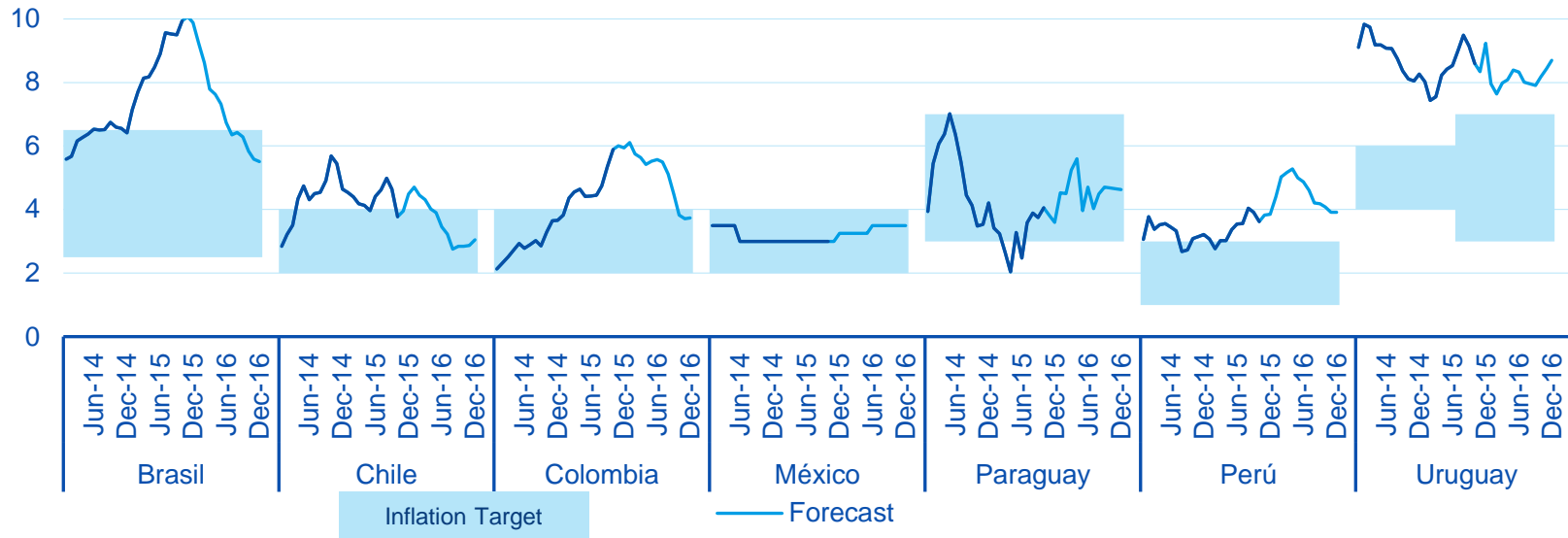
Pacific Alliance to grow close to 2,5% in 2015-16, still below potential (3,8%)

Paraguay, Peru and Colombia, the top performers in 2015-16.

# Inflation above central bank targets in South America, pushed by exchange rate depreciation

## Latam: inflation (%yoy) in Inflation Targeting countries

Source: BBVA Research and Haver



Inflation remains above Central Bank targets (except in Mexico and Paraguay) ...

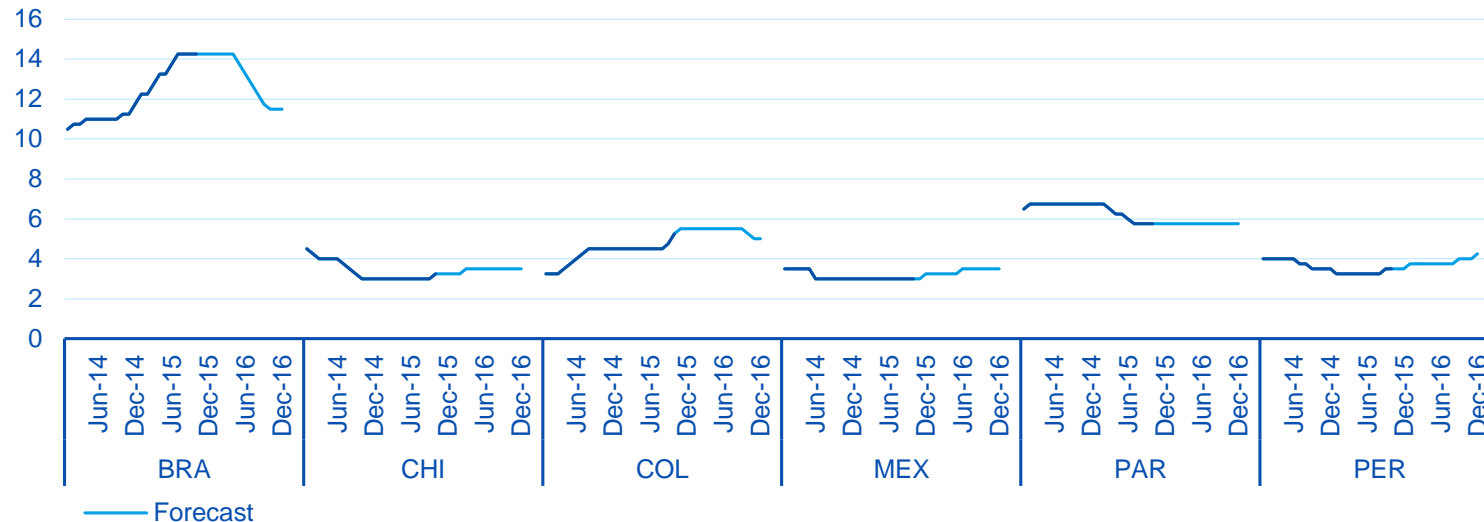
... despite a weak cycle, due to sharp depreciation of exchange rates



# Andean Central Banks tighten monetary policy

## Official interest rate in inflation targeting countries (%)

Source: BBVA Research and Haver



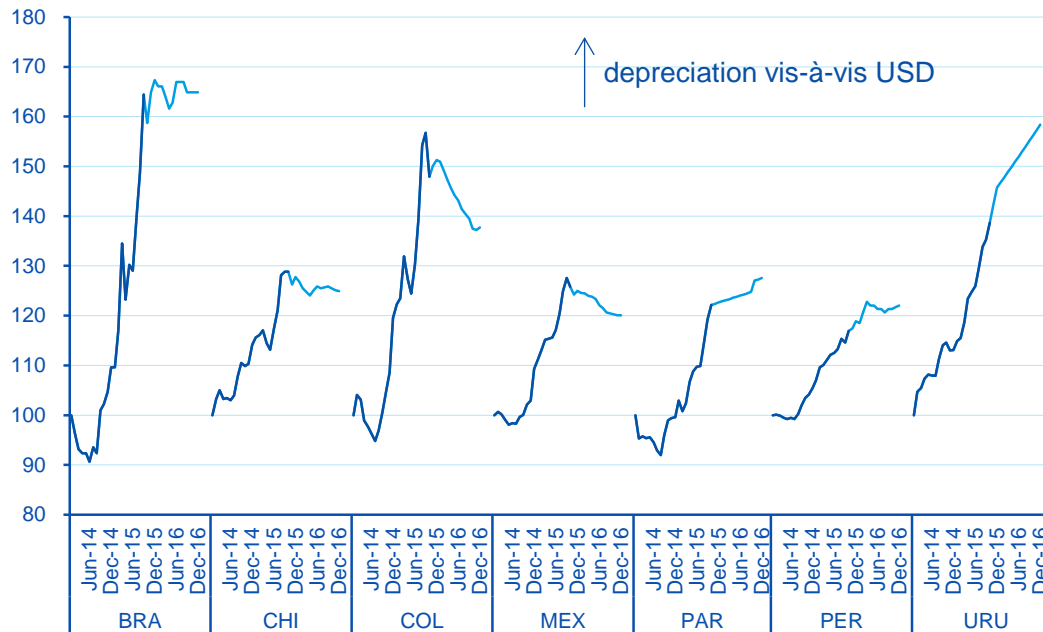
Given some risk of unanchored inflation expectations, Andean Central Banks countries hiked interest rates in September-November

Mexico would synchronize with Fed hikes, at least initially, to contain market volatility.

# Exchange rates will remain under pressure, on the weak cycle and external environment

## Exchange rates to USD in inflation targeting countries (index Dec 2014=100)

Source: BBVA Research and Haver



Sharp depreciation in July-August : a tail-risk event (1% probability)

Markets will be watching closely the first Fed hike and growth in China

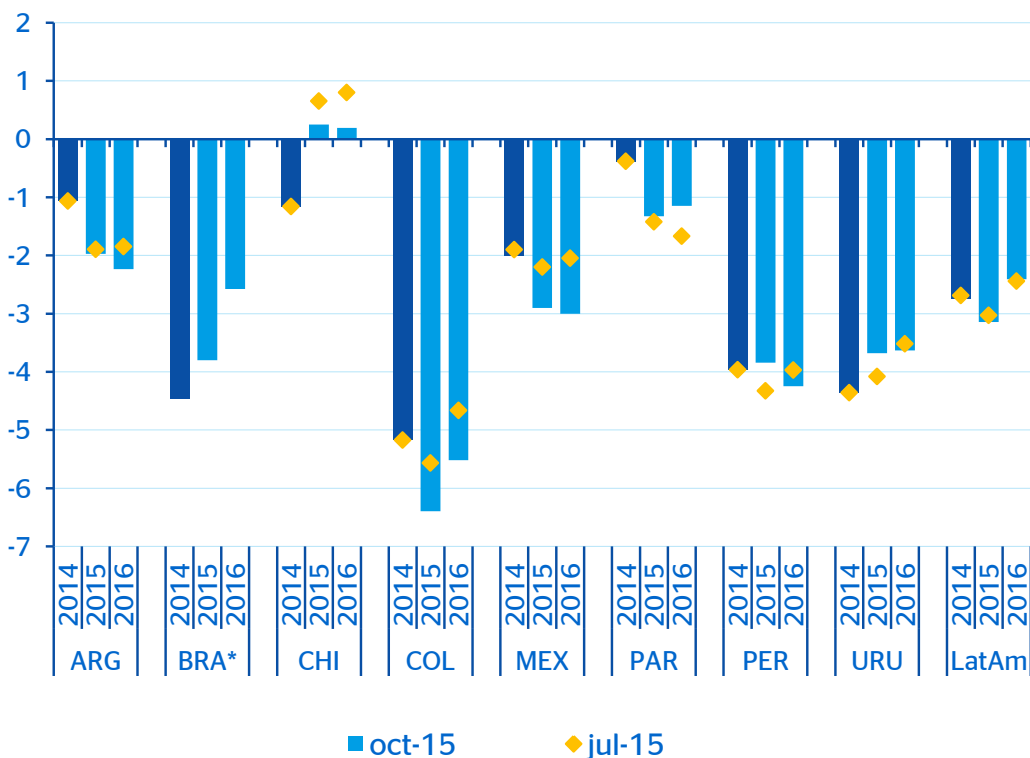
Mexico, Colombia and Chile could see some appreciation in 2016, on higher growth and also a gradual recovery of oil and copper prices.

— Forecast — Observed

# Low commodity prices will underpin high external deficits (except Chile)

**Latam: Current account deficit (%GDP)**

Source: BBVA Research and Haver



External deficits, except in Chile

Some moderation of external deficits in 2016 on FX depreciation, weak domestic demand and some recovery of terms-of-trade

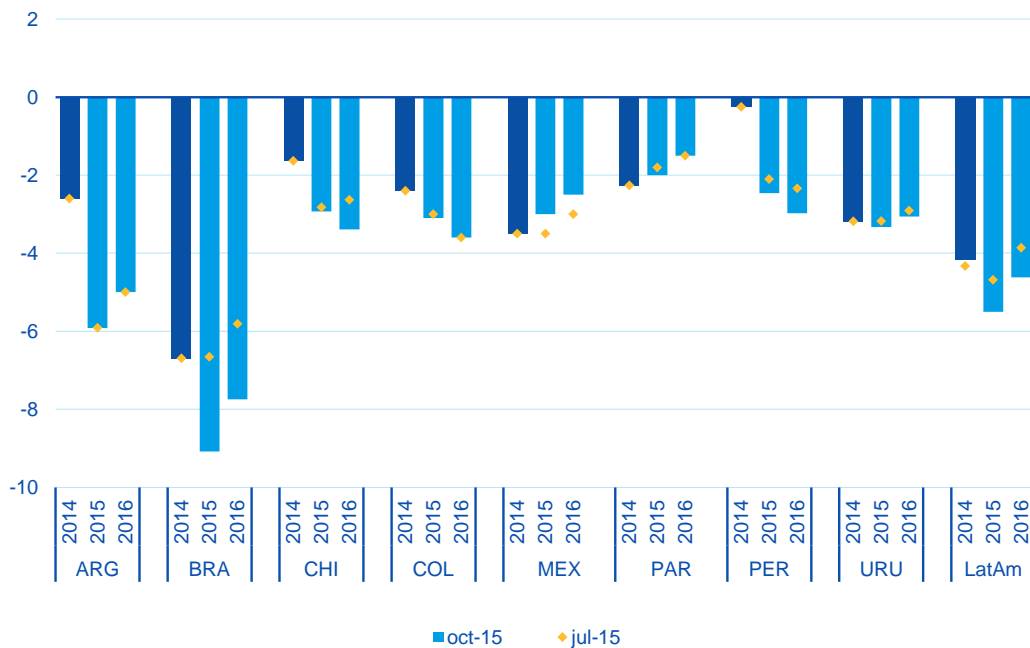
FDI weakens due to lower commodity prices and loses importance as source of foreign financing of current account deficits. But vulnerability remains manageable

\*Change in methodology adopted by the BCB. Previous and actual forecasts are not comparable

# Fiscal outlook worsens, especially in Brazil

## Latam: Fiscal deficit (%GDP)

Source: BBVA Research and Haver



Negative impact of deceleration on tax collection, joined by increasing expenditure in some cases

Fiscal outlook worsens the most in Brazil, due to strong recession and political impasse, which will prevent reaching targets for primary balance

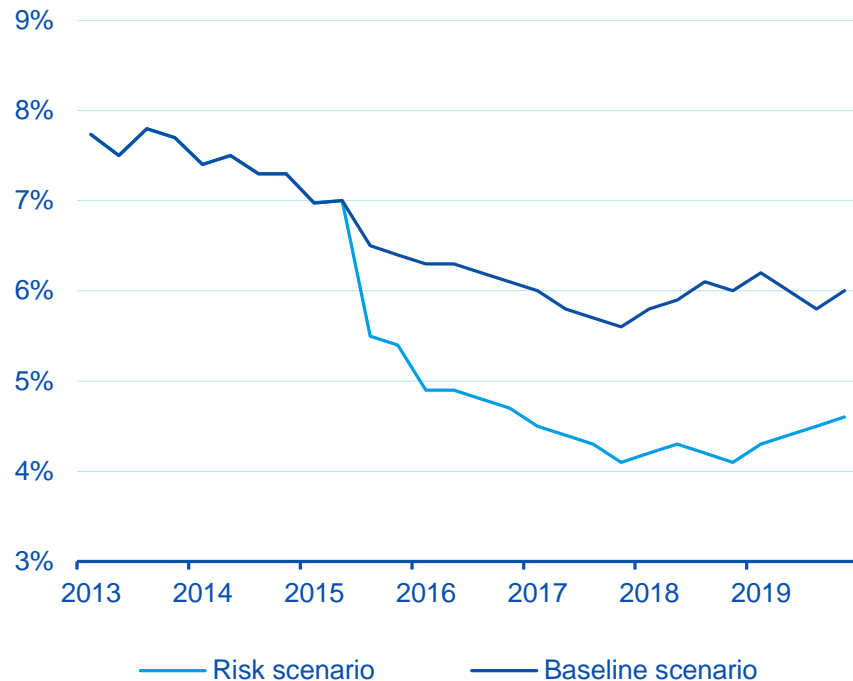
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# A sharp deceleration in China is one of the main risk scenarios for Latam

## China: GDP growth in the baseline and risk scenario (% yoy)

Source: BBVA Research and Haver



A relevant risk scenario for Latam is a possible sharp deceleration in China, although is a low probability event.

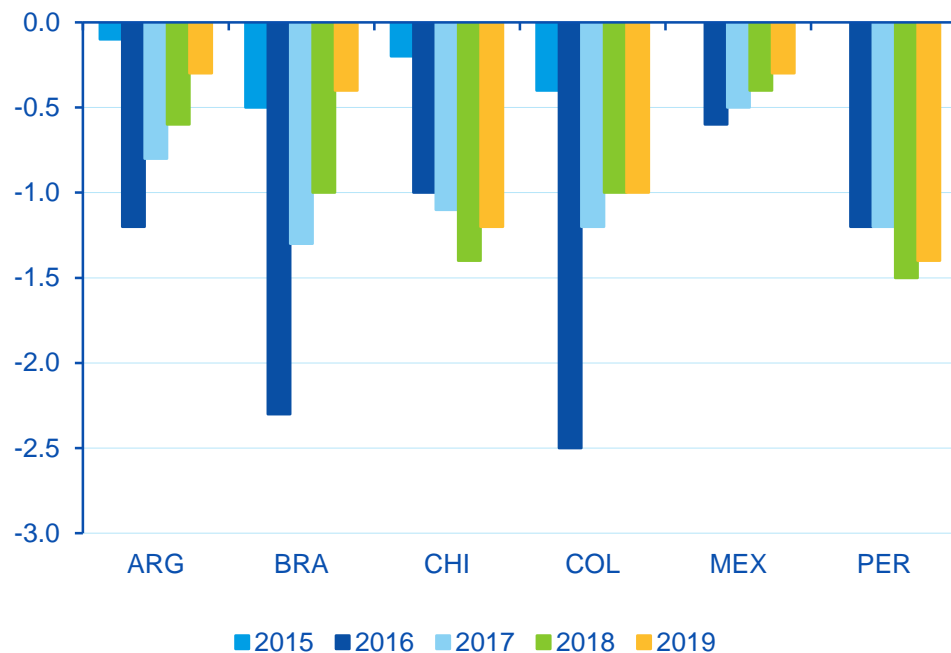
Could be the result of excessive leverage or reduced confidence on the profitability of investments

Main impact on investment, but also (smaller) negative effects on consumption

# What is the impact of Chinese growth falling to 4%?

**Latam: impact on growth of a persistent deceleration of Chinese GDP to 4% (pp growth difference relative to baseline scenario)**

Source: BBVA Research



Latam impacted through two channels  
fall in commodity prices  
(smaller for foodstuffs)  
and increased risk aversion

Amplified through two propagation  
mechanisms: fall in confidence and  
procyclical fiscal policy  
(except Chile and Peru)

Strong impact in countries with weaker  
fundamentals (BRA) or more closely  
dependent on oil prices (COL).

Smaller impact in Argentina, more  
dependent on food exports,  
and in Mexico, less synchronized to the  
Chinese cycle

## Main takeaways

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# Annex: Latam GDP growth forecasts

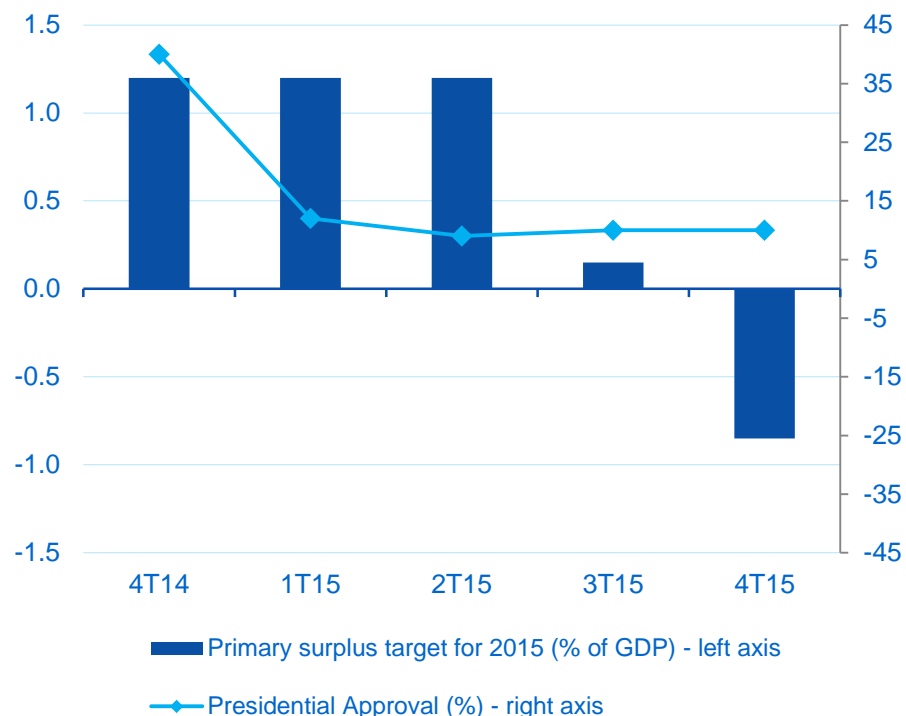
<b>GDP (% a/a)</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015*</b>	<b>2016*</b>
<b>Argentina</b>	<b>0.8</b>	<b>2.9</b>	<b>0.5</b>	<b>1.4</b>	<b>1.4</b>
<b>Brazil</b>	<b>1.8</b>	<b>2.7</b>	<b>0.2</b>	<b>-2.5</b>	<b>-0.5</b>
<b>Chile</b>	<b>5.5</b>	<b>4.2</b>	<b>1.9</b>	<b>1.9</b>	<b>2.0</b>
<b>Colombia</b>	<b>4.0</b>	<b>4.9</b>	<b>4.6</b>	<b>2.7</b>	<b>2.4</b>
<b>Mexico</b>	<b>3.9</b>	<b>1.5</b>	<b>2.1</b>	<b>2.2</b>	<b>2.5</b>
<b>Paraguay</b>	<b>-1.2</b>	<b>14.2</b>	<b>4.4</b>	<b>3.2</b>	<b>3.4</b>
<b>Peru</b>	<b>6.0</b>	<b>5.8</b>	<b>2.4</b>	<b>2.5</b>	<b>2.8</b>
<b>Uruguay</b>	<b>3.3</b>	<b>5.1</b>	<b>3.5</b>	<b>1.7</b>	<b>1.5</b>
<b>Mercosur</b>	<b>1.7</b>	<b>2.5</b>	<b>-0.4</b>	<b>-2.3</b>	<b>-1.3</b>
<b>Pacific Alliance</b>	<b>4.3</b>	<b>2.9</b>	<b>2.6</b>	<b>2.3</b>	<b>2.4</b>
<b>Latin America</b>	<b>2.8</b>	<b>2.7</b>	<b>0.8</b>	<b>-0.3</b>	<b>0.3</b>

# Brazil: political impasse hinders needed fiscal adjustment (and other reforms)

## Brazil: Fiscal target for 2015 and presidential approval rate\*

\* Primary balance target of -0,85% GDP could be increased up to -2,0% depending on payment of past year's expenditure.

Source: IPEADATA; CNI and Finance Minister



Political noise hinders approval of fiscal consolidation measures and other structural reforms

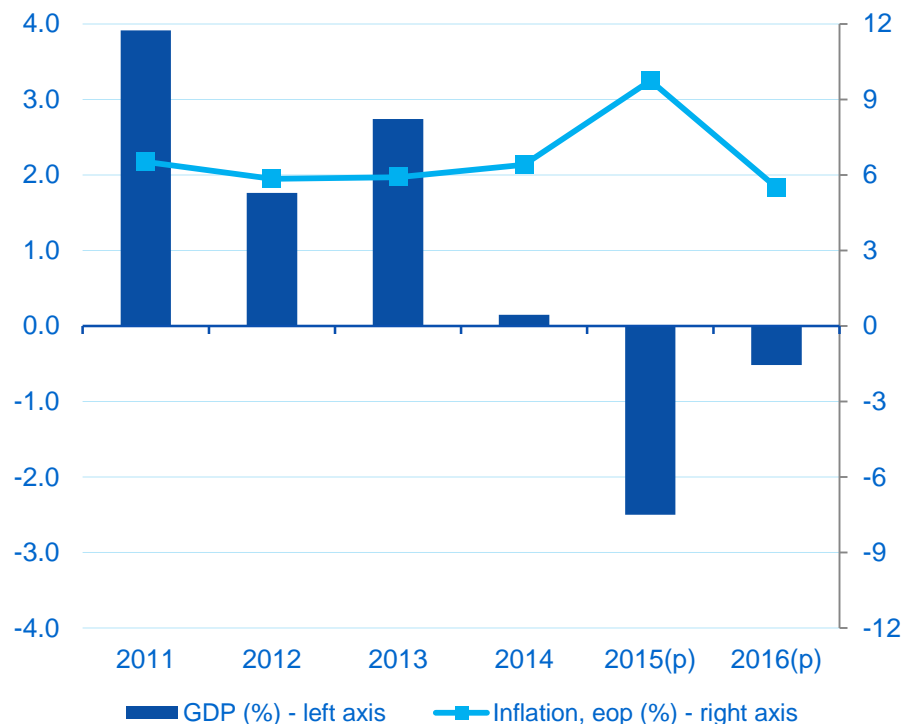
Baseline scenario: political impasse and inaction until 2018

Fiscal deficit (including interests) could reach 9% GDP in 2015 and over 7% in 2016. Public debt would reach at least 70% GDP in 2016

# Brazil: political noise and fiscal woes will extend the recession and press on inflation

## Brazil: Growth and inflation (%)

Source: BBVA Research and IBGE



Recession of close to 3% in 2015 would extend also to 2016

Lack of fiscal adjustment could press also on inflation and will continue to do it on the exchange rate, specially after a second sovereign downgrade below investment grade

Resolving political impasse is crucial for a return to sustained growth.