BBVA | RESEARCH

# LatinAmerica Economic Outlook

4TH QUARTER 2015| LATAM COORDINATION UNIT

01
There is a two-speed Latam, with the Pacific Alliance growing 2.4% in 2015-16 and Brazil in recession, weighing down Mercosur

02
Markets were highly volatile due to doubts around China, triggering a sharp depreciation in exchange rates

03
Inflation remains above central bank targets (except Mexico). The Andean countries tighten monetary policy

04
A risk scenario with a sharper slowdown in China would have a highly significant negative impact on Latam

# Contents



**Closing date: 13 November 2015**

# 1 Summary

**World growth slows slightly in 2015 to 3.2%, and picks up again in 2016 to 3.5%.** Both these figures are slightly lower than the forecasts of three months ago and factor in the weakness of growth, especially in the emerging economies, against a backdrop of doubts about growth in China. These doubts generated an episode of high volatility in international markets in July and August, which affected the assets of the emerging economies in particular. Prices of the main assets in Latin America, very closely linked to prospects for the Chinese economy (especially South America) were not immune to this process, registering falls of a magnitude rarely seen over the last 10 years.

**Doubts about China also generated downside pressure on the price of the main export commodities of the region of course, moderating the prospects of a recovery in prices.** Risks to the USA stemming from a more unfavourable global environment have delayed the first interest rate hike there. This will probably now occur in December, followed by a more gradual increase in 2016 than expected three months ago. All in all, the possible volatility that this process could trigger and the very cyclical weakness of the region will continue to put pressure on Latin American markets.

**Confidence indicators continued to weaken in the region.** They were weighed down by the political noise and the adverse external environment, as well as a weaker labour market and rising inflation. This continued to weaken both investment and consumption more or less generally. On the other hand, the external sector in the region also continued to weaken, on doubts about growth in China and another price correction to the main export commodities.

**Against this backdrop, our growth forecasts for Latin America are revised down against those of three months ago.** We expect the average for the region to remain practically flat both this year and next. More specifically, we expect a 0.3% slowdown in activity in 2015 and a slight (0.3%) increase in 2016. All in all, the regional average will mask a generalised slowdown in growth, but this will be a two-speed event. On the one hand, the Pacific Alliance (Mexico, Colombia, Peru and Chile) will grow at an average of around 2.4% in 2015 and 2016, whereas Brazil will fall into a deep recession in both those years (with growth falling 2.5% and 0.5% respectively), which will end up by weighing down the other Mercosur countries, which have strong trading relations with Brazil. Peru, Colombia and Paraguay will be the countries that maintain greater growth in the region this year and next (see the forecast tables in section 9). Growth, which will start gradually towards the end of 2016, will be driven by: i) increased external demand, on the back of increased world growth and a depreciated exchange rate, and ii) the support of public sector investment, especially in the Andean economies and Mexico. Hence the region should tend towards an average growth close to its potential of almost 3% by 2018.

**Inflation remains above the targets of the central banks of the region, despite cyclical weakness.** Convergence with the targets of the central banks will be slower than expected, to a large extent due to greater-than-expected depreciation, particularly after the July-August episode of volatility. Inflation also surprised the region with its rise due to idiosyncratic factors including the rise in administered prices (Brazil), shocks to food prices (Peru, Colombia) and inertial factors (Uruguay, Brazil). The main exception to this pattern of rising inflation is Mexico, where it is below the central bank’s target, largely due to the impact of the reforms made to the telecommunications and energy sectors. More important than the increase in inflation rates, some increases – still small – started to appear in inflation expectations in some countries once again, with the exception of Mexico.

**Hence, faced with the risk of a de-coupling of inflation expectations, the central banks of the Andean countries decided to tighten the tone of their monetary policies, with increases in the reference rates, despite a context of greater slowdown.** Brazil, in turn, maintained the current restrictive levels, in the face of higher-than-target inflation and Mexico also left its monetary policy rate unchanged, waiting to synchronise its first hike with the Federal Reserve. In the future, as pressure on inflation persists and economic activity recovers, we expect further increases in the interest rate in the three Andean countries in the remainder of the year or in 2016, which is more restrictive than we expected three months ago. Mexico will try to synchronise its monetary policy with the first hikes by the Fed in December and in 2016, to reduce market volatility, so it can then de-couple and focus more on domestic conditions of low inflation and relative slowdown. At the other extreme, Brazil could start reducing its high monetary policy rate in the second half of 2016, as inflation is brought down, although there is a risk to inflation from further depreciation or from a failed fiscal correction.

**With the Fed's interest rate hikes, a less favourable external environment and greater slowdown in the region, the trend of depreciating exchange rates will continue in most countries.** The recent depreciation, highly intense in July and August, occurred against a backdrop of lower commodity prices and doubts around growth in China. Moving forwards, there will probably be new episodes of volatility in anticipation of rising interest rates in USA. In countries like Mexico, Chile and Colombia, after reaching their weakest level after the first Fed hike, there will probably be a certain appreciation of the exchange rate in 2016 as growth recovers slowly and also a slight increase in the prices of oil and copper.

**Moderate prices of the main export commodities will keep external deficits in the region high (except Chile) and will also put upside pressure on fiscal deficits.** External deficits will start to moderate in 2016 in some countries, because of the depreciated exchange rate, weak domestic demand and a certain recovery of the terms of trade. Prospects for fiscal balances suffer, especially in Brazil, as a consequence of a deeper-than-expected recession and the political impasse that will be a major obstacle to adopting the necessary fiscal adjustment measures.

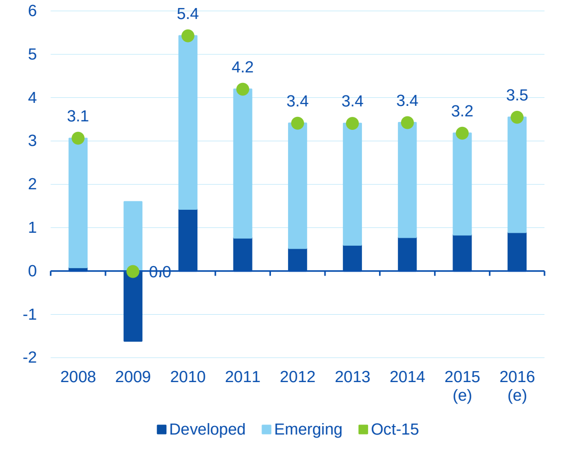
**One of the main risks for the region is a greater slowdown in China.** A risk scenario with a slowdown in investment leading to growth of around 4% in China would have an impact on the region through a fall in commodity prices and increased aversion to risk (Box 1). The impact of these two elements would be multiplied by the lack of room for countercyclical policies (except for fiscal policy in Peru and Chile) and the significant impact that it would have on households and businesses – which are already at very low levels. The countries most affected by this shock would probably be Brazil and Colombia, as they are highly exposed to China, as well as weak macro-economic fundamentals in the case of Brazil, and the impact of a sharp fall in oil prices in the case of Colombia. The least-affected countries, in turn, would be Mexico and Argentina. Mexico is less tied to the Chinese cycle or to raw materials, whereas Argentina faces a lesser impact on its terms of trade, although it would suffer from the indirect impact through Brazil.

# 2 Slower global growth in 2015 and a limited improvement in 2016

According to our estimates, global GDP has chalked up four consecutive quarters of growth below the 2010-14 average, mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

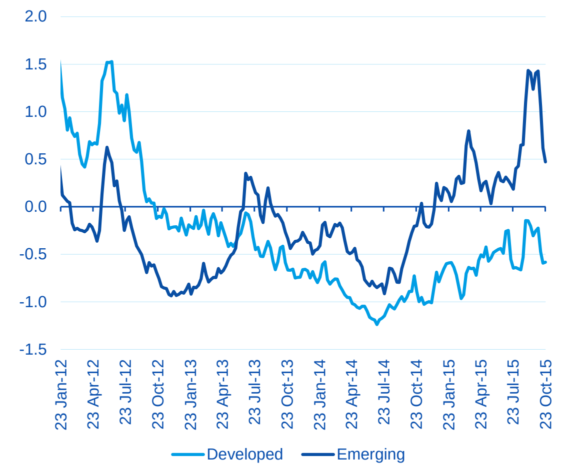
As a result, global GDP should grow at 3.2% in 2015 (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1), with growth in the emerging markets moderating to barely 4% YoY, compared to average growth in the five previous years of more than 5.5%. The outlook for 2016 is slightly more favourable, with global growth recovering to 3.5% (0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies.

Figure 2.1
**World GDP: annual growth (%). Forecasts 2015-16**




Source: BBVA Research

Figure 2.2
**BBVA Financial Tensions Index**




Source: BBVA Research and Bloomberg

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies — accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads — are evidence that the balance of global risks is still to the downside. Even though monetary policy in the developed countries could mitigate the impact of a scenario of slower growth, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, that takes the annual growth of that economy well below 6%, with an even slower recovery of the developed economies block than has been observed to date, is without a doubt a significant risk scenario, both because of its degree of plausibility (limited, but not extreme) and its severity, given its potential impact on the world economy generally and on Latin America in particular (see Box 1 regarding the specific impact on Latin America).

## USA: downward growth revision due to the deterioration in the external environment

An overview of the principal economic areas shows a notable stabilisation of economic growth in the US at lower rates than in other recovery episodes. Private consumption remains key to the dynamics of economic recovery, although it will probably not be sufficient to wholly offset the drops in both exports (owing to the dollar's appreciation and the weakness of the emerging economies) and investment in the energy sector. GDP growth should thus be 2.5% in 2015 and 2016 as well.

The risks for the US economy in a more unfavourable global environment are influencing the Fed response and when the initial rate hike takes place, which ought to be in December. Whatever happens, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%.

## China: upward revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement of change regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of economic activity, which has taken GDP growth below 7% YoY in the third quarter.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016.

## Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

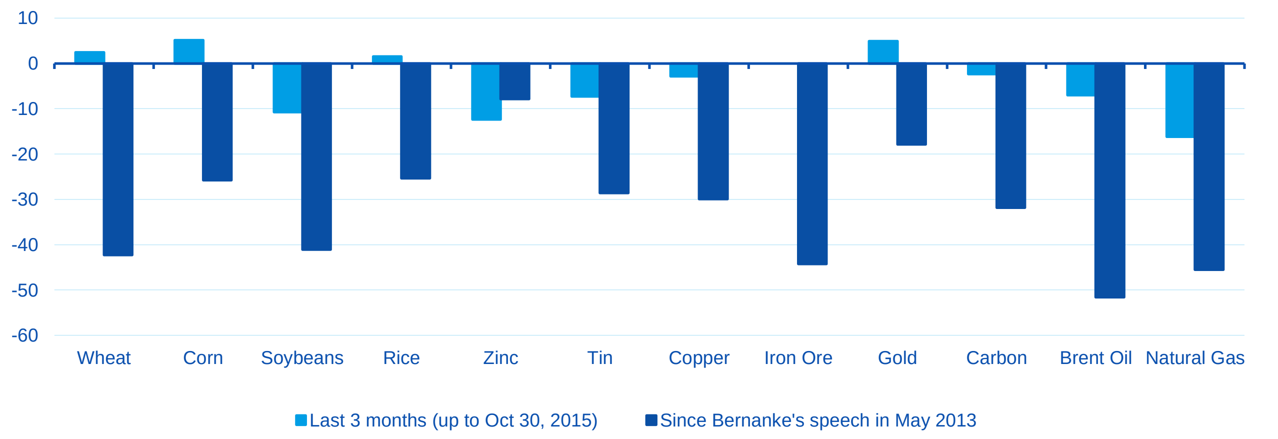
In the eurozone, the economic recovery continues although the pace has not intensified as we anticipated some months ago. The pace of eurozone GDP growth could increase to 1.8% in 2016 (only 10bp less than we expected last quarter) due to the upturn in Italy and France. The accentuation of the risks to the downside to inflation forecasts, largely due to cheaper imported goods, together with the recent appreciation of the euro, appears to be pushing the ECB towards adopting new stimulus measures in the short term, as it has suggested.

# 3 Highly volatile Latin American markets on the back of doubts about growth in China

## Prices of the main commodities suffer the impact of doubts about growth in China, on top of the adjustment to supply shocks in the second quarter of the year

The prices of raw materials continued to fall over the last three months, with the exception of some agricultural commodities, gold and iron ore, where prices remained constant. The fall in prices was sharper on the natural gas, zinc, soya, tin and oil markets and less pronounced in copper and coal (Figure 3.1). In all cases considered, prices at the close of October were significantly down against just over two years ago, when the speech by Ben Bernanke, then the Chairman of the American Federal Reserve, led markets to reflect on the start of tapering and the normalisation of monetary policy in the USA.

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




Source: Bloomberg

The main factor behind moderating commodity prices is the fall in China's growth rate and the re-orientation of its economy towards consumption, becoming less intensive in commodities (mainly metals and energy) at the expense of investment. Although commodity markets have been watching the Chinese economy and its impact on demand for years, concern has increased in recent months, mainly in July and August, as a consequence of the turmoil mentioned in the previous section, which has helped decisively to drive the downside corrections observed recently.

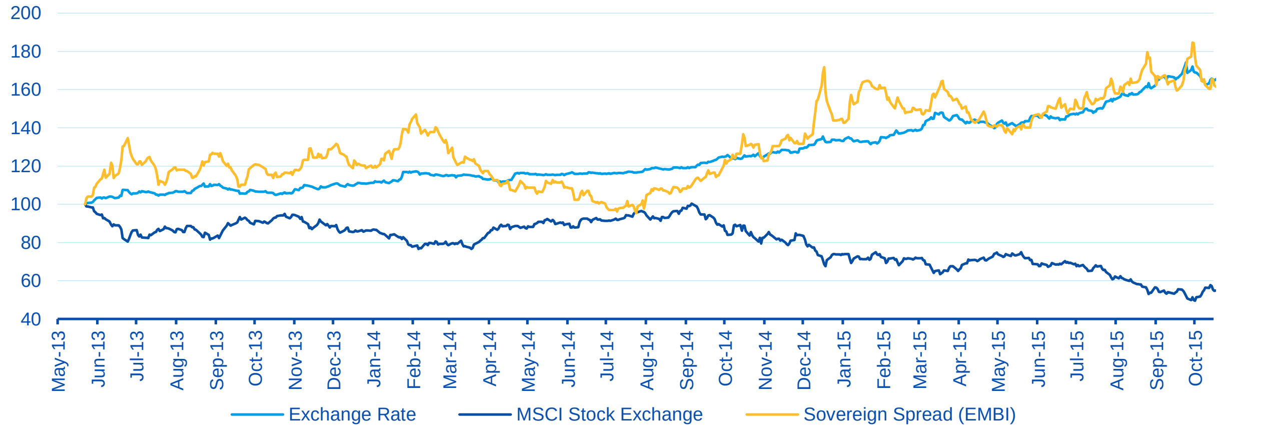
Slowing demand also appears to be the main justification in the face of increased supply to explain the fall in oil prices from USD60 per barrel half way through the year to around USD45 in November. The dynamics of oil are similar to those of other raw materials, mainly metals such as copper and iron ore, which is consistent with the existence of a factor common to all of them, linked to the constraint of demand. In the case of soya, a very important product for countries like Argentina, Brazil, Paraguay and Uruguay, apart from global factors the good US crop has had an influence. In general terms, the adjustment to supply in the face of significant price falls is starting to show, but this has been unable to offset the effects of weaker demand.

## Falling commodity prices and volatile markets weighed on the main regional assets

Problems in China have had a direct impact, not only on commodity markets but also on the financial markets of the region, because of the importance of the Chinese economy – and of primary products – for practically every economy in the region. Although the US Federal Reserve delayed the first interest rate hike, markets remained nervous, reflecting the uncertainty about the next steps that the American monetary authority will take.

Apart from the unfavourable external environment, the domestic situation in most countries of the region also had a negative effect on the price of Latin American financial assets, mainly due to a generalised moderation in economic activity. The internal factors of the region included a strong fiscal deterioration and the consequent downgrading of Brazilian debt from investment grade by S&P in September. In practice, the deterioration of the Brazilian economy is another negative element weighing on Latin American financial markets, although its impact is limited, and most probably less than the slowdown in China and the normalisation of monetary policy in USA[1].

Figure 3.2
**Latam: stock market prices, sovereign spreads and exchange rates (index 23 May 2013=100)***



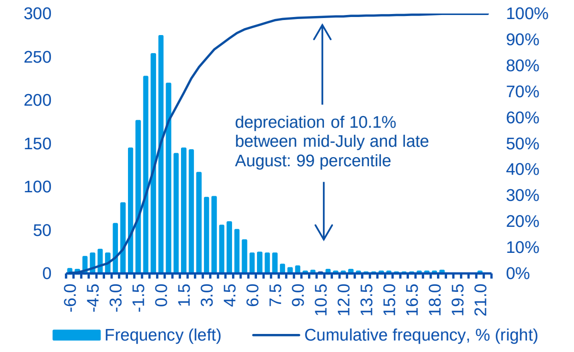

* Exchange rate: average of the countries of the region. Stock market indicator: MSCI. Sovereign risk: EMBI Latam. In the case of the exchange rate, an increase in the index indicates a depreciation
Source: Haver Analytics, Datastream and BBVA Research

In this context, the prices of the main financial assets were revised down even further over the last three months, mainly due to the corrections observed up to the beginning of September. From the close of July to the end of October, the EMBI Latam rose approximately 20 basis points, the MSCI stock market index contracted almost 10% and exchange rates depreciated by around 8% on average (Figure 3.2). These are significant losses, greater than those seen during the *taper tantrum* of summer 2013, after Ben Bernanke's famous speech.

The corrections observed in the approximately 45 days between mid-July and the end of August, when there was turmoil on Chinese financial markets and concerns about the Chinese economy intensified, also assumed unusual proportions. The case of the currency markets is illustrative: in the 45 days that financial tensions lasted in China, the exchange rate of the main Latin American countries depreciated by an average of 10.1%. Over the last 10 years, the region had only seen such a sharp depreciation in its currencies at the

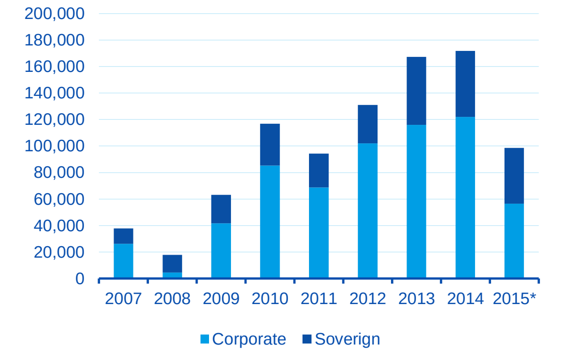
1: For further details about the loss of investment grade in Brazil and the eventual consequences for the region, see our report "Economic Watch: Brazil, back to high-yield" start of the Lehman Brothers crisis in 2008. In the other cases, accounting for 99% of the period between 2005 and now, currency depreciation has never been more significant than recently (Figure 3.3).

Figure 3.3
**Distribution of the average accumulated frequency of currency depreciation over 45 days in Latam***




* Accumulated exchange rate variation in 45 days calculated directly between November 2005 and October 2015. The positive (negative) numbers reflect depreciation (appreciation) in the exchange rate. Simple averages of the currencies of Argentina, Brazil, Chile, Colombia, Mexico and Peru
Source: Datastream and BBVA Research

Figure 3.4
**Issues in foreign currency (USD millions)**



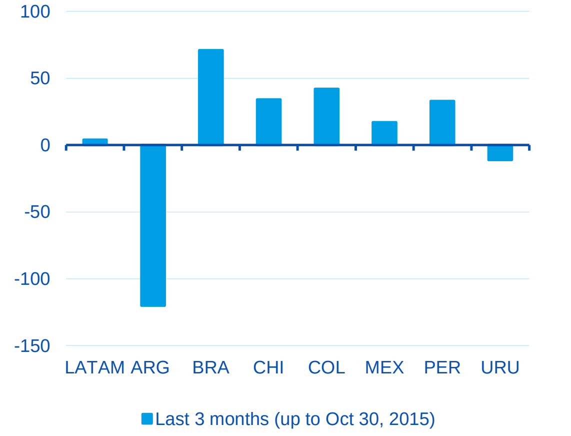

* In the case of 2015, the figure refers to issues to October
Source: Bloomberg and BBVA Research

Another consequence of the current economic context was a moderation in capital flows into the region, although they remain at positive levels. Foreign currency issues of both sovereign bonds and corporate shares have also slowed down significantly this year, compared to the last three years (Figure 3.4). Specifically, issues to October 2015 are down 34% year on year. The most significant slowdowns have been in the corporate sector (down 54%) and issues made by Brazil (down 83%).

Financial losses in recent months have been wide-spread, both in terms of countries and assets. The only clear exceptions were the Argentine sovereign spread and stock market, which stayed in positive territory over the last three months, probably due to the economic prospects for the country after the presidential elections in November.

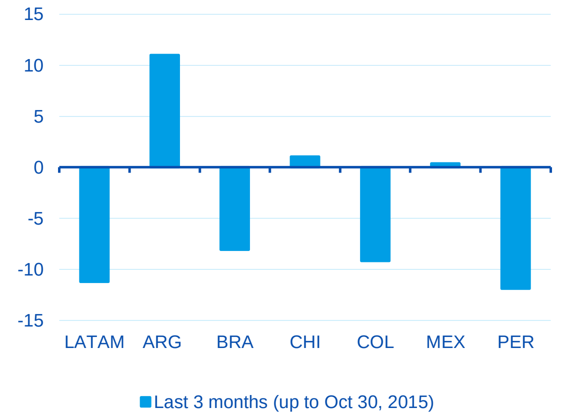
In all the countries analysed, except Argentina, the sovereign spread widened over the last three months, albeit less so in Uruguay, possibly related to the movements observed in Argentina, and in Mexico, where the economic dynamics are different from the other countries of the region as Mexico benefits more directly from a recovery of economic activity in USA and it has less exposure to the Chinese economy. Increases in country risk were more pronounced in Brazil, due to the impact of the aforementioned fiscal deterioration and political instability (Figure 3.5).

Figure 3.5
**Sovereign spreads in Latin America (EMBI, basis points**




Source: Haver Analytics and BBVA Research

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



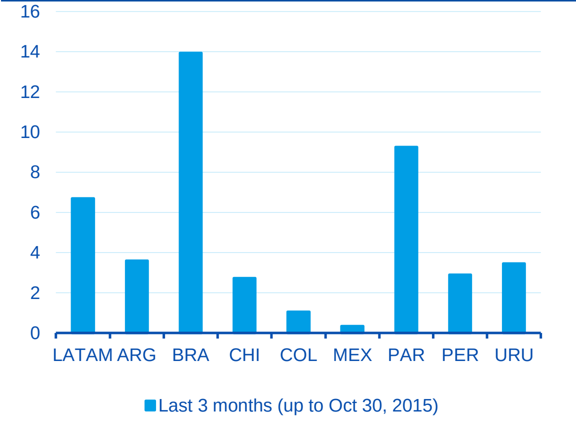

Source: Haver Analytics and BBVA Research

The losses seen on the stock markets over the last three months were as important, if not more so, in Colombia and Peru as in Brazil. Apart from their higher starting points, Peruvian and Colombian stock market prices fell on the recent slowdown of their economies, with the political noise in the former case and with the strong fall in oil prices in the latter. On the other hand, stock markets managed to remain relatively stable in Chile and Mexico, despite the complex international environment (Figure 3.6).

Finally, in the exchange markets, all the currencies, without exception, have weakened since the close of July. As in previous cases, the strongest adjustment occurred in Brazil, which, together with the strong correction to soya prices and downside pressure on the currency, could have contributed to even stronger depreciatory pressures in Argentina, Paraguay and Uruguay than in the other countries of the region (Figure 3.7).

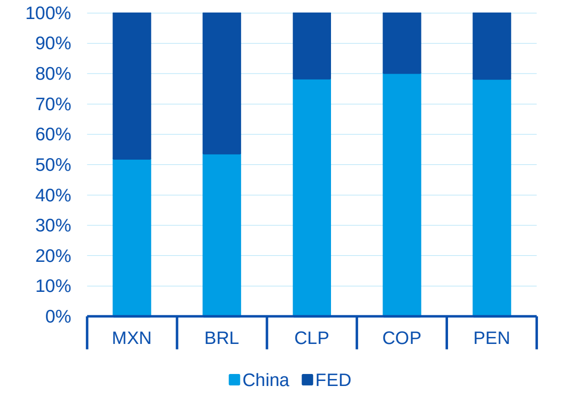
It is worth highlighting that although both the slowdown in the Chinese economy and the uncertainty regarding the normalisation of monetary policy in USA have a negative impact on the financial assets of all the countries of the region, the former weigh heavier on the Andean countries than on Brazil and Mexico, as Chile, Peru and Colombia depend to a larger extent on the sale of primary products to China. The impact of the turmoil triggered by the Federal Reserve raising interest rates is significantly greater in Mexico and Brazil, due to the greater depth of their financial markets (Figure 3.8).

Figure 3.7
**Exchange rates in Latin America (% var.)**




Source: Datastream and BBVA Research

Figure 3.8
**Weight of the slowdown in China and doubts about the Fed in exchange dynamics in Latam (accumulated since January 2013)**




* MXN: Mexican peso; BRL. Brazilian real; CLP: Chilean peso; COP: Colombian peso; PEN: Peruvian new sol. For details about the estimation methodology, see our report "Flows & Assets Report 3Q15".
Source: BBVA Research

## Volatility will continue, due to the Fed's actions and doubts surrounding the slowdown in China

As the Chinese economy continues to adjust and the Fed reveals its interest rate hike strategy, Latam financial markets will continue to react, very probably with one shock following another, given the importance and the high levels of uncertainty that surround both processes. Against this backdrop, it is difficult to imagine that the financial markets of the region will rapidly recover the losses accumulated in recent times.

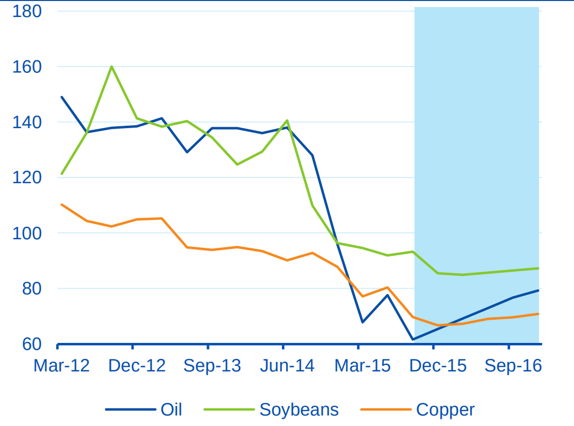
Another factor that points in the same direction is Brazil's likely downgrade below investment grade by a second risk-rating agency in the coming months (possibly in mid-2016), which will trigger an automatic adjustment to the portfolio of certain kinds of investors, which could have an impact, albeit limited, on the region beyond Brazil.

All in all, regional financial markets should benefit from a recovery in the prices of some key raw materials such as oil and copper against the current depressed levels, which would drive some strongly associated markets such as Colombia, Peru and Chile (Figure 3.9).

In the case of oil, we expect prices to exceed USD50 per barrel by the end of the year, converging towards something closer to USD60 in the course of next year. Similarly, we expect the price of copper to rise gradually over 2016, after hitting rock bottom around USD2 per pound, to approximately USD2.14. Although these forecasts are more negative than three months ago on greater concern about China, they both continue to factor in the expected impact of further adjustments to supply on prices. On the other hand, we think it more likely that soya prices remain relatively stable within the timeline of the forecast.

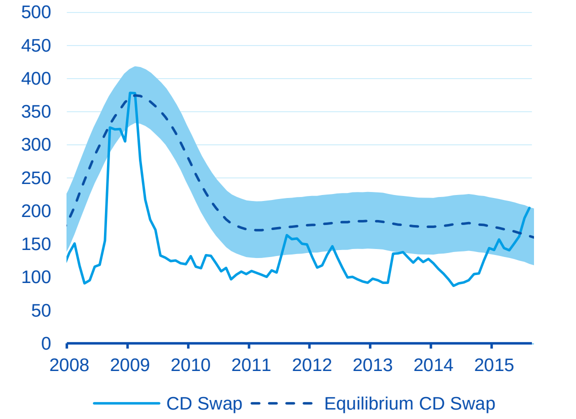
Finally, after recent corrections, we forecast that the price of at least some financial assets of the region may currently be below their "equilibrium" price according to their fundamentals. This is the case of CDS Latam, for instance, illustrated in Figure 3.10. In our opinion, this should limit downside pressure in the coming months.

Figure 3.9
**Main commodity price forecasts (average index 2010 = 100)**




Source: BBVA Research

Figure 3.10
**Risk premium in Latam: CDS observed and equilibrium (basis points)***




* Shaded area: average of four alternative models + 0.5 standard deviation. For further details about calculating the equilibrium, see our report "Flows & Assets Report 3Q15".
Source: BBVA Research

# 4 Two-speed slowdown in America

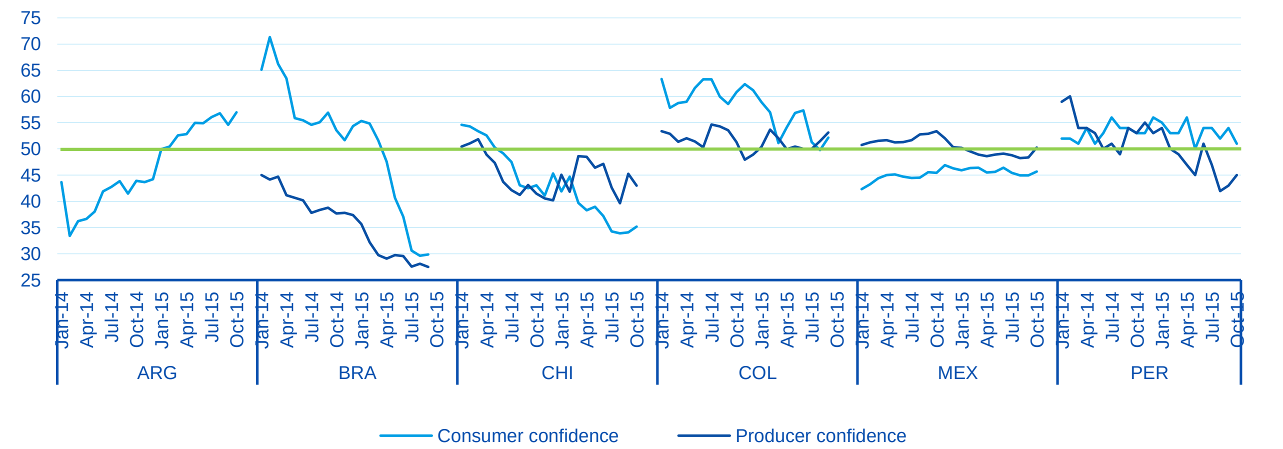
## Family and business confidence indicators remain weak, driving down domestic demand

Household and business confidence remains in pessimistic territory in most countries of Latin America. The factors behind this are still, on the producers' side: i) political uncertainty and uncertainty regarding economic policy (Brazil, Chile, Peru), and ii) a less favourable external environment, driven by the fall in commodity prices and lower demand for products among regional partners. For households, the decisive factors are: i) the higher cyclical deterioration that has implied less buoyant labour markets, and ii) higher inflation that affects disposable income and, hence, household consumption.

Among producers, the deepening pessimism has been particularly pronounced in Brazil (and to some extent in Peru), affected by political noise and, in the case of Brazil, the uncertainty associated with future economic policies. In Colombia and Mexico, consumer confidence remains largely the same as in previous months, and in Chile we have seen a slight spike associated with temporary effects and a very slight spike stemming from slightly better-than-expected economic activity data, although confidence remains low at pessimistic levels.

Inflation rates have remained high against historic levels (Figure 5.1), with more than a few surprises against what was expected a few months ago. High inflation has directly hit real salaries and disposable income. The quality of jobs continues to deteriorate, with slowdowns in paid employment in the Andean countries and Brazil. Hence, consumer confidence has suffered significantly in Brazil, Chile and Colombia, while it remains stable but weak in Peru. In Mexico, on the other hand, limited inflation rates (falling sharply in Mexico) and improved labour markets have underpinned consumer confidence, keeping it high.

Figure 4.1
**Consumer and producer confidence (values above 50 indicate optimism)**



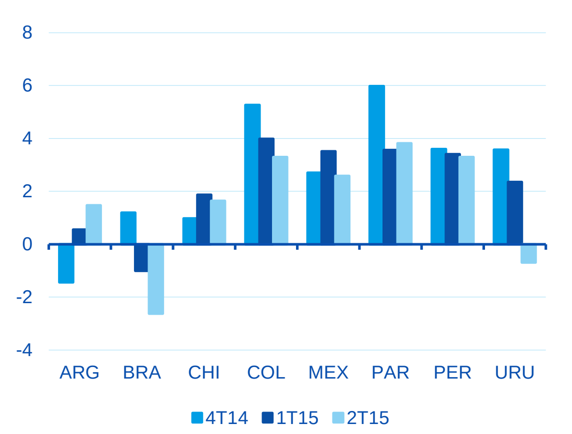

Source: BBVA Research and national statistics

The slowdown in confidence has in general translated into lower growth in both consumption and investment in the second quarter, on the latest data available. Private sector consumption slowed down (in year-on-year terms) in all the economies of the region except Argentina and Paraguay. Falls in household consumption in Brazil and Uruguay were particularly sharp (Figure 4.1). In the former, consumption has been particularly intense, and in fact it is the strongest seen since at least 2005. The slowdown (and fall) in consumption is concentrated in tradable goods, hit by the major depreciation of the currencies of the region and the moderation of labour markets.

The component of domestic demand that has slowed the most is investment (Figure 4.2), as in previous quarters. In 2Q15, it lost drive year-on-year in all countries except for Argentina and very slightly in Colombia. In the case of Argentina, the investment comparison may be driven by a major statistical effect: there was little investment in 2014. Investment dynamics were weak in the quarter for most countries of the region.

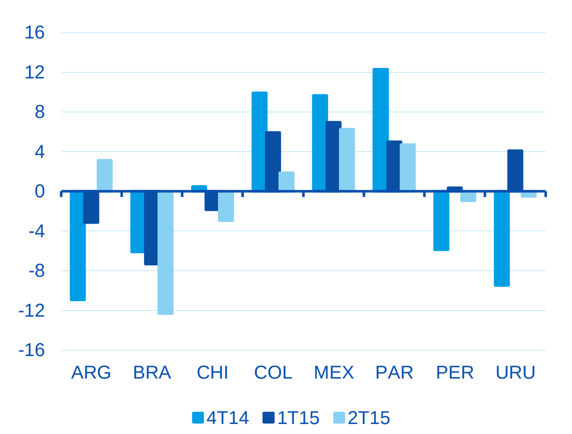
It is worth mentioning that, despite being two of the economies with the greatest potential for being affected by a recession in Brazil, the dynamics in Argentina and Uruguay have followed very different patterns, impacted by a strong drive to public expenditure and investment in the former case (normal at times of elections), so some of the positive effects will probably be reversed in the coming quarters.

Figure 4.2
**Private consumption: YoY % var.**




Source: BBVA Research and national statistics

Figure 4.3
**Investment: YoY % var.**




Source: BBVA Research and national statistics

A recovery in domestic demand will take somewhat longer to materialise, as confidence levels are expected to remain low in the coming quarters, curbing consumption and investment.

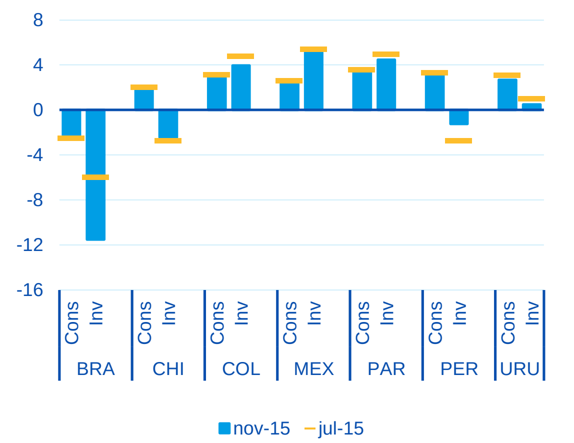
Political turmoil and fiscal deterioration mean that the expectation of lower domestic demand is particularly high in Brazil, where there are still no signs of stabilisation. On the contrary, we believe that consumption and investment will deteriorate further in the coming quarters, suggesting that 2015 will show the worst dynamics of the last decade (private consumption: down 2.6%, investment: down 11.5%) and will even continue into 2016 (consumption down 1.0%, investment: down 4.3%).

The situation in the Andean countries will also be one of more lasting moderation than the forecasts of a quarter ago. We expect the slowdown in investment to reach greater depths in Peru and, to a lesser extent, in Colombia (Figure 4.3). In Peru, unlike the forecasts of a few months ago, we now expect a greater impact of the “El Niño” phenomenon, and there are signs that growth has been driven to a certain extent by a build-up of stocks, which could be reversed. In Chile, domestic demand remains weak, particularly in investment, which implies a delayed recovery.

The exception to all this bad news is Mexico, where some recent indicators have risen surprisingly, although we expect some slowdown towards the end of the year, given the announced public spending cuts.

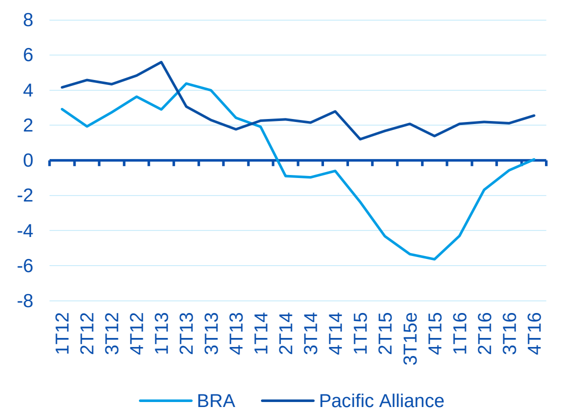
Thus, there will be a two-speed slowdown in domestic demand in South America: on the one hand, with Brazil suffering a deep recession in 2015 and 2016 and, on the other, the Andean countries (Figure 4.4 and 4.5), with slightly longer-lasting moderation than estimated a quarter ago but growing at between 2% and 3%. In Argentina, the positive dynamics of domestic demand will continue in 2015. In any event, we will not see any improvement in domestic demand in the region much before the end of 2016.

Figure 4.4
**Consumption and investment in 2015, YoY % var, expected in July and current forecast**




Source: BBVA Research and national statistics

Figure 4.5
**Domestic demand: Brazil and Pacific Alliance, YoY % var.**




Source: BBVA Research and national statistics

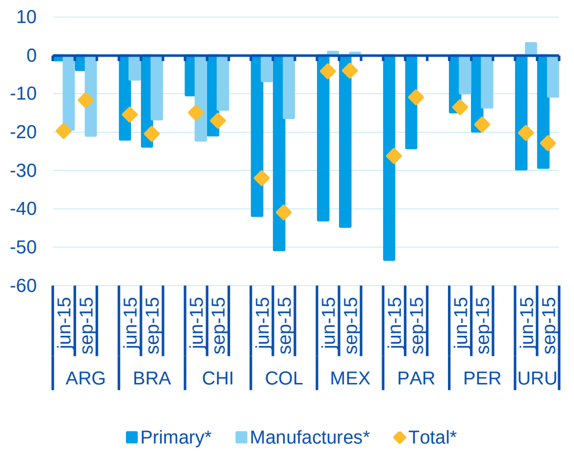
## Exports continue to suffer the impact of falling commodity prices

As mentioned in the previous chapter, commodity prices continued to lose drive in Q3 and, although we expect a recovery scenario, it will be more gentle and delayed than previously expected. These lower commodity prices have had a negative impact on the region: although commodity export volumes have not changed drastically, prices remain low, which has hit the total value of exports (Figure 4.6). In annual terms, the fall in exports has been particularly dramatic in Brazil, Colombia, Peru and Uruguay.

Non-traditional exports (in other words, those that are not either raw materials or that derive from their basic processing) have remained weak despite the sharp depreciation against the dollar in recent quarters. The slowdown of the region itself, which represents an important market for these exports (Figure 4.7), has involved slowdowns in the exports of manufactured goods in all these countries. The most striking example (albeit not the only one) is the feedback between weak demand for industrial exports between Argentina and Brazil. Furthermore, the poor response of non-traditional exports is also partially due to the fact that Latin American currencies have all depreciated at the same time, cancelling out any striking gain in competitiveness against the dollar.

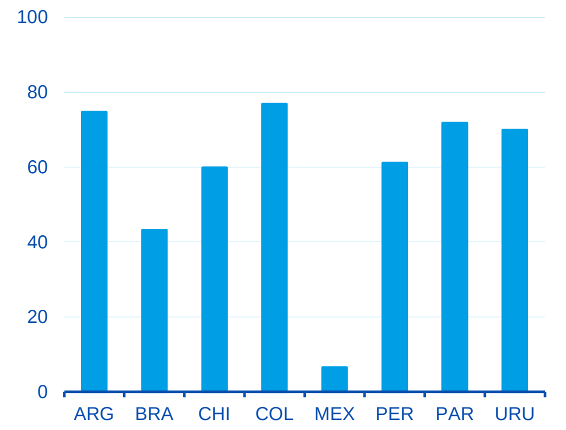
In the case of Mexico, although the automotive industry maintains high growth, manufactured exports other than the automotive sector show poor growth, despite the depreciation of the peso and also despite improved growth in the United States.

Figure 4.6
**Value of exports, YoY % var.**




Source: BBVA Research and Haver. In Chile, "Primary" products include mining products; in Colombia and Peru, they include traditional exports and in Mexico, oil exports. In Colombia and Peru, "Manufactured good" refer to non-traditional exports

Figure 4.7
**Exports of non-basic exports* to Latam as % of non-basic exports (2014)**




Source: BBVA Research and national statistics
* It includes chemical products, rubber, plastics, rubber, textiles, garments, leather and footwear, electronic machinery, transport equipment and other non-basic manufactured goods

## Economic activity will remain practically stagnant in Latin America in 2015-16 (-0.3% and +0.3% respectively)

The dynamics for the first part of 2015 were characterised by Brazil entering recession, led by a fall in investment, more prolonged moderation in domestic demand in the Andean countries, Paraguay and Uruguay and a continuing loss of value of total exports throughout the region.

In most of these countries (except Argentina and Chile), growth in Q2 was less than expected a quarter ago. This disappointing information (and in the partial data for Q3), along with less-robust prospects on the external and, more so, the internal front, have led to growth forecasts being revised down for 2015 in all countries except Peru (unchanged) and Argentina, where the positive surprise of Q2 led to the forecast for the year as a whole being revised up.

In 2015, we revised down our growth forecasts against those of July, especially in Brazil (0.8pp), Uruguay (0.9pp), Paraguay (0.5pp) and Chile, Colombia and Mexico (average 0.3pp). Peru, in turn, now sees a variation in the growth forecast for 2015 and we have adjusted it up in Argentina (0.8pp). We now expect -0.3% YoY growth in the region in 2015 (0.2% one quarter ago).

For 2016, we expect the recession to continue in Brazil, strongly determined (as we say in Chapter 7) by lack of political change and the adjustments that remain pending on the fiscal front. This adjustment will have a negative impact on the estimated growth of its main trading partners (Argentina, Paraguay and Uruguay). In the case of Argentina, we expect the positive surprise of Q2 to be reversed slightly and the future dynamics will be highly dependent on the confidence of stakeholders in the incoming government in December.

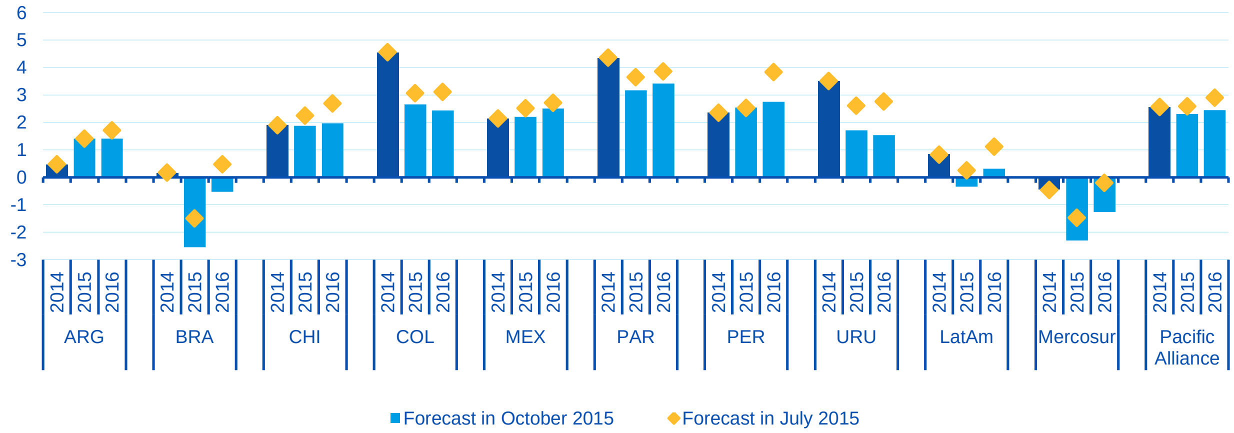
The prospects of gentle recovery in the Andean countries, underpinned by a drive in public-sector investment, coinciding with a gradual fall in political noise and the uncertainty associated with the reform processes, and a less unfavourable external environment will be consolidated too, with a slow rise in the prices of the main export commodities.

The Mexican economy maintains moderate growth. The economy has been affected by lower external demand that will improve slowly, and oil prices that have hit exports hard. On top of all these factors, there is also another one: the fact that public spending has failed to contribute to growth and the consequences of announcing further spending cuts. Despite all this, private domestic demand, but mainly consumption, continues to surprise in a positive sense. US recovery and the tendering processes related to the oil reform will be key to 2016 dynamics.

In any event, we continue to expect an increase in growth in 2016, which will be slow. This increase will depend on the drive of the aforementioned public-sector investment, particularly in the Andean countries and the expected increase in world growth (Figure 4.8).

The main element of risk for the central scenario is a greater-than-expected slowdown in China (growth of around 6% per year). This scenario would have a significant effect on the region, first of all through the trade channel and even lower commodity prices, apart from increased volatility in international financial markets, as explained in Box 1.

Figure 4.8
**GDP YoY%, 2015 and 2016**




Source: BBVA Research and Haver

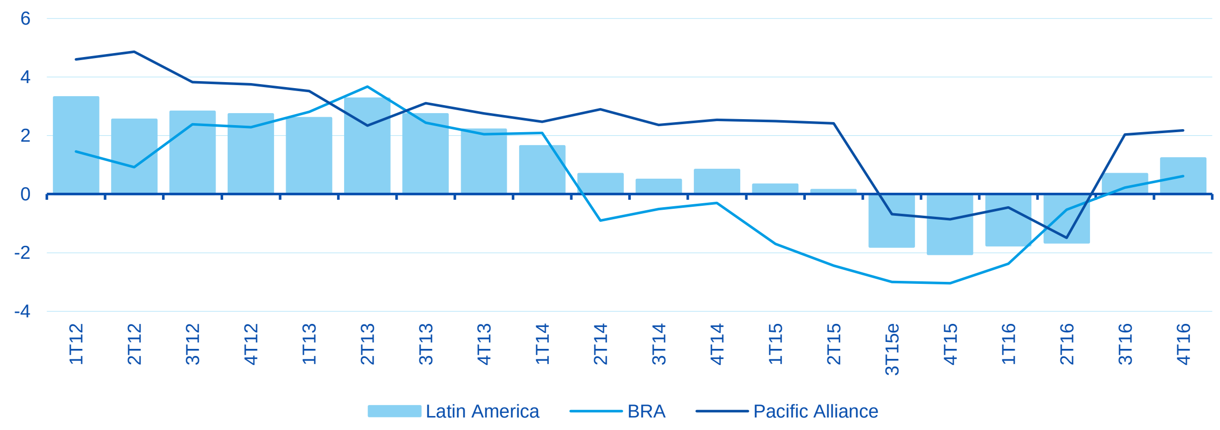
## There will be a two-speed slowdown in the region: the Pacific Alliance countries will grow by around 2.4% in 2015 and 2016, while Brazil goes deeper into recession in the same two years

All in all, the correction to growth in the region will be at two (and even three) speeds (Figure 4.9 and Table 9.1). Brazil, on the one hand, will fall into a recession that we forecast will last into 2016. We have revised our expected growth in Brazil for 2015 and 2016 from -1.5% and 0.5%, three months ago, to -2.5% and -0.5%. This is by far the most relevant adjustment, which has triggered strong corrections in Paraguay and particularly in Uruguay. In Argentina, the positive effect of increased government spending drives up the growth forecast for 2015 that we estimate will slowly reverse in 2016, so growth for 2015-16 as a whole remains almost unchanged (1.6% previously against 1.4% now).

The countries of the Pacific Alliance will adjust at a different speed. They will maintain their growth stable around 2.4% on average for 2015-16, revised down by only two-tenths against our forecast three months ago. The adjustment is less for Mexico: from 2.5% and 2.7% estimated three months ago, for 2015 and 2016, to 2.2% and 2.5% now. Thus the most affected countries in this second group will be Colombia because of the adjustment in the price of oil and Peru because of the El Niño phenomenon.

Latam as a whole will shrink slightly in 2015 (by 0.3%) and it will grow by 0.3% in 2016, well below the estimated potential growth for the region (close to 2.7%). The leaders of this growth will continue to be Paraguay (3.3%), Peru (2.7%) and Colombia (2.5%) as the average over the two years.

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




Source: BBVA Research

## Box 1. What would be the impact on Latin America of a greater slowdown in China?

Doubts over the strength of China's economic cycle and financial stability provoked a significant upsurge in financial turmoil and new corrections to commodity prices in August and September this year.

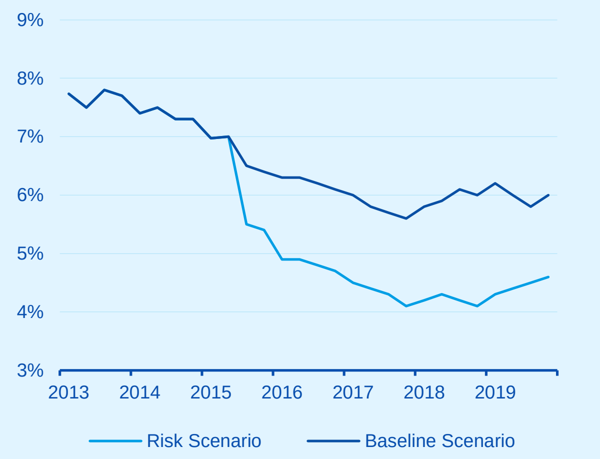
### A risk scenario for China: persistent deceleration

Even though our central scenario assumes that the authorities will continue to provide support for annual growth of at least 6%, it is still useful to examine the effect of a sharp and long-lasting deceleration in China which leads to growth that is significantly below such levels.

The touch-paper for such a low-growth scenario could be a situation of scant progress in structural reform to rebalance consumption and investment. In this setting, where there are doubts over the quality of heavy real estate investment and productive capacity, growth in China would dampen considerably in the ensuing few years. Although it would still be the case that the authorities would redouble efforts to stimulate domestic demand (probably by means of stepping up public sector investment), this would not manage to offset already shrunken private sector investment. Thus, in spite of the boost from economic policy (both fiscal and monetary), the economy would be running below its potential. At the same time, the stimulus measures would put pressure on both the CNY to depreciate and inflation to rise. This would produce a scenario of enduring stagnation where GDP growth rates would approach 4% (instead of the 6% we have in the central scenario, see Figure B.1.1), while investment would increase at under 7% YoY (Figure B.1.2) and industrial production at below 4% (Figure B.1.3), instead of the rates of 11% and 7% respectively that are envisaged under the baseline scenario.

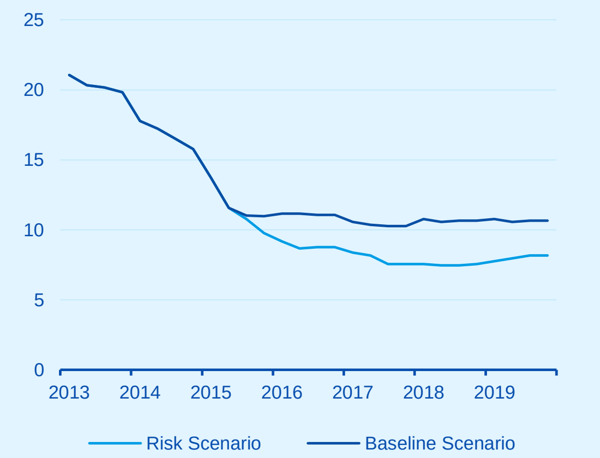
It is important to make the point that this is a scenario that has a low, yet significant, likelihood of materialising, particularly bearing in mind that the central scenario already factors in a slowdown in growth. Even so, such a scenario would have a major impact on economies that are closely linked to China, such as those in South America.

Figure B.1.1
**China: GDP growth under the baseline and risk scenarios (% YoY)**



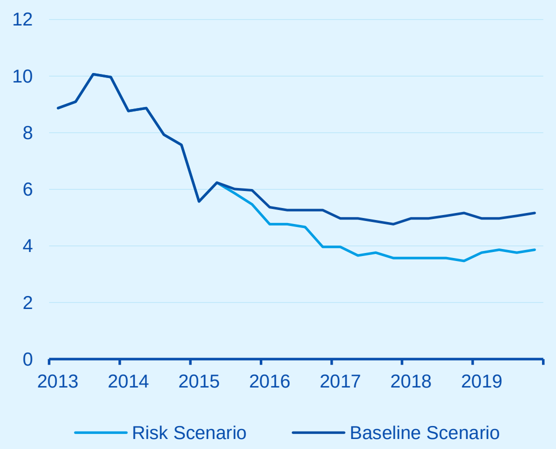

Source: BBVA Research

Figure B.1.2
**China: variation in fixed asset investment (% YoY)**




Source: BBVA Research

Figure B.1.3
**China: variation in industrial production (% YoY)**




Source: BBVA

## A negative shock in relation to growth in China would hit South America especially hard, above all via lower demand and softer commodity prices

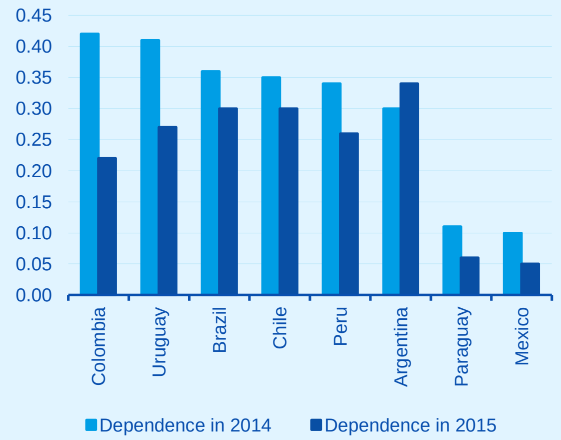
The risk scenario described above would affect Latin America mainly through two pivotal channels: i) a reduction in Latin America's external demand, though chiefly a drop in the price of key export commodities, and ii) increased global risk aversion, with the fallout being particularly harsh on the assets of emerging economies. These channels would be particularly active for the countries in South America, but less so for Mexico as it is less commodity-dependent (except as regards tax revenues) and less tied to China's cycle.

Turning to the first channel, it should be remembered that China is one of Latin America's major trading partners, especially for the South American countries. Those countries for which direct exports to China have the greatest weight out of the total are Chile, Brazil, Peru and Uruguay, which ship between 15% and 25% of their exports there. In contrast, Mexico only sends 2% of its exports to China.

Dependence on China is nonetheless not solely due to direct exports into it, but also to China's influence on the region's key commodity export prices. Specifically, a Latin American country's dependence on China will be greater the larger is the weight of its overall exports of commodities into China, where the latter has such a predominant position (on the demand side for these) that this goes a long way to dictating their final price.

Bearing in mind China's weight of this kind in the market of each export commodity, Figure B.1.4 shows a summary of the dependence index[2] for each of Latin America's principal countries with respect to China in 2008 and 2014. On the one hand, it highlights the rise in dependence on China among most of the countries over recent years (except for Argentina, owing to the fall in soybean and oil exports to China). On the other hand, it brings out the dichotomy between the high dependence of the countries in South America and Mexico's low reliance, as we have discussed earlier.

Figure B.1.4
**Index (0-1) of export dependence on China***



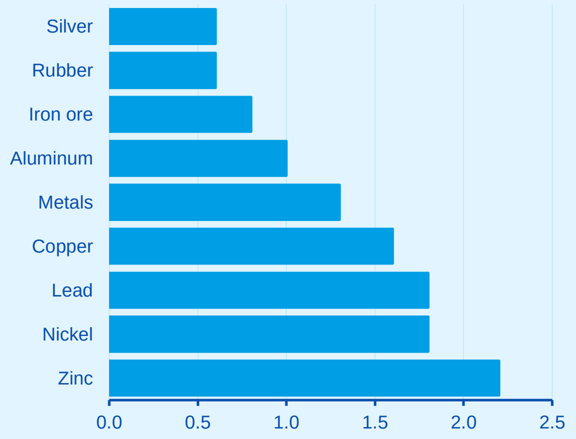

* A higher index means greater dependence on China.
Source: BBVA Research

Moreover, the impact on the prices of key export commodities will, to a large extent, depend on the strength of the demand for each type of commodity, which is created by investment in China (the GDP component that is most affected in this risk scenario). Figure B.1.5 shows the

2: For further details on how the index of dependence on China is constructed, see the BBVA Research 15/26 Working Paper "Measuring Latin America's export dependency on China" of August 2015.

elasticities of the prices of the major industrial commodities in relation to a drop in investment.

Figure B.1.5
**Elasticity* of commodity prices with respect to investment in China**



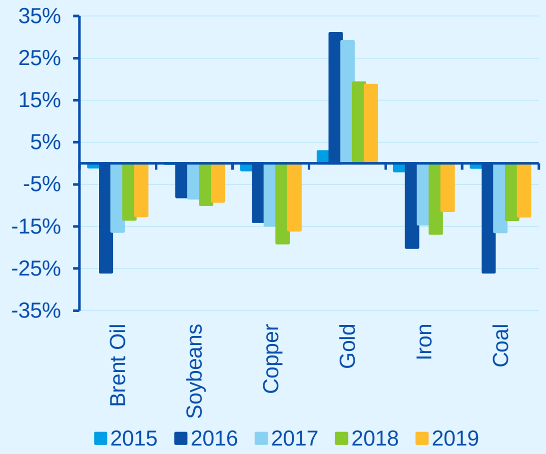

* Percentage impact on commodity prices one year after a 1pp decrease in fixed asset investment growth in China.

Source: IMF and BBVA Research

Taking into account these elasticities and the impact which we estimate for consumption and investment in China under the risk scenario, as well as the expected rise in global risk aversion (see details below) and the current glut in certain commodity markets (the most notable being the oil market), Figure B.1.6 shows the estimated impact on the prices of the region's key export commodities in relation to the baseline forecast scenario.

Particularly notable here is the strongly negative effect which this risk scenario would have on the prices of the key industrial metals (copper, iron ore), especially owing to the drop in industrial demand and for real estate investment. Prices of energy commodities would be hard-hit too, especially oil and initially even more so than metals, since the shock of lower demand would come on top of lingering doubts over the capacity to soak up current excess supply. On the other hand, food prices would not suffer such a heavy fall, since they are more closely associated with consumption, which is less affected by this kind of shock.

Figure B.1.6
**Effect on the price of major commodities under the risk scenario in China (% price difference vs. the baseline scenario)**




* Percentage impact on commodity prices one year after a 1pp decrease in fixed asset investment growth in China.
Source: BBVA Research

## The second channel for an impact on the region would be an increase in global risk aversion

A severe slowdown in China would be highly likely to bring with it a rise in global risk aversion as doubts intensify over the ability to sustain world growth, the chances of financial turbulence in China, and asset quality, both there and among the emerging economies most closely linked to it. In China's case, there could be a rise in risk premiums beyond even those seen immediately following the Lehman Brothers failure, and the impact on Latin America would be substantial, with risk premiums approaching those observed in 2009. The increase in risk aversion would unleash a flight to the safety offered by assets of developed economies and put asset prices in Latin America under pressure, as well as exchange rates. Precisely such a flight to safer assets would underpin a rise in the gold price to over the level forecast in the baseline scenario (Figure B.1.6)

### The potency of these two channels would be amplified by the adverse impact on household and business confidence, as well as the lack of available options for counter-cyclical policies, except on the fiscal front in Peru and Chile

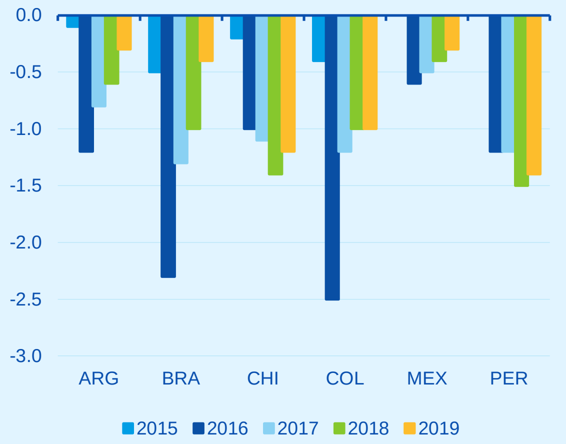
The two spillover channels would be augmented by the adverse impact on family and business confidence in the region. In fact, following the 2008 Lehman Brothers collapse, one of the main channels of transmission to Latin America was the sharp fall in confidence among both types of economic agents, which led to a very pronounced and sudden contraction of domestic demand. Given China's importance to South America, it is highly likely that confidence would crumble again, although this would be aggravated by the fact that the confidence indicators are already languishing at very depressed levels (they are actually at a lower ebb than in 2009 in the case of Brazil, for example). Specifically, we assume that the negative effect on family and business confidence would be of a degree akin to what was observed in the wake of the Lehman Brothers bankruptcy, and last for 4-6 quarters.

It should also be recalled that, unlike in 2009, the region has far less room to manoeuvre in terms of counter-cyclical economic policies that could deaden the impact of the shock. On the monetary side, the rise in inflation and the risk of unanchoring of expectations (except in Mexico) makes monetary easing highly unlikely (it would not be required in Mexico). On the other hand, fiscal scope has been used up in certain countries, such as Brazil and Argentina (and has been much reduced in the others) on account of the impact on the public finances of the drop in key commodity prices. The only exception would be Peru and Chile, where a lower base in their fiscal deficits and government borrowing in 2015 would give them some (but not too much) leeway, so as not too jeopardise their sovereign ratings. Thus policies in most countries would be clearly pro-cyclical and would leave exchange rate depreciation to absorb most of the shock.

### A scenario of sustained investment deceleration in China would have a substantial negative impact on South America, which would be best tolerated by Argentina, Chile and Peru

Faced with a scenario of slowdown in China such as that described above, domestic demand in South America would be battered by the falls in both consumption and investment deriving from the drop in family and business confidence. Even though the countries with scope for counter-cyclical economic policies (chiefly Chile and Peru) would implement some sort of initial fiscal stimulus, domestic demand would still be harmed, albeit less than in other countries where such margin does not exist. Figure B.1.7 shows that specifically Brazil and Colombia would be among the worst-hit countries owing to their high exposure to China; in Colombia's case, due to suffering from the impact of the oil price collapse (which fell more dramatically than the price of other commodities), and in Brazil's case, due to having to face the shock with very badly weakened fundamentals and a need to continue with its fiscal correction.

Figure B.1.7
**Impact on growth of the risk scenario in China (difference in pp vs. the baseline scenario)**



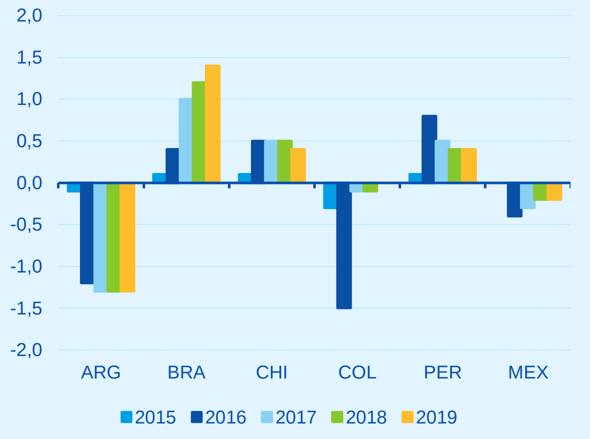

Source: BBVA Research

Meanwhile, Peru and Chile are highly exposed to a shock from China, but have something of a shock-absorber in the shape of scope for counter-cyclical fiscal policies (at least initially) which would soften the initial impact. In Argentina, the impact would be smaller, largely because the shock affects the prices of food (its chief type of export good) far less than metals, while the fall in the price of imported oil actually counteracts part of the negative effect on its external accounts. Finally, the effect on Mexico would be only marginal, on account of its low exposure to China, although its public finances would suffer from the impact of a lower oil price.

Thus, under the risk scenario, Brazil would face a withering recession in 2016 (deeper than that already built into our baseline scenario) and stagnation in 2017, while growth in Argentina and Colombia would be practically nil in 2016, although with a recovery at rates of closer to 2.5% in 2017. Growth in Peru and Chile would be reduced to only around 1.5% in 2016, thereafter picking up to a pace of between 2.5% and 3% in subsequent years. It is interesting to note that, much as occurred in 2008, the sharp reduction in domestic demand would more than make up for the deterioration in external demand and the terms of trade, which would mean that the external deficits in the case of Peru, Chile and Brazil improve on the situation in the baseline scenario (Figure B.1.8).

The results of this simulation exercise therefore show that certain countries in the region, such as Mexico, Peru and Chile, can withstand a shock from China relatively better, although their weak macroeconomic starting point means that for most countries, with the exception of Mexico, the effects are potentially quite pronounced. At the same time, the exercise underscores the importance of having some margin for counter-cyclical policies, while the stock of such scope has still not been replenished after being successfully used up to soften the impact of the 2008-09 global crisis.

Figure B.1.8
**Impact on the current account (% GDP) of the risk scenario in China (difference in pp vs. the baseline scenario)**




Source: BBVA Research

# 5 Depreciating exchange rates drive inflation in South America

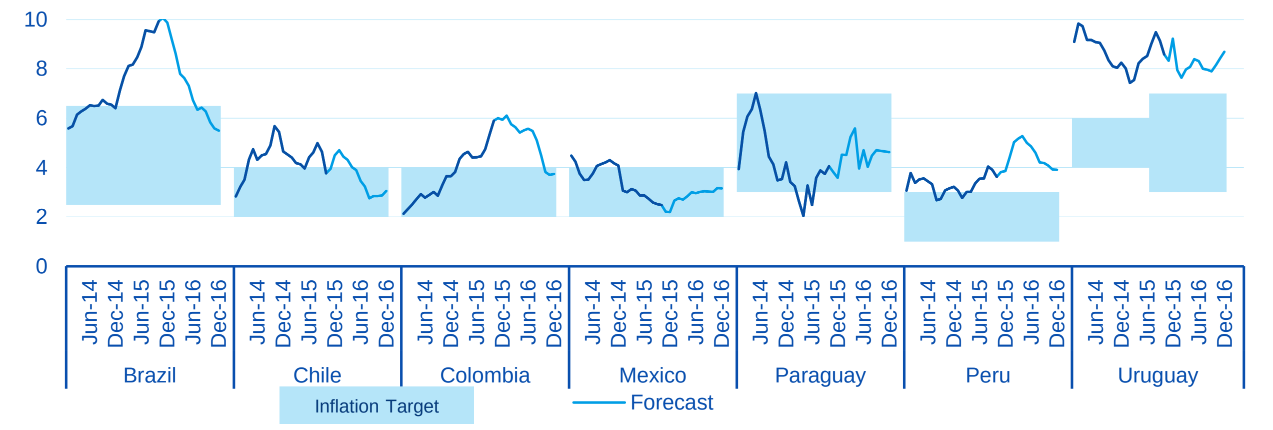
## Pressure on inflation remains high in South American countries with inflation targets, despite cyclical weakness

Despite the more negative tone of economic activity, inflation remains above target and rising in most countries of South America, in general due to supply factors. The main factor is depreciation in the exchange rate, as it is a major element of this pressure in all the countries we have analysed. The other factors include rising food prices, rising government-regulated prices and the impact of tax changes.

The situation is more complex in Brazil and Uruguay, where inflation is very high: 9.8% in the former and 9.2% in the latter. It is lower in Chile, Colombia and Peru, but in all three cases above the target range ceilings of 4% in the first two and 3% in Peru. The only country of South America where inflation is currently within the range established by the monetary authorities is Paraguay (Figure 5.1).

Inflation has been rising in all countries of South America in recent months. Exchange rate depreciation has been playing an important role in this deterioration. This is due more to the magnitude of the depreciation (Figures 3.7 and 6.2) than to an increase in the pass-through coefficient (i.e. the degree to which a given depreciation in the exchange rate is passed on to domestic prices)[3]. In some cases, such as Chile, there are even indications of second-round effects related to exchange-rate depreciation.

Figure 5.1
**Inflation: observed and forecast (% YoY)**



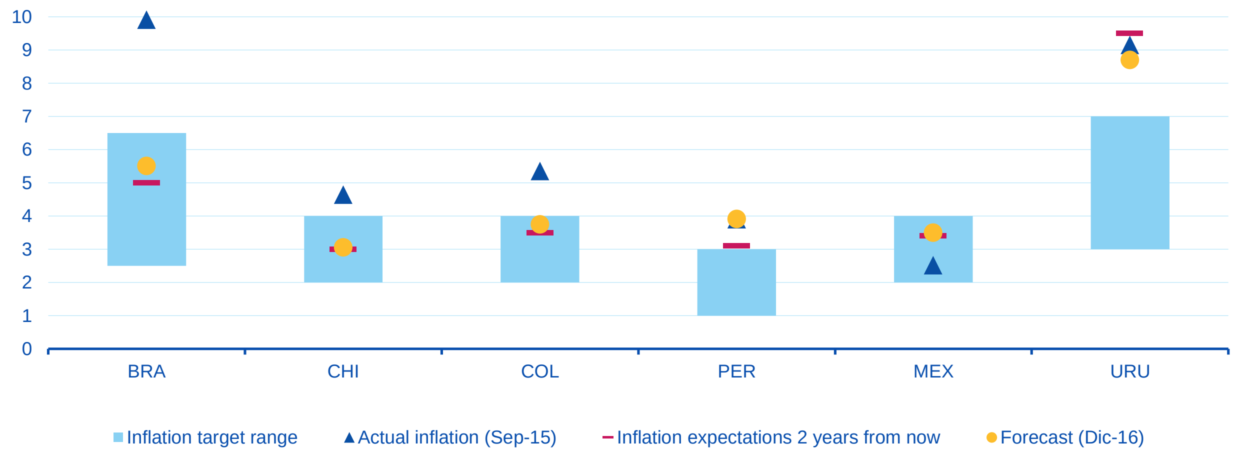

Source: National statistics and BBVA Research

Apart from this factor, the dynamics of inflation are adversely affected in Brazil by the strong increase in the prices of goods and services administered by the government (17.5% YoY in October), against a backdrop of lower fiscal margin making it more difficult to maintain subsidies through regulated prices. Another problem faced by the country is that of inflationary inertia, given that a whole range of price indexing mechanisms remain in operation. This is a problem that has affected the inflationary dynamics not only of Brazil, but also of Uruguay. In many countries, food prices have helped to drive the rise in prices in recent months. This is the case for Colombia and Peru, where the effect of weather anomalies related to the strong El Niño phenomenon has played an important role in the prices of produce.

3: For further details on this matter, see our report Latin American economic outlook of the third quarter or the report Latam Economic Observatory "Has the exchange rate pass-through to prices increased in Latin America?"

As always, these factors explain the recent surprises in inflation and, consequently, the adjustments to our forecasts in South America (see below). They also explain the deteriorating inflation expectations in many countries, mainly in Peru, where it is already above the target range of its central bank (Figure 5.2).

Figure 5.2
**Inflation: current and market expectations (YoY %)**




Source: National statistics and BBVA Research

The situation in Mexico is in contrast with the other countries of the region, as inflation remains at historic lows (2.5% in September), at the lower end of the Banxico target range and slowing down. Apart from the fact that demand pressure remains weak, low inflation is also explained by the impact of reforms in the telecommunications and energy sectors, lower exchange rate depreciation than in other countries and a relatively low degree of pass-through.

## Inflation will converge with central bank targets more slowly than expected

Inflation in the region, in general, tends to moderate as the aforementioned shock supply measures fade out, especially when exchange rates stop depreciating as fast as they have recently. When this happens, there will be a predominant effect of domestic demand that is weaker than in recent years, accompanied by a slowdown in the labour market and nominal salaries. The low tolerance that most central banks of the region have been showing to inflation and the toughening of the tone of their monetary policy limit the risk of inflationary de-coupling and support the view of future price moderation.

All in all, recent upside surprises, and a more negative scenario in exchange rate and food prices terms, have led us to adjust our inflation forecasts up in practically all countries analysed, in both 2015 and 2016. We also continue to expect inflation to converge on the inflation targets, albeit more slowly than we forecast three months ago (Figure 5.1).

Although the process of convergence on lower levels could start in the coming months, in Colombia and Peru, inflation is most likely to remain above the target range at least until the end of 2016. In Chile, the convergence process should occur sooner and inflation is expected to close 2016 at 3.1%, very close to the Chilean central bank target. In Brazil, inflation will start to moderate due to the waning strength of administered price adjustments next year and, as in the other countries, because of a moderation in domestic demand. In this case, inflation is expected to fall from 9.9% at year-end 2015 to 5.5% at year-end 2016.

Convergence with targets in Paraguay and Mexico will be different, from below, as inflation at this time is below the central point of their respective target ranges. In the case of Mexico, we forecast that inflation will remain around 2.5% until the end of this year and it will then pick up slightly to reach 3.3% by the end of 2016.

In Uruguay, there will be a very gradual moderation in inflation. Domestic prices will continue growing at a very high rate, at least until the close of 2016 with inflationary inertia feeding off index-linked salaries to a large extent.

# 6 Tightening of monetary policy in South America against rising inflation

## Rising inflation and the risk of de-coupling expectations led to a rise in interest rates in the three Andean countries

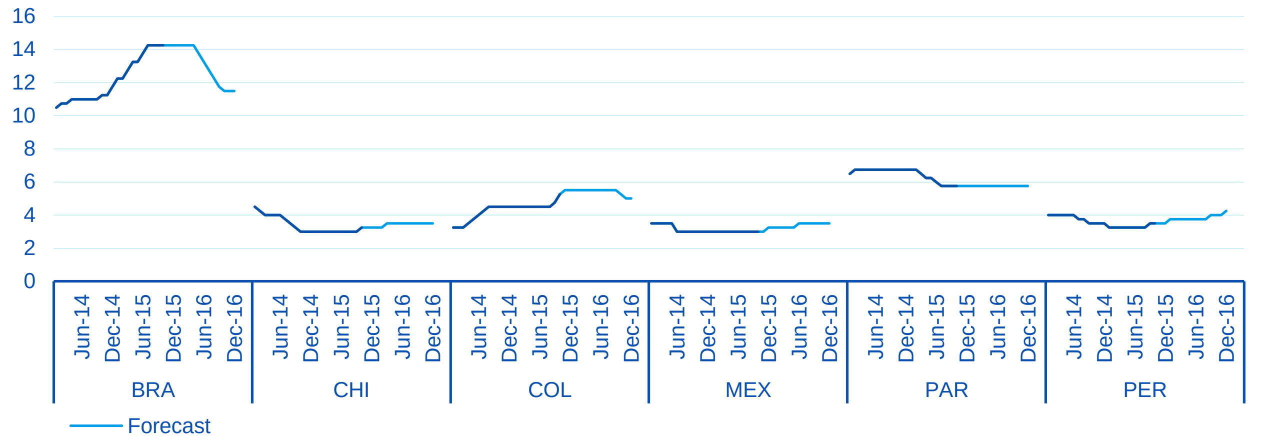
In the face of the rise in inflation in recent months, expected in part, and deteriorating expectations, the central banks of Chile, Colombia and Peru have decided to tighten the tone of their monetary policies. More specifically, the Central Bank of Chile raised its reference rate for monetary policy by 25 basis points in October, the Bank of the Republic of Colombia increased its interest rates by 25bp in September and then 50bp in the last week of October, leaving them at 5.25%, and the Central Reserve Bank of Peru increased its monetary policy rate by 25bp in September (Figure 6.1).

In all three cases, the monetary squeeze surprised at least part of the market, which expected interest rates to remain unchanged given the sharp slowdown in economic activity. The change toward a tougher monetary policy, albeit not free of risk in terms of activity, shows a commitment to inflation targets.

The Central Bank of Brazil has kept its Selic interest rate stable at its latest meetings, after adjusting it 300bp since the end of 2014 and July 2015, even though inflation continues to rise strongly. Its strategy appears to be to tolerate higher inflation in 2015 and 2016 and to keep interest rates at the current restrictive level until 2017 inflation forecasts converge at 4.5%.

Monetary policy interest rates also remained unchanged in recent months in Paraguay and Mexico, which is hardly surprisingly as inflation in both countries is not far from their respective targets. In the case of Mexico, although inflation and economic activity may have triggered greater accommodation from Banxico, concerns about the imminent hike in interest rates in USA seem to be weighing more in the risk balance of the monetary authority.

Figure 6.1
**Monetary policy rate in the countries with inflation target systems (%)**




Source: BBVA Research

## Additional hikes in interest rates are expected in the Andean countries as inflation persists. Mexico will synchronise its interest rate hikes with the Fed, at least initially

In our opinion, the process of tightening monetary conditions in the three Andean countries will continue in the coming months, after the adjustments announced in recent months. In Chile, we expect a new 25bp adjustment in 1Q16 and then the monetary rate will remain stable at 3.5% until year end. In Colombia, the most likely scenario is an additional rise of 25bp over the rest of the year and cutbacks in the monetary policy rate at the end of 2016. In the case of Peru, there will be an additional 25bp increase in January and later tightening from August, taking it to 4.25% at the end of the year (Figure 6.1). In all three cases, we would thus have a less accommodative track than we expected three months ago[4].

In Mexico, Banixco's monetary policy will most probably be synchronised with the Fed policy during the early part of the process of adjusting interest rates in USA. This synchronisation will allow the Mexican monetary authority to reduce the risk of financial volatility related to the adjustments of its neighbour. After the initial synchronisation with the Fed, the monetary authority will most probably give more consideration to the domestic fundamentals and less weight to the Fed's monetary policy. In practise, we forecast a 25bp hike in the funding rate in December and later on, in 2016, two additional 25bp hikes, so that this rate will close the year at 3.75%.

In Brazil, taking into account the recent communiqué of its central bank, after a period of stable Selic rates, which should last at least until the second quarter of 2016, the most likely scenario would be to start a cycle of monetary easing, as price pressures ease off and the 2017 inflation forecasts tend to converge on 4.5%. The risk however, is that a weaker exchange rate or new fiscal deterioration could delay this cutback to the second quarter of the year.

## Exchange rates in the region will remain depressed, driven down by the Fed's interest rate hikes and a less-favourable external environment

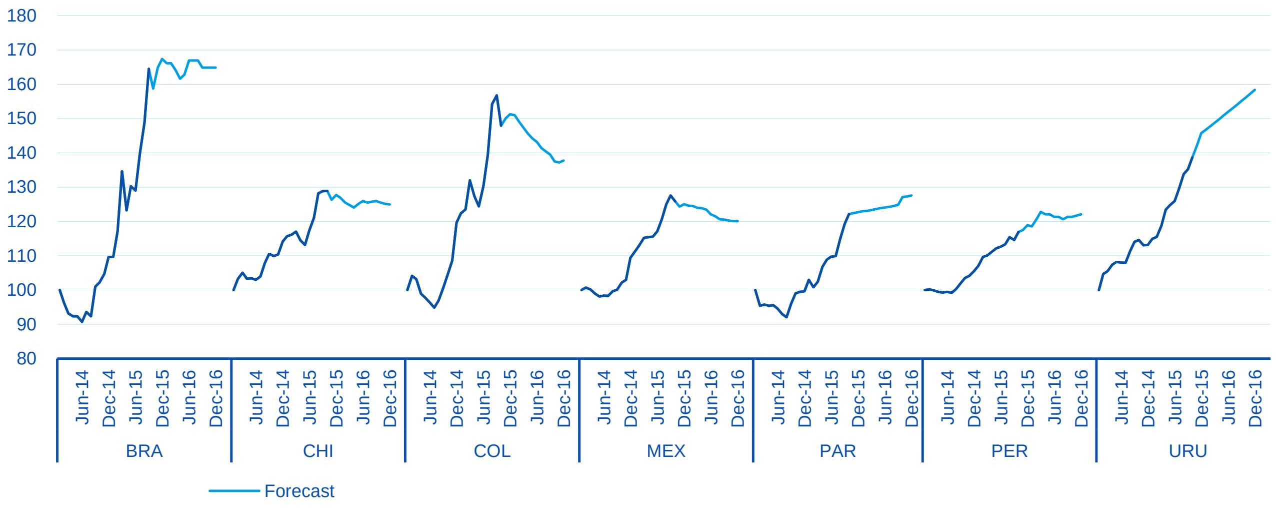
As mentioned in Section 3, both the Fed's monetary normalisation process and the adjustment of the Chinese economy will continue to determine the performance of Latin American financial markets, particularly the currency markets. Volatility will probably also persist and it will not leave too much room for any significant increase in exchange rates in the countries of Latin America.

In some countries, such as Brazil, Peru, Paraguay and Uruguay, their currencies will most probably continue to weaken further. On the other hand, in Mexico, Chile and Colombia, we forecast that, once the interest rate hikes start in USA and as commodity prices gradually adjust upward (Figure 3.9) and their fundamentals strengthen, their currencies will appreciate moderately over 2016 (Figure 6.2 and table of forecasts presented at the end of this report).

In an environment of high volatility, economic authorities may continue to adopt measures in an attempt to curb sudden movements in their currencies. Measures of this kind have recently been rolled out in Mexico, Brazil, Colombia, Peru and Uruguay, for example.

4: See our report Latin America Economic Outlook third quarter for further details

Figure 6.2
**Exchange rates: observed and expected (local currency/USD) (January 2014 = 100)**




Source: BBVA Research

# 7 High overseas deficits in Latam, which will be corrected only slowly

## The overseas deficits of the region will continue to be determined by moderate prices of the main export commodities

The forecast for external deficits for the region for 2015 and 2016 have had mixed movements. On the one hand, exports will continue to suffer falling commodity and manufactured goods prices and the moderation in demand from trading partners and, on the other hand, apart from the lower expected imports driven by lower domestic demand, we estimate that there will be lower profit remittances made by businesses, factors that will offset lower revenues on the current account.

Terms of trade have continued to worsen for most of the countries of the region, which has tended to erode the external balance. All in all, in most of the countries, lower imports on slowdowns in domestic demand and depreciating exchange rates, along with lower outflows on income from the factors of production will not be sufficient to offset a continued fall in exports and expected weaker external demand.

The balance of trade, lower imports in the region on the back of moderating domestic demand will not offset the fall in exports because of lower commodity prices and lower external demand (Argentina, Chile, Colombia, Mexico and Uruguay). In the balance of factors, we will see deficits close due to lower dividends paid out by businesses because of low financial returns (Chile, Peru). In general, the effect of increasing the deficit (or less reduction in the surplus in the case of Chile) will tend to prevail. In the cases of Brazil and Peru, we forecast an improvement in the balance of trade due to a growth in mining exports in Peru and the positive effect of depreciation on Brazilian exports. In the medium term, we will see a slightly slower adjustment in current accounts, which will continue to close as the terms of trade stabilise.

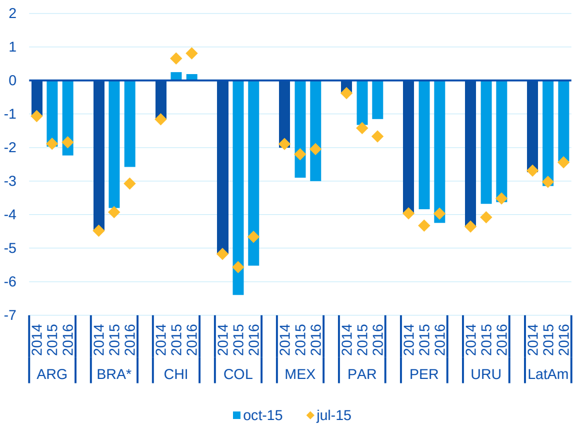
## The overseas vulnerability of the region will remain limited but there will be greater dependency on short-term financing

In Q2, Foreign Direct Investment (FDI) continued to fund most of the deficit on the current account in the region, albeit to a lesser extent than in the past (Figure 7.2). Exchange rate pressure during the quarter in turn, has been reflected in a moderation in international reserves in some countries, accentuated in Q3 in Uruguay and Paraguay and to a lesser extent in Brazil, Argentina and Colombia. In Chile and Peru, we have observed a slight improvement in reserves during the quarter.

One of the effects of the expected moderation in the region is lower outflows from the financial account associated with a reduction in the remittances – on the back of low returns on financial and corporate assets in local currency – against a backdrop of more depreciated exchange rates. This expected fall in repatriated profits will also imply less inflows of FDI, which in the future could imply greater external vulnerability insofar as a larger proportion of the current account is funded by short-term capital instead of FDI.

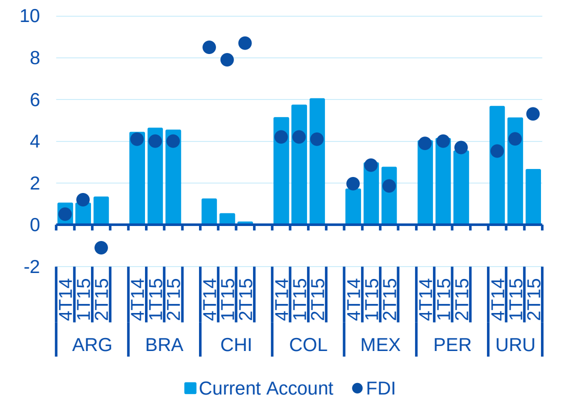
In the medium term, the convergence towards lower deficit levels will be slower than estimated a quarter ago, although in normal international liquidity conditions, it will still be possible to fund most of it with long term inflows.

Figure 7.1
**Current account as % of GDP**




* Change of methodology adopted by the BCB. Previous and current forecasts not comparable
Source: BBVA Research

Figure 7.2
**Deficit on the current account and FDI as % of GDP**




Source: BBVA Research and national statistics

# 8 Fiscal prospects hit by commodities and slowdown, and by the political process in Brazil

## Fiscal deterioration will continue in Brazil

Scepticism about the implementation of the fiscal adjustment remains in Brazil, due to the problems – largely political – that the government is facing to cut spending back and raise taxes and also because of the impact of a fall in domestic demand on revenues. Hence, the view that the country will be incapable of hitting its fiscal targets is consolidating, even though they have been revising them down recently, which has contributed to the recent downgrade from investment grade by S&P. We also expect the fiscal adjustment to occur very gradually, without preventing the fiscal results from worsening and government debt from continuing to rise. In this context, the most likely scenario is one of additional downgrades to the rating of Brazilian debt.

We have adjusted the prospects of fiscal balances for the region, particularly in Brazil (by 1pp in 2015 and 1.7pp in 2016) down from 6.7% to 9.1% in 2015 and from 5.8% to 7.7% of GDP in 2016. The fiscal situation will remain complicated in Argentina, although we maintain the prospect of a continuing fall with a deficit of around 5.9% of GDP in 2015 and 5% in 2016, assuming a track of adjustment to energy and transport prices.

In Chile and Peru, we estimate a fiscal deterioration on the back of lower tax receipts due to a slowdown in the economy, apart from the impact of lower commodity prices. In Chile, spending will increase more than forecast by the authority and in both cases, the closure of the structural fiscal deficit will have to wait a few more months. All in all, the public debt limit will be enough to finance the greater deficit which is expected. In Peru, fiscal deterioration will imply a growing government debt profile over the next few years. In Colombia, in turn, we estimate a major reduction in government spending in 2015-16, accompanied by lower revenues because of slowdown in economic activity, which maintains the prospects of a practically unchanged fiscal balance over the two years against the previous scenario (Figure 8.1). Mexico, also, has announced public spending cuts towards the second half of the year, which is already factored into expected growth and will mainly affect physical investment and, to a lesser extent, current expenditure. Despite the spending cuts, government debt will continue to increase towards 2016.

## Government investment programmes will be one of the factors of growth, especially in the Andean countries, albeit with less intensity than expected three months ago

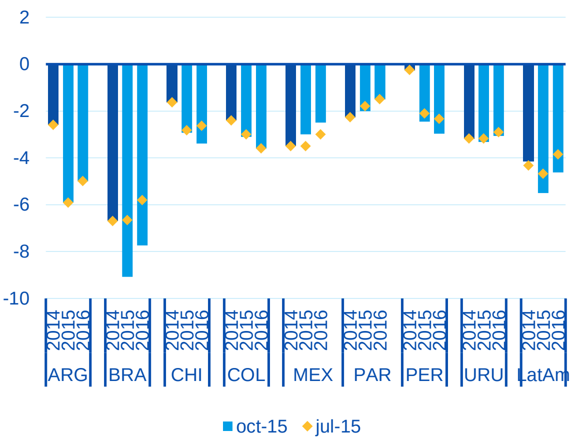
Receipts in the Andean countries will be affected by economic slowdown. Government spending, in turn, will continue to underpin growth in all three cases, albeit to a lesser extent than expected three months ago.

Chile's fiscal deficit will grow, as public spending will have a key impact on growth in 2015. Despite the reduced public investment, it will grow this year by almost 7.3% and by 5.7% in 2016. The estimated fiscal deficit will be financed by the debt limit established in the Budget Act. In Colombia, the fiscal deficit will remain stable in 2015 and incorporates an adjustment to expenditure (0.2pp in 2016). This adjustment will require a major effort and additional revenues will be necessary, thus we do not rule out a tax reform. In Peru, the falling trajectory of structural deficits posed by the government will imply less expansion of public spending and investment, although they will remain relevant.

In Mexico, forecasts incorporate fiscal reforms aimed at promoting investments such as the immediate deduction of investments in small and micro-enterprises and incentives for re-investing profits, as well as an expected cut in public spending. We lower our estimate of fiscal deficit against our forecast of a quarter ago by half a point, although we maintain the estimate that government debt will rise to just above 50% of GDP.

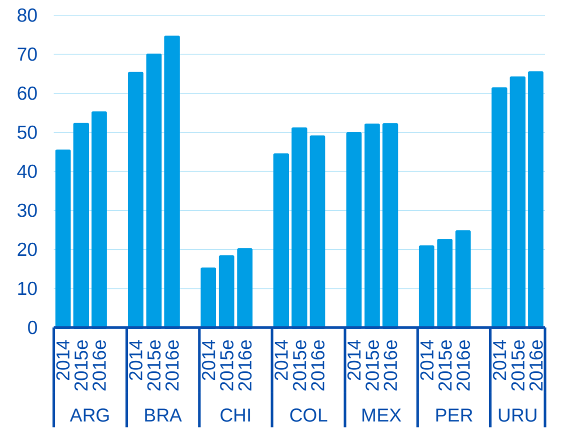
In Argentina, Paraguay and Uruguay, we expect little change in fiscal deficit against our estimates of three months ago. But changes will include a slight change in Paraguay, where the fall in tax revenues will be greater than expected last quarter and will not be offset by lower expenditure.

Figure 8.1
**Fiscal balances as % of GDP**




Source: BBVA Research and national statistics

Figure 8.2
**Gross public debt (% of GDP)**




Source: BBVA Research, WEO of IMF and national statistics

# 9 Tables

Table 9.1
**GDP (% YoY)**

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 0.8 | 2.9 | 0.5 | 1.4 | 1.4 |
| Brazil | 1.8 | 2.7 | 0.2 | -2.5 | -0.5 |
| Chile | 5.5 | 4.2 | 1.9 | 1.9 | 2.0 |
| Colombia | 4.0 | 4.9 | 4.6 | 2.7 | 2.4 |
| Mexico | 3.8 | 1.6 | 2.1 | 2.2 | 2.5 |
| Paraguay | -1.2 | 14.2 | 4.4 | 3.2 | 3.4 |
| Peru | 6.0 | 5.8 | 2.4 | 2.5 | 2.8 |
| Uruguay | 3.3 | 5.1 | 3.5 | 1.7 | 1.5 |
| Mercosur | 1.7 | 2.5 | -0.4 | -2.3 | -1.3 |
| Pacific Alliance | 4.3 | 2.9 | 2.6 | 2.3 | 2.4 |
| Latin America | 2.8 | 2.7 | 0.8 | -0.3 | 0.3 |

* Forecasts
Source: BBVA Research

Table 9.2
**Inflation (average % YoY)**

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 10.0 | 10.6 | 20.6 | 15.7 | 16.0 |
| Brazil | 5.4 | 6.2 | 6.3 | 8.9 | 6.9 |
| Chile | 3.0 | 1.8 | 4.4 | 4.3 | 3.5 |
| Colombia | 3.2 | 2.0 | 2.9 | 4.9 | 5.0 |
| Mexico | 4.1 | 3.8 | 4.0 | 2.8 | 3.3 |
| Paraguay | 3.7 | 2.7 | 5.0 | 3.3 | 4.6 |
| Peru | 3.7 | 2.8 | 3.2 | 3.5 | 4.6 |
| Uruguay | 8.1 | 8.6 | 8.9 | 8.5 | 8.1 |

* Forecasts
Source: BBVA Research

Table 9.3
**Exchange rate (vs. USD, average)**

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 4.55 | 5.48 | 8.12 | 9.25 | 12.47 |
| Brazil | 1.96 | 2.18 | 2.36 | 3.42 | 4.00 |
| Chile | 486 | 495 | 570 | 651 | 674 |
| Colombia | 1798 | 1869 | 2001 | 2711 | 2800 |
| Mexico | 13.2 | 12.8 | 13.3 | 15.8 | 16.1 |
| Paraguay | 4417 | 4312 | 4514 | 5244 | 5845 |
| Peru | 2.64 | 2.70 | 2.84 | 3.19 | 3.47 |
| Uruguay | 20.2 | 20.4 | 23.2 | 27.5 | 32.5 |

* Forecasts
Source: BBVA Research

Table 9.4
### Interest rate (%, average)

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | 13.8 | 16.9 | 22.5 | 21.0 | 21.5 |
| Brazil | 8.5 | 8.4 | 11.0 | 13.6 | 12.9 |
| Chile | 5.0 | 4.9 | 3.7 | 3.1 | 3.5 |
| Colombia | 4.9 | 3.4 | 4.0 | 4.8 | 5.4 |
| Mexico | 12.9 | 13.0 | 14.4 | 16.5 | 15.9 |
| Paraguay | 6.0 | 5.5 | 6.7 | 6.1 | 5.8 |
| Peru | 4.3 | 4.2 | 3.8 | 3.3 | 3.9 |
| Uruguay | 18.6 | 17.7 | 21.5 | 22.1 | 23.0 |

* Forecasts
Source: BBVA Research

Table 9.5
### Current account (% GDP at end of period)

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | -0.2 | -0.8 | -1.1 | -2.0 | -2.2 |
| Brazil | -3.1 | -3.2 | -4.5 | -3.8 | -2.6 |
| Chile | -3.6 | -3.7 | -1.2 | 0.3 | 0.2 |
| Colombia | -3.1 | -3.3 | -5.2 | -6.4 | -5.5 |
| Mexico | -1.4 | -2.4 | -2.0 | -2.9 | -3.0 |
| Paraguay | -2.0 | 1.7 | -0.4 | -1.3 | -1.1 |
| Peru | -2.7 | -4.2 | -4.0 | -3.8 | -4.2 |
| Uruguay | -5.3 | -4.9 | -4.4 | -3.7 | -3.6 |
| Mercosur | -1.8 | -2.1 | -2.8 | -3.1 | -1.8 |
| Pacific Alliance | -2.1 | -2.9 | -2.7 | -3.2 | -3.2 |
| Latin America | -1.9 | -2.4 | -2.7 | -3.1 | -2.4 |

* Forecasts
Source: BBVA Research

Table 9.6
### Fiscal balance (% GDP at end of period)

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Argentina | -3.5 | -3.3 | -2.6 | -5.9 | -5.0 |
| Brazil | -2.5 | -3.1 | -6.7 | -9.1 | -7.7 |
| Chile | 0.6 | -0.6 | -1.6 | -2.9 | -3.4 |
| Colombia | -2.3 | -2.4 | -2.4 | -3.1 | -3.6 |
| Mexico | -2.6 | -2.3 | -3.5 | -3.0 | -2.5 |
| Paraguay | -1.8 | -2.0 | -2.3 | -2.0 | -1.5 |
| Peru | 2.3 | 0.9 | -0.3 | -2.5 | -3.0 |
| Uruguay | -2.7 | -2.4 | -3.2 | -3.3 | -3.1 |
| Mercosur | -3.1 | -3.0 | -5.2 | -7.4 | -5.9 |
| Pacific Alliance | -1.7 | -1.8 | -2.8 | -3.0 | -2.8 |
| Latin America | -2.5 | -2.5 | -4.2 | -5.5 | -4.6 |

* Forecasts
Source: BBVA Research

Table 9.7
### Commodities forecast

| | 2012 | 2013 | 2014 | 2015* | 2016* |
|---|---|---|---|---|---|
| Oil (Brent, USD/barrel) (average) | 112 | 109 | 99 | 54 | 59 |
| Soya (USD/ton) (av.) | 538 | 517 | 458 | 352 | 332 |
| Copper (USD/pound) (av) | 3.61 | 3.32 | 3.11 | 2.51 | 2.37 |

* Forecasts
Source: BBVA Research

**DISCLAIMER**

## This report has been produced by the Latam Coordination

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