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Latin America Economic Outlook

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01
The positive effect on growth of the recovery in commodity prices will be offset by more restrictive public spending

02
Latin American GDP will contract by 1.1% in 2016, dragged down by Brazil. The Pacific Alliance bloc will grow by 2.2%

03
Growth will recover to 1.7% in 2017 thanks to increased global growth and greater investment in some countries

04
Inflation will ease slightly in the majority of countries, helped by the recovery in regional currencies

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Closing date: 23 May 2016

1 Summary

The global economic situation has improved, but world growth will remain low. The stresses in the international financial markets moderated appreciably from February on, supported by the improvement in China's economic indicators (including the reduction in downward pressure on its currency), the recovery in commodity prices and the moderation of expectations of interest rate hikes by the US Federal Reserve. World growth in the last few quarters has accelerated, but is still not enough to reach our forecast average of 3.2% for 2016; it should increase slightly to 3.4% in 2017. All the same, global improvement continues to be fragile and dependent, in the short term, both on how China's economy evolves and on the resolution of the sources of geopolitical instability present in Europe. In any case, repeat bouts of financial volatility like the one seen at the beginning of this year cannot be ruled out.

Reduced global risk aversion drove commodities and prices of financial assets in Latin America in general. In general, the assets that recovered most were those that had suffered worst in the last half of 2015, but they still did not make up the ground lost in the past two years. In any case, the market recovery may prove short-lived, given the continuing risks regarding China and the pace of monetary adjustment in the US, even though the former have diminished following the Chinese authorities' monetary and fiscal stimulus measures, while the US Federal Reserve has room to calibrate interest rates hikes in the next few months.

The majority of countries in the region will make significant adjustments to spending, more significant than we foresaw three months ago, with the big exception of Brazil. The slow recovery in commodity prices and the weakness of economic activity have led to lower tax revenues in many countries and in turn to announcements of public sector spending cuts to safeguard the fiscal rules in force and avoid jeopardising sovereign credit ratings. To this is added the gradual process of fiscal consolidation under way in Argentina as part of the macroeconomic overhaul, staring out from a badly deteriorated position. The main exception to these spending cuts is Brazil, where no significant adjustment has been possible due to the lack of political agreement on implementing the government's fiscal consolidation initiatives, which has led to further downgrading of its sovereign debt credit rating.

Despite the recovery in commodity prices, the necessary adjustments to public spending will act as a drag on growth in the region. Confidence indicators in the region remain weak, clearly pessimistic in Argentina, Brazil, Colombia and Chile and very weak in the remaining countries. In line with this weakness in household and business confidence, consumption and investment have also shown very little dynamism, and are not expected to recover much between now and the end of the year. As regards our forecasts of three months ago, the recovery in commodity prices is a positive factor for growth, but the expected increased adjustment to public spending already commented on will more than offset this effect, leading to a slight downward revision of growth forecasts for the region.

Latin American GDP will contract by 1.1% in 2016, dragged down by Brazil and, to a lesser extent, Argentina. Growth in 2016 will be badly hampered by Brazil, which will again show a significant (3%) contraction in GDP, similar to that of 2015. In contrast, the countries of the Pacific Alliance will continue to grow at around 2.5% in the two-year period 2016-2017. By countries, the main downward revisions of growth for 2016 refer to Argentina and Uruguay. In the former case, growth is revised downwards by 1.1 percentage points (pp) to a negative 0.4% in view of a monetary and fiscal policy which will remain contractive for longer than anticipated to tackle the macroeconomic imbalances that have built up over the past years. In the case of Uruguay the downward revision is by 0.4 pp due to the stagnation of private consumption which had already begun to be noticeable in 2015. For Brazil we are not revising our 2016 growth forecasts, since the

increased political uncertainty will be offset by improved terms of trade and a more expansive fiscal policy than anticipated.

Regional growth will recover to 1.7% in 2017, driven by the external sector and investment. The momentum of the export sector will be underpinned by recovery in global growth, currency depreciation and some improvement in terms of trade. At the same time we expect to see strong investment drives in countries such as Argentina, Peru and Colombia. Thus, Peru, Paraguay, Mexico and Colombia will be the countries with the most growth in 2016, to be joined by Argentina in 2017 once the economic normalisation programme starts to correct the imbalances this year and private investment recovers.

Inflationary pressures diminish slightly due to appreciating currencies. Inflation remains within the target range in Mexico and Paraguay, but is still above it in all the other countries. However, it is starting to moderate in Peru, Chile and Brazil, no doubt helped by the appreciation of their currencies in the past few months added to the slowdown in internal demand. On the other hand, inflation is refusing to come down in Argentina (increased public service charges), Colombia (food prices) and Uruguay (food and adjustment to regulated prices). In these three countries, as well as in Brazil, the greater inertia of inflation relative to other countries is another adverse factor (Box 1). Looking ahead, inflation will remain within central banks' target ranges in Mexico and Paraguay and will moderate and move towards them in the remaining countries, arriving within range at the end of 2016 or in 2017, with the exceptions of Colombia and Uruguay.

The reduction in inflationary pressures will allow central banks a breathing space, except in Colombia, where interest rates will be raised in the short term. In the past three months benchmark interest rates have held steady in Brazil, Chile, Mexico, Paraguay and Peru. In Colombia, in contrast, they have risen – by even more than expected - to reach 7.0% at the end of April. Furthermore, monetary policy has taken on a more restrictive tone in Argentina and Uruguay too. Looking ahead, the recent moderation in inflation and the weakness of internal demand will lead central banks to hold their interest rates unchanged for the rest of the year in Brazil, Chile, Peru and Paraguay. In contrast, persistently rising inflation in Colombia will lead to additional interest rate increases, to 7.5%, while Mexico will continue to act in step with whatever interest rate hikes the US Federal Reserve decides on. Argentina and Uruguay will continue with their restrictive monetary policies, at least in the short term.

The region's currencies will depreciate under pressure from interest rate hikes by the US Federal Reserve and the slowdown in China's growth. Following the appreciation of the past three months, future currency depreciation will probably be most pronounced in Argentina, Brazil and Uruguay in view of the high rate of inflation and the need to increase external competitiveness. On the other hand, in Chile, Colombia and Mexico we anticipate some room for appreciation of their currencies as the fundamentals of these economies gain in strength and in line with the gradual recovery in oil and copper prices.

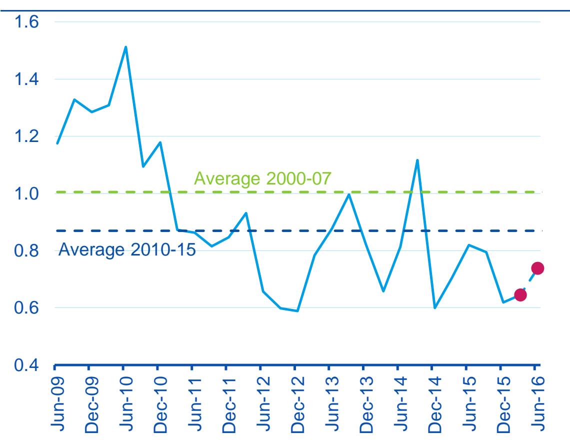
External deficits are starting to correct in the majority of countries. External deficits continue to diminish due to the depreciation of national currencies and the slowdown in internal demand. Deficits continue to be largely financed by long-term capital including foreign direct investment (FDI).

2 Global environment: fragile and China-dependent growth

The information available for the first quarter of 2016 supports our view that global growth will stabilize at low levels, although not as low as at the end of 2015. Our BBVA-GAIN[1] indicator shows that quarterly global GDP reached 0.6% at the beginning of the year (2.6% at an annualized rate), much lower than recorded between 2010 and 2015 (Figure 2.1). This growth rate, which could slightly accelerate in the second quarter, if the evidence provided by recent indicators of production, trade and business confidence is reinforced, is still insufficient for the annual progress of the worldwide economy to reach approximately 3.2% (our estimate for the whole of 2016).

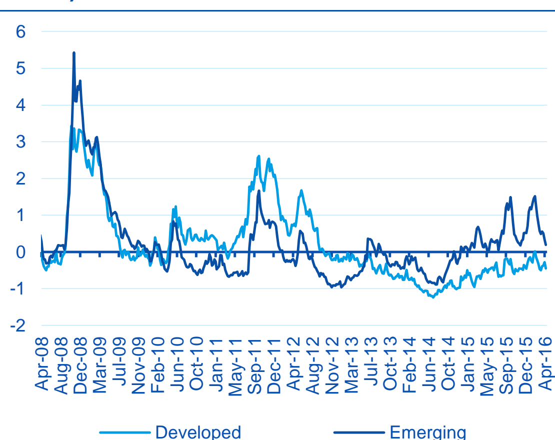
The significant increase in financial volatility observed between December 2015 and February 2016, in addition to responding to the downturn in global activity, threatens to be substantial if it continues with the same intensity and ends by being reflected in a tightening of spending decisions. The better than expected assessment for the economic indicators in China, together with the decreased downward pressure on the price of the Yuan, the recovery of prices for raw materials and the moderation of the expectations for a rise in interest rates by the Fed have been fundamental in the remission of financial stress from then onwards and in lessening, in turn, the probability of a stressful short-term scenario occurring on an international scale.

Figure 2.1
World GDP (QoQ%). Forecasts for 1Q16 and 2Q16 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA index of financial tensions (normalized values)



Source: BBVA Research and Haver

China: lower short-term risk, but more doubts in the long term

The reinforcement of incentive policies, both monetary and fiscal, by the Chinese authorities have contributed toward softening the effects of the manufacturing sector's readjustment to aggregate output and, therefore, to the trade flows of the country with the rest of the world. In the short term, the implementation of counter-cyclical measures may enable a more gradual than expected downturn in the economy. Nevertheless, if this similarly brings about a delay in the correction of fundamental imbalances, such as the increased leverage of the corporate sector or the oversupply in some areas of industry and construction, the financial vulnerability of China in the event of shocks like the one observed in summer 2015 would increase

1 See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

and, with it, its potential for destabilizing the rest of the world. Taken overall, these factors lead us to an upward revision of the growth estimates for China in 2016, up to 6.4% in 2016, and to sustained growth of 5.8% in 2017.

The international context conditions the decisions of the Fed and contributes to alleviating the pressures on emerging blocks

The weight granted by the agents of the worsening international context on the reaction of the Fed explains the delay in the expectations for the next rise in interest rates. In the face of the two increases forecast by the members of the FOMC for 2016, the market has postponed the next increase to the beginning of 2017. The reaction of the dollar, depreciating despite the relatively good behaviour that domestic demand in the United States is continuing to display, and the relaxation of the long sections of the dollar curve have contributed to alleviating the financing restrictions on the emergent block, as reflected in: (i) the BBVA rate of financial stress for this region, which has corrected the entire upturn observed for the first months of 2016 (Graph 2.2), and (ii) the reactivation of foreign capital inflows, in which net capital inflows have been produced in the emerging countries since the middle of February due, in part, to the relocation of investment flows to instruments with greater profitability.

Furthermore, since the central banks in developed economies have maintained the same tone for their monetary policies as in recent months (reinforcement or maintenance of the stimulus in the case of the ECB and the Bank of Japan; caution in the normalization of interest rates in the case of the Fed), the emergent authorities will have a greater margin for manoeuvre when prioritizing, among other objectives, economic recovery. The expected gradualism of the FED (which is a factor supporting capital flows into the region) and the recent recovery of currencies (which restricts the possible increase in inflation due to increases in the price of imported goods) limit the need to undertake aggressive increases in interest rates.

All in all, the relative improvement in the global economic scenario over the last quarter continues to be fragile and conditioned, in the short term, by both the progress of the Chinese economy and the resolution of the points of geopolitical instability that are present in Europe. In any case, in a context of high uncertainty about the capacity of the emergent block to sidestep economic deceleration and the ability of the central banks in the developed countries to relaunch growth, the occurrence of new periods of financial volatility, like the one observed at the beginning of this year, is not unlikely.

3 Reduced global risk aversion boosts commodities and Latin American assets

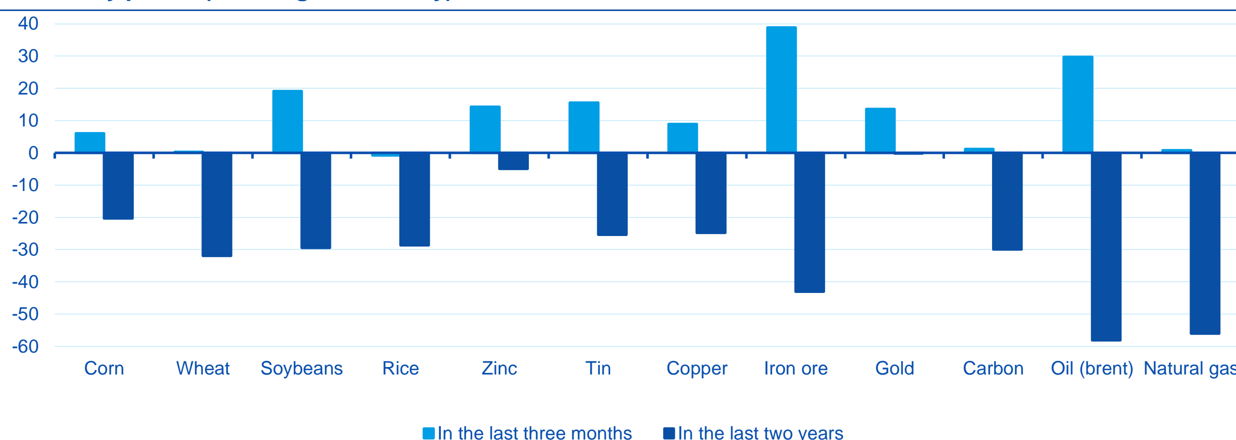
Led by iron ore, oil and soya beans, commodity prices picked up in the past three months

Following the sharp falls of the previous months (see our Latin America Economic Outlook, first quarter 2016), commodity prices have increased significantly in the past three months. The most marked increases were in prices of iron ore (20%), Brent crude (+31%) and soya beans (+18%). And while none of the main commodities showed a significant fall in price, some, such as rice, wheat, coal and natural external deficits did show practically no change in price during the period. In general, commodity prices are also considerably below those seen two years ago when concerns about the slowdown in China's economy started to grow (Figure 3.1).

We would do well to remember that the downward trend in commodity prices in the past few years, including the sharp falls seen at the beginning of 2016, has been related to the moderation of Chinese demand and doubts about its ability to avoid a hard landing. In the same line, the rebound seen in the past three months in the primary product markets is due, precisely, to the reduced risk of China's economy moderating in the short term much beyond expectations and also of the yuan depreciating sharply (see the previous section for further details on how China's economy is evolving).

The improved performance of commodity prices in the past few months is also due, in part, to the consolidation of the view that the process of monetary policy normalisation in the United States will be a gradual one. In particular, the dynamic of the US dollar, which remained at a much more depreciated level than many were expecting, has also supported commodity markets.

Figure 3.1
Commodity prices (% change, to 23 May)



Source: Bloomberg

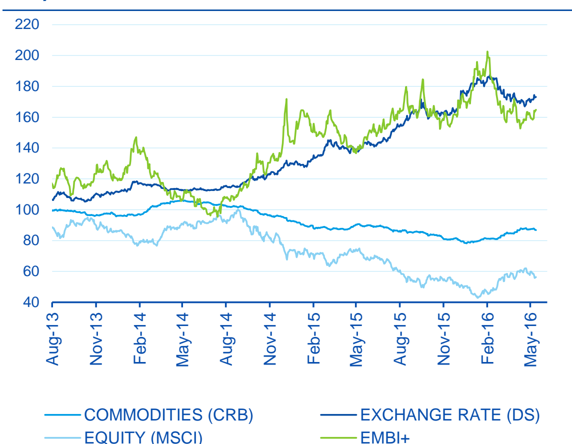
Beyond the aforementioned global factors, the price of oil was also affected in the past few months by supply decisions brought about, in turn, by the lower prices (particularly in the US), by the reduction in inventories of refined products in the US and by production cuts due to geopolitical factors or the need to maintain production facilities, as in Iraq, Turkey and Nigeria.

Soya bean markets were also influenced by less positive prospects for the next harvest, mainly due to less favourable weather conditions in the US and in the southern hemisphere. In the case of copper, another important commodity in Latin America, mainly for Chile and Peru, the recent upward pressure was contributed to, as well as by global variables, by the moderation in speculative short-selling and by a major Indonesian producer's losing its export licence.

The region's financial assets have recovered in the past few months, cancelling out some of the losses previously posted

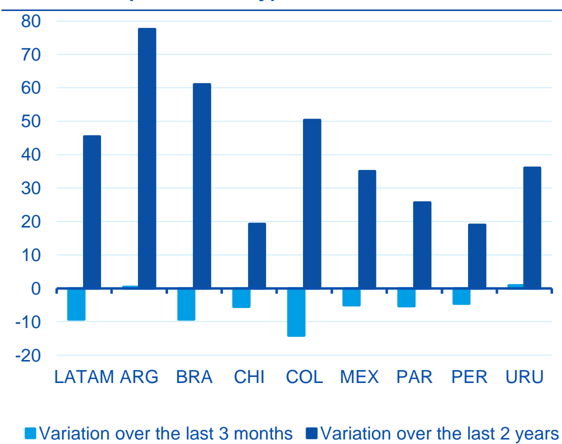
The stabilisation of global growth, reduced fears over a hard landing in China and over the monetary policy normalisation process in the US have allowed not just an upturn in commodity prices, as already mentioned, but also (and partly linked to the improved prices for primary products) a significant recovery in the prices of the main financial assets of the countries of Latin America in the past few months (Figure 3.2).

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



* Exchange rate: average for Latin American countries. Stock market indicator: MSCI. Sovereign risk: EMBI Latam. For exchange rates, an increase in the index indicates depreciation.
Source: Haver Analytics, Datastream and BBVA Research

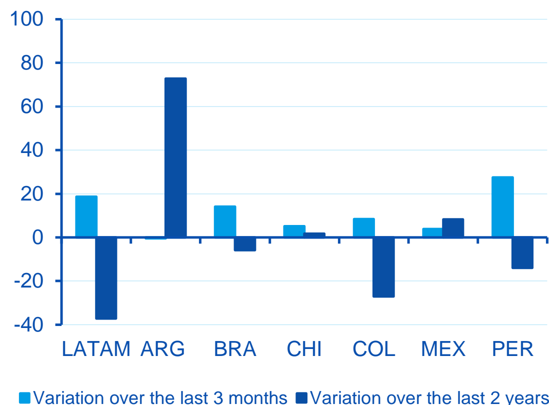
Figure 3.3
Trends in Latin American exchange rates against the dollar* (% to 23 May)



* Positive variations represent currency depreciations.
Source: Datastream and BBVA Research

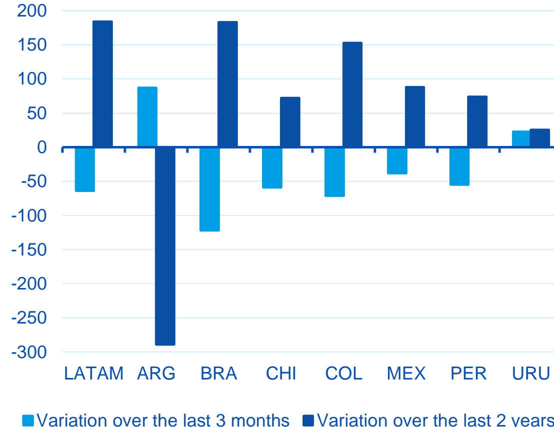
As shown in Figure 3.3, the region's main currencies appreciated, with the exception of the Argentine and Uruguayan pesos, which held practically steady in nominal terms instead (in real term, discounting both countries' high rates of inflation, both currencies have appreciated). The recent appreciation has been more marked in Brazil and Colombia (9% and 15% respectively), the previous depreciation having also been greater in both countries. Indeed, on a cumulative basis over the past two years, and in spite of recent gains, the depreciation seen in these two countries has been surpassed only by that recorded in Argentina, where exchange controls were lifted at the end of 2015. In the past few months the Brazilian real has also benefited from the strong uptick in prices of iron ore, soya beans and oil, as well as from the optimism of the country's financial markets with a government led by Vice-president Michel Temer, while the appreciation of the Colombian peso largely reflects the recovery of oil prices in world markets. The currencies of Chile, Mexico, Paraguay and Peru appreciated in the past three months by around 5% in nominal terms. In any case, even these countries' currencies are still at more depreciated levels than two years ago, when concerns about the moderation of China's growth increased and the process of gradual withdrawal of the monetary stimulus in the US started with the tapering of the US Federal Reserve's bond purchases.

Figure 3.4
Latin American stock markets: change over time (change %, in national currency, to 23 May)



Source: Haver Analytics and BBVA Research

Figure 3.5
Sovereign spreads in Latin America: change over time (EMBI, basis points, changes up to 23 May)



* In the case of Argentina, the recent changes were due not only to economic factors but also to a change in the basket of bonds used to measure country risk following April's successful bond issue to finance payment to the holdouts.
Source: Haver Analytics and BBVA Research

The global markets' relatively optimistic mood also reached the regions stock markets in the past few months (Figure 3.4). Gains were posted in all countries, rather timid ones in Mexico, Chile and Colombia and more significant in other cases. In particular, recent gains in Argentina bring the stock market's cumulative advance over the past two years to 94%, which is explained by the growing optimism over the course of the period about the probability and outcome of macroeconomic adjustments. In Peru and Colombia the recent gains on the stock markets measured in national currency have been significant, but not enough to erase the losses that have built up over the past two years. In Mexico, recent performance has been positive, with the cumulative result increasing since mid-2014. Lastly, Brazil and Chile have offset the losses suffered in the two previous years, bringing the stock market to a similar level to that of mid-2013.

As regards sovereign spreads, we have seen considerable downward adjustments in the past few months, mainly in the countries that had seen the biggest increases before that (Figure 3.5). Argentina's sovereign spread decreased by approximately 90 bps from the beginning of February to the end of April, which is when the mentioned adjustment of the index happened.

Lastly, it is important to point out that the increase in the price of financial assets in Argentina benefited not only from the macroeconomic adjustments set in train in the past few months, but also from the agreement that the country reached with its holdout creditors, which enabled it to return to global financial markets. Apart from this, it is interesting to note that the gains seen in the Brazilian markets, partly stimulated by the prospects of a new government, came about in spite of the country's further ratings downgrade announced in the second half of February (specifically, Moody's cut the country's rating by two notches, depriving it of its investment grade status, and S&P cut its rating by one notch to BB, two notches below investment grade).

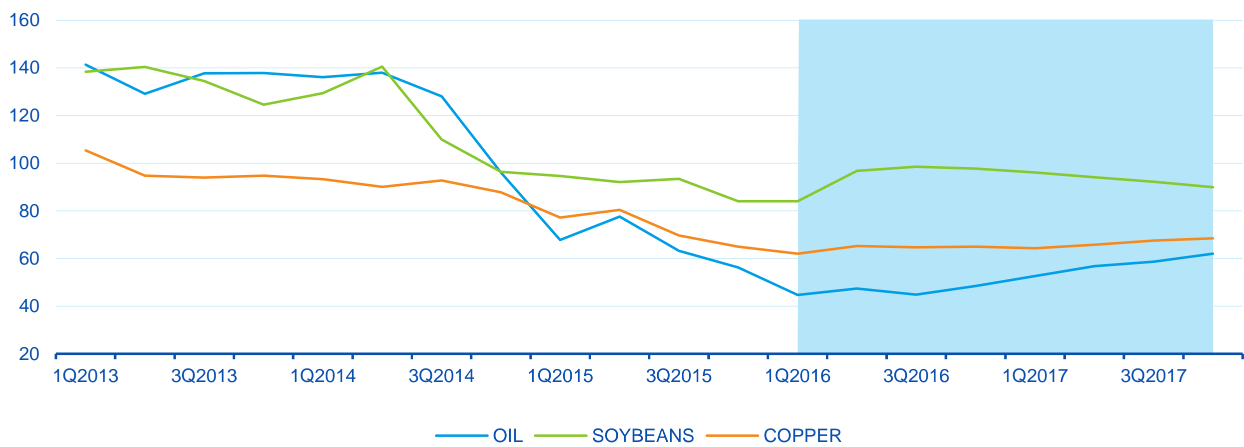
The markets' recovery may prove short-lived, since risks remain in respect of China and US monetary adjustment

In line with what we have been highlighting for some time now, the process of moderation of economic activity in China and the normalisation of monetary policy in the US have continued to set the course for global financial markets, and in particular those of Latin America. Since neither China's deceleration nor the

US Federal Reserve's rate hikes are near their end, they will both continue to influence market trends in the near future.

We are still expecting a soft landing for China's economy and an orderly normalisation of monetary policy in the US, so that most probably the region's commodity and financial markets will show a relatively positive trend in the medium and long term. However, the risks relating to both events will remain, and this will continue to be a source of volatility in global markets. In particular, we see some room for downward corrections to commodity prices in the next few months, which would jeopardise the recent gains in prices of the main financial assets in Latin America (Figure 3.6).

Figure 3.6
Projected prices of the major commodities (average index 2010 = 100)



Source: BBVA Research

4 Less expansive public spending in Latin America in 2016

Depending on the country, we anticipate significant adjustments to public spending or a considerable slowdown given the decrease in tax revenues.

Public spending will be less expansive than we anticipated three months ago in the majority of countries in the region. On the one hand, the slow recovery in commodity prices and the weakness of economic activity have taken their toll on tax revenues in many economies. In the context of reduced fiscal room for manoeuvre in the majority of countries and the achievement (and preserving) of the credibility of the fiscal rules in force, has led to public sector spending cuts being announced in many countries. To this is added the process of gradual reduction of spending (as part of the normalisation of macroeconomic policies) under way in Argentina, starting out from a badly deteriorated position. The main exception to these spending adjustments is Brazil, where more significant cuts have not been possible due to the lack of political agreement on implementing the government's fiscal consolidation initiatives. This has led to its sovereign debt credit rating being downgraded[2]. Taking account of this dynamic of revenues and spending, our public sector deficit forecasts for the countries in the region are not substantially different from those of three months ago, except in the case of Argentina (with a more ambitious reduction in energy and transport subsidies) and Peru and Chile, with public sector deficits increasing in 2016 but at a slower pace than anticipated three months ago (Figure 4.1).

In the case of Argentina the cuts in spending on subsidies will be significant, as part of the set of measures announced by the government in the first few months of the year aimed at correcting the imbalances in pubic accounts. Prominent among these measures are the increase in public service charges, electricity, gas, water, fuel and transport. Thus we estimate that the deficit will be reduced from 5.3% of GDP in 2015 to 4.1% in 2016 and that it will continue to fall until it reaches less than 1% of GDP in 2019.

Among the countries of the Pacific Alliance, Chile and Mexico also announced cuts in public spending during the quarter: the limited improvement in the prices of their main commodities has led to the need for significant adjustments to public spending. We should mention that Colombia announced cuts in public spending too, already included in the forecasts of three months ago, so that the base scenario remains unchanged. In the case of Peru, the new government is unlikely to make significant adjustments to spending, and the adjustment we have seen came about mainly due to financing delays on certain infrastructure projects.

Among these four countries the case of Chile stands out: Chile announced a fiscal adjustment of US$540 million for 2016. This adjustment is influenced mainly by the downward revision of the estimate of the long-term price of copper. We should mention that just over 70% of the adjustment will be in current expenditure. With the cuts announced, and also due to more efficient tax collection following the tax reform, we estimate that the effective fiscal deficit will be reduced from the 3.3% estimated three months ago to 2.7% of GDP estimated now.

Mexico announced cuts in public spending equivalent to nearly 1% of GDP, aimed at adjusting expenditure to the reduced oil revenues. The major part of the cut will be applied this year to the Pemex budget. These

2 : As a reminder, in February of this year Fitch was the third rating agency (after first S&P and then Moody's) to remove Brazilian sovereign debt from the investment grade category. One of the main reasons for doing so was the poor state of the country's public finances. As for Mexico, on 31 March Moody's lowered its sovereign debt outlook from stable to negative, indicating that progress on fiscal consolidation will be a determining factor for any future change in the rating. In this regard, the SHCP (finance ministry) bought back its own debt for the equivalent of 0.5% of GDP using the remaining funds from the Banxico transaction.

spending cuts will continue in 2017 in order to meet the target of fiscal consolidation. Reduced public spending could affect the growth rate for the year, but in terms of fiscal deficit we do not envisage any change from the forecast of three months ago.

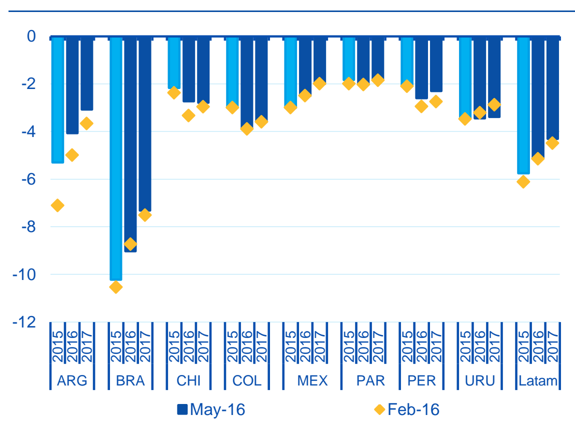
Peru for its part has corrected its fiscal deficit outlook for 2016 by 0.4 pp, so that it now averages 2.5% in the two-year period 2016-2017, compared with the 2.8% previously estimated. We would mention however that government revenue as a percentage of GDP will decline in 2016 as a result of lower tax rates, lower metal and oil prices and very slow recovery of non-primary GDP. Once the new government is installed, it will be important to establish into which infrastructure projects it intends to channel the increased resources announced.

Colombia had already announced the pertinent adjustments to its budget last quarter. The downward inflexibility of spending and the reduced external interest charges (because of the stronger currency) lead us to think that the adjustments to spending in 2016 will not be bigger than that incorporated into January's scenario. Thus, we estimate that Colombia will hold its fiscal deficit at 3.9% of GDP in 2016 and 3.6% in 2017.

In the case of Brazil, the political situation has prevented the more significant fiscal adjustments needed to halt the deterioration in the public accounts from being made. We therefore anticipate that the country's primary deficit will evolve with rather more laxity. Spending cuts will be less ambitious than initially envisaged, and the new government of Michel Temer, replacing the recently suspended Dilma Rousseff, will be hamstrung by the need to muster the necessary support in Congress for such adjustments as it may seek to implement. Thus the primary deficit as a percentage of GDP in 2016 and 2017 will be greater than that estimated three months ago (1.5% and 0.6% respectively in the new forecasts) and the total deficit will be 9% of GDP in 2016 and 7.3% in 2017.

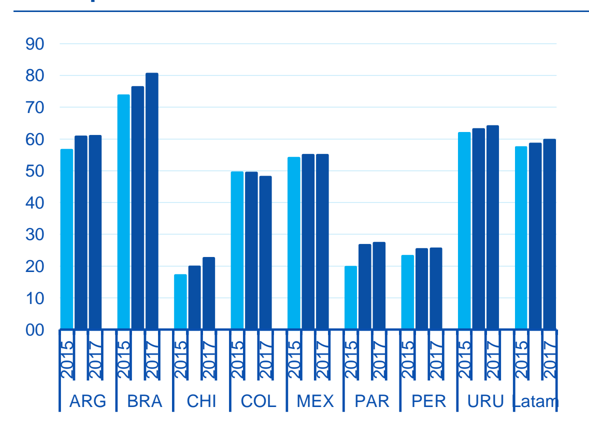
In Uruguay and Paraguay we now expect a slower reduction in the fiscal deficit in the two-year period 2016-2017. One is struck by the deterioration in the fiscal situation in Uruguay since 2014, continuing through 2015, with the considerable downward inflexibility of current expenditure and reduced tax revenues putting a stop to the reduction in public debt as a percentage of GDP which had been under way since the amicable restructuring of 2005 (Figure 4.2). For Paraguay there is no change in our expected fiscal result relative to last quarter; the reduction will be gradual so as to comply with the 1.5% of GDP limit stipulated by the law.

Figure 4.1
Fiscal Balance as % of GDP



Source: BBVA Research

Figure 4.2
Gross public debt (% of GDP)



Source: BBVA Research, IMF World Economic Outlook (WEO)

5 Spending cuts will act as a drag on growth in Latin America in 2016, despite commodities' recovering

Confidence indicators remain weak, dragging down demand

Many of the factors undermining confidence in the region still remain: (i) high level of political noise in several countries, (ii) uncertainty about economic policies (including reform processes in some countries); (iii) cyclical deterioration, including the persistence of less buoyant labour markets; (iv) high inflation, which continues to affect disposable income; and (v) a less favourable external environment influenced by the weak recovery in commodity prices (Figure 5.1).

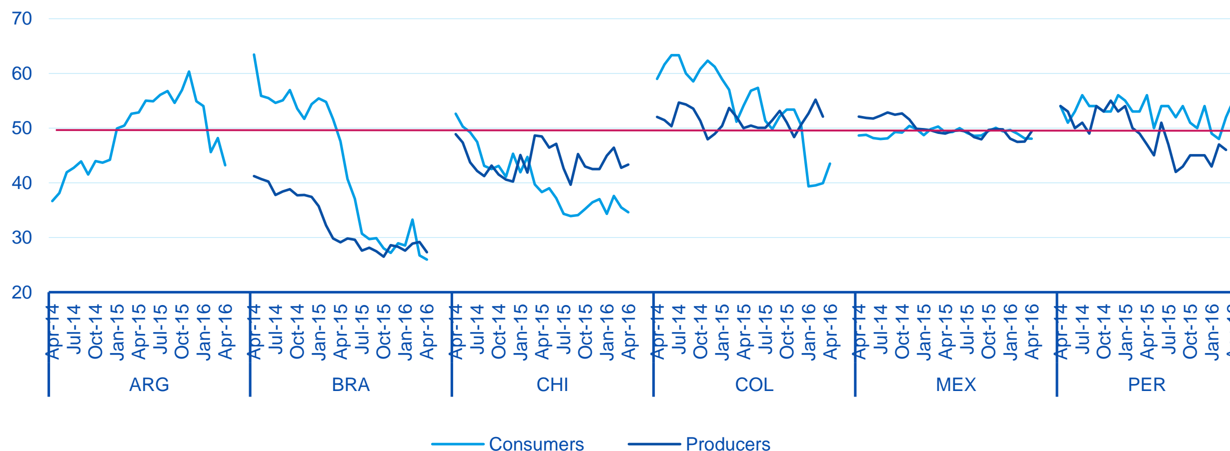
Confidence indicators remain in pessimistic territory in the majority of countries (Argentina, Brazil, Chile, Colombia and Mexico) and at only slightly optimistic levels in Peru. The sharp falls in consumer confidence in Argentina and Colombia in the past few months are particularly noticeable.

In the case of Argentina, consumer confidence has been affected by the increase in inflation following the devaluation, plus the effect of the increases (both actual and announced) in power, water and transport rates and the high real interest rates which make it difficult to buy durable goods. In the case of Colombia the sharp fall in consumer confidence is related to the President's low approval ratings, currency depreciation and consequently dearer imported goods, as well as the continued deterioration of the labour market. Paradoxically however, this fall in confidence has not been carried through to consumption indicators, which continue to show high growth rates.

In Brazil, the high level of political uncertainty, the high inflation rate and the weakness of the labour market have led to a continuous deterioration in consumer confidence, which reached an all-time low in April, less than half the level of eighteen months ago.

Business confidence remains in pessimistic territory in Brazil, Chile and Mexico, although it has not deteriorated as much as consumer confidence. In Brazil, key factors have been political uncertainty and in general the impact of currency depreciation on businesses' production costs. In Peru, on the other hand, confidence has recovered recently with the prospect of the economic model being kept in place after the first round of elections.

Figure 5.1
Consumer and manufacturing confidence (values over 50 points indicate optimism)



Source: BBVA Research

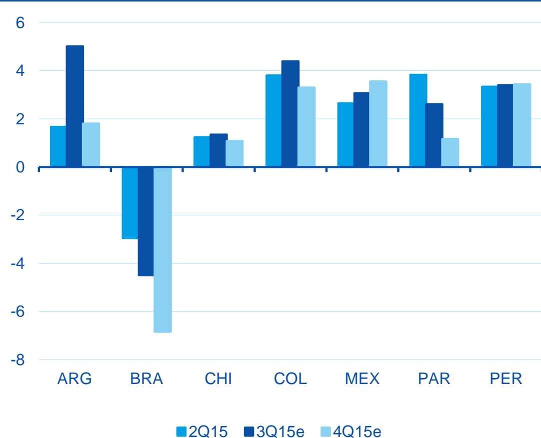
As pointed to by confidence indicators and in line with the moderation observed, consumption and investment have continued sluggish, and we estimate very little recovery for the rest of this year. Available indicators point to internal demand having grown very little in the first few months of 2016, and having in fact moderated in Argentina, Brazil, Paraguay and Peru, while in the remaining countries it will have improved slightly relative to the same period of the previous year (Figures 5.2 and 5.3). In any case, weakness of investment in the region is particularly noticeable, with falls in the last few quarters, with the exception of Mexico.

We foresee little improvement in the next few quarters, although it will be essential to distinguish a statistical component in the second half of the year in Argentina and Brazil, which in comparative year-on-year terms will show substantial growth. In the case of Argentina we foresee strong recovery in investment in the second half of the year, particularly private investment, thanks to the lifting of exchange controls and the country's exit from default which will give access to financing[3]. In Brazil we believe investment will start to flow in 2017 once the political uncertainty diminishes and the central bank starts to cut its benchmark interest rates.

In Argentina and Peru we estimate that public investment could play an important role in view of the announced infrastructure plans, contrary to the cases of Colombia and Mexico where we estimate a slowdown in public investment in 2016 and 2017 due to the reduced revenue from royalties and the low rate of execution of regional projects in the former case, and cuts to previously announced infrastructure projects in the case of Mexico. From the end of 2016, however, we estimate that public investment will pick up in Colombia due to the start of 4G works.

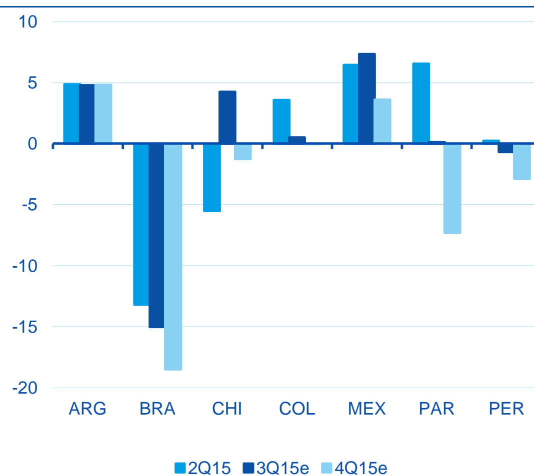
Consumption will start to recover slowly in the region from the second half of the year, driven by improvements in real wages resulting from the easing of inflation. In the case of Brazil we estimate that the falls in consumption in the second half of the year will be less sharp than those seen so far. In the Andean countries we estimate very little recovery in the consumption, although there will be some in the second half of the year. By our estimates the hoped-for improvement in private consumption in all three countries for 2017 will be slight, and with limited room for expansion.

Figure 5.2
Private consumption: Chg.% YoY



Source: BBVA Research and national statistics

Figure 5.3
Investment: Chg.% YoY



Source: BBVA Research and national statistics

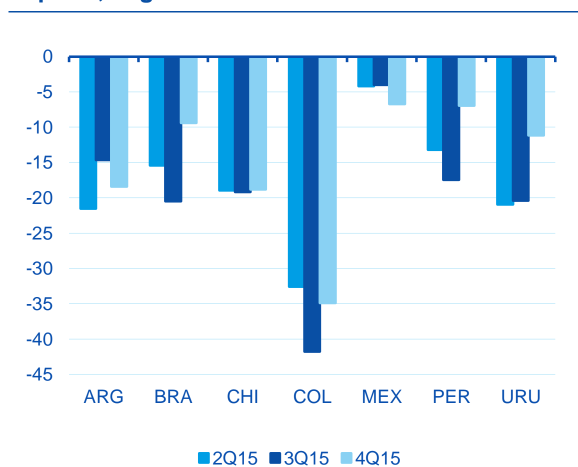
3 : Argentina declared a "statistical emergency" at the end of 2015 in the context of a process of comprehensive revision of the economic statistics. The INDEC (national statistics institute) will resume publication of statistics in June of this year. For the analysis we used series generate by private organisations (Rubinstein y Asociados).

Exports continue to suffer the impact of the fall in commodity prices and the weakness of Latin American markets

Exports remained weak in the first few months of 2016 due to the shorter commodity export cycles, although physical volumes of commodities did not decline by much. Furthermore, as has been the case in the past few quarters, the weakness of demand in the region was a further drag on exports.

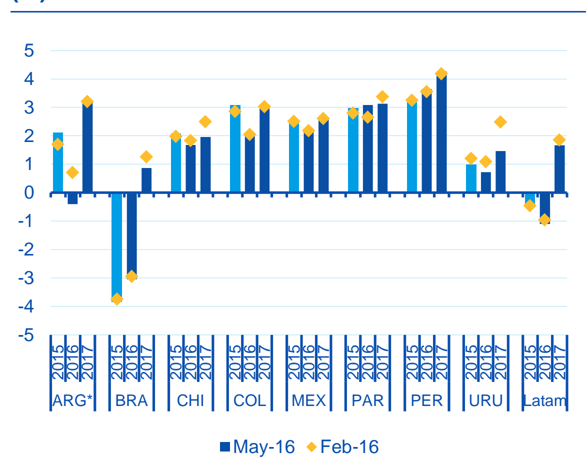
Although in year-on-year terms exports continue to fall in all countries, this decline eased in the last quarter of 2015 and available data point to its having eased further in the first few months of 2016. Argentina stood out as an exception, its exports suffering the effects of reduced demand from Brazil. For the rest of this year and 2017 we estimate a slow improvement in exports of goods, in line with the improvement in commodity prices and external demand (Figure 5.4).

Figure 5.4
Exports, chg.% YoY



Source: BBVA Research and national statistics

Figure 5.5
Latin American countries: Average GDP growth (%)



Source: BBVA Research and national statistics *For Argentina we used a private GDP measurement

Latin American GDP will contract by 1.1% in 2016 and will recover in 2017, growing by 1.7% helped by the external sector and investment in some countries.

We have revised our growth forecasts for Latin America for 2016 and 2017, since despite the increase in commodity prices, adjustments to public spending in the majority of countries will largely offset this positive effect.

Among countries in the region, the downward revision for 2016 is concentrated mainly in Argentina, which we have revised downwards by 1.1 pp to reflect the more restrictive fiscal and monetary policy adopted to tackle the imbalances that have built up in the past few years. The second biggest downward revision is for Uruguay (by 0.4 pp) and is related to the surprise 0.1% QoQ fall in growth in the last quarter of, deriving in turn from stagnation in private consumption. For Chile we have revised the 2016 growth estimate down slightly (by 0.2 pp), due mainly to the surprisingly slow recovery from the dip in consumer confidence, which remains weak.

In the remaining economies we envisage few changes this year relative to our estimates of three months ago (Figure 5.5). In particular, we have not revised our 2016 growth forecasts for Brazil, since the increased political uncertainty will be offset by better-than-expected terms of trade and more expansive fiscal policies.

For 2017, the main downward revisions are concentrated in Uruguay (down by 1 pp), Chile (0.5 pp) and Brazil (0.4 pp). The sharp revision in the case of Uruguay is due to the stagnation in private consumption and the still meagre impetus envisage for investment. In Chile we estimate that both consumers' and manufacturers' confidence will take some time to recover, given the context of very moderate growth, plus the uncertainty about the final outcome of the structural reforms under way. Accordingly we envisage no significant increases in activity but rather an economy remaining below its potential and with not much growth. The downward revision for Brazil assumes a smaller improvement in terms of trade for 2017 given the improvement of prices in 2016.

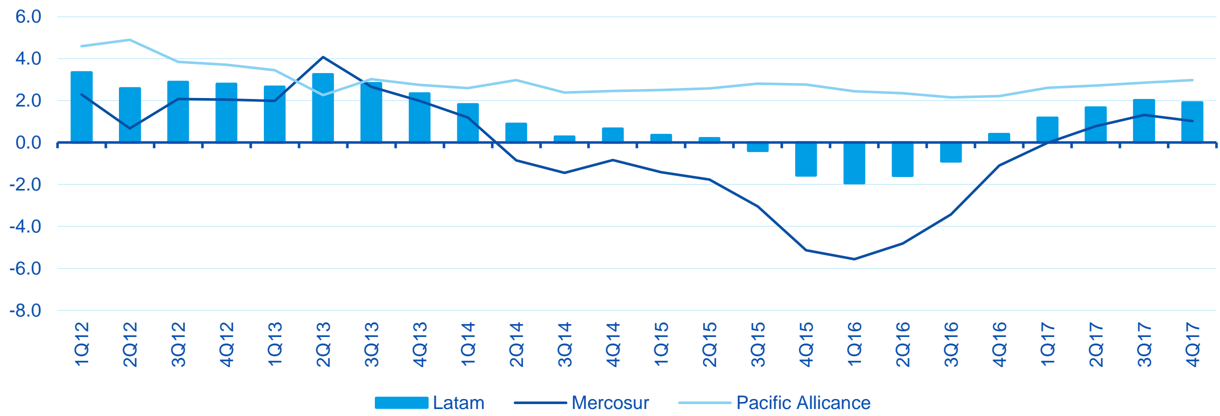
For Colombia and Peru we are maintaining our January growth forecasts practically unchanged. In Colombia, the main growth factor will be the increase in investment in both years (from 3.7% to 5.9% between 2016 and 2017), driven by the 4G works. Investment will also benefit from the reduced depreciation of the currency. Peru's increased contribution to growth will extend to 2017, mainly thanks to increased mining production, with major copper extraction projects coming on stream, and infrastructure works, with a large public sector component. To this is added relief from the toll taken by El Niño on the agricultural sector and the normalisation of oil and gas production. For Mexico too we have left our 2017 growth estimate unchanged from January (2.6%), since the country will continue to benefit from the improvement in growth in the US.

Accordingly we see the most significant increase in the region's growth coming in 2017, although this increase will be slow. The drivers of this growth will be the same as those we envisaged three months ago: (i) increased impetus from the external sector, helped by recovery in world growth, improved terms of trade and the depreciation of national currencies in the past year and a half, (ii) the resurgence of (mainly private) investment in Argentina, which will be of crucial importance now the dispute with the holdouts has been settled; and (iii) the impetus from investment in infrastructure in Colombia and Peru.

Wide disparities among countries in the region will persist. Pacific Alliance countries will be the most dynamic in 2016, and Argentina will join in 2017

The countries of the Pacific Alliance will maintain stable growth, albeit less than that seen three years ago and less than their potential, growing at around 2.5% in the two-year period 2016-2017. In contrast, Brazil will remain stuck in recession for the second year running, and will probably take a long time to come out of it (Figure 5.6). Peru, Paraguay, Mexico and Colombia will be the countries with the most growth in 2016, to be joined by Argentina in 2017 once the economic restructuring programme starts to correct the imbalances this year and private investment recovers.

Figure 5.6
Latin America countries: growth in GDP (% YoY)



Source: BBVA Research

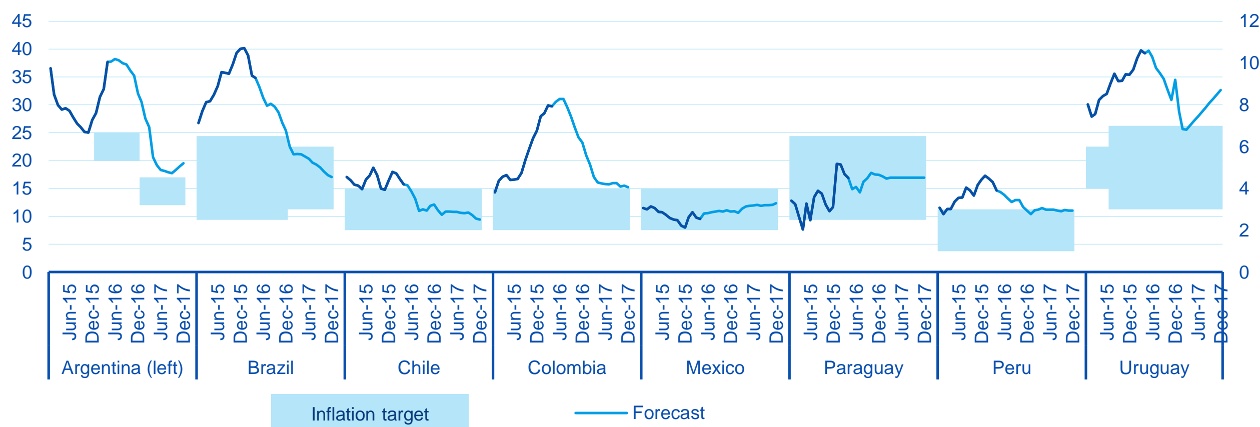
6 Inflationary pressures will ease slightly, thanks to stronger currencies and cyclical weakness

Inflation remains within target range in Mexico and Paraguay. It is moderating more clearly in Brazil, Chile and Peru, but not yet in Argentina, Colombia or Uruguay

Inflation remains within the target ranges set by the respective monetary authorities in Mexico and Paraguay, in line with the lack of demand pressure, the preventive interest rate hikes announced in the past few months, the impact of reforms on prices in sectors such as telecommunications in the case of Mexico and the reduction in regulated prices (partly due to the effect of lower oil prices on fuel prices) in Paraguay. Even so, in both economies current rates of inflation (2.5% in Mexico and 4.5% in Paraguay) are lower than in previous months (Figure 6.1).

In contrast with the situation of Mexico and Paraguay, inflation remains above the target range in all other countries of the region, with the effects of the depreciation of national currencies seen up until the beginning of the year and the pressure on food prices from adverse weather events not being entirely offset by the weakness of internal demand. Added to these regional factors are idiosyncratic factors such as the alignment of regulated prices in Brazil and Uruguay, the fiscal adjustments in Chile and the persistence of inflation (Box 1).

Figure 6.1
Inflation: observed and forecast * (YoY %)



* Left axis: data for Argentina. Right axis: data for all other countries.
Source: National statistics and BBVA Research

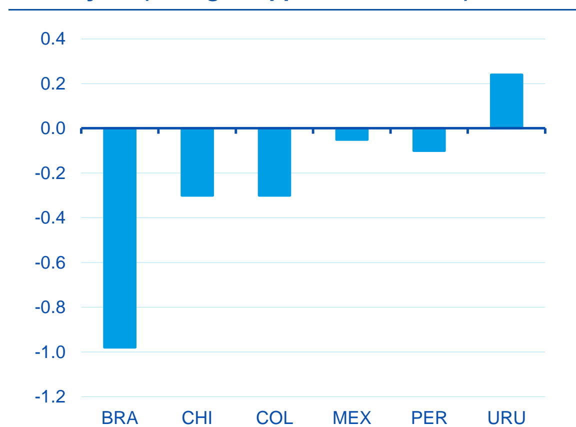
In any case, in some of the countries in which inflation remains above the target range, there are already clear signs of moderation (Figure 6.1). Specifically, inflation has been slowing for some months now in Brazil, Chile and Peru, having reached 9.3%, 4.2% and 3.9% respectively in April. The recent dynamic of inflation in these three countries has benefited not only from the fading strength of some of the sources of pressure, such as the adjustments to regulated prices in Brazil or to taxes in Chile, but also from the appreciation of their currencies in the past few months.

On the other hand in some countries inflation remains above the monetary policy reference ranges and shows no signs of easing. In Colombia, prices rose by 7.9% in April, 3.2 pp more than in April last year,

mainly because of the persistent effects of *El Niño* on food prices. In Argentina, where the inflation rate reached 40.5% in April, recent pressures have come largely from the adjustments to charges for certain regulated public services (water, gas, public transport, etc.) and from the depreciation of the peso following the lifting of exchange controls, although there is evidence that the exchange rate pass-through has diminished (see Box 2), and in spite of the effect's being partly neutralised by the more restrictive monetary policy. Lastly, in Uruguay the inflation rate reached 10.5% in April, under particular pressure from increases in food prices and regulated prices, and in spite of some progress towards cutting down on wage indexation.

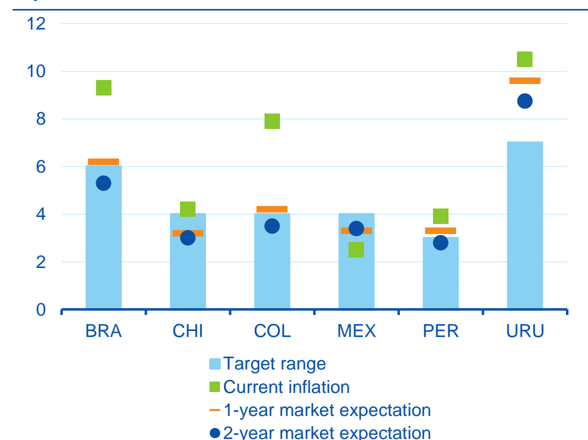
All in all, it is possible to assert that in spite of national idiosyncrasies, inflationary pressures have diminished slightly in the past few months, due to stronger currencies and the continuing weakness of internal demand throughout the region. This view is reflected in the recent adjustments to the market's inflationary expectations (Figure 6.2). However, the risk of unanchoring of inflationary expectations remains, mainly in Uruguay, but also to some extent in Brazil and Colombia.

Figure 6.2
Changes in the market's inflationary expectations at one year (change in pp since Dec. '15)*



* From December 2015 to February 2016 for Peru, March 2016 for Colombia and Mexico and April 2016 for Brazil, Chile and Uruguay.
Source: National statistics and BBVA Research

Figure 6.3
Inflation: current and market expectations (YoY %)



Source: National statistics and BBVA Research

Inflationary pressures will moderate as time goes by

Despite the fact that in some cases inflationary pressures have not dissipated in the past few months, currency appreciation, diminished prospects of future depreciation and the weakness of economic activity confirm us in our view that inflation will moderate over the course of 2016 and in 2017. Indeed these prospects of moderation are also backed up by the vigilant tone of most of the central banks, the fiscal prudence of many countries and economic growth below the potential rate. All the same, the speed of moderation in inflation will depend on the degree of inertia existing in each economy (Box 1).

Specifically, we foresee inflation returning to the target range by the end of the first half-year in Chile, by the end of this year in Peru, at the beginning of next year in Brazil and in early 2018 in Colombia, while remaining within the target range in Mexico and Paraguay.

For Chile, we have reduced our forecasts of inflation for the end of 2016 and 2017 to 3.2% and 2.5% respectively (0.5 pp and 0.4 pp below the forecasts of three months ago), in the former case largely due to the increased strength of the Chilean peso, and in the latter mainly because of the prospect of a widening output gap. For Peru, recent data have been somewhat lower than expected, in line with the stronger currency and a diminishing effect of El Niño on food production and distribution, so we have revised out

forecast for this year's inflation down from 3.2% to 2.9%. For 2017, we have adjusted Peru's inflation up slightly, to 2.9% to reflect the slightly greater currency depreciation expected next year. In the case of Brazil, we are leaving unchanged our forecasts of moderation to 6.8% in December 2016 and 4.5% in 2017, since the latest signs confirm our view that smaller adjustments to regulated prices and the impact of the current recession would eventually create space for the reduction of inflationary pressures. In the case of Colombia, we have adjusted our forecast for this year upwards by 0.6 pp to 6.2%, largely in view of the impact of El Niño on food prices, and that for 2017 by 0.3 pp to 4.1% due to the persistence of inflation following the price uptick of 2016.

Inflation will fall in Argentina and Uruguay too (sharply in the former case), although it will continue at relatively high levels (above each country's reference range). In the case of Argentina, the expectation of moderation is based on the view that inflationary pressures lose force as the impact of the exchange adjustment fades and the more restrictive tone of fiscal and monetary policies makes itself felt.

Lastly, although inflation could increase slightly in both Mexico and Paraguay, it will, in any case, remain within reasonable bounds, close to the central objectives of 3.0% in the case of Mexico and 4.5% in that of Paraguay. More precisely, we foresee inflation of 2.9% this year and 3.3% next in Mexico, practically the same forecasts as three months ago. In this case inflation will increase somewhat next year as economic activity regains its dynamism. As regards Paraguay, we have adjusted the 2016 forecast slightly upwards to 4.7% due to food supply factors, keeping the forecast for 2017 at 4.5%.

Box 1. The persistence of inflation in Latin America

When will inflation in Brazil, Chile, Colombia, Peru and Uruguay return to the target range? At what rate will inflation in Argentina slow down after the recent economic measures that have been adopted? How long will inflation stay below the 3% target in Mexico?

To address that particular issue and, more generally, to analyse the domestic price dynamic, we need to understand just how persistent inflation is in a specific economy.

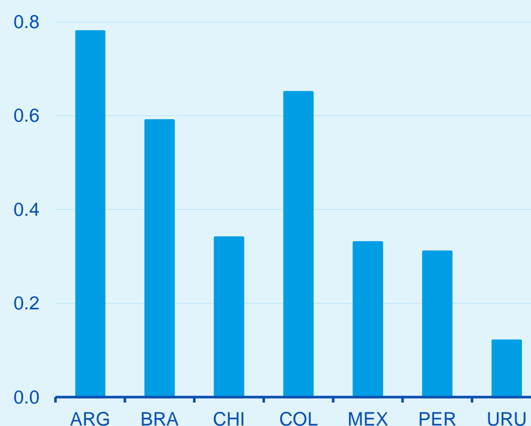
With this in mind, we have estimated an auto-regression model AR (1), in which current inflation depends solely on the level of inflation for the immediately preceding period. We have analysed monthly data from January 2004 to March 2016 for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Uruguay. As a measure of inflation, we have taken monthly inflation which we have then deseasonalised and annualised[4].

The estimated value of the parameter that relates current inflation to that from the preceding month can be taken as a measure of persistence. The higher it is, the greater the impact of past inflation on current levels, suggesting greater persistence.

Figure R.1.1 shows that the persistence of inflation based on the AR (1) is greater in Argentina, Brazil and Colombia and less in Chile, Mexico, Peru and Uruguay[5].

This initial measurement is in part determined by factors such as economic activity, the exchange rate and external inflation, among others. In order to exclude such extrinsic effects and have a measure of persistence that actually reflects the impact of intrinsically inertial factors on inflationary forces, related to the existence of price index mechanisms, we use the generalized method of moments (GMM) to estimate a Phillips curve for each economy, in which current inflation depends on the product gap, past inflation, inflation expectations, the exchange rate and the price of raw materials on global markets[6].

Figure B.1.1
Persistence of headline inflation: based on the estimation of an AR(1) model (Jan/04-Mar/16)*



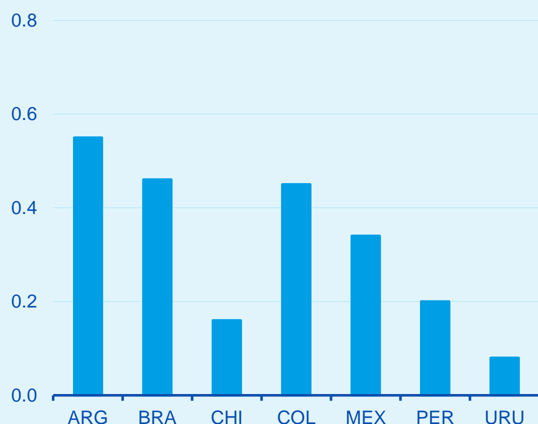
* Results are significant at 5% level, with the exception of Uruguay.
Source: BBVA Research

In this case, the parameter that relates current inflation to past levels is an indicator of intrinsic persistence, free from the effect of other variables included in the estimate.

Despite the fact that in this case, the level of persistence has changed – in general it has fallen in comparison to previous analysis – due to the exclusion of extrinsic factors, the results once again show that persistence is higher, at around 0.5, in Argentina, Brazil and Colombia, and lower in the other cases (Figure R.1.2)[7].

4 In none of the countries the inflation series exhibit a unit root, according to standard tests. In all cases, therefore, these are stationary series.
5: In the period analysed, average inflation stood at 19.8% in Argentina, 6.0% in Brazil, 3.4% in Chile, 4.3% in Colombia, 4.0% in Mexico, 3.0% in Peru and 7.7% in Uruguay.
6: We took the same measure of inflation and the same reference period as used in the AR(1) estimate, with the exception of Argentina, where due to insufficient data, analysis began in August 2006. The independent variables enter with only one lag, apart from inflation expectations, which enter contemporaneously (and have to be instrumented for)..
7: The introduction of further backwardness to the explicative variables does not notably change results, although in the case of Chile it means that the level of persistence is significant at 5% and somewhat higher (at around 0.25).

Figure B.1.2
Persistence of headline inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*



* Due to data issues, the sample for Argentina starts in August 2006. The results are significant at a 5% level for Argentina, Brazil, Colombia, Peru and Mexico and at 10% for Chile.
Source: BBVA Research

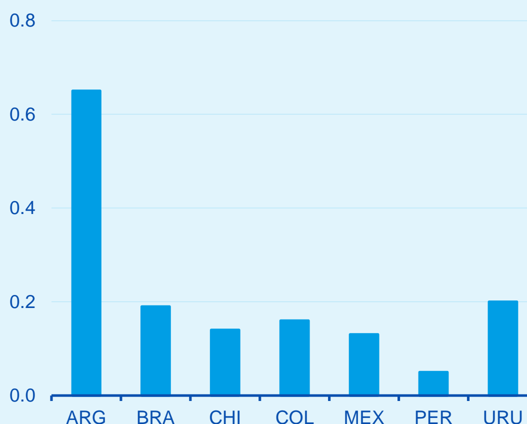
We have re-estimated the previous model using a dependent variable, instead of general or underlying inflation, which exclude the calculation of more volatile prices, for example foodstuffs and regulated prices. In this case, the level of estimate persistence is generally lower than with the general inflation model, with the exception of Argentina and Uruguay, where, due to a lack of data, samples are not identical[8]. The result still shows that persistence is lower in Chile, Peru and Mexico and higher in Argentina, Brazil and Colombia, although the difference in the level of persistence in the latter two countries compared to Chile, Peru and Mexico is small. Results in this case show a greater persistence relative to inflation in Uruguay compared to other countries (Figure R.1.3).

In general, results back up the idea that inflationary inertia is lower in countries where central banks have been less tolerant with regard to inflation and higher in countries where inflation is usually higher[9].

Finally, in order to analyse inflation persistence in the long term, we have estimated both the Phillips curve with general and underlying inflation for the past three years (April 2013 to March 2016) and for earlier periods of the same duration.

Despite the fact that the reduced size of sub-samples reduces the robustness of the results, both models suggest that inflationary inertia has increased over the past three years in Colombia, Peru and Uruguay. In other cases, results are not so conclusive.

Figure B.1.3
Persistence of core inflation: based on the estimation of a Phillips curve (Jan/04-Mar/16)*



* Due to data issues, the samples for Argentina and Uruguay start in April 2008 and January 2011, respectively. The results are significant at a 5% level for Argentina, Brazil, Colombia and Mexico and at a 10% level for Peru and Uruguay.
Source: BBVA Research

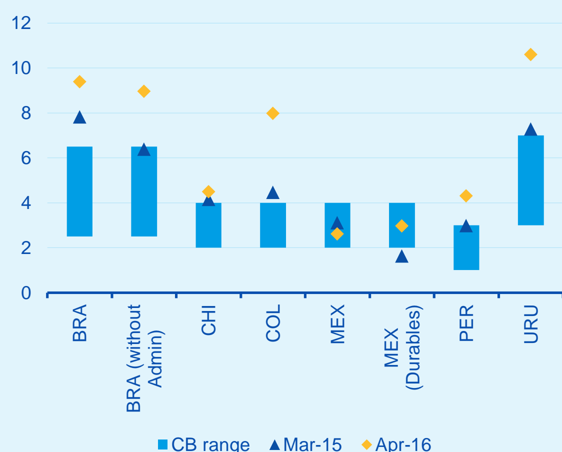
In general, analysis shows that indexing mechanisms play a more negative role in processes designed to ensure the convergence of inflation with targets over the coming months, mainly in Argentina, but also in Brazil, Colombia and Uruguay. In Chile, Mexico and Peru, these factors are of less relevance to future inflation, although not necessarily less than a few years ago in the case of Peru.

8: The comparison of the two models using identical periods of time shows that in both countries, persistence is higher in the underlying inflation model.
9: Results do no change significantly with the inclusion of more inflation backwardness in the model.

Box 2. Has the exchange rate pass-through increased in 2016 in Latin America?

For more than a year now, inflation in the majority of Latin American countries has been above central banks' target ranges, with the significant exception of Mexico (Figure R2.1). Much of the increase in inflation during this time has been a knock-on effect of the sharp currency depreciation seen in the majority of countries since mid-2014.[10]

Figure B.2.1
Central bank target range & inflation, Mar.'15 & Apr.'16

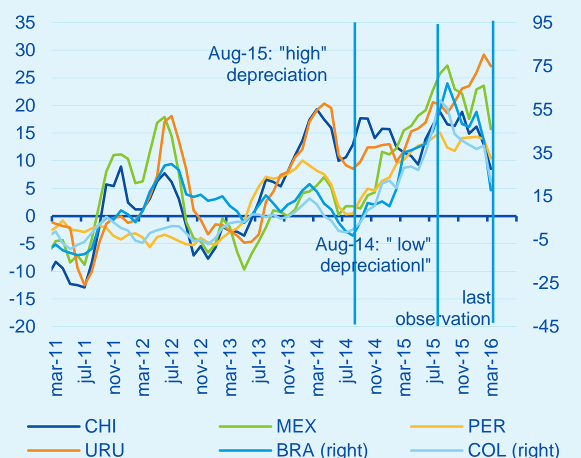


Source: BBVA Research

From a preliminary analysis with data up to the first quarter of 2015[11] one could deduce that the impact on domestic inflation had mainly been due to the magnitude of the depreciation of the currency rather than to an increase in the exchange rate pass-through. All the same, the question remains as to whether in the case of a currency depreciation that is expected to be permanent, there may possibly be an increase in the exchange rate pass-through. In fact the academic literature acknowledges that the exchange rate pass-though usually increases in periods of greater currency depreciation and at times when the weakening of the currency is perceived as a persistent phenomenon, which is the case with many economies in the region.

In this box we study whether the current degree of exchange rate pass-through has changed relative to that seen at two other times[12]: before the last bout of volatility, which we place in August 2014; the time of maximum depreciation (August 2015) and the present[13] (Figure R2.2).

Figure B.2.2
Currency depreciation in Latin America (YoY %)



Source: BBVA Research

As with previous estimates, it is necessary to bear in mind that in many of the economies of the region the exchange rate has not been the only factor behind the increase in inflation, but that there have been other idiosyncratic factors such as tax increases in Chile and Brazil, supply shocks to food prices in Colombia, Peru and Brazil, government realignment of regulated prices in Brazil and regulatory reforms and changes in Mexico. The cases of Brazil and Mexico are particularly notable in this regard. In Brazil, the increases in regulated prices had a big impact on inflation; while in Mexico, the reforms and increased competition in the telecommunications sector pushed inflation down. In both cases there was considerable influence on the general level of prices, for which reason we also analyse inflation trends discounting these components.

10 See for example the analysis of the causes of the surprise increase in inflation in Latin America Economic Outlook, second quarter of 2015.
11: See Observatory "Has the exchange rate pass-through increased?" October 2015.
12: We have updated the model estimated one year ago: Has the exchange rate pass-through increased in Latin America? October 2015.
13: Argentina is not included in the analysis since official price series are not yet available.

In order to ascertain whether there has been an increase in the exchange rate pass-through, we estimated a uniform VAR model for all countries. The results of estimates that take account of the idiosyncrasies of each economy are consistent with those of this uniform exercise.

Analysis with a VAR model: uniform estimate

A time-variable coefficients VAR is used for the period January 2000 to March 2016 with monthly data[14]. Estimates based on data to March 2016 are compared with estimates of August 2014 and August 2015. We seek to establish whether the exchange rate pass-through is greater or less now than at those two earlier dates and whether this difference is statistically significant.

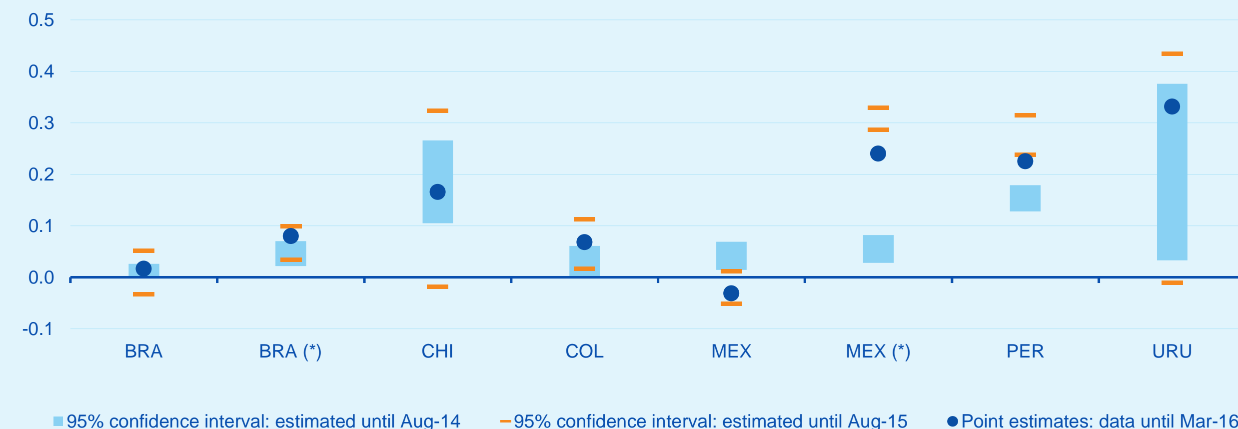
For all countries we use the national CPI. For Brazil and Mexico we also estimate two price sub-indices, since we consider it of interest to assess the pass-through to specific baskets with significant weight in each. In the case of Brazil we use the price index that does not take account of regulated prices[15]. In the case of Mexico we use the durable goods price index, since when looking at each price index separately it stands out as the one with the biggest increases. As can be seen in Figure R2.3, we found evidence to suggest that, compared with two years ago, the response of inflation to currency depreciation has increased slightly in Peru and significantly in Mexico (taking only durable goods into account in the latter case). All the same, in the case of Mexico it has to be borne in mind that there is no evidence of second-degree effects on other prices (and some of them have received favourable shocks) and the depreciation has taken place in a context of weak demand and slack in the economy.

The current estimate of the exchange rate pass-though is not statistically different from those made with data to August 2014 or 2015 in Brazil, Colombia, Chile or Uruguay, although in all three cases there is a very high degree of statistical uncertainty. In the case of Mexico we would add that there is no evidence of second-degree effects; there are favourable shocks on other prices and the depreciation has taken place in a context of weak demand and slack in the economy.

Apart from this, we find that the correlation between the exchange rate pass-through and the extent of currency depreciation is positive and has increased in nearly all countries (Figure R2.4), which suggests greater asymmetries in the exchange rate pass-though (greater at times of depreciation than at times of appreciation such as those seen more recently). The only exception in the general sub-index is Mexico. In this case the low ratio confirms that the exchange rate pass-through is centred on durable goods and not on the rest of the basket, for which inflation has continued at all-time lows.

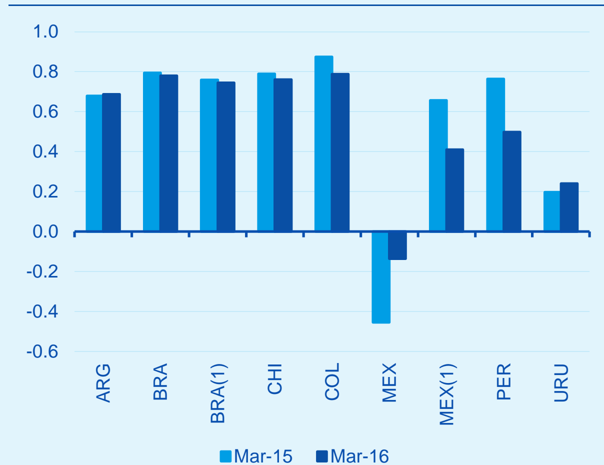
14: Endogenous variables include the following: an index of economic activity, benchmark interest rate, the exchange rate of the national currency against the dollar and the general price index. Exogenous variables include the US Industrial Production indicator, the US Federal Reserve interest rate, the US CPI and the IMF Commodity Price Index. The reason for making this estimate by means of a time-varying coefficients VAR (TVC-VAR) is that this method estimates the coefficients best suited to the model at any given time, as opposed to the average of the sample as with a conventional VAR. The TVC-VAR allows the estimated coefficients to vary over time; the idea underlying this method of estimation is to take account of changes affecting relationships among variables in the series. The exchange rate pass-through is calculated as the cumulative response of inflation in the first year to a 1% change in the nominal exchange rate.
15: It also has to be borne in mind that regulated prices have a very different dynamic from free market prices and a weight of approximately 23% in the CPI.

Figure R.1.3
Cumulative 12-month effect of a 1% currency depreciation



* BRA (*) and MEX (*) refer to the index of unregulated prices in Brazil and to the basket of durable goods in Mexico. For the rest, reference is made to the national CPIs.
** Does not correspond exactly to the pass-though ratio as idiosyncratic items are excluded from the estimate.
Source: BBVA Research

Figure R.2.4
Correlation ratio between the cumulative 12-month impulse response of inflation to an exchange rate shock and appreciation (-) or depreciation (+) (moving six-year correlation)



Source: BBVA Research

Conclusion: in general, persistent currency depreciation has not led to increased exchange rate pass-through.

The uniform estimate for the countries studied shows that, in general, there has been no significant increase in the exchange rate pass-through in the region, in spite of currency depreciation which, in view of its intensity and structural backdrop (slowdown in China and moderation of commodity prices) can be perceived as persistent. The main exception is Peru, where we do see an increase in exchange rate pass-through compared with two years ago, but a downward correction relative to the estimate made with data to August 2015. In Mexico too we see a significant increase in the pass-through from exchange rate to prices of durable goods, but not to prices in the general index.

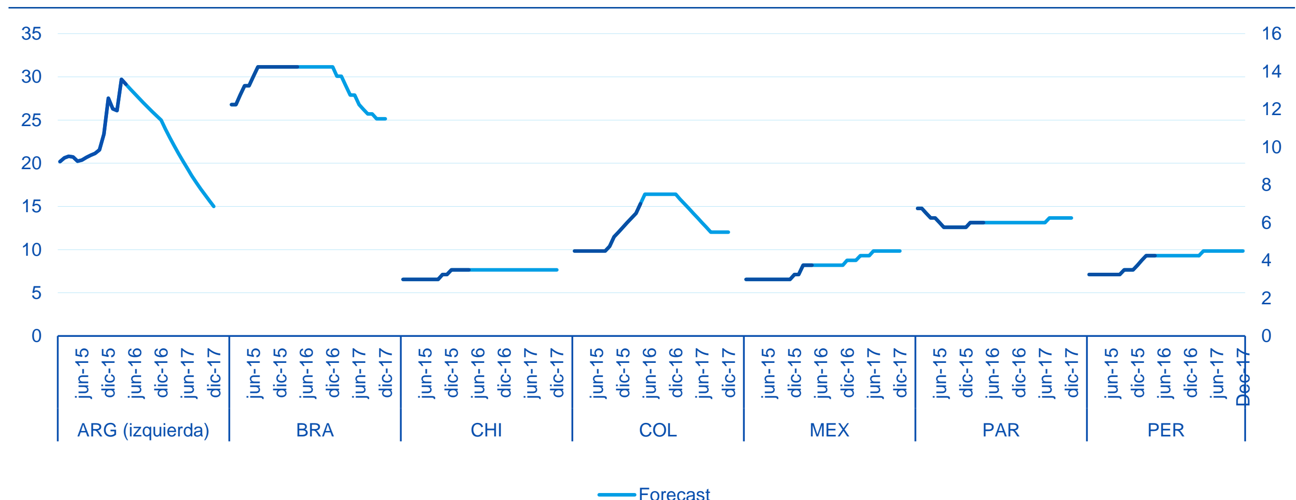
7 Monetary policy on hold in most of the region

Reduced inflationary pressures allowed benchmark interest rates in Latin America to remain stable, with the main exception of Colombia

In the past three months benchmark interest rates have held steady in Brazil, Chile, Mexico, Paraguay and Peru. In Colombia, in contrast, they have risen – by even more than expected - to reach 7.0% at the end of April (Figure 7.1). Furthermore, monetary policy has also taken on a more restrictive tone in Argentina, where a system of inflation targets has yet to be put in place, and in Uruguay, where the system of targets is based on movements in certain monetary aggregates and not on setting a benchmark interest rate.

Thus the tone of monetary policy in the past few months has been strictly related to the recent trends in inflation: a wait-and-see stance in the countries where inflation remains within the target range (Mexico and Paraguay) or has eased recently (Brazil, Chile and Peru) and a more restrictive stance in the countries where inflationary pressures have increased significantly (Colombia, Argentina and Uruguay).

Figure 7.1
Monetary policy rate in countries with inflation targets systems (%)*



* The Argentine central bank has not yet adopted a system of inflation targets, but has already established objectives for the country's inflation.
Source: BBVA Research

In the particular case of Mexico, the central bank's decision to hold interest rates at 3.75% following February's surprise preventive 50 bp hike was influenced not only by inflation's being under control but also by the stability of interest rates in the period and the reduced downward pressures on the currency. Public spending cuts have also served to reduce pressure on monetary policy, both in Mexico and in other countries in the region (with the notable exception of Brazil).

Expectations of stable interest rates in the next few months, with the exception of Colombia, while Mexico will continue to keep step with the US Federal Reserve

We envisage monetary policy interest rates continuing unchanged for the rest of the year at 14.25% in Brazil, 3.5% in Chile, 4.25% in Peru and 6.0% in Paraguay. The tone of monetary policy will thus be less hawkish than we envisaged three months ago.

In the case of Brazil, the more favourable dynamic of inflation in the past few months has practically eliminated the possibility of an upward adjustment in Brazil and has increased the risk of cuts to the SELIC (central bank short-term interest rate) in the next few months. However, we are maintaining our outlook for stability in SELIC rates until such time as inflation is back within the target range and prospects once again well anchored, which we expect to be in early 2017. It should also be noted that with the suspension of President Dilma Rousseff, her replacement Michel Temer has recently appointed a new chairman of the central bank, and this increases the present uncertainty about the future dynamic of interest rates.

In Chile the upward bias of monetary policy has given rise to a neutral tone following the recent dynamic of the exchange rate and inflation, and we have slightly adjusted our forecasts of monetary policy. We were previously expecting an adjustment of 25 bps in 2016 and another of the same size in 2017, whereas we now find it more likely that the official rate will be held at 3.50% not just for the rest of 2016 but throughout 2017 too.

Similarly, in Peru, the recent changes in the macroeconomic environment previously commented on make it most likely that benchmark rates will not reach 4.50% until the beginning of next year rather than in 2016, as we previously anticipated.

As regards Paraguay, we are maintaining our outlook for stability in interest rates in 2016 with a small adjustment of 25 bps next year.

On the other hand we expect monetary policy to become more contractive in the next few months in the other countries of the region. In Colombia, the central bank will probably increase the official interest rate to 7.5% in its May meeting and hold it at this level until the beginning of 2017 when the moderation in inflation will allow a gradual reduction in the interest rate to 5.5% at year-end. Our forecasts for the end of 2016 and 2017 for Colombia are respectively 1.0 bps and 0.25 bps higher than they were three months ago.

Mexico will continue to keep pace with the US Federal Reserve in 2016 and 2017. Specifically, taking account of our expectations of normalisation of US monetary policy, Mexico's reference rate will most probably end 2016 at 4.0% and 2017 at 4.50%. Also, greater currency depreciation or higher-than-expected growth of economic activity would lead to a hardening of monetary policy, which would not necessarily coincide with the US Federal Reserve's adjustments.

Lastly, we expect Argentina to continue to maintain a restrictive monetary policy, even more so than we anticipated three months ago, with the intention of bringing inflation back down towards objectives. Even so, as this policy begins to produce positive results and inflation starts to ease, there should be room for interest rate reductions. As regards Uruguay, where a reduction in the growth target for the money supply from a range of 7% to 9% to one of 4% to 6% was recently announced, it will also maintain a restrictive tone in its monetary policy, given the persistence of inflationary pressures even with the beginnings of wage de-indexation.

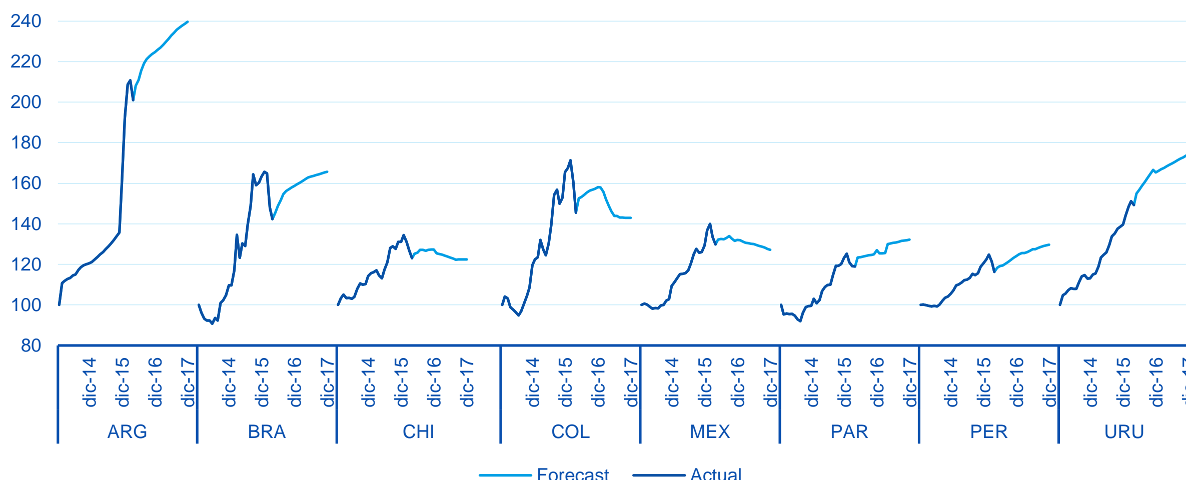
The region’s currencies will depreciate under pressure from interest rate hikes by the US Federal Reserve and a less favourable external environment

As was remarked upon in section 3, the currencies of the countries in the region have appreciated (more than expected) in the past few months in line with the (stronger-than-expected) upturn in commodity prices, the easing doubts about China’s economy and the consolidating perception that the adjustment to US monetary policy will be gradual. In any case, as China’s economy continues to moderate and the US Federal Reserve continues to announce increases in its interest rates, and bearing in mind the probable absence of sharp upward adjustments to commodity prices, the most probable outcome is that the region’s currencies will once again depreciate going forward.

Future currency depreciation will probably be more pronounced and lasting in Argentina, Brazil, Uruguay, Paraguay and Peru (Figure 6.2). In the first three countries, the high rate of inflation and the need to increase external competitiveness will be the two main factors tending to lead to further depreciation.

On the other hand, in Chile, Colombia and Mexico the depreciation of the national currency will not only be less significant than in the other countries of the region, but also temporary (Figure 6.2). Indeed, we expect these three economies’ currencies to cease weakening and start appreciating at the beginning of 2017 as their fundamentals strengthen and in line with the gradual recovery in copper and oil prices.

Figure 7.2
Exchange rate: observed and expected (national currency / US dollar) (January 2014 = 100)*



* Increases indicate depreciation.
Source: BBVA Research

8 Large external deficits in Latin America, though they are starting to correct themselves

Moderate staple commodity prices will continue to affect trade deficits in Latin America

In general, external deficits continue to show signs of correction, influenced by currency depreciation, weak internal demand and a slight recovery in the terms of trade in the past few months. Important exceptions for 2016 are Argentina and Chile, where the current account deficit will be significantly higher than we estimated three months ago. In contrast in Brazil the deficit will tend to close much faster, as in Colombia. In Mexico, Peru, Uruguay and Paraguay we estimate minor adjustments in the balance of trade (Figure 8.1).

The case of Argentina stands out, with INDEC (the national statistics institute) revising balances downwards (i.e. deficits upwards) from 2010, involving significant historical corrections. Thus we have revised our January estimate of the average current account deficit for the two-year period 2016-2017 from 2.8% to 3.6% of GDP. Brazil's recession will have a negative impact on the trade balances of neighbouring countries, particularly Argentina, Uruguay and Paraguay. In these countries we estimate that exports will continue to fall, and in the case of Argentina imports will become more dynamic as a result of the lifting of exchange controls. The other case that stands out is Chile, where the forecast of bigger deficits than forecasted three months ago is due mainly to a worse starting point in 2015, following adjustments to the balance of trade statistics plus the reduced volume of current transfers. In Peru and Uruguay the deficit will diminish significantly in 2016 and 2017, thanks to greater export volumes in the former case, and to the increased weakness of internal demand and significant imports in the latter.

In contrast, for Brazil we estimate that the current account deficit will close faster than anticipated a few months ago, as a result of contraction in domestic demand: we have revised our estimate of the current account deficit by 0.7 pp in 2016 to 2.1%. For Colombia, we have revised it by 0.4 pp to 6.3% of GDP. The gradual recovery in oil prices and the base effect of the greater GDP in dollars given the reduced depreciation will help close the external deficit faster.

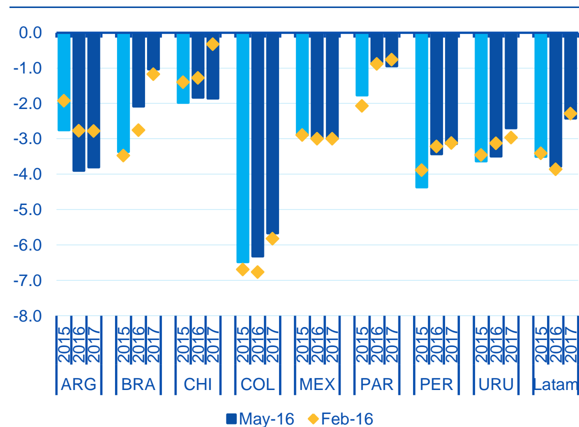
We are maintaining our outlook for a gradual closing of external deficits within the forecast horizon, helped by the recovery in commodity prices and the improvement in external demand, particularly from trading partners in the region.

Greater reliance on short-term financing, although external vulnerability remains limited

Although we do not yet have information on most countries for the first quarter of 2016, in the last quarter of 2015 FDI continued to finance most of the region's current account deficit. However, FDI has weakened, particularly influenced by the lower commodity prices, and this has meant less investment in significant sectors (Figure 8.2).

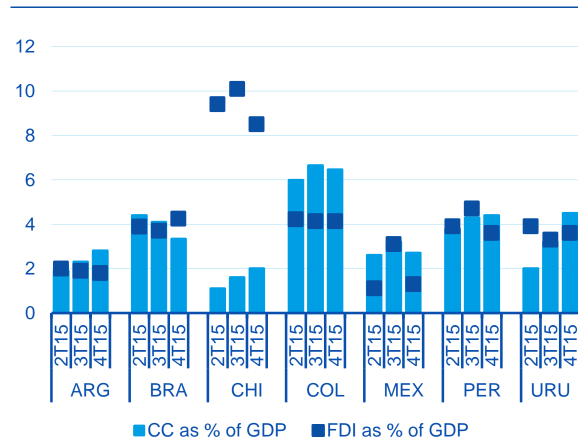
The current and estimated levels of current account deficits remain sustainable and will continue to be financed mostly by FDI.

Figure 8.1
Current account as % of GDP



Source: BBVA Research

Figure 8.2
Current account deficit and FDI as % of GDP



Source: BBVA Research and national statistics

9 Tables

Table 9.1
GDP (% YoY)

	2012	2013	2014	2015e	2016f	2017f
Argentina	0.8	2.9	0.5	2.1	-0.4	3.2
Brazil	1.9	3.0	0.1	-3.9	-3.0	0.9
Chile	5.5	4.0	1.9	2.1	1.7	2.0
Colombia	4.0	4.9	4.4	3.1	2.0	3.0
Mexico	3.8	1.6	2.3	2.5	2.2	2.6
Paraguay	-1.2	14.0	4.7	3.0	3.1	3.1
Peru	6.0	5.9	2.4	3.3	3.6	4.3
Uruguay	3.5	4.6	3.2	1.0	0.7	1.5
Mercosur	2.1	3.0	-0.1	-2.8	-3.7	0.8
Pacific Alliance	4.3	2.9	2.6	2.7	2.3	2.8
Latin America	3.0	2.9	1.1	-0.4	-1.1	1.7

e = estimated f = forecast
FuSourceente: BBVA Research

Table 9.2
Inflation (average % YoY)

	2012	2013	2014	2015	2016f	2017f
Argentina	n.a.	n.a	38.1	26.5	37.4	19.2
Brazil	5.4	6.2	6.3	9.0	8.6	5.2
Chile	3.0	1.8	4.4	4.4	3.7	2.8
Colombia	3.2	2.0	2.9	5.0	7.6	4.4
Mexico	4.1	3.8	4.0	2.7	2.8	3.1
Paraguay	3.7	2.7	5.0	3.1	4.5	4.5
Peru	3.7	2.8	3.2	3.5	3.6	3.0
Uruguay	8.1	8.6	8.9	8.7	9.7	7.7

f = forecast
Source: BBVA Research

Table 9.3
Exchange rate (vs. USD, average)

	2012	2013	2014	2015	2016f	2017f
Argentina	4.6	5.5	8.1	9.3	15.2	16.5
Brazil	1.96	2.18	2.36	3.40	3.75	3.96
Chile	486	495	570	654	685	663
Colombia	1.798	1.869	2.001	2.742	3.097	2.880
Mexico	13.2	12.8	13.3	15.9	17.6	17.1
Paraguay	4.415	4.333	4.514	5.226	5.798	6.082
Peru	2.64	2.70	2.84	3.19	3.40	3.58
Uruguay	20.2	20.4	23.2	27.3	32.9	36.2

f = forecast
Source: BBVA Research

Table 9.4
Interest rate (%, average)

	2012	2013	2014	2015	2016f	2017f
Argentina	13.8	16.9	22.5	21.5	27.6	19.2
Brazil	8.5	8.4	11.0	13.6	14.3	12.4
Chile	5.0	4.9	3.7	3.1	3.5	3.5
Colombia	4.9	3.4	4.0	4.8	7.1	6.1
Mexico	4.5	3.9	3.2	3.0	3.7	4.4
Paraguay	6.0	5.5	6.7	6.1	6.0	6.1
Peru	4.3	4.2	3.8	3.4	4.2	4.5
Uruguay	18.6	17.7	21.5	21.4	24.3	22.8

f = forecast
Source: BBVA Research

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

	2012	2013	2014	2015	2016f	2017f
Argentina	-0.3	-2.1	-1.6	-2.8	-3.9	-3.8
Brazil	-3.0	-3.1	-4.3	-3.4	-2.1	-1.0
Chile	-3.5	-3.7	-1.3	-2.0	-1.8	-1.9
Colombia	-3.0	-3.2	-5.2	-6.5	-6.3	-5.7
Mexico	-1.4	-2.4	-2.0	-2.9	-3.0	-3.0
Paraguay	-2.0	1.7	-0.4	-1.8	-0.8	-0.9
Peru	-2.7	-4.2	-4.0	-4.4	-3.4	-3.1
Uruguay	-5.3	-5.0	-4.6	-3.6	-3.5	-2.7
Mercosur	-1.9	-2.3	-3.1	-3.4	-4.0	-1.7
Pacific Alliance	-2.0	-2.9	-2.7	-3.6	-3.5	-3.4
Latin America	-1.9	-2.6	-2.9	-3.5	-3.8	-2.4

f = forecast
Source: BBVA Research

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

	2012	2013	2014	2015	2016f	2017f
Argentina	-2.2	-2.0	-2.6	-5.3	-4.1	-3.1
Brazil	-2.5	-3.0	-6.7	-10.2	-9.0	-7.3
Chile	0.6	-0.6	-1.6	-2.2	-2.7	-2.8
Colombia	-2.3	-2.4	-2.4	-3.0	-3.9	-3.6
Mexico	-2.6	-2.3	-3.5	-3.0	-2.5	-2.0
Paraguay	-1.8	-2.0	-2.3	-1.8	-2.0	-1.8
Peru	2.3	0.9	-0.3	-2.1	-2.6	-2.3
Uruguay	-2.7	-2.4	-3.5	-3.5	-3.4	-3.4
Mercosur	-2.8	-2.7	-5.3	-8.0	-6.8	-5.8
Pacific Alliance	-1.7	-1.8	-2.7	-2.8	-2.8	-2.4
Latin America	-2.3	-2.3	-4.2	-5.8	-5.1	-4.3

f = forecast
Source: BBVA Research

Table 9.7
Commodities forecast

	2012	2013	2014	2015	2016f	2017f
Oil (Brent, USD/barrel) (average)	112	109	99	53	37	46
Soya (USD/ton) (av.)	537.7	517.4	458.1	350.3	362.7	358.2
Copper (USD/pound) (av)	3.61	3.32	3.11	2.50	2.20	2.28

f = forecast
Source: BBVA Research

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