

Latin America Economic Outlook

3rd QUARTER 2016 | UNIT: LATAM COORDINATION UNIT



01 Market volatility in the wake of Brexit was offset by an expected more accommodating tone on the part of the Fed

02 The slowdown in Latin America will bottom out in 2016. But growth in 2017 (1.8%) will still be below that of the OECD

03 Inflation, although high in South America, is starting to come down in the majority of countries. Inflation remains low but is rising in Mexico

04 Lower inflation and weak growth will move the central banks to adopt a more accommodative stance. But Mexico will keep in step with the Fed

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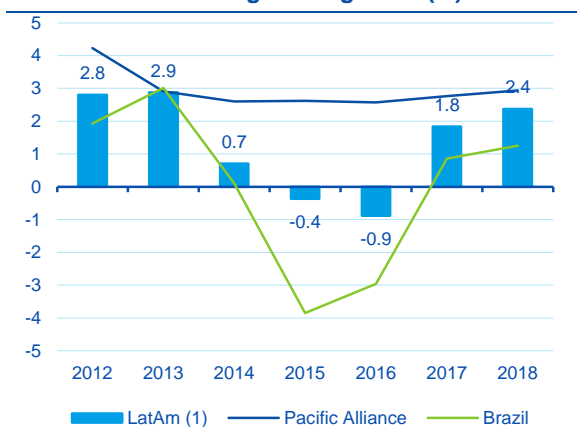
Closing date: 4 August 2016

1 Summary

After a difficult start to the year, external and domestic conditions seem to be improving in the majority of Latin American countries. Fewer doubts about China favoured greater calm in the markets, which managed to absorb Brexit and the resulting increase in global risk aversion without any problems, no doubt thanks to the reaction of the developed economies' central banks, in the case of the Fed by making the rate hike slope even more gradual.

In this context, and even though the region's activity still looks weak, some recovery in growth can be discerned, especially towards the second part of this year. 2016 will still be a year of adjustment, with a fall in activity of 0.9%, making five years of slowdown and three of growth below that of OECD countries, something that had not been seen since the beginning of this century. Even so, the second half of this year should bring greater dynamism, and the region's slowdown should touch bottom this year. Growth should be 1.8% in 2017, still below the OECD and the region's potential, which is nearer to 3%, but it will mark a turning point, buoyed up by the external sector overall and public and private investment in countries like Argentina, Peru and Colombia.

Figure 1.1
Latin America: Average GDP growth (%)



Source: BBVA Research and national statistics

There will of course be great disparities in the region, with the Pacific Alliance countries (Mexico, Colombia, Peru and Chile) sustaining an average growth of around 2.7% in 2016-17, as against the recession in Brazil and Argentina this year (Figure 1.1). In 2017, the countries that will grow most in Latin America will be Peru, Argentina, Colombia and Paraguay.

News on inflation has been positive in the majority of countries. Although inflation is still above the central banks' targets (except for Mexico, Paraguay and, recently, Peru), it has been falling in the past few months, thanks to reduced pressure from exchange rates. The exceptions have been Colombia, Argentina and Uruguay, although in the first two it should start to come down in the next few months.

Obviously, inflation dynamics largely determine the response of the Latin American central banks. In South America, with inflation in retreat and business cycles still weak, many of them have opted to keep interest rates unchanged in the past few months, and in the case of Chile and Brazil we anticipate some reduction in interest rates going forward. Colombia, in contrast, will need to maintain a contractionary monetary policy for a few more months, and Argentina and Uruguay will have to do so for longer. The case of Mexico is slightly different, since it reacted quickly to the depreciation of the peso caused by Brexit-related volatility, to prevent its being transferred to inflation. Looking ahead, it will very likely synchronise future interest rate hikes with those of the US Federal Reserve so as to minimise further bouts of market volatility.

The risks surrounding this prediction continue to be biased downwards, although they are now less intense than three months ago, partly due to reduced (though still significant) concerns about China's economy and the US Federal Reserve's shift towards a more gradual approach. We must not forget however that the region also faces internal risks, due to the political process in many countries, low confidence or possible delays in investment in infrastructure.

2 Latin America: towards a gradual recovery

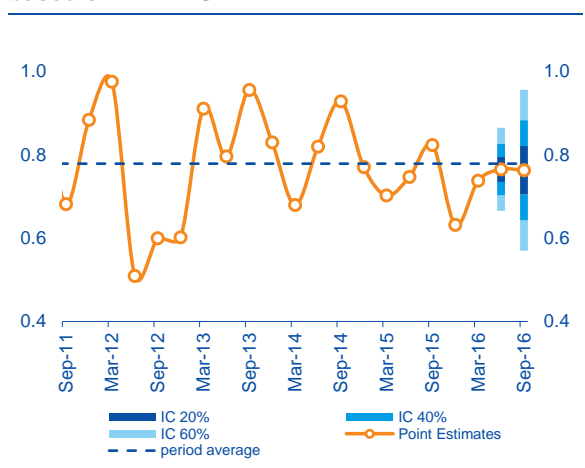
Global environment: central banks check Brexit effects

In the past three months, the global economy continued the moderate trend of previous quarters, with growth rates of around 3% (Figure 2.1), well below the pre-crisis rates. Within this average, the developed economies show no signs of recovery, whereas we are starting to see some improvement in emerging economies, especially in Asia. As a result, aggregated data at a global level has either improved somewhat or slowed down their decline.

Brexit brought with it a substantial increase in financial volatility, common to most asset classes. Its effect, however, was transient and non-systemic (Figure 2.2.), partly thanks to the response of the central banks, which either delayed the process of normalising interest rates (the US Federal Reserve) or remained ready to strengthen stimulus measures (ECB, BoE and BoJ). In particular, the Fed's response was crucial to how emerging markets weathered the storm. The search for yield in an environment of very low interest rates and the relief produced by the Federal Reserve's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging bloc, which in July received the largest inflow of foreign capital since 2013.

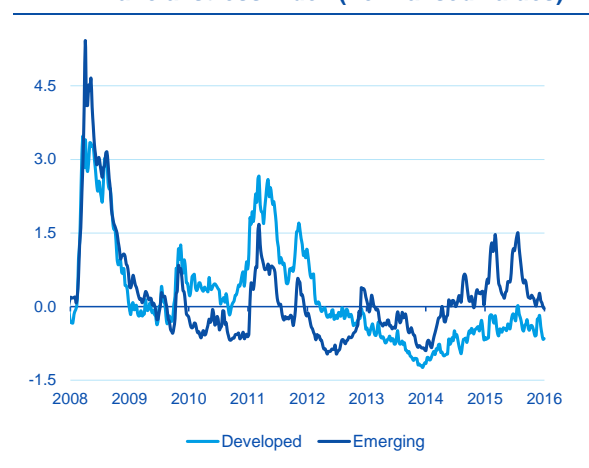
In the US, the poor activity data for the first and second quarters still do not show the expected degree of recovery. This, together with the uncertainty surrounding the elections in the second half of the year and global risks (Brexit and other risks in Europe, and in China in the longer term), leads us to reduce our growth forecast for 2016-17 from around 2.5% to around 2%. In addition, in its latest meetings the US Federal Reserve expressed increasing doubts about the US economy's potential for long-term growth in productivity and GDP, and this, coupled with the risks of the global economy, led it to put its rate normalisation process on hold. In this context, we now expect the Fed to announce one additional rate hike this year (probably in December) and two in 2017.

Figure 2.1
Global GDP, % QoQ. 2Q and 3Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalised values)



Source: BBVA Research

In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, although there are less encouraging signals coming from weak investment, especially by the private sector. However, we are maintaining our forecast of a slowdown in growth to 6.4% in 2016 (from 6.9% in 2015) and to 5.8% in 2017. Short-term risks persist regarding financial

stability, the depreciation of the renminbi and capital outflows, as well as the property market and corporate indebtedness, while long-term questions remain about growth prospects due to the slow progress of structural reforms in some key areas, particularly in public companies.

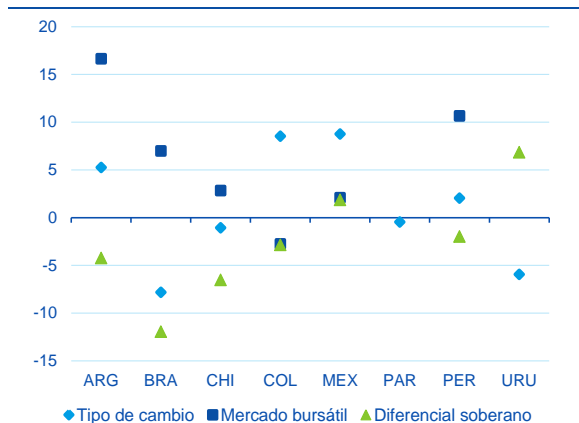
Continuing recovery of markets in Latin America, which successfully absorbed the impact of Brexit

Latin American financial markets, in general, performed relatively well in the past three months, increasing the gains made so far this year. Particularly notable were the gains on stock markets and the narrowing of sovereign yield spreads since the end of April (Figure 2.3).

A fundamental factor contributing to the generally positive tone of markets in the region was the expectation that the developed economies' central banks will adopt a more accommodating stance than previously thought, in particular in the US, where there was a change of perspective regarding the US Federal Reserve's monetary policy normalisation process. Latin America's financial markets also drew strength from easing concerns about China's economy and from some signs of more stable growth in the region.

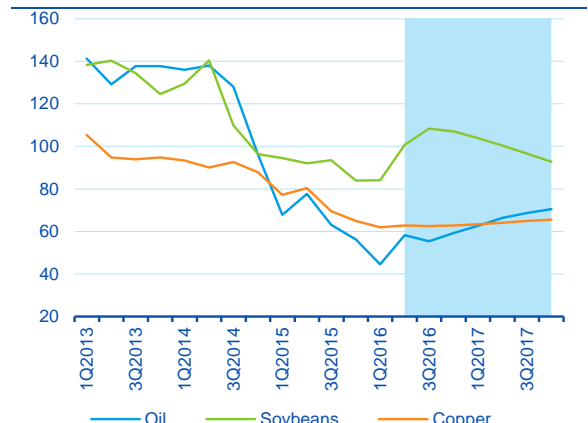
In any case, as became clearer in the second half of July, the main determining factor for movements in the markets is the prospect of action by the Fed. In this period, an increase in the probability of interest rate hikes this year (which however is still below its level of three months ago) has led to falls in the prices of some of the main commodities, taking them to levels below those seen three months ago. Oil, copper, iron ore and maize prices, for example, ended July 12%, 2%, 5% and 14% below their end-of-April levels, respectively, while the price of soybeans held practically steady. The currency markets also reacted negatively to the adjustments made in the past few weeks to the prospects for the normalisation of US monetary policy.

Figure 2.3
Financial markets: % change in the three months to 29 July*



Exchange rate: domestic currency / dollar. In this case, an increase indicates depreciation. Sovereign yield spread: EMBI.
Source: Haver Analytics, Datastream and BBVA Research

Figure 2.4
Prices of major commodities (average index 2010 = 100)*



* Lines represent quarterly averages.
Source: Bloomberg and BBVA Research

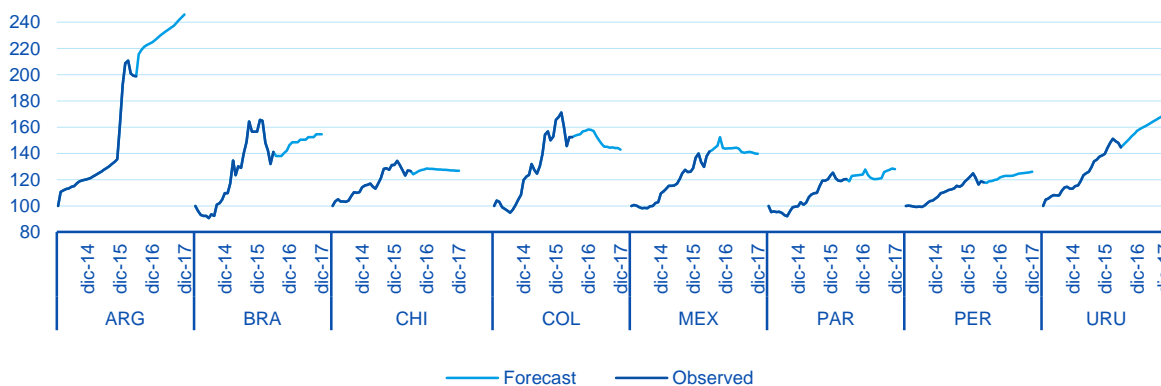
It is important to note that the negative effect on Latin American markets of the Brexit vote of 23 June was relatively limited and lasted only a few days, with previous levels being regained as early as the end of June, largely due to the perception that the developed economies' central banks would do whatever was necessary to calm down the markets.

Looking ahead, we expect the Fed to continue setting the dynamic for financial assets in the region. If our baseline scenario of a rate hike in the US at year-end materialises, the likeliest outcome is that the dollar will appreciate and both global commodity markets and regional financial markets will come under downward pressure.

Bearing this in mind, our forecast is for prices of the main commodities to remain at relatively low levels in the next few months (Figure 2.4). In any case, supply factors should favour conditions for a slight increase in prices in some markets. For example, bad weather in the Southern hemisphere and the prospect of a reduction in the area planted in the US will support soybean prices in the short term before they start to converge with long-term equilibrium levels. As regards oil, the low prices will most probably continue to lead to gradual supply cuts and end up producing a slight recovery in crude prices in the medium term. Lastly, in the case of copper, current prices are already close to production costs, which should limit further falls.

As for exchange rates, although downward pressures on currencies are bound to continue, there is room for a slight appreciation in certain countries, such as Colombia and Mexico, whose currencies we believe are somewhat undervalued relative to their equilibrium levels. The prospects for a slight recovery in commodity prices and economic activity also support this view (Figure 2.5).

Figure 2.5
Exchange rate: observed and expected (national currency / US dollar) (January 2014 = 100)*

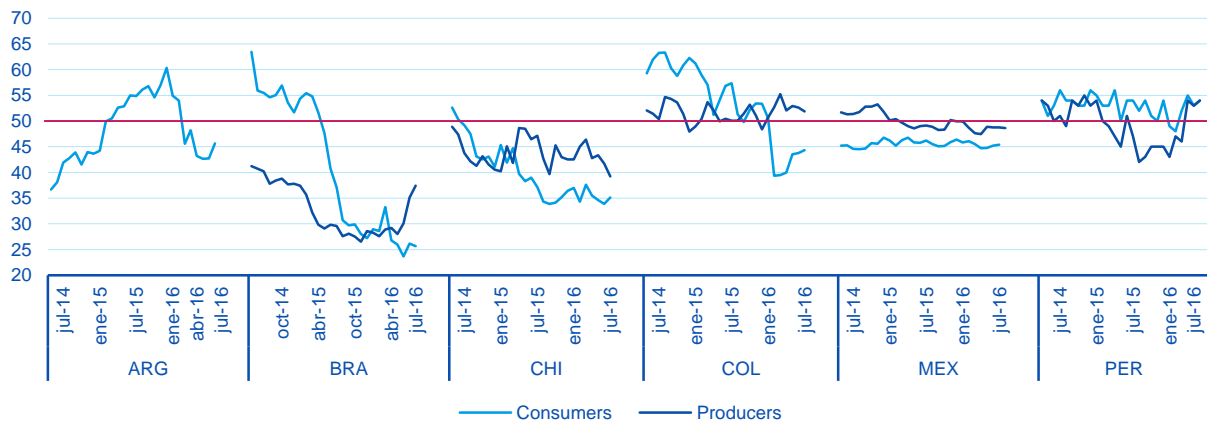


* Increases indicate depreciation.
Source: BBVA Research

The slowdown in Latin America will bottom out in 2016, but recovery will be very gradual in 2017

As was mentioned earlier, the various external shocks affecting the region over the past three months tended to offset one another. The increase in volatility and risk aversion brought about by Brexit (and the recent fall in the prices of the main commodities) was largely offset by expectations of a more gradual increase in interest rates by the Federal than anticipated three months ago, with the consequent inflow of capital into the region. On the domestic front, confidence indicators remain weak in the majority of countries (Figure 2.6), due to the continuing weak cycle, some political noise in certain countries (albeit less than before), inflation that remains high and persistently sluggish labour markets. The main exceptions are the recoveries in Brazil and Peru, in both cases linked to reduced political uncertainty.

Figure 2.6
Consumer and manufacturing confidence (values over 50 points indicate optimism)



Source: BBVA Research

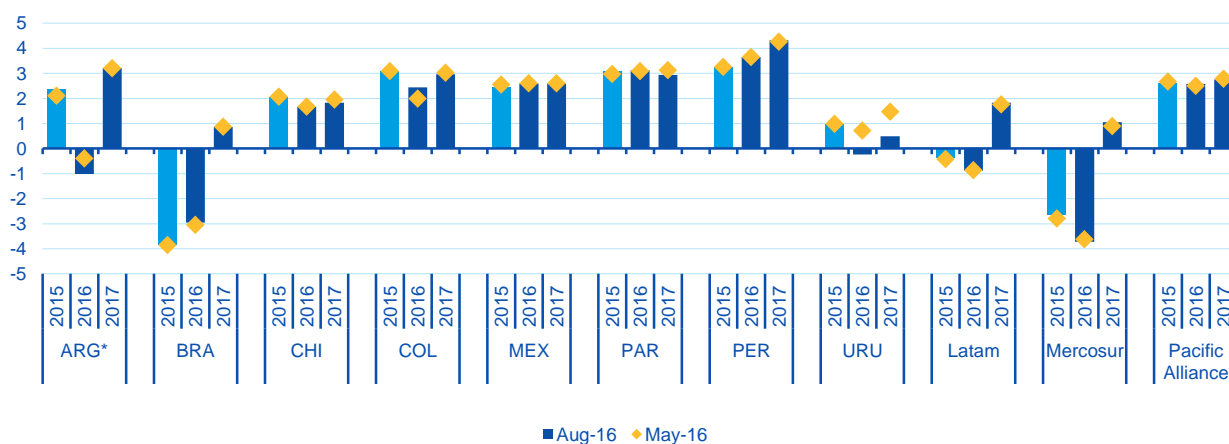
Taking this into account, growth forecasts for the region in the next two years remain practically unchanged. Following the slight contraction in economic activity in the region in 2015 (by 0.3%), we expect activity to contract again this year, by 0.9% (Figure 1.1). The region will therefore come to the end of the period of slowdown that started in 2012, leading to three years (2014-2016) of growth below that of the OECD, something that had not happened since the beginning of the century. All the same, we are starting to glimpse some recovery in growth in certain countries, particularly toward the second part of the year, while at the same time Brazil is starting to leave its recession behind. We therefore foresee Latin America's slowdown touching bottom in 2016, opening the way for positive growth of 1.8% in 2017. This growth in 2017 will be underpinned both by the increased dynamism of the external sector, which should benefit from the sharp currency depreciations of the past and the gradual increase in commodity prices, and by the increase in investment, both public and private, in countries such as Argentina, Peru and Colombia. In any case, growth will still be slow compared to both that of the developed countries (and still below that of the OECD) and to the region's potential, which is closer to 3%.

Growth by country is of course marked by wide disparities (Figure 2.7). On the one hand, the Andean economies (Peru, Colombia and Chile) are still in a process of orderly adjustment to the new and less favourable external conditions that led to a sharp fall in export revenues. Mexico is also maintaining moderate dynamism, shackled to the continuing weak industrial cycle in the US. On the other hand, low confidence is still weighing on economic activity in Brazil, although some uncertainties are dissipating. And, in the case of Argentina, the process of macroeconomic rebalancing has weighed more heavily than expected on activity so far this year.

- In **Brazil**, we are maintaining our growth forecast at a negative 3.0% for this year, with a slow recovery of 0.9% in 2017. The slight recovery in confidence and commodity prices is largely offset by the stronger currency.
- In **Mexico**, we continue to expect moderate growth of 2.6% in 2016 and 2017, although with a downward trend, given the weakness of growth in the US, the cuts in public spending and, to some extent, the increase of 100 bps in interest rates carried out so far this year.
- In **Argentina**, we are revising growth for 2016 down by 0.4% to a negative 1.0% in view of the effect of the revision of the historical GDP series and further contraction in activity in the first half of this year due to the increase in inflation and the necessarily contractionary tone of its monetary policy. All the same, we still anticipate an uptick in growth to 3.2% in 2017, driven by investment.

- In **Colombia**, we are revising growth for 2016 upwards from 2.0% to 2.4% in view of the good performance of consumption and the increase in the price of oil. Activity will continue to increase in 2017, by 3%, largely driven by public investment in infrastructure and private investment in mining and industry.
- In **Peru**, we are maintaining our growth forecast at 3.6% and 4.3% for 2016 and 2017 respectively. It will be underpinned mainly by mining this year and by infrastructure projects in 2017.
- In **Chile**, we are maintaining our growth forecast of 1.7% for 2016, but with less investment in mining and property, offset by fewer imports and more public spending. Nonetheless, the risks to our forecast for 2017 are materialising in the form of weaknesses in investment in mining and the labour market, so we are adjusting it from 2.0% to 1.8%.
- In **Uruguay**, growth has stalled, and there is no room for countercyclical policies on either the fiscal or the monetary front. We are therefore revising our growth projections for 2016 and 2017 sharply downwards (by around one percentage point in each year), to a negative 0.2% and a positive 0.5% respectively.
- In **Paraguay**, we are maintaining our growth forecast for 2016 unchanged at 3.1% and revising that for 2017 slightly downwards to 2.9% in view of delays in the start of some flagship infrastructure projects (airport and routes 2 and 7). In any case, the slow pace of investment also introduces a certain downward bias to medium-term growth (2018-2020).

Figure 2.7
Latin America countries: GDP growth (%)



Source: BBVA Research

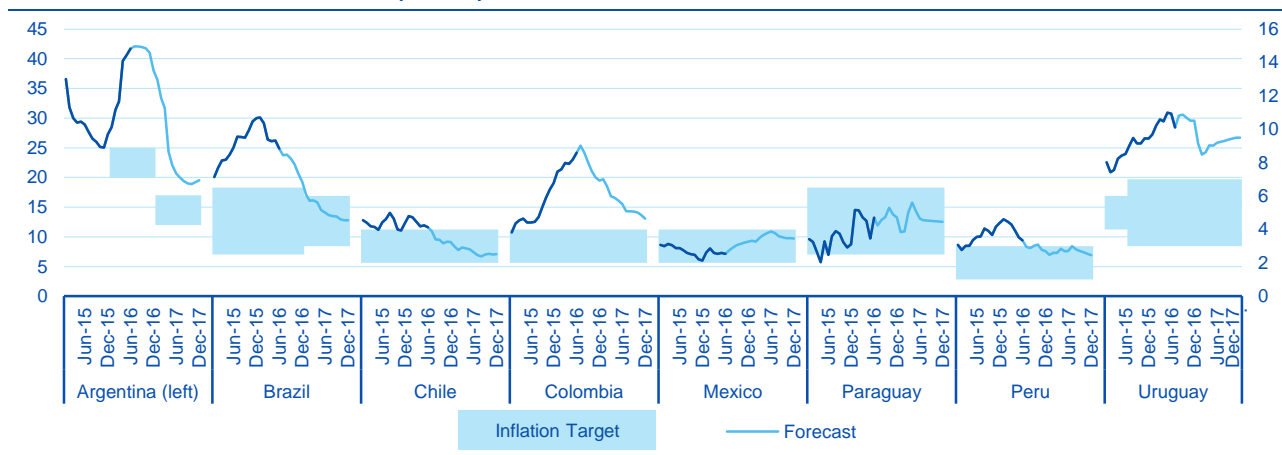
Inflation, although high in South America, continues to fall in the majority of countries. In Mexico it remains within the target range

As expected, inflation has continued to weaken in the majority of South American countries in the last few months (Figure 2.8). This downward correction is in line with the relative weakness of domestic demand, reduced currency depreciation and the fading of certain shocks specific to particular countries (such as tax adjustments in Chile and an alignment of regulated prices in Brazil).

The exceptions to the downward trend continue to be Argentina, Colombia and Uruguay. In all three cases, inflation is continuing to rise, largely due to the impact of supply shocks on food prices (a factor which drove up inflation, albeit not decisively, in other countries in the region, such as Brazil and Paraguay). In Argentina, the main reasons for the continuing rise in inflation are the impact of the peso's depreciation following the elimination of exchange controls and the adjustments to prices of certain public services.

Although there is considerable disparity among the recent dynamics and levels of inflation, inflation nevertheless remains above target in all South American countries except Paraguay and, following July's surprisingly low figure, Peru.

Figure 2.8
Inflation: observed and forecast * (YoY %)



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

In Mexico, inflation is within the target range. Its situation contrasts with that of most Latin American countries where inflationary pressures are very limited. Despite the depreciation of the Mexican peso, the monetary authorities have succeeded in containing second-around effects on domestic prices. Moreover, inflation in Mexico continues to benefit from the positive effects of the economic reforms carried out in the past few years, in particular the pro-competitive reform of the telecommunications sector.

The most likely outcome is that the lack of demand-side pressure and the greater stability of exchange rates, among other factors, will keep inflation close to central targets in Mexico and Paraguay, although not as low as in the past few months in the former case, and that it will move more clearly toward the target range in the third quarter in Peru and Chile and at the beginning of 2017 in Brazil. In Colombia, as in Argentina and Uruguay, inflation will moderate, but convergence with targets will take longer, meaning that there is still a risk of expectations slipping anchor.

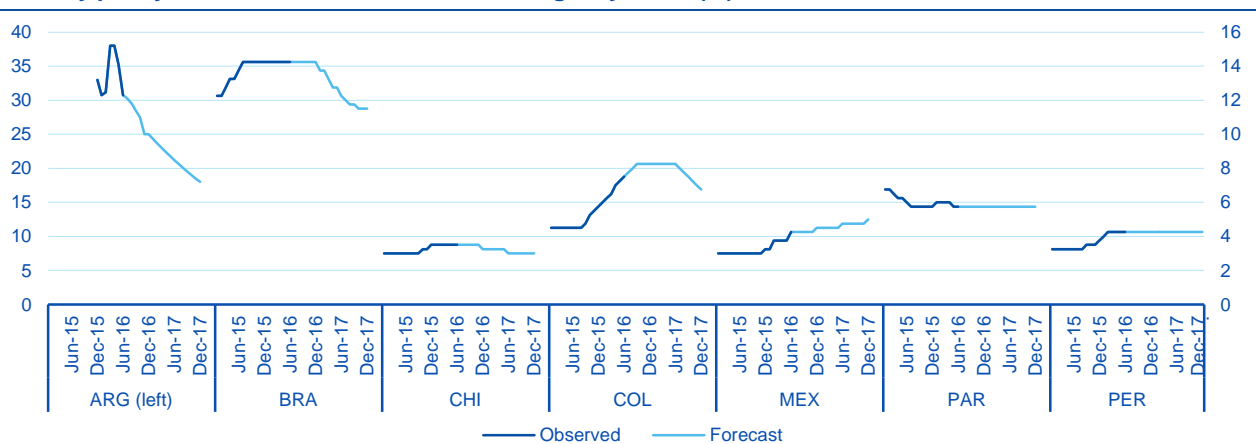
Central banks are adopting a slightly relaxed stance, except in Colombia, where inflation remains a concern, and Mexico, where the spotlight is on the US Federal Reserve

In the majority of cases, the central banks have played a waiting game in recent months, leaving key rates unchanged (Figure 2.9). On the one hand, above-target inflation and, in some cases, the risk of unanchored expectations prevented them from cutting interest rates. On the other hand, the weakness of economic activity left no room for a hardening of monetary policy.

In Colombia, however, growing inflationary pressures and relatively strong (less weak) demand compared with other countries led the central bank to decide to continue raising policy rates, which reached 7.75% at the end of July.

In Mexico, again in contrast to the majority of countries in the region, Banxico surprised the markets once more in June with a 50 bp hike in its key rate, to 4.25%. This reflects the central bank's particular sensitivity to the depreciation of the peso and financial volatility, despite inflation's being under control.

Figure 2.9
Monetary policy rate in countries with inflation target systems (%)*



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

In both Colombia and Mexico, the monetary authorities will most likely continue to increase their benchmark rates. Specifically, we expect Colombia's central bank to announce two additional increases of 25 bps in the next few months with a view to containing inflationary pressures and anchoring expectations. On the other hand, we expect Mexico's monetary policy, after the recent surprise adjustments, to fall in step with its Northern neighbour, which probably means one more 25 bp hike this year and two more in 2017 (Figure 2.9).

In most of the region, monetary policy will be looser in the next few months, in line with the outlook for moderating inflation and a relatively weak activity cycle. We therefore envisage cuts in the base rates at year-end and in mid-2017 in Chile and the start of a cycle of monetary relaxation in Brazil at the beginning of 2017. In Peru, we foresee stability at 4.25% for a long period. Lastly, it is worth noting that in Argentina, where the monetary authority is continuing with plans to adopt a system of inflation targets, monetary policy will continue to be contractionary, but less so than in the last few months, due to concerns about an excessive appreciation of the peso and the slowdown in economic activity.

External risks continue to be centred on China and the US Federal Reserve. Domestic risks are centred on lack of confidence

The region (especially South America) has suffered a sharp external shock, mainly to its terms of trade, due to the fall in the price of its main export commodities. Although this fall in prices seems to have touched bottom, the outlook for prices is still heavily dependent on that for China's economy and also on the volatility of international financial markets. The news on both fronts has been relatively positive in the past few months but significant risk factors remain.

In the first place, the risk associated with the performance of China's economy has receded somewhat with the stabilisation of growth in the second quarter, rather better than expected, supported by strong consumption and an increase in lending. The less encouraging signals coming from investment, especially by the private sector, might also be seen in a positive light if they reflect the beginning of the awaited deleveraging process, as they seem to have been concentrated in the sectors with the greatest excess installed capacity. However, as we mentioned at the beginning of this report, short-term risks persist regarding financial stability, the depreciation of the renminbi and the outflow of capital, while doubts remain as to long-term growth due to the slow progress of structural reforms. A sharp adjustment to China's

economy would have a strong impact on the region through falls in commodity prices and in exports to China and the consequent increase in volatility on international financial markets.

Another risk factor for the region is the hardening of international financial conditions. The vote in favour of Brexit led to a sharp increase in financial volatility and risk aversion which, as already mentioned, was offset by the more accommodating stance of the major central banks of the developed countries. Expectations of a more gradual process of interest rate increases by the US Federal Reserve than previously envisaged favour the region and the inflow of capital, but it is a process that can be quickly halted or even reversed if there is a reaction to any changes in the perception of the Fed's future actions.

On the domestic front, the risks are varied, depending on the widely varying particularities of the region. On the one hand are the risks associated with the political process, which could again lead to increased uncertainty in Brazil, delay the implementation of the necessary tax reform in Colombia or hinder the structural reform process needed in Peru. Similarly, the nascent return of confidence to countries such as Argentina, Brazil, Peru and Colombia may also be stifled if the incipient recovery does not take hold. These factors, together with the weakness of the labour markets, risk weakening consumption and investment even further in the countries of the region. Lastly, we must not forget that part of the recovery in growth in 2017 in certain countries will depend on the implementation of public investment plans (Argentina, Peru, Colombia) so that any additional delays to these plans also represent a high-impact risk.

3 Tables

Table 3.1
GDP (YoY%)

	2014	2015	2016f	2017*
Argentina	-2.6	2.4	-1.0	3.2
Brasil	0.1	-3.8	-3.0	0.9
Chile	1.9	2.1	1.7	1.8
Colombia	4.4	3.1	2.4	3.0
México	2.2	2.5	2.6	2.6
Paraguay	4.7	3.1	3.1	2.9
Perú	2.4	3.3	3.6	4.3
Uruguay	3.2	1.0	-0.2	0.5
Mercosur	-0.8	-2.7	-3.7	1.1
Pacific Alliance	2.6	2.6	2.6	2.8
Latin America	0.7	-0.4	-0.9	1.8

* Forecasts.
 Source: BBVA Research

Table 3.2
Inflation (average % YoY)

	2014	2015	2016*	2017*
Argentina ¹	38.0	26.7	42.7	25.8
Brazil	6.3	9.0	8.8	5.1
Chile	4.4	4.4	3.9	2.7
Colombia	2.9	5.0	7.9	5.5
Mexico	4.0	2.7	2.8	3.6
Paraguay	5.0	3.1	4.7	4.6
Peru	3.2	3.5	3.5	2.7
Uruguay	8.9	8.7	10.6	9.2

* Forecasts. ¹ Índice de la Ciudad de Buenos Aires (IPC CABA)
 Source: BBVA Research

Table 3.3
Exchange rate (vs. USD, average)

	2014	2015	2016*	2017*
Argentina	8.12	9.27	15.0	16.7
Brazil	2.36	3.37	3.50	3.68
Chile	570	654	685	685
Colombia	2,001	2,742	3,090	2,900
Mexico	13.3	15.8	18.6	18.7
Paraguay	4,514	5,226	5,696	5,829
Peru	2.84	3.19	3.37	3.49
Uruguay	23.2	27.3	31.9	35.1

* Forecasts.
 Source: BBVA Research

Table 3.4
Interest rate (% average)

	2014	2015	2016*	2017*
Argentina	22.5	21.5	27.7	19.2
Brazil	11.0	13.6	14.3	12.4
Chile	3.7	3.1	3.5	3.1
Colombia	4.0	4.8	7.4	7.8
Mexico	3.2	3.0	4.0	4.7
Paraguay	6.7	6.1	5.8	5.8
Peru	3.8	3.4	4.2	4.3
Uruguay	21.5	21.4	24.6	24.5

* Forecasts.
 Source: BBVA Research

Table 3.5
Current account (% GDP at end of period)

	2014	2015	2016*	2017*
Argentina	-1.4	-2.5	-2.8	-2.7
Brazil	-4.3	-3.3	-1.3	-0.5
Chile	-1.3	-2.0	-1.7	-0.9
Colombia	-5.2	-6.5	-5.9	-5.4
Mexico	-2.0	-2.9	-3.0	-3.0
Paraguay	-0.4	-1.8	-0.8	-0.7
Peru	-4.0	-4.4	-3.3	-3.4
Uruguay	-4.5	-3.5	-3.1	-2.5

* Forecasts.
 Source: BBVA Research

Table 3.6
Fiscal balance (% GDP at end of period)

	2014	2015	2016*	2017*
Argentina	-2.7	-4.8	-4.6	-3.4
Brazil	-6.7	-10.2	-9.8	-9.4
Chile	-1.6	-2.2	-2.9	-3.3
Colombia	-2.4	-3.0	-3.9	-3.6
Mexico	-3.5	-3.0	-2.5	-2.0
Paraguay	-2.3	-1.8	-2.0	-1.8
Peru	-0.3	-2.1	-2.9	-2.9
Uruguay	-3.5	-3.5	-3.7	-3.7

* Forecasts.
 Source: BBVA Research

Table 3.7
Commodities forecast

	2014	2015	2016*	2017*
Oil (Brent, USD/barrel) (average)	99.0	52.6	43.3	53.3
Soya (USD/ton) (average)	458	350	385	379
Copper (USD/pound) (average)	3.11	2.5	2.14	2.21

* Forecasts.
 Source: BBVA Research

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