BBVA | Research

Latin America Economic Outlook

1st QUARTER 2018 | SOUTH AMERICA UNIT

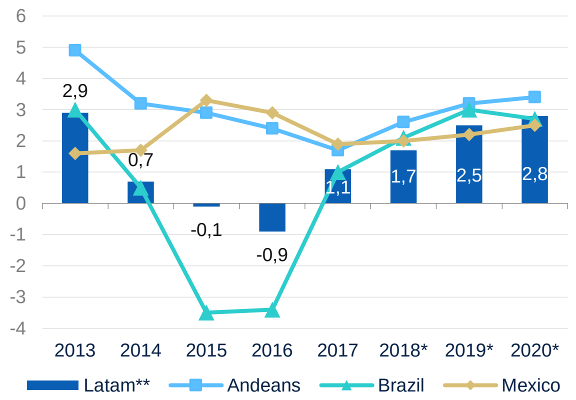
Contents

Closing date: **20 January 2018**

1. Summary

Financial markets in Latin America have continued to show a positive tone. Volatility remained low and capital inflows persisted, although these did ease up gradually. This positive trend was underpinned by improved world growth and the rise in commodity prices. Going forward, we anticipate modest depreciations of exchange rates in the region on the back of the divergence between monetary policy paths in the US, where the Fed will continue to adjust interest rates up, and Latin America, where easing cycles are coming to an end. Taking the latter into account, there exists a risk of increased bouts of volatility along the way.

Figure 1.1 Latam: GDP growth (%)



*Forecasts. ** Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela
Source: BBVA Research

Latin America will grow 1.7% in 2018 and 2.5% in 2019, after having expanded 1.1% in 2017. The about-turn in the trend in the region is thus taking hold, following a five-year slowdown up to 2016. (Figure 1.1). The forecast for 2018 is 0.1pp higher than it was three months ago after we revised growth upwards for many countries in the region on better-than-expected activity figures, higher world growth and firmer commodity prices. The main exceptions are Mexico and Colombia (for which forecasts remain unchanged) and Peru (where we have lowered our forecast amidst an upturn in political unrest). Regional growth in the next two years will be driven by the external sector and investment. Growth in 2019 will be approaching the region's potential level, yet this is below the potential rate exhibited in the decade of surging commodity prices up to 2013, which points to a new normal for Latin America.

Inflation pressure remains relatively limited, except in Argentina and Mexico. Inflation ended 2017 at low levels, apart from in Argentina (although this showed a clearly downward trend) and Mexico. Instrumental here were frail domestic demand and currency strength. With inflation now almost in line with central bank targets, there is still room for some additional interest rate cuts in certain South American countries going into 2018, following which rates should remain stable up until early 2019. In Mexico's case, Banxico should hold rates steady over the rest of 2018 after a possible additional upside correction in February.

Risks surrounding forecast growth have downside bias, but they have abated relative to three months ago. On the external front, short term risks linked to China have diminished after a local authorities' sharper focus on reducing imbalances. The risks associated with monetary normalisation in the United States and US trade policy remain however. Within the region, political risks have died down in Argentina and Chile after elections, but upheaval and political uncertainty remain in Peru, Brazil, Colombia and Mexico. There is also still the persistent risk of delays to infrastructure projects underway in several countries.

2. Latin America: recovery towards a new normal

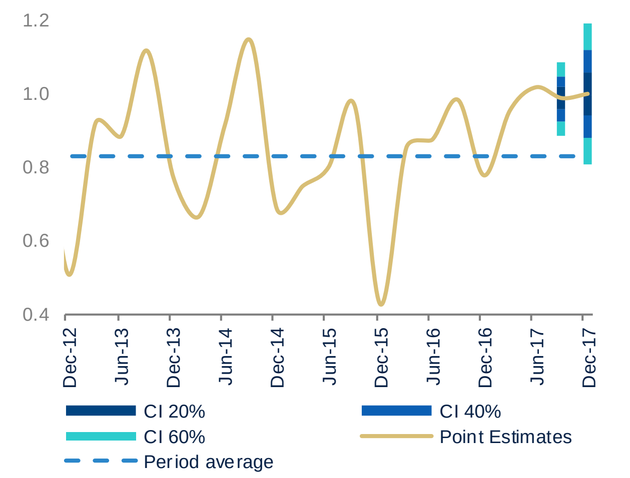
Global growth is taking root

World economic growth consolidated at around 1% QoQ (Figure 2.1) in late 2017, reflecting improved results in all major areas and prospects of continuing in good health over the coming quarters. Support from economic policy, particularly in developed economies, has eventually had a clear impact on the real economy: the recovery of investment gained traction, buoyed by increased demand and international trade, which in turn continues to drive the recovery of the industrial sector. Meanwhile, private consumption continues to perform well in advanced economies, while gaining momentum in emerging economies. Moreover, the outlook and confidence in many of these have been boosted by higher commodity prices, as well as the relative calm on financial markets. As regards these, an absence of adverse global shocks has meant that fundamentals have sustained risk-taking by investors (Figure 2.2) who continue to prompt capital inflows into the emerging economies, although there has been a degree of gradual let-up to this in recent months. World growth could have picked up by 0.4pp to around 3.7% in 2017, i.e. 0.2pp more than was predicted three months ago.

Over the past three months, there have been more reasons to remain optimistic in all of the key areas. In the United States recovery has been taking hold over the year, with slightly higher-than-expected growth rates and improvements in the labour market. Tax reform has finally been passed, which may extend cyclical recovery, even if it might not have a very significant impact in the long term. Meanwhile, recent Federal Reserve appointments point to an unchanged monetary policy, which should be reflected in a very gradual normalisation of it. In China, the measures passed by the authorities have managed to put the economy on an even keel, while certain structural reforms have been undertaken and there has been approval for an economic strategy that focuses more on getting imbalances under control and less on meeting growth targets. Finally, the eurozone recorded higher-than-expected activity growth in 2017, supported by an improved global climate and stronger internal demand which is benefiting from less political uncertainty.

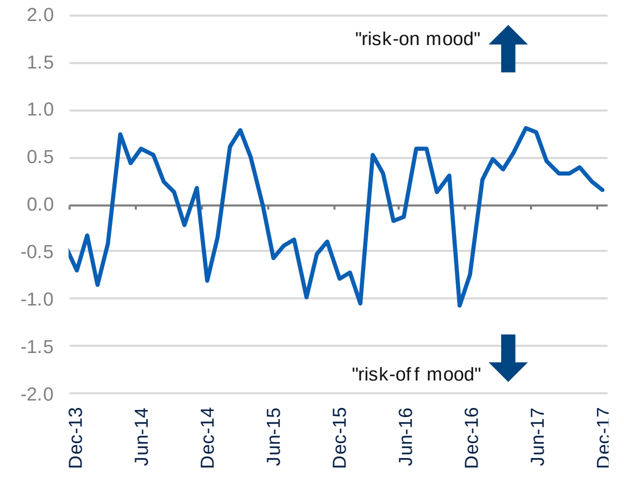
This scenario of increased growth and higher demand has thusfar been accompanied by subdued inflation, despite the expansionary measures adopted by major central banks and the gradual reduction in idle capacity in developed economies. Whatever the case, increased growth and higher oil prices should push inflation up in the short term, facilitating progress in the normalisation of central bank policy in developed economies, while many emerging economies still have room for manoeuvre when it comes to continuing to use monetary policy to bolster growth.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

Figure 2.2 Risk appetite indicator (global factor using EPFR flows)



Source: BBVA Research based on EPFR

Global risks are stabilizing compared to three months ago, although they are still substantial, especially those of a political hue

Our forecasts point to global growth slightly accelerating in 2018-19 (by around 0.1pp) to 3.8%, meaning an upward revision of 0.3pp with respect to the scenario advanced three months ago. This change has come in response to higher growth forecasts now for the United States, China and the eurozone in 2018, mainly due to improved economic activity in recent quarters, although also to the economic measures implemented in the first two areas. Specifically, we expect the United States to grow 2.6% in 2018 (0.4pp more than three months ago) and 2.5% in 2019, driven by the effects of tax reform and improved external and domestic fundamentals. For China we predict a more sedate slowdown (thanks to the better international climate and economic policy strategy in the wake of the 19th Communist Party Congress) with growth of 6.3% in 2018 and 6% in 2019, compared to 6.7% in 2017. On the other hand, in the eurozone we are revising growth upwards by 0.4pp in 2018 to 2.2%, which should be followed up by 1.8% in 2019, shored up by the strength of internal demand and a positive contribution from net exports. Finally, in Latin American economies, we expect to see a somewhat stronger recovery this year, due to the upward revision for global demand and higher commodity prices. Despite the envisaged stability of world growth, we still expect a certain tempering of growth in developed economies in 2019, while the recovery will continue to consolidate in most emerging economies.

The risks to this relatively benign worldwide outlook are still present, though to a lesser extent than three months ago. The most notable among these are those of a political and geopolitical nature, which could hit economic confidence and how financial markets behave.

Latin American financial markets: caught between Fed moves and commodity prices

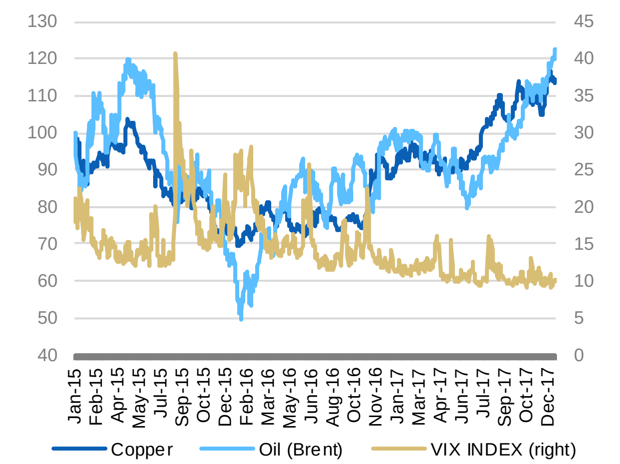
Although Federal Reserve decisions on developments in US interest rates and scaling down their balance sheet continue to prompt wariness and, at certain times, a downward correction in asset prices, the overall tone in Latin American financial markets over the past three months has been positive. Thus the gains seen earlier in 2017 have been joined by those observed in the past few months. 2017 witnessed the coming together of rises on stock markets, falls in risk premiums and exchange rate appreciations (at least in real terms) in all of the countries within the region. Mexico has been no exception, despite the fact that the renegotiations of the North American Free Trade Agreement (NAFTA) and the imminent presidential elections in July 2018 have given rise to turbulence on the country's financial markets, mainly from October 2017 onwards.

The price rises of financial assets in the region, both those marked in the past three months and those accumulating over 2017, relate to the pick-up in global growth and greater optimism about China's economy, largely due to their effect on commodity prices. In this respect, the oil and the copper price rose by 22% and 6% respectively over the past three months, and 18% and 31% over 2017. The price of the soybean, which is another key product of the region, has not shown any substantial change, either in recent months or in 2017 as a whole.

Besides the higher global growth, volatility on global markets has remained relatively limited (Figure 2.3), which has contributed to the brighter progress for financial assets in Latin America.

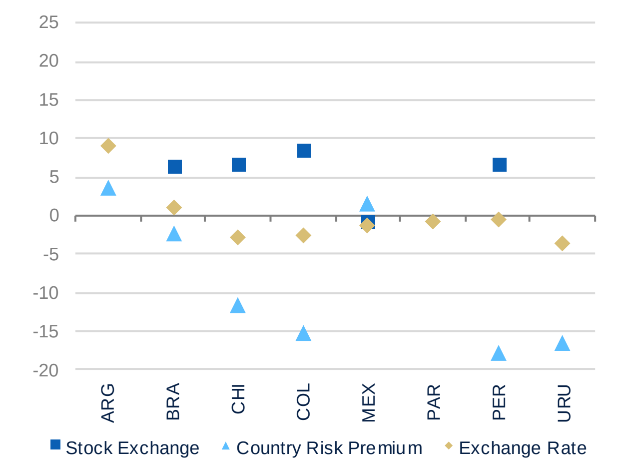
Finally, we should point out that the recovery of economic activity in most of the countries in the region has also been a source of support for its financial markets.

Figure 2.3 Volatility, and the price of oil per barrel (Brent) and of copper*



* Oil and copper prices: indices with base of 100 as at 1 January 2015.
Source: BBVA Research, Datastream and Bloomberg

Figure 2.4 Financial markets: percentage change over the past three months*



* Changes between 10 October and 10 January. Exchange rate: domestic currency/US dollar. In this case increases indicate depreciation. Country risk premium: EMBI.
Source: Haver Analytics, Datastream and BBVA Research

Specifically with regard to risk premiums, in the past three months these have plummeted in Brazil, Chile, Colombia, Peru and Uruguay, while they have held virtually stable in Argentina and Mexico (Figure 2.4). In 2017 as a whole, risk premiums built up falls that ranged from 18% in Mexico and 23% in both Colombia and Argentina to 34% in Uruguay and 36% in Peru. In Mexico's case it is worth noting that despite the recent turmoil, the risk premium is currently quite a way below the levels seen immediately following Donald Trump's election as president of the United States in November 2016.

Similarly stock markets have risen in the past three months in all countries except Mexico, where they fell back 1% (Figure 2.4). Notable here was the Argentine securities market, which spiked 25%, boosted by the support shown for the current government's policies and reforms in legislative elections in October and subsequently in Congress. Reinforced by the encouraging performances of stock markets in the last few months, 2017 closed with gains of 8% in Mexico, 14% in Colombia, 28% in Peru and Brazil, 34% in Chile and 77% in Argentina.

Looking ahead, exchange rates will depreciate given the growing gap between the region's interest rates and those of the Fed

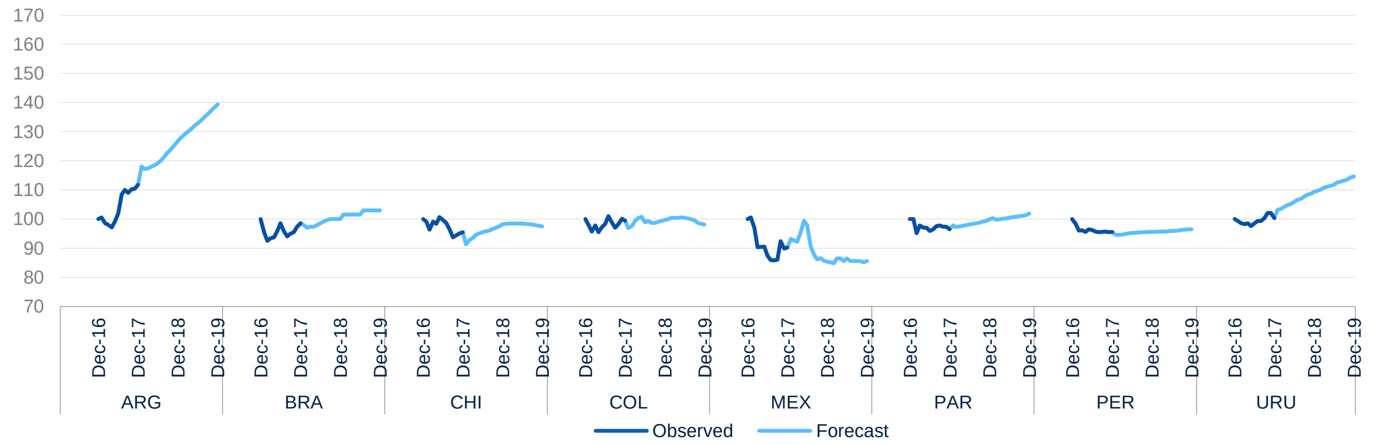
Turning to currency markets, the Argentine peso and the Brazilian real have weakened, while the Mexican peso and the Peruvian sol currently stand at levels very much on a par with those of three months ago, despite the recent turmoil, and the currencies of the other countries in the region have strengthened, even in Chile, where the presidential elections prompted quite a bit of noise (Figure 2.4). In Argentina's case, peso weakness has been contributed to by the recent changes in inflation targets, which augurs a more relaxed monetary policy, while in Brazil's case recent movements of the real have been affected by a bleaker outlook for approval of the necessary social security reform, and in Mexico uncertainty over the NAFTA negotiations has played a major role. In 2017 as a whole there were nominal appreciations of the currencies in Chile (8%), Colombia (1%), Mexico (5%), Paraguay (4%), Peru (3%) and Uruguay (2%). Although the Argentine peso and the Brazilian real lost 19% and 2% respectively in nominal terms, they appreciated in real terms last year.

The boost provided by commodities should wear off slightly going forward. After the powerful surges noted of late, we see some margin for prices in general to adjust downwards slightly over 2018 and 2019. Specifically we predict that the oil price, which currently stands at around 69 dollars to the barrel (buoyed by higher demand, lower inventories and the extension of the OPEC agreement to curb output), will ease back gradually to 65 dollars at the close of 2018 and to 63 dollars in 2019, as production is stepped up in response to the recent price rise. In the case of copper, we foresee prices slipping from the current level of 3.24 dollars / lb. to 2.83 dollars in December this year and 2.75 dollars in December next year, driven by a scaling down of positions by non-commercial players in the market. Finally we see scope for the soybean price to rise from 338 dollars per metric ton at the moment to around 370 dollars in 2018 and 2019 as such favourable supply-side conditions as those seen in recent years are not likely to be repeated in the next few years. Likewise, for the three commodities analysed, prices currently being forecast are somewhat higher than those three months ago, which is largely due to the better growth outlook we have for China.

A dampening of commodity prices, additional Fed rate hikes and a decrease in global liquidity could provoke a correction of Latin American financial asset prices looking ahead. To be precise, in the Forex market we see it as likely that most of the region's currencies will depreciate gradually in 2018 and 2019 (Figure 2.5). The exceptions are the Mexican peso, which should firm up towards its equilibrium level once the risks currently besetting the country disappear, and the Colombian peso, which will probably appreciate as the economy recovers. Again, compared to our previous forecasts of three months ago, our current ones reveal a generally stronger path for exchange rates, in line with recent movements on Forex markets, higher predictions for commodity prices and better growth prospects.

Finally it is important to stress that potential political unrest could emerge in the region, sparking financial turmoil and a less promising than expected course for exchange rates, particularly in Mexico, Colombia, Brazil and Paraguay, where presidential elections are due to be held over 2018.

Figure 2.5 Nominal exchange rate: observed and expected (local currency/US dollar) (January 2016=100)*

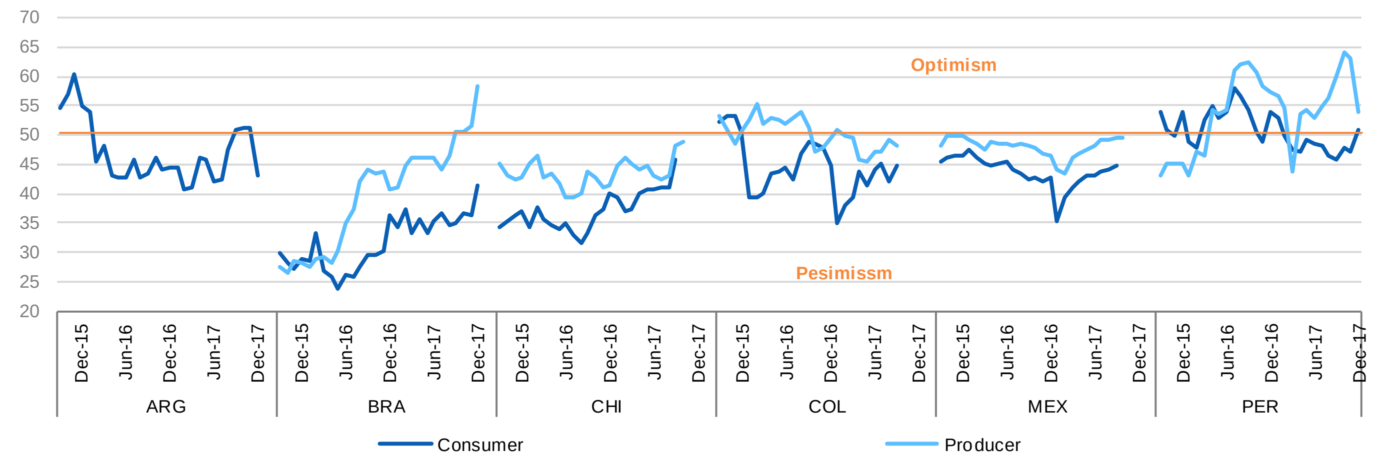


* Increases indicate depreciation.
Source: BBVA Research

Growth on the rise in Latin America, which should reach its potential level in 2019, but one lower than in the previous decade.

Private sector confidence indicators continued to recover gradually in most countries in the region (Figure 2.6) in a continuation of the trend of previous quarters, even though they are still generally keeping to levels that are associated with a mild degree of pessimism (except in Peru). As far as businesses are concerned, the recovery has been partly inspired by the calm on international financial markets, the increase in commodity prices, especially copper, and a decline in political noise and uncertainty in some countries, especially in Chile, after the recent elections. On the other hand, in Mexico private sector confidence continued to improve, driven by the positive tone of economic activity in recent months and in spite of the toughening of rhetoric from the new administration in the United States regarding the NAFTA negotiations. In the case of households, the easing of inflation in most countries has continued to improve purchasing power and confidence levels, while labour market weakness would appear to have bottomed out given the recovery of economic activity.

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



Source: BBVA Research

Economic activity in the region continued to gather pace in line with the recovery of confidence figures, although this was clearly mixed. The growth of recent months gradually took hold in Argentina, continued to rally in Brazil, Chile and Peru, but remained relatively weak in Colombia, while it showed a declined —which we view as temporary— in Mexico.

Having closed 2017 with an estimated growth of 1.1%, GDP for Latin America as a whole will rise to 1.7% this year and 2.5% in 2019. The change of trend in the region in the wake of the slowdown suffered in the five years leading up to 2016 is therefore becoming established. The rise in growth in 2018 and 2019 will rest on two factors in particular. On the one hand, the external sector will benefit from consolidated and widespread world growth, while higher commodity prices will also provide a boost for exports and investment in the primary sector. The other major source of growth will be investment by both, the private sector (especially in Argentina, following the outcome of elections that extends the horizon of pro-market policies, and the recovery of investment in Brazil) and the public sector, which largely focusses on infrastructure, in countries such as Colombia, Peru and Argentina.

Our new growth forecasts for 2018 are 0.1pp higher than those of October, while those for 2019 are unchanged. Most countries in the region see a rise in their forecast growth for 2018, thanks to economic activity figures that are better than those expected in the past three months, as well as a more promising external outlook, given the aforementioned greater world growth and higher prices for the major export commodities. The main exceptions to this upward revision in forecasts are Mexico, Colombia and Peru. In the former two cases, there is no change in our growth forecast for 2018, while in the case of Peru we reduced forecast growth for 2018 by 0.4pp given the escalation in political unrest and uncertainty, which should have an adverse impact on private investment and execution of programmed public investment.

We revised forecast growth in 2018 upwards in most countries, except in Colombia and Mexico (unchanged) and Peru (downwards)

The growth forecast for 2019, of 2.5%, should already be approaching the potential rate for Latin America, of between 2.5% and 3%. This new potential growth rate, which is below the level exhibited by the region in the decade of surging commodity prices (up to 2013), suggests a new normal for the region, where growth ought not to be very different from that in the developed regions and therefore growth in income per capita will not significantly close the gap that separates the region from the developed economies, as occurred between 2000 and 2013. This highlights the importance of returning to the path of structural reform to restore productivity growth going forward.

Within this general panorama, the countries which will show the most growth in the next two years are Argentina, Peru, Paraguay and Uruguay (Figure 2.7). Heterogeneity remains at the core in regional economic performance:

- In **Brazil,** the surprise on the high side of growth figures throughout 2017, together with more solid external demand prospects and higher commodity prices, lead us to revise our growth forecast upwards to 2.1% in 2018 and 3.0% in 2019 (0.6pp and 0.3pp above the levels of three months ago). Growth in the next two years should continue to be underpinned by the boost from the external sector and investment. Overall, there is still a risk attaching to the outcome of the election process at the end of this year and the impact on necessary reforms, especially reform of a provisional nature.

- In **Mexico**, we are maintaining our growth forecasts for 2018 and 2019 unchanged at 2.0% and 2.2%, respectively. We expect that the feeble level of dynamism seen in the latest growth figures published in the third quarter of 2017 should be temporary and that growth should make a comeback, shored up by consumption and construction, as well as exports to the United States. All in all, investment is expected to contract in 2018 for the second year in a row due to a climate of uncertainty over the outcome of the NAFTA negotiations and the presidential elections.

- In **Argentina**, recent indicators confirm that growth is recovering. Moreover, the positive effect of higher growth in Brazil and the rest of the world will serve to boost exports. Investment will also be driven by the positive impact of the structural reforms underway, especially those concerning taxation. On account of all of these factors, we are revising growth upwards by 0.3pp in 2018 and 2019 to 3.3% in both years. Investment and consumption will be the principal drivers of growth.

- As regards **Colombia** we are keeping our growth forecasts unchanged at 2.0% and 3.0% in 2018-19, with a stronger performance by consumption and the external sector, which is offset by weaker-than-expected activity in the residential construction sector. Even so, investment in infrastructure will continue to be the main engine of growth, especially in 2018.

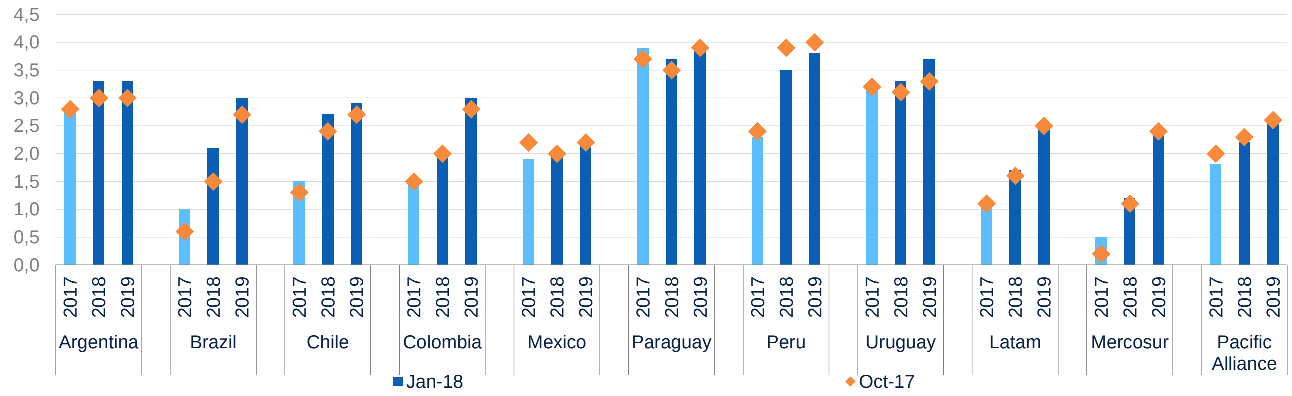
- In **Peru**, the political unrest that began in the middle of December should have an adverse impact on private investment and the execution of public investment. We are therefore cutting our growth forecast for 2018 and 2019 back to 3.5% and 3.8% respectively (0.4pp and 0.2pp below our forecasts of three months ago). Growth will continue to be driven by the mining industry, spurred on by a rise in expected copper prices and investment in infrastructure and reconstruction.

- In **Chile**, there has been a rapid recovery of the confidence indicators, both among consumers and the business community, partly due to the improved external scenario, the rise in the copper price, the change in the political situation and low inflation. We have therefore raised our growth forecast to 2.7% in 2018 and 2.9% in 2019 (0.3pp and 0.2pp up on three months ago), the latter representing a clip close to the potential level. Growth will be driven by both domestic demand and the export sector.

- For **Uruguay**, we are revising growth upwards to 3.3% in 2018 and 3.7% in 2019 (0.2pp and 0.4pp above our forecasts of three months ago) on prospects of a bigger contribution from external demand in connection with Brazil and China, as well as tourism from Argentina. Growth will be boosted by the dynamism of private consumption on account of improvements to real wages from a drop in inflation. Similarly, the construction of the third cellulose plant scheduled to begin in late 2018 will fully impact on 2019 investment.

- In **Paraguay**, GDP should grow by 3.7% and 3.9% in 2018-19, which implies a revision of 0.2pp in 2018 and standing by our forecast for 2019. The upward revision for 2018 is on higher expected growth for its key trading partners (Brazil and Argentina). Activities tied in with domestic demand will continue to shore up growth, especially investment.

Figure 2.7 Latam countries: GDP growth (%)



Source: BBVA Research

Inflation pressure remains relatively limited, except in Mexico.

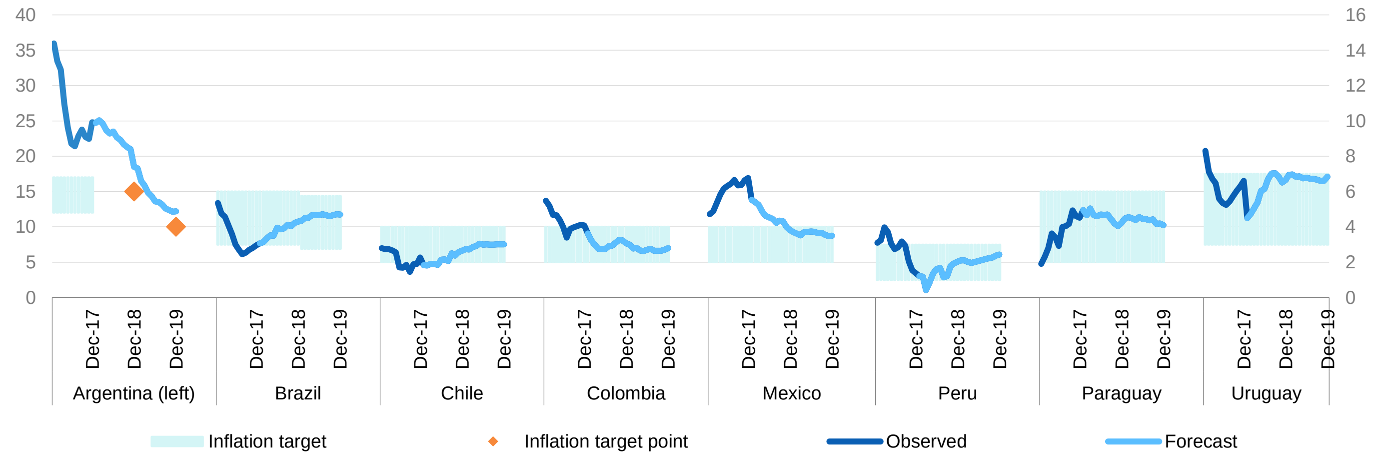
Inflation closed 2017 at relatively low levels in most of the region (Figure 2.8). Specifically, changes in price levels have been at their lowest in at least the last three years in Argentina, Brazil, Chile, Colombia, Peru and Uruguay. The process of dampening inflation in the region has been helped along by the weakness of demand from within it, the relative strength of currencies and, in several cases, more favourable trends in food prices.

After the recent slowdown, inflation is now within or very close to the range established by the monetary authorities in Brazil, Chile, Colombia, Peru and Uruguay. Also in Paraguay inflation is now within the target range, although in this case inflation has not lost steam recently as it has in most of the region.

Even though inflation fell back in Argentina in 2017, it stayed at relatively high levels (24.8% YoY in December), well above the benchmark range of 12% to 17%. Likewise, the comparatively slow process of deceleration in core inflation in the country lead local authorities to announce at the end of 2017 an adjustment to the path of inflation targets – that postpones achieving the 5% medium term target rate by one year to 2020. To be precise the target for 2018 was moved to 15% (previously 10% with a tolerance range of plus or minus 2 percentage points), while that for 2019 became 10% (previously 5%, with a tolerance range of plus or minus 1.5 percentage points) and that for 2020 and subsequent years was set at exactly 5%.

In contrast to the other countries in the region, in Mexico inflation has risen substantially in recent months and closed 2017 at 6.8%, which is a particularly high level by the country's standards and far above the upper limit on Banxico's range of variability (4%). In this case inflationary pressure is basically attributable to the adjustments to gas prices and the weakness of the Mexican peso.

Figure 2.8 Inflation: observed and forecast (YoY %)



Source: BBVA Research

Going forward, the recovery of domestic demand, the probable (moderate) exchange rate depreciation and the accommodative tone of monetary policy should contribute to inflation edging upwards in Brazil, Chile and Peru. In particular, we forecast that it will converge on 4.3% in 2018 and 4.7% in 2019 in Brazil, on 2.7% in 2018 and 3.0% in 2019 in Chile and on 2.0% in 2018 and 2.4% in 2019 in Peru.

Inflation in Brazil and Chile has already bottomed out, and should do so in Peru in the first quarter of 2018

In Argentina and Colombia inflation should continue to ease back over 2018 and 2019, drawing closer to (though not reaching) the new targets in Argentina's case and returning to within the target range in Colombia's case (Figure 2.8). We estimate that in 2018 and 2019 inflation will converge towards around 18% and 12% in Argentina, and 3.1% and

2.8% respectively in Colombia. Similarly, in Argentina it will remain to be seen whether the recent shift in the path of targets ends up affecting the credibility of the central bank, thereby making it harder for inflation to converge on target levels.

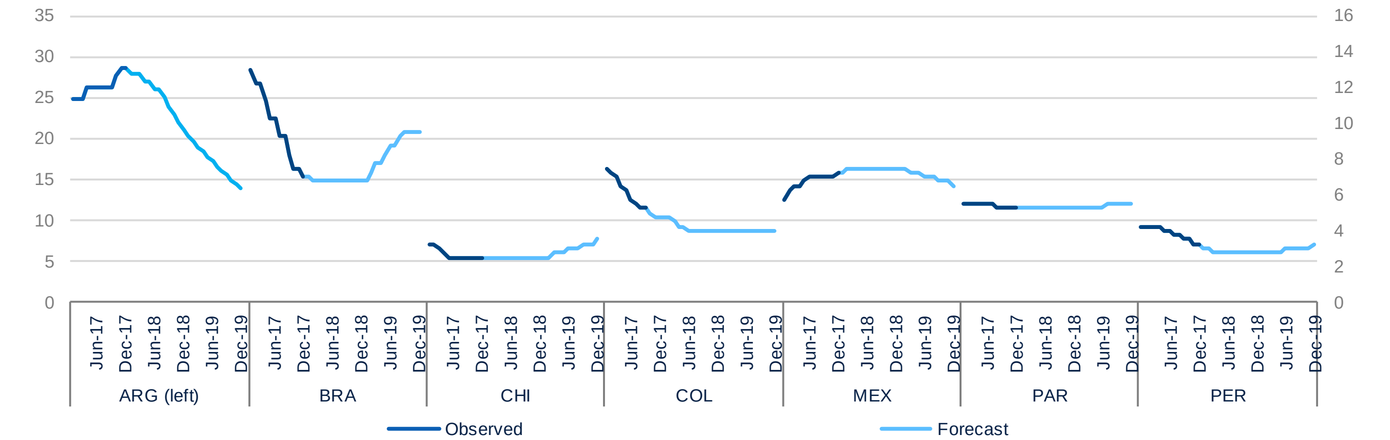
In Mexico the most likely outcome is that, after the recent sharp spike, inflation will suddenly fall back in January and continue to ease at a rapid pace over the rest of the first quarter, then keep to a pattern of gradually decreasing over the rest of the year and in 2019. The risk in this scenario concerns a significant deterioration in relations with the United States or political instability which end up causing greater peso weakness. Thus, our baseline scenario is one where inflation in Mexico is trimmed to 3.8% in December 2018 and 3.5% at the end of 2019.

Finally we predict that over the forecast horizon considered, inflation will hold close to the upper limit of the target range of 7% in Uruguay and will approach the central target of 4% in Paraguay.

Close to the end of interest rates cuts in most countries in South America

As inflation climbs up from low levels over the next few months in Brazil, Chile, and from the second quarter on in Peru, the scope for the monetary authorities in these countries to announce new cuts to the reference rate will diminish. Indeed, in Chile's case the recent signalling by its central bank indicates that, following the cuts announced in 2017 which brought down the monetary policy rate from 3.5% to 2.5%, rates will remain stable over the course of 2018. In Brazil the most likely scenario is that, at its first meeting in 2018, the monetary policy committee will announce a final Selic rate cut of 25bp and leave this at 6.75% for a long time, which is a particularly low level for the country (before the start of the rate-lowering cycle in October 2016, the Selic rate stood at 14.25%). In Peru, where interest rates reached 3.0% in January after cuts totalling 125bp since May 2017, we predict that the central bank will mark an end to the rate-lowering cycle with a final cut of 25bp over the first quarter of the year. Likewise in these three countries the recovery of economic activity and the expected rise in inflation lend themselves to a foreseeable start on a cycle of rate hikes over 2019 (Figure 2.9).

Figure 2.9 Interest rates: observed and forecast



Source: BBVA Research

In Colombia, where the central bank surprised by announcing two rate cuts in the last quarter of 2017, the expected additional reduction of inflation pressure should ensure a bit more scope for supplementary rate cuts in the coming months. Whatever the case, the cycle of reference rate reductions is also drawing to a close in Colombia: we forecast that three 25bp cuts will take rates to 4.0% up to the end of the first half of 2018 and that from then on the monetary policy rate should be held stable at that level until at least the close of 2019.

In Paraguay interest rates should stay at their current level of 5.25% over 2018 and move upwards slightly in 2019 to keep inflation pressure at bay.

In general, in all of these cases examined here, the expected continuity of rate hikes in both the United States and other developed regions will contribute to limit the room for additional cuts in local rates.

The exception among the South American countries is Argentina, where the gradual process of inflation normalisation is expected to enable a significant potential lowering of interest rates over 2018 and 2019. Fuelling this expectation has also been the recent adoption of higher inflation targets. Indeed, in the first monetary policy meeting after the announcement of a shift in targets, the central bank cut interest rates by 75bp, which was followed up by another 75bp cut at the end of January. In practice these cuts already reflect a change in direction for monetary policy, as up to November 2017 reference rates were being adjusted higher (between April and November they rose by 400bp) Although Argentina's central bank will have to be wary and condition new rate cuts on favourable trends in inflation, we predict that rates will go down from their current level of 28.0% to 21.0% at the close of this year and to 14.0% at the end of next year.

In Mexico, after a new upward rate correction we foresee a long period of stability and cuts only from 2019 onwards.

As regards Mexico, after keeping the bank funding rate steady at 7.0% since June 2017, a 25bp hike was announced at the monetary policy meeting in December, which was the first one chaired by the new governor of Banxico, Alejandro Díaz de León. Recent signalling by the central bank indicates that a new monetary adjustment could be announced soon. This further tightening of monetary policy in Mexico, which we had not factored into our baseline scenario of a few months ago, is intended to keep expectations anchored and encourage inflation to return to its target range in a context where inflation rose unexpectedly in the fourth quarter and concerns linger over a possible hit to the peso from the NAFTA renegotiations and the presidential elections. Any hiking of the bank funding rate at the next monetary policy meeting in February should in any case be the last one in the current cycle. Banxico should only announce a new adjustment to the bank funding rate (in this case downwards) in the first quarter of 2019, when we expect inflation pressure to have worn off somewhat.

External risks will subside in the short term, but are still significant.

The risks to our forecasts for Latin America remain biased to the downside, both due to domestic ans external factors. All in all, in both cases we see a certain dwindling of these risks in the short term compared to our assessment of three months ago.

On the side of internal factors within the region, political noise and unrest in a good number of Latin American countries still stand out, in several cases allied to accusations of corruption and in others given the uncertainty over the result of forthcoming election processes, such as in Colombia, Brazil and Mexico for example. The uncertainty and political tension have diminished in Argentina and Chile now that the election results are out. Overall, the concentration of a whole raft of election processes in the region over the rest of the year (including in the region's two largest countries, Brazil and Mexico) generates potential for surprises and the risk of an emergence of populist governments, and paves the way for shocks and continued political uncertainty, with adverse effects, especially for confidence and investment.

Political risks are developing unevenly over the region. They are heightening in Peru yet subsiding in Argentina and Chile

Moreover, and in part to do with the political ructions and corruption scandals, the potential delay to infrastructure projects in countries such as Argentina, Peru and Colombia also represents a considerable risk to growth over the forecast horizon. This is a significant risk in that one of the cornerstones of growth in the next two years will be demand from inside and, within that, investment.

On the external front, two sources of risk to Latin America stand out. With respect to China, which has particular relevance for South America, the removal of the strict growth target after the 19th Communist Party Congress suggests a greater focus on reducing imbalances, while the measures aimed at opening up the economy and structural reforms should help improve growth potential. Thus, short term risks of a collapse in growth dissipate. Even so, the unevenness in the Chinese economy and borrowing remain at a high level, while over-capacity in the state business sector continues to absorb a high proportion of credit, which worsens the risks to financial stability in the medium and long term.

The second group of risks comes from the United States. Although the risks from this economy have diminished, they are still substantial, as there is still a high level of political turmoil and the threat of a clearly protectionist change of tack remains present, which could affect Mexico in particular. At the same time, some assets could be showing certain signs of being over-valued after a lengthy period of accommodative monetary policies. On the very subject of monetary policy, the economic scenario of growth running at a strong clip has served to endorse monetary policy normalisation increasingly clearly, for which reason we should expect a rise in the cost of borrowing on a global level and a potentially significant reduction in capital flows into the emerging economies (and into Latin America in particular). Communication policy has been very well handled by the Fed so far, yet it still remains an element of potential risk.

Finally, in the medium to long term there exists the structural risk of the reforms needed to boost productivity growth not being initiated. As we have said earlier in this report, growth in 2019 should already be approaching the region's new potential level, at between 2.5% and 3%. This rate of growth is insufficient to narrow the gap in income per capita with the developed countries, so it is essential for the necessary consensuses to be arrived at to push ahead with reforms in relation to the labour and goods and services markets, as well as in the provision of education and health, and of the state itself. The risk is of the region becoming used to this new potential growth level and failing to seize the opportunity to relaunch productivity growth.

3. Tables

Table 3.1 Macroeconomic forecasts

GDP (% YoY)

	2016	2017*	2018*	2019*
Argentina	-2.2	2.8	3.3	3.3
Brazil	-3.4	1.0	2.1	3.0
Chile	1.6	1.5	2.7	2.9
Colombia	2.0	1.5	2.0	3.0
Mexico	2.9	1.9	1.9	2.2
Paraguay	4.0	3.9	3.7	3.9
Peru	4.0	2.3	3.5	3.8
Uruguay	1.4	3.2	3.3	3.7
Mercosur	2.7	1.8	2.2	2.6
Pacific Alliance	-0.9	1.1	1.7	2.5
Latin America	-0.9	1.1	1.7	2.5

Inflation (% YoY, end of period)

	2016	2017	2018*	2019*
Argentina	39.4	24.8	18.5	12.2
Brazil	6.3	2.9	4.3	4.7
Chile	2.7	2.3	2.7	3.0
Colombia	5.7	4.1	3.1	2.8
Mexico	3.4	6.8	3.8	3.5
Paraguay	3.9	4.5	4.2	4.1
Peru	3.2	1.4	2.0	2.4
Uruguay	8.1	6.6	6.7	6.8

Exchange rate (vs. USD, end of period)

	2016	2017	2018*	2019
Argentina	15.83	17.70	20.08	22.06
Brazil	3.35	3.30	3.35	3.45
Chile	667	637	655	650
Colombia	3010	2991	3000	2953
Mexico	20.73	18.70	17.69	17.73
Paraguay	5718	5515	5710	5821
Peru	3.40	3.25	3.25	3.28
Uruguay	28.80	28.88	31.50	33.00

Interest rate (%, end of period)

	2016	2017	2018*	2019*
Argentina	24.75	28.75	21.00	14.00
Brazil	13.75	7.00	6.75	9.50
Chile	3.50	2.50	2.50	3.50
Colombia	7.50	4.75	4.00	4.00
Mexico	5.75	7.25	7.50	6.50
Paraguay	5.50	5.25	5.25	5.50
Peru	4.25	3.25	2.75	3.25
Uruguay**	24.70	22.50	23.00	22.80

Current account (% of GDP)

	2016	2017*	2018*	2019*
Argentina	-2.7	-5.1	-5.3	-5.0
Brazil	-1.3	-0.3	-0.6	-2.0
Chile	-1.4	-1.0	-1.5	-1.2
Colombia	-4.4	-3.6	-3.2	-3.4
Mexico	-2.7	-2.8	-2.9	-3.0
Paraguay	1.7	0.1	0.3	0.4
Peru	-2.7	-1.3	-1.8	-2.0
Uruguay	1.7	1.7	0.3	-0.7

Fiscal balance (% of GDP)

	2016	2017*	2018*	2019*
Argentina	-5.9	-5.8	-5.1	-4.1
Brazil	-9.0	-9.6	-8.5	-6.1
Chile	-2.7	-2.6	-2.0	-1.8
Colombia	-4.0	-3.6	-3.1	-2.5
Mexico	-2.6	-2.4	-2.0	-2.0
Paraguay	-1.4	-1.5	-1.5	-1.5
Peru	-2.6	-3.2	-3.4	-2.7
Uruguay	-3.9	-3.5	-3.1	-2.6

Commodity forecasts

	2016	2017	2018*	2019*
Oil (Brent USD/bbl) (average)	49.53	54.12	65.93	64.08
Soybeans (USD/metric ton) (average)	363	360	367	371
Copper (USD/lb.) (average)	2.21	2.79	2.90	2.79

Source: BBVA Research
*Forecasts. ** Interest rate on loans.

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