BBVA Research

Latin America Economic Outlook

Second quarter 2018

South America Unit

Creando Oportunidades

Contents

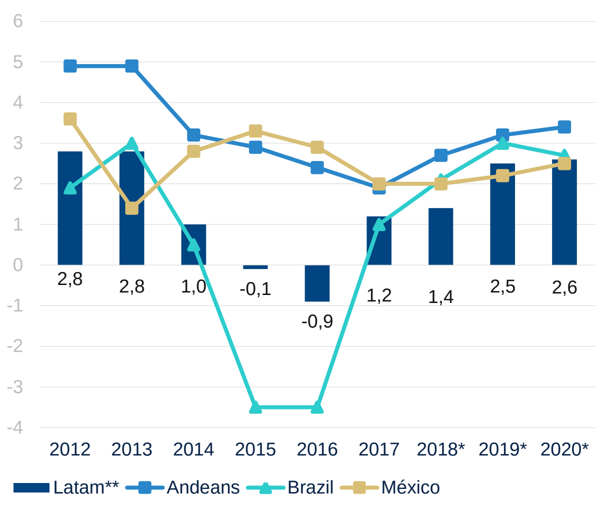
Closing date: **6 April 2018**

1. Summary

The Latin American financial markets held up well in the face of increased volatility in the developed markets and political noise in certain countries. Several markets posted gains to varying degrees, the main exceptions being Argentina and, to a lesser extent, Brazil. Volatility remained low and capital inflows continued, although they eased up gradually. The relatively strong resistance of the region's financial assets was underpinned by prospects of recovering growth and higher commodity prices. Looking ahead, we anticipate a moderate depreciation in the region's exchange rates in line with the US Federal Reserve's expected rate hikes while interest rates in Latin America will in general remain unchanged, but in an environment in which volatility settles at a higher level.

Latin America will grow by 1.4% in 2018 and 2.5% in 2019, continuing the upward growth trend. Growth in 2019-20 will then be close to the region's potential (between 2.5% and 3%, Figure 1.1). The forecast for 2018 is 0.3 pp lower than three months ago, despite the more favourable external environment, with a high rate of global growth and an increase in commodity prices. The downward revision for Argentina and Uruguay (drought), Paraguay (poor harvest) and Peru (political noise) totally offsets the upward revision of growth for Chile (higher copper prices and improved confidence). Even so, the negative shocks behind these revisions are mostly of a temporary nature and do not affect our medium-term outlook for the region. Growth in the next two years will continue to be underpinned by the external sector and the momentum of investment.

Figure 1.1 Latin America: GDP growth (%)



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

The cycle of interest rate cuts will come to an end in South America in the second quarter. Monetary policy will continue to be accommodating as long as inflation remains within the central banks' target ranges, but economic activity is still below its potential, albeit in a recovery phase. The exception in South America is Argentina, where interest rates will start to fall again once inflation is on a downward path. In Mexico, interest rates will be kept on hold until the end of 2018, when we should start to see cuts, providing the external and electoral risks are not realised.

The main external risks concern protectionism (up), the withdrawal of stimulus measures by the Federal Reserve (stable) and China (more moderate than three months ago). On the domestic front, political noise and the possible deferment of public and private investment is a growing risk in a number of countries, excluding Argentina and Chile.

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2. Latin America: recovery amid turbulence

Global economy: growth rate holds firm but risks of protectionism intensify

The global economy is currently being subjected to divergent forces. The new fiscal stimulus measures approved by the US administration will prolong the favourable phase in the world economic cycle, which has so far been bolstered by high levels of confidence and the positive tone of industrial activity and international trade, which also benefit China and Europe. On the other hand, the increased vulnerability of the US public accounts brought about by these fiscal stimulus measures, combined with the prospect of some financial markets facing greater volatility than in 2017, make this scenario more uncertain. Added to this is the ratcheting up of protectionist rhetoric in the US, which has started to find expression in specific measures. All this is taking place in a context of monetary policy normalisation following years of exceptional stimulus measures, which may also give rise to additional doubts.

Global growth remained stable at the beginning of 2018 (Figure 2.1), with greater dynamism in the emerging economies and some signs of moderation in the developed countries. Data available for the first two months of the year suggest that global growth in the first quarter would sit at a similar level to the average for 2017 (1% QoQ). This growth was favoured firstly by the good performance of world trade, which picked up substantially, especially as regards exports from emerging economies, and in particular (in February) from Asia (mainly China and India). A second factor is the sound growth in industrial production, especially in the emerging markets.

Probably the biggest news in the global context in the past three months has been the fiscal stimulus approved in the United States in February. This move should have a moderate effect on short-term growth (since the US economy is already very close to full employment) and could exert upward pressure on interest rates (in the midst of monetary normalisation by the US Federal Reserve). For all these reasons, we estimate that it will exert a small multiplier effect on activity (of around 0.4), which would lead to an upward revision in GDP growth of around 0.2 to 0.3 pp in both 2018 and 2019.

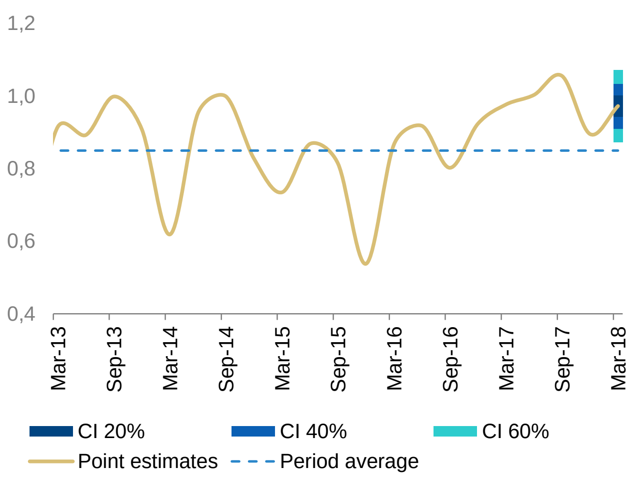
That said, in the short term the US fiscal stimulus might prolong the global expansionary phase, extending the cyclical recovery and leading to an increase in global demand. However, this effect will be countered in our scenario by an increase in volatility worldwide or by the resurgence of greater political uncertainty in some areas, as well as by the possible negative effect of the uncertainty associated with protectionist measures.

Following a year dominated by optimism and risk-taking in the financial markets, the first quarter of 2018 has shown a more cautious tone. On the one hand, financial conditions, which have been highly accommodating, have started to tighten. And, above all, volatility, which has been unusually low, seems to be transitioning towards a more “normal” situation (higher volatility and possibly more persistent volatility shocks), while monetary policy continues to normalise. In the case of the US Federal Reserve in particular, we expect the process to speed up a little (with four 25 bp reference rate hikes in 2018, as against the three previously forecast) following the fiscal boost. In addition, long-term interest rates are settling at higher levels, especially in the US, due to increased growth and fiscal deterioration, which implies greater financing needs and adds a risk premium to the financing of the US Treasury.

On the other hand, the bout of volatility in early February, which prompted a sharp correction on the stock markets of the developed countries, has for the time being led to very little spill-over to other kinds of assets. All this has contributed to pushing up our financial stress indicator for both the developed and emerging economies (Figure 2.2).

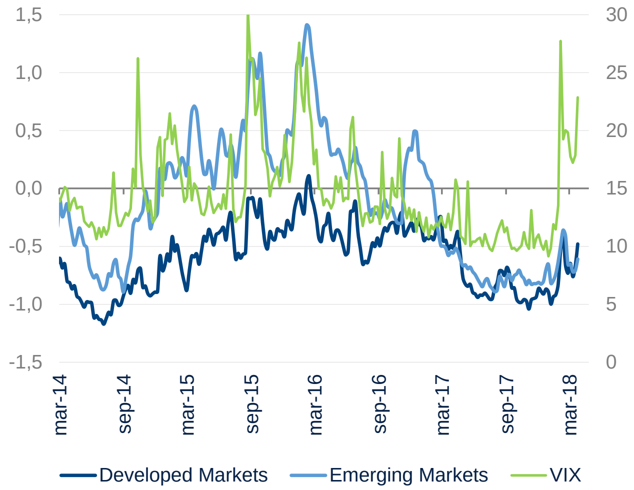
Given this scenario, we are standing by our forecast for world growth of 3.8% for the 2018-19 period. This does however involve an upward revision of growth prospects for both the US and the euro zone, offset by slightly less buoyancy in the emerging economies, especially in South America.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (%, t/t)



Source: BBVA Research

Figure 2.2 BBVA index of financial tensions and VIX



Source: BBVA Research based on EPFR

For China, we are holding our growth forecasts at 6.3% and 6.0% for 2018 and 2019 respectively. The majority of recent data shows that the momentum is holding in both domestic demand and exports. Confirmation of an economic policy approach that combines a prudent monetary policy with an expansive fiscal policy, together with the approval of restrictive financial regulation measures, make us somewhat more optimistic about the domestic risks associated with China's economy.

Global risks are abating as regards China, though they are mounting in the United States, especially due to protectionism.

In the case of the United States, the positive figures for the past few months for activity and foreign trade come on top of the above-mentioned short-term effects of a more expansive fiscal policy, which combines both the tax cuts approved in December (already factored into our previous forecasts) and the new fiscal stimulus measures. As a result, US growth is estimated at 2.8% for both 2018 and 2019 (involving upward revisions of 0.2 pp and 0.3 pp respectively).

In Europe, the solid figures last quarter for exports and fixed investment, plus resilient private consumption, lead us to maintain our growth forecast for the euro zone (revised slightly upwards to 2.3% in 2018). For 2019, we continue to forecast some moderation of activity, with growth of around 1.8%, due to a degree of fatigue in the cyclical momentum, as already anticipated by the leading indicators.

The risks around our global scenario have grown because of protectionist threats, which materialised with the US increase in tariffs and the Chinese response. Although the impact on global activity of the measures adopted so far has been limited, uncertainty has been fuelled regarding a possible escalation in trade restrictions among the major economic regions that could end up discouraging investment worldwide. Other sources of uncertainty involve the normalisation of monetary policies, especially a faster than expected exit by the US Federal Reserve, associated not with higher growth but with an unexpected surge in inflation. On the other hand, the risk associated with a sudden correction of the Chinese economy has lessened to some extent because of the measures approved following the Chinese Communist Party Congress in October and signs of a gradual reining in of borrowing.

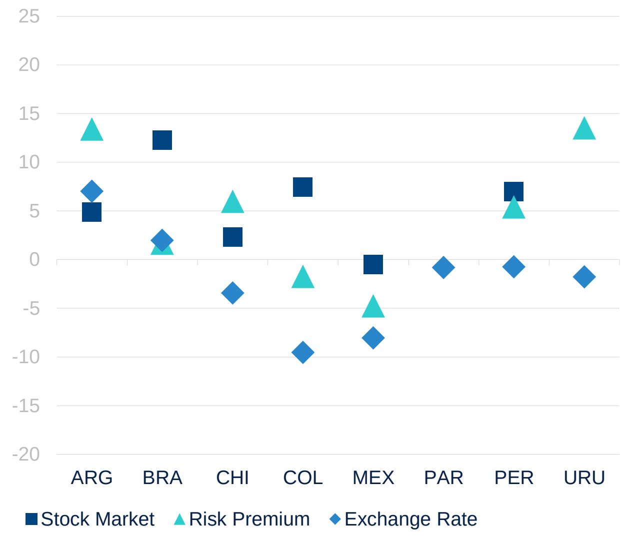
Latin American financial markets: resistance to rising volatility in the developed markets

Despite the increase in global financial tensions highlighted in the previous section and local factors, such as the political noise generated in countries such as Peru, Colombia, Mexico and Brazil, and the concern about the effect on Mexico of the renegotiation of the North American Free Trade Agreement (NAFTA), the tone of the Latin American financial markets has not been especially negative so far this year (Figure 2.3).

In fact, in many markets there have been gains in the prices of financial assets in the last few months. This is the case on most of the region's stock and exchange markets. In regard to stock markets, the main exception is Mexico, where the market has fallen slightly since the beginning of the year, erasing part of the 8% increase registered in 2017. In regard to exchange rates, the Argentine peso and the Brazilian real contrast with the overall positive dynamics of the region's currencies. In an environment of greater volatility in global markets and a great need for external financing, Argentina's currency has depreciated by 7.4% so far this year, mainly due to concerns about possible greater tolerance with respect to inflation by the country's authorities following the upward adjustment of inflation targets in December 2017 and the cut in the monetary policy interest rate. In the case of the Brazilian real, which has depreciated by 2% this year, the political noise has had a negative effect, in an environment in which the presidential elections are beginning to dominate the political agenda and no additional measures have yet been taken to solve the fiscal problem.

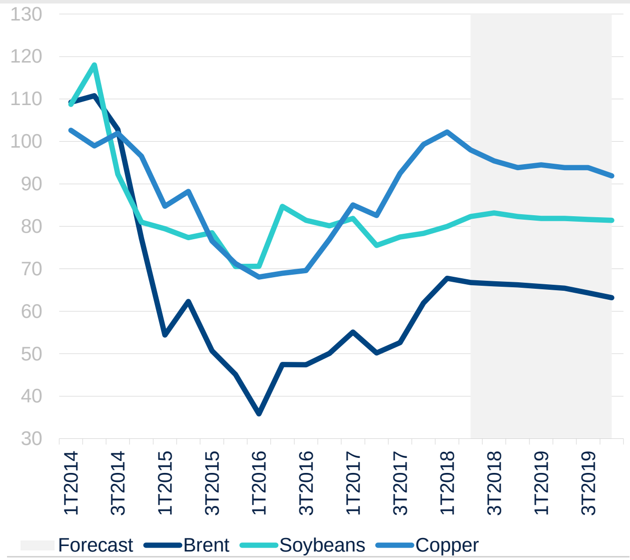
The relative resilience of financial assets in the region has been supported by factors such as the progressive consolidation of prospects for a recovery in economic activity and commodity prices. In regard to the latter factor, the price of oil has risen by 11% this year after increasing 18% in 2017. Meanwhile, soybean prices are up by 9% in 2018, offsetting the drop of 4% registered last year. The price of copper, another commodity that is of particular importance to the countries in the region, has corrected downwards this year (-3%) but remains at relatively high levels after increasing by more than 30% in 2017 (Figure 2.4). In general terms, commodity prices are being supported by relatively robust global demand, as well as by some supply factors (mainly in the case of soybeans, due to the prospect of a sharp fall in production in Argentina as a result of adverse weather conditions) and financial factors (the recent depreciation of the dollar, which mainly benefits the price of oil, and, in the case of copper, the positioning of the non-commercial agents in the financial markets).

Figure 2.3 Financial markets: percentage change YTD



*Changes between 31 December 2017 and 18 April 2018. Exchange rate: domestic currency/dollar. In this case, an increase indicates depreciation. Country risk premium: EMBI. Stock markets: change in indices in domestic currency.
Source: Haver Analytics, Datastream and BBVA Research

Figure 2.4 Prices of main commodities (average index 2014 = 100) *



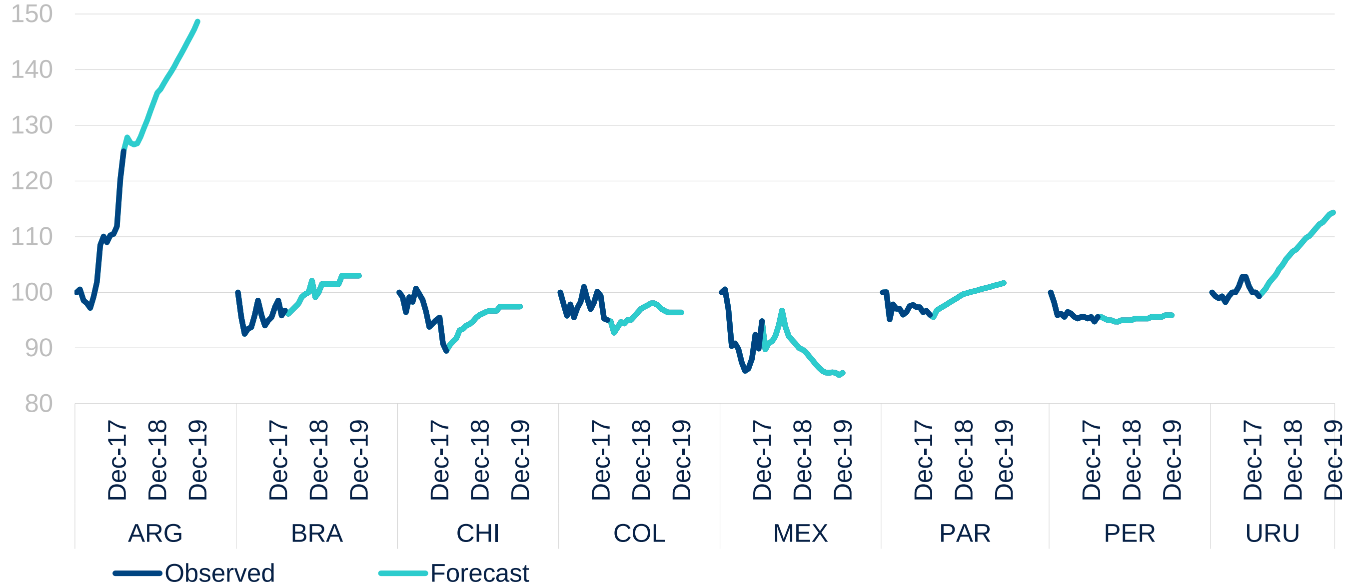
* Lines represent quarterly averages.
Source: Bloomberg and BBVA Research

Going forward, it is likely that volatility in the global financial markets and a gradual reduction in the appetite for emerging market assets as interest rates in developed countries adjust upwards will continue to limit gains in the region's financial markets. In addition, commodity prices will probably not be as favourable in the coming years as they were in the first few months of 2018, although they will remain slightly higher than we previously anticipated, at least in the case of soybeans and copper (the former due to the effect on supply of the drought in Argentina and the latter mainly due to higher global growth). Finally, it should be noted that presidential elections will be held in many countries this year (Colombia in May, Mexico in July and Brazil in October), which may increase the volatility of local markets.

Going forward, currencies will depreciate gradually as interest rates rise in the US

Taking the foregoing into account, in general we expect the regions' currencies to depreciate in nominal terms (Figure 2.5 and forecast tables in section 3). However, mainly due to the upward revision in our commodity forecasts, we now expect the currencies of Chile, Colombia, Paraguay, Peru and Uruguay to move towards less depreciated levels in 2018 and 2019 than previously forecast (for details on our previous projections, please see our Latin American Economic Outlook for the first quarter). In contrast, we now expect the Argentine peso and the Mexican peso to remain at more depreciated levels in the coming months than we previously anticipated. In the case of Argentina, we have incorporated into our expected path the effect of greater inflationary pressures and the higher current account deficit. In the case of Mexico, we now see a weaker peso in 2018, which is explained by political and NAFTA renegotiation risks, but we maintain the assumption in our baseline scenario that these risks will not materialise and that therefore the currency will appreciate significantly in 2019.

Figure 2.5 Nominal exchange rate: observed and expected (local currency/US dollar) (January 2017=100) *

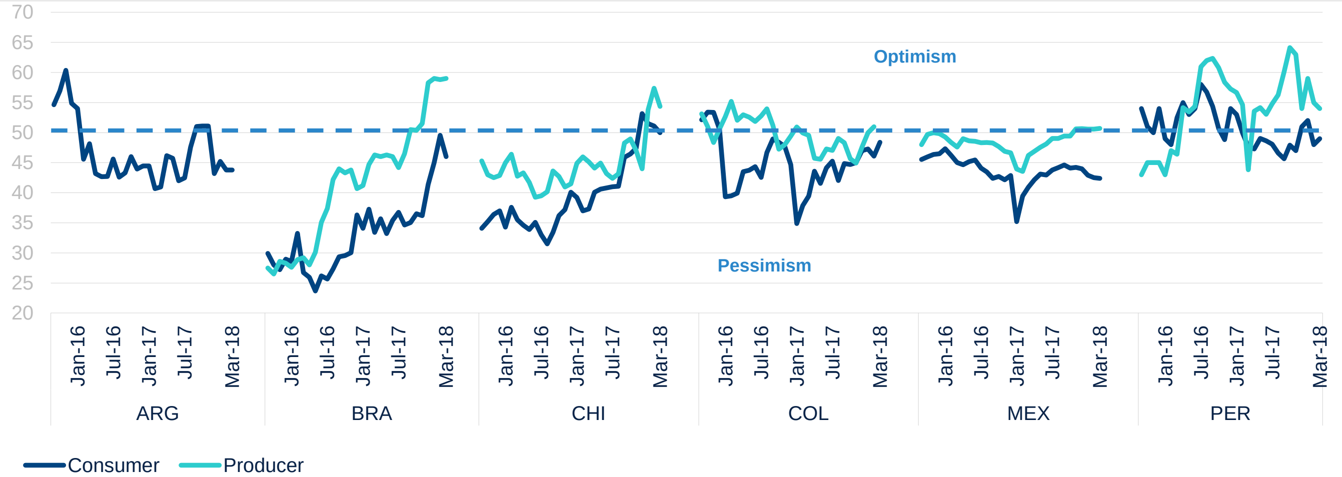


* Increases indicate depreciation.
Source: BBVA Research

Growth recovery continues in Latin America, with a few temporary shocks

In the last three months, recovery in the region's economic activity has generally remained brisk, albeit rather less so in the case of Colombia. Confirming this recovery, household and business confidence indicators for the region continued to improve (Figure 2.6), and particularly rapidly in Brazil and Chile. From the household point of view, except in Argentina, reduced inflation is continuing to boost optimism, while the labour markets seem to have stabilised (stopped deteriorating) or are even starting to show signs of recovery, as in the case of Chile and Argentina. For businesses, recovery has been favoured by an increase in commodity prices, especially copper, and by greater political calm in Chile, and Argentina too, following the recent elections, as shown by our political tensions indicator (Figure 2.7). However, business confidence has been adversely affected by the political factor in countries like Peru (Figure 2.8), where political tensions and uncertainty reached very high levels during the first quarter of this year, countering the positive effect of the rise in copper prices. In Mexico, confidence in the private sector held steady, waiting for the outcome of the negotiations on NAFTA with the US.

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



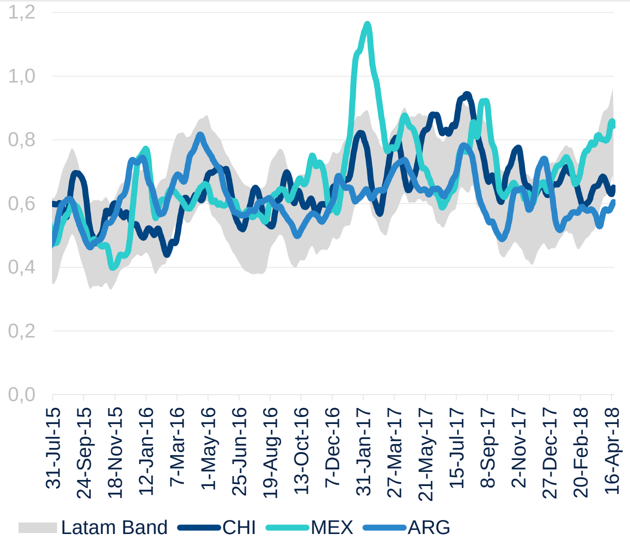
Source: BBVA Research

In this context, over the last few months growth has been relatively solid in Argentina, Brazil, Chile and Mexico, a little less dynamic in Peru and considerably less so in Colombia, although output gaps remain negative in the majority of countries.

The GDP of Latin America as a whole will grow by 1.4% this year and 2.5% in 2019, compared with the 1.2% rise posted in 2017. The outlook therefore remains one of a gradual recovery of dynamism in the region following the downturn seen between 2014 and 2016. Growth in 2018 and 2019 will continue to be driven by the external sector, with prospects of favourable prices for the major commodities (though not as high as those of 2013-2014) and robust global growth, as mentioned in section one. Investment will be another growth factor, both in the private sector (especially in Argentina, Colombia and Brazil) and in the public sector, particularly in infrastructure in Colombia, Peru and Argentina.

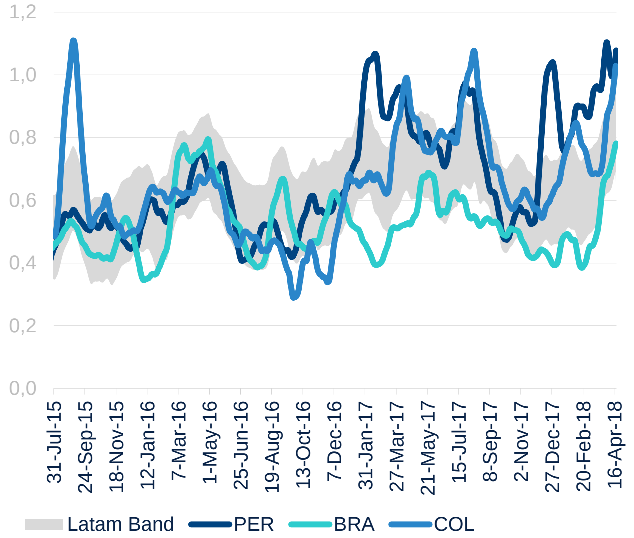
Our new growth forecasts for 2018 are 0.3 pp lower than those we estimated three months ago, while those for 2019 remain unchanged. As detailed below in the summary by country, we have revised the growth forecasts for Argentina downwards, mainly in view of the drought, which will affect the soybean harvest. The drought will also have a negative impact on Uruguay, while Paraguay too has seen lower crop yields after a string of record years. We have also revised the growth forecasts for Peru downwards in view of the impact that the political noise and uncertainty associated with the presidential impeachment process have already had in the first quarter of the year. Negative though they are, most of these shocks will in the main be temporary, so they do not compromise the trend towards potential growth in the medium and long term in most of these economies. In contrast, we have revised our growth forecasts for Chile upwards in view of the increase in copper prices and the marked increase in business confidence in the past few months. Growth forecasts for the other countries (Brazil, Mexico and Colombia) remain unchanged.

Figure 2.7 BBVA index of political tensions* Argentina, Chile and Mexico



* Tone of news and comments on politics in the press, weighted by total media coverage. 30-day moving average.
Source: BBVA Research and GDELT

Figure 2.8 BBVA index of political tensions* Brazil, Colombia and Peru



* Tone of news and comments on politics in the press, weighted by total media coverage. 30-day moving average.
Source: BBVA Research and GDELT

As we pointed out previously, growth in 2018 will still be below its potential in many countries, and the level of economic activity also still leaves a negative output gap, so that activity can still be considered relatively weak, although in the process of picking up. As we shall see presently, this still justifies expansive positions on the part of the central banks in the majority of countries, where inflation rates are already within their target ranges.

We have revised growth for 2018 downwards, but the rising trend that started in 2017 remains in place and should continue for the next few years

Although many countries should achieve their potential growth as early as 2019 and 2020, this new growth potential points to an average for Latin America of between 2.5% and 3%, which is below that of other emerging regions and too close to that of the developed regions to be able to reactivate the process of convergence with them. As we comment below in the section on risks, one of the major long-term risks for the region is neglecting the reform process that is required to boost productivity and, therefore, potential growth.

The region is characterised by considerable disparities, but we should highlight the dynamism of Argentina, Chile, Peru, Paraguay and Uruguay in 2018-2019 (Figure 2.9). However, the pattern of increasing growth between 2017 and 2019 is almost general throughout the region:

- In **Brazil,** the prospect of more robust external demand and better commodity prices is offset by slightly less dynamic domestic demand than we had anticipated. For this reason, we are holding our growth forecasts unchanged at 2.1% and 3.0% for 2018 and 2019 respectively. Growth in these two years will continue to be supported by the external sector and the recovery in domestic demand in particular. In this scenario, we assume that the significant progress needed in social security reform will only be made from 2019 on, by the new government elected at the end of the year.

- For **Mexico**, we are maintaining our growth forecasts for 2018 and 2019 unchanged at 2.0% and 2.2% respectively. Growth will be driven above all by private consumption and exports of manufactured goods (buoyed by greater US growth). These two factors will more than offset the contraction in investment in 2018 in reaction to uncertainty about the outcome of the NAFTA negotiations and the presidential elections.

- In **Argentina**, the positive impact of the external environment on economic activity will be more than offset by the negative impact of the drought on soyabea and maize production. We have therefore revised our growth forecast downwards by 0.7 pp in 2018, leaving it unchanged for 2019 at 3.3%. Investment will be driven by the positive effect of the structural reforms that are under way, especially the tax reform, and will be one of the pillars of growth in both years.

- In **Colombia**, we are holding our growth forecasts unchanged, at 2.0% and 3.0% for 2018 and 2019 respectively. An acceleration of domestic demand in the second half of 2018 and in 2019 will be one of the growth drivers (and, within this, investment in infrastructure), and it will also benefit from a recovery in confidence and lower interest rates.

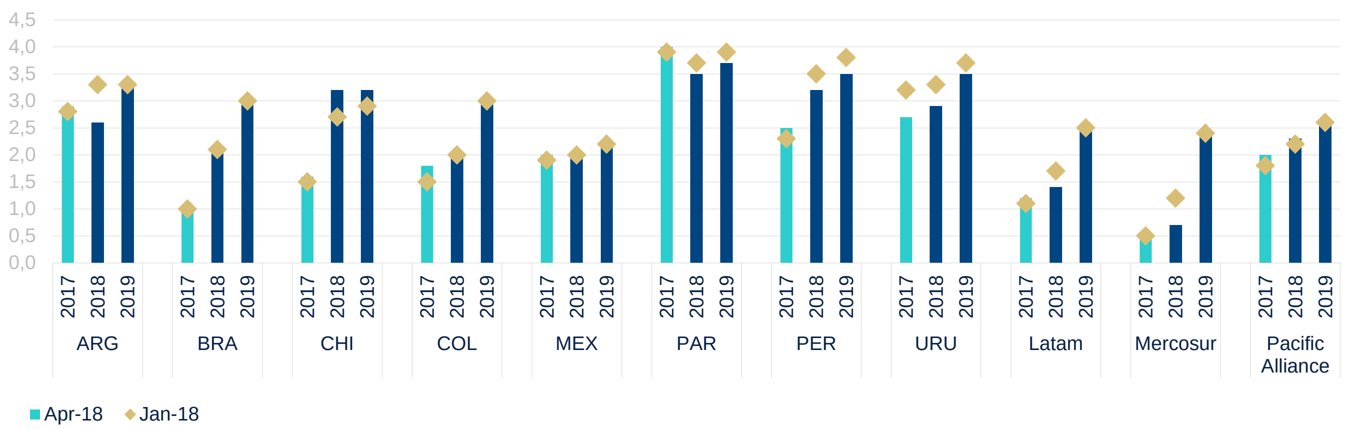
- In **Peru**, despite the improved outlook for copper prices, we have revised our growth forecasts for 2018 and 2019 downwards to 3.2% and 3.5% respectively (0.3 and 0.2 pp less than three months ago). This revision is mainly due to the sharp increase in political tensions between December and March (Figure 2.8) following the two attempts at presidential impeachment — the second of which led to the president’s resignation — and the consequent negative impact on public and private investment. Growth will continue to be driven by investment in infrastructure and reconstruction.

- In **Chile**, higher copper prices and the greater dynamism shown by exports, together with improved investment figures (due partly to telecommunications projects, but also to a sharp rise in confidence) lead us to revise growth upwards to 3.2% in both 2018 and 2019 (0.5 pp and 0.3 pp more than three months ago). Growth will be driven by both domestic demand and the export sector.

- In **Uruguay**, we have revised growth for 2018 down to 2.9% and 3.5% in 2019 (0.4 pp and 0.2 pp below our forecasts of three months ago) in view of the reduced carryover effect from 2017, when growth came in at a surprisingly low 2.7%, and the negative impact of the drought on the agricultural and livestock sector, which counteracts the positive effect of the reopening of the state-owned Ancap oil refinery. Growth will be driven by lively private consumption thanks to improvements in real wages owing to the drop in inflation. Also, the construction of a third cellulose plant will greatly boost investment in 2019.

- In **Paraguay**, GDP should grow by 3.5% and 3.7% in 2018 and 2019 respectively, which implies a downward revision of 0.2 pp for both years, due partly to less growth in Argentina and also to lower soybean yields following years of record harvests. Domestic demand, especially investment, will continue to provide the main support for growth.

Figure 2.9 Latin American countries: GDP growth (%)



Source: BBVA Research

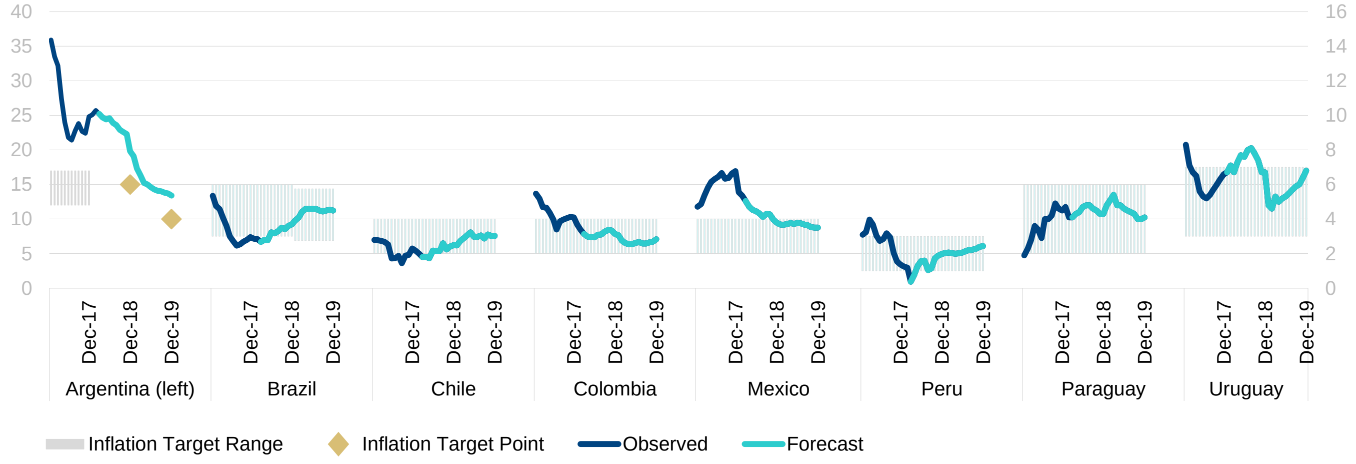
Inflationary pressures ease, except in Argentina

Low global inflation, weak domestic demand and relative currency stability have contributed to inflationary pressures generally continuing to be contained in the Latin American economies. In Brazil, Chile, Colombia, Paraguay, Peru and to a lesser extent Uruguay, inflation is currently relatively low. The same cannot yet be said of Mexico or Argentina, where pressure on prices remains particularly strong. In Mexico, the latest data confirm expectations of a sharp drop in inflation, while in Argentina the readings have been less favourable in the last few months, although, when viewed over a longer period, inflation remains on the downward path on which it started following the initial impact of the lifting of foreign exchange controls known as the "*cepo*" (clamp) at the end of 2015.

In Brazil, Chile and Peru annual inflation reached 2.7%, 1.8% and 0.4% respectively at the end of the first quarter, below the lower limits of their respective target ranges (Figure 2.8). In the case of Brazil, inflationary pressures in the first few months of the year were less than we had previously projected, while in Chile and Peru they were in line with our expectations. In Colombia and Paraguay, after moderation in the last few months, in March inflation drew near to the middle of the target range of 3.0% for the former and 4.0% for the latter. In Colombia, a high base of comparison, due to the impact of the increase in VAT at the beginning of 2017, also contributed to inflation's moving towards its target recently. In Uruguay, although the recent dynamic of domestic prices has been less positive than in the other cases and inflation reached 6.7% in March, the pace of price increases continues to be more moderate than in the recent past (inflation averaged 8.0% in the last ten years and 8.4% in the last five).

In Mexico inflation reached 5.0% in March, significantly below December's 6.8% reading, although still above the 4.0% ceiling of the target range. The rapid decrease in inflation in the first three months of the year is related to a base effect, as the impact of the liberalisation of energy prices in January 2017 dissipates and that of the increased pace of pass-through in the first half of 2017 gradually fades. Also, there has been no repeat this year of the supply shocks that affected inflation during the second half of 2017 (increases in the prices of gas and fruit and vegetables). Lastly, in Argentina the situation contrasts to some extent with that of the other countries in the region, since inflation not only remains high but has also increased in the past few months, reaching 25.4% in March. The inertia shown by inflation, the adjustments to public tariffs, the nominal depreciation of the peso in the last few months and the perception of greater tolerance with respect to inflation following the revision of inflation targets for the next few years have all contributed to inflation's not having eased in the last few months.

Figure 2.10 Inflation: observed and forecast (YoY %)



Source: BBVA Research

The gradual recovery of domestic demand, the probable weakening of nominal exchange rates and a less favourable contribution from food prices than in the recent past will lead to an increase in inflation in Brazil, Chile and Peru, where it will move from exceptionally low levels towards the middle of the target range in each case (Figure 2.10 and forecast tables in section 3). In the case of Brazil, recent inflationary surprises have led us to revise our inflation forecasts downwards to 3.7% for year-end 2018 and 4.5% for year-end 2019. We are maintaining our forecasts that inflation will end 2018 at 2.7% and 2019 at 3.0% in Chile and 2.0% this year and 2.4% next year in Peru.

Inflation will continue to move towards the central banks' targets, but more slowly than anticipated in Argentina

In Colombia and Mexico inflation will continue to ease during 2018 and 2019. A relatively stronger currency and the absence of strong demand pressures should allow inflation to ease to 3.1% this year and 2.8% in 2019 in Colombia and to 3.8% in 2018 and 3.5% next year in Mexico. In both cases we are maintaining our forecasts of three months ago. We should point out that in the case of Mexico our baseline scenario does not envisage the materialisation of the negative risks currently hanging over the country's economy.

In the case of Argentina, the recent negative surprises, the less restrictive tone of monetary policy and the prospect of greater currency depreciation will mean that the inflation moderation process will be more gradual than previously projected. Specifically, we have revised our inflation forecasts for Argentina upwards, from 18.5% to 19.8% in 2018, and from 12.2% to 13.5% in 2019. Inflation will therefore remain above the new targets announced by the monetary authority in December 2017.

Lastly, in both Paraguay and Uruguay inflation should end 2018 and 2019 at levels not far removed from the current ones. In both cases we maintain the forecasts presented three months ago practically unchanged.

Nearing the end of the cycle of interest rate cuts in South America

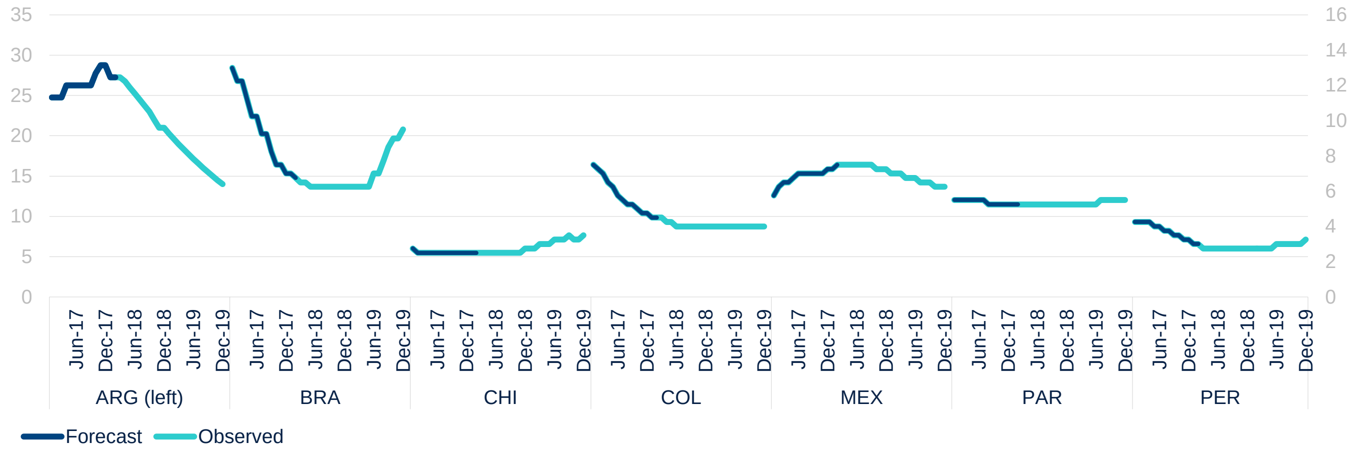
In line with generally low inflationary pressures and timid economic growth, most of the region's central banks have been cutting reference interest rates recently to below the equilibrium levels and making monetary policy have a clearly expansive tone at the moment.

In Chile and Paraguay the last interest rate cuts took place in May and August 2017, respectively. Since then the monetary authorities have held them at 2.50% and 5.25% respectively, where they will probably remain at least until the end of 2018 (Figure 2.11). In Peru the last reduction in the monetary policy rate took place more recently, in March, when the monetary authority announced a cut of 25 bps to 2.75%. As in previous cases, further cuts will most likely not be announced for the rest of this year, although in this case we see a more significant risk of an excessively timid recovery in economic activity creating space for additional interest rate cuts.

In the cases of Brazil and Colombia, we consider that the cycle of monetary easing has still not played itself out, despite the cumulative cuts of recent years (775 bps and 325 bps respectively, since the fourth quarter of 2016, including the relatively surprising 25 bp cuts announced in March in Brazil and in January in Colombia). In the case of Brazil, this outlook is in line with the comments from the monetary authority, which clearly signalled that it is most likely to announce a final cut of 25 bps in interest rates at its next monetary policy meeting in May, something we had not built in to our forecasts previously. In the case of Colombia, on the other hand, our outlook does not tally with the announcement made by the central bank in January to the effect that the cycle of interest rate reductions had come to an end. In our opinion, inflation will moderate more and growth will be less dynamic than forecast by the monetary authority, forcing it to announce two additional 25 bp cuts in the next few months.

Therefore, in all five of the cases initially considered, the cycle of interest rate cuts will be ended at mid-year. In a context with inflation under control and a gradual normalisation of monetary conditions in the developed countries, we forecast that interest rates will hold steady through the second part of 2018 and that only in 2019, when the recovery in economic activity is confirmed, will the central banks start to consider withdrawing the monetary stimulus measures that are in place. In this environment, we expect the central banks of Brazil, Chile, Paraguay and Peru to adjust interest rates upwards in 2019.

Figure 2.11 Interest rates: observed and forecast



Source: BBVA Research

The situation in Argentina contrasts with that of the other South American countries. The resistance of inflation to downward pressures and the need to anchor expectations following December's announcement of less ambitious inflation targets and the two 75 bp interest rate cuts at the beginning of the year have forced the central bank to adopt a harsher tone in regard to pressures on prices and to hold interest rates steady at 27.25% in recent months. Also, the expected moderation in inflation should create room for a reduction in nominal interest rates over the course of 2018 and 2019. Specifically, we are maintaining our forecast that interest rates will move to 21.0% at the end of this year, although we now foresee a more gradual adjustment starting in the second half of the year, and to 14.0% by the end of next year.

In Mexico we expect interest rates to remain stable until the end of 2018, when cuts will probably start

In Mexico, the monetary authority decided at its April meeting to hold interest rates steady at 7.50% following the two 25 bp hikes announced at the first two monetary policy meetings chaired by the new governor of Banxico, Alejandro Díaz de León, in an environment marked by concern regarding the outcome of the NAFTA renegotiations. The recent significant moderation in inflation and preventive increases in the monetary policy rate have now allowed Banxico to take the decision not to raise it any further. The most likely outcome is that the reference interest rate will be held at 7.5% during most of the remainder of 2018, despite the fact that the Federal Reserve will continue with its gradual interest rate increases. We also now expect that the balance of risks for inflation will allow Banxico to reduce the interest rate at the end of this year, starting a cycle of monetary easing that will continue through 2019 (Figure 2.9 and forecast tables in section 3).

External risks are increasing, except in China

The risks to our forecasts for Latin America have a downward bias, determined by both external and internal factors. On the external side, except in the case of China, we see a resurgence of risks, especially those relating to US trade policies and the possibility of a resurgence of protectionism on a global scale. On the internal side, the risks remain, especially those associated with political noise and uncertainty (in several cases linked to the electoral processes now under way) and the risk of a delay in public and private investment, also partly linked to the political environment.

Specifically, on the external front, the greatest risk is of an increase in protectionist measures triggered by the increase in import tariffs proposed by the US administration, which comes on top of past actions, such as the US withdrawal from the TPP, the suspension of negotiations on the TTIP and the renegotiation of NAFTA with Mexico and Canada. Although the impact on global activity of the measures adopted so far (import duties on steel and aluminium and on a long list of products coming from China) is still limited (even if not for certain countries and sectors), the mere fact of announcing them raises uncertainty about a possible escalation of trade restrictions among the major economic regions that could end up discouraging investment worldwide.

Beyond the risk of protectionism, which has intensified in the past few months, other sources of uncertainty, external to the region, persist. The normalisation of monetary policies, especially a faster-than-expected withdrawal by the US Federal Reserve associated not with increased growth but with an unexpected surge in inflation, is one of the most significant factors, in a context in which the financial markets are highly vulnerable to increases in financing costs, precisely because the central banks would no longer be as predisposed to act to cushion market volatility. Lastly, the risk associated with a sudden correction of the Chinese economy has lessened with the measures approved following the Chinese Communist Party Congress in October and signs of a gradual reining in of borrowing. Even so, the imbalances 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.

Internal risks remain, with considerable disparity from one country to another Political risks predominate, together with the risk of delays in investment

Still prominent among the risks on the internal Latin American front are the political noise and uncertainty in several countries, such as Peru (linked to the presidential impeachment process), and Colombia, Brazil and Mexico in the context of the electoral processes now under way. This can be seen in the increase in the index of political tensions in those countries in Figures 2.7 and 2.8. The risk is that this political tension will continue to increase and end up dragging down or quashing the process of the recovery of confidence that we have seen in the region, with the resulting negative impact on the consumption of durable goods and, above all, on investment. On the positive side, this risk of political tensions seems to have abated in Argentina and Chile now that the results of the latest elections are known.

Partly related to the political tensions and changes of government, the possible delay in infrastructure projects in countries such as Argentina, Peru and Colombia also represents a significant risk to growth at the forecast horizon. If this risk should materialise, the impact would be serious, as investment will be one of the main drivers of growth in the next few years (together with the external sector).

Lastly, we should stress that, apart from the short-term risks, the region is facing a more structural risk to its prospects for growth in productivity. With a potential growth for the region that we estimate at between 2.5% and 3%, it will be very difficult for it to narrow the per capita income gap with the developed economies, while at the same time Latin America will also grow less than Asia or emerging Europe. The main risk is that the new Latin American governments will not push through the agenda of reforms needed to boost productivity, whether by design or for a lack of a consensus or political capital. As we have mentioned in previous reports, the region needs to get back to generating the kind of consensus that most countries reached 30 years ago in order to push through reforms to its labour markets and markets for products and services, as well as its education and healthcare systems and governance. The risk of inaction on this front is high.

3. Tables

Table 3.1 Macroeconomic forecasts

GDP (% YoY)

	2016	2017	2018*	2019*
Argentina	-1.8	2.9	2.6	3.3
Brazil	-3.5	1.0	2.1	3.0
Chile	1.6	1.6	3.2	3.2
Colombia	2.0	1.8	2.0	3.0
Mexico	2.9	2.0	2.0	2.2
Paraguay	4.0	4.0	3.5	3.7
Peru	4.0	2.5	3.2	3.5
Uruguay	1.7	2.7	2.9	3.5
Mercosur	-4.0	0.5	0.7	2.4
Pacific Alliance	2.7	2.0	2.3	2.6
Latin America	-0.9	1.2	1.4	2.5

Inflation (% YoY, end of period)

	2016	2017	2018*	2019*
Argentina	39.4	24.8	19.8	13.4
Brazil	6.3	2.9	3.7	4.5
Chile	2.7	2.3	2.5	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	4.3	4.1
Peru	3.2	1.4	2.0	2.4
Uruguay	8.1	6.6	6.7	6.8

Exchange rates (vs. USD, end of period)

	2016	2017	2018*	2019*
Argentina	15.8	17.7	21.5	23.5
Brazil	3.4	3.3	3.4	3.5
Chile	667.0	637.0	640.0	650.0
Colombia	3010.0	2991.0	2920.0	2900.0
Mexico	20.7	19.7	18.6	17.7
Paraguay	5718.0	5515.0	5700.0	5815.0
Peru	3.4	3.3	3.2	3.3
Uruguay	28.8	28.9	30.5	32.6

Interest rates (%, end of period)

	2016	2017	2018*	2019*
Argentina	24.8	28.8	21.0	14.0
Brazil	13.8	7.0	6.3	9.5
Chile	3.5	2.5	2.5	3.5
Colombia	7.5	4.8	4.0	4.0
Mexico	5.8	7.3	7.3	6.3
Paraguay	5.5	5.3	5.3	5.5
Peru	4.3	3.3	2.8	3.3
Uruguay**	24.7	24.6	23.0	23.2

Current Account (% GDP)

	2016	2017	2018*	2019*
Argentina	-2.7	-4.8	-5.4	-5.5
Brazil	-1.3	-0.5	-0.5	-1.8
Chile	-1.4	-1.3	-1.4	-1.4
Colombia	-4.3	-3.3	-2.7	-3.2
Mexico	-2.1	-1.9	-2.0	-1.9
Paraguay	1.5	-1.2	-1.3	-0.9
Peru	-2.7	-1.3	-1.3	-1.8
Uruguay	0.8	1.6	-0.2	-1.4

Fiscal Balance (% of GDP)

	2016	2017	2018*	2019*
Argentina	-5.8	-6.0	-5.3	-4.3
Brazil	-9.0	-7.8	-7.4	-5.4
Chile	-2.7	-2.8	-1.7	-1.3
Colombia	-4.0	-3.6	-3.1	-2.5
Mexico	-2.5	-1.1	-2.0	-2.0
Paraguay	-1.4	-1.5	-1.5	-1.5
Peru	-2.6	-3.1	-3.4	-3.0
Uruguay	-3.8	-3.5	-3.1	-2.7

Average commodity prices

	2016	2017	2018*	2019*
Oil (Brent USD/bbl)	44.8	54.4	65.6	64.1
Soya beans (USD/ton)	362.9	358.8	375.5	374.3
Copper (USD/lb.)	2.2	2.8	3.0	2.9

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

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