BBVA Research

Latin America Economic Outlook

Third quarter 2018

South America Unit

Creating Opportunities

Contents

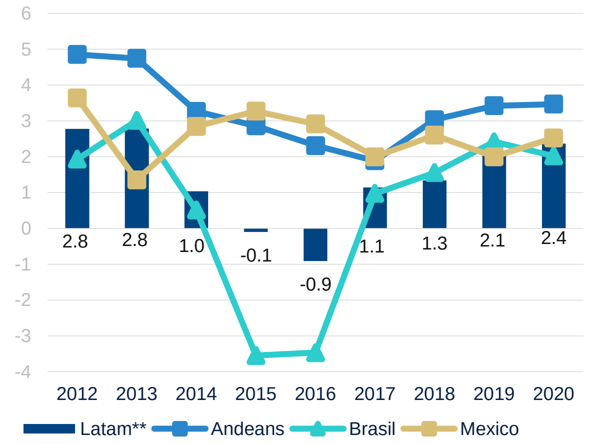
Closing date: **18 July 2018**

1. Summary

Latin American financial markets reacted unevenly to the increase in interest rates in the US. In the second quarter global volatility particularly affected Argentina and Brazil, due to their external and political-fiscal vulnerabilities, respectively. The remaining countries held up relatively well in a context of recovering growth and still high prices of the main commodities. Looking ahead, we anticipate gradual currency depreciation in the region, in line with the US Federal Reserve's interest rate hikes. The main exceptions could be seen in Mexico and Brazil, where whose currencies might appreciate in response to ratification of NAFTA in the former case and reduced political uncertainty in the latter.

Latin America will grow by 1.3% in 2018 and 2.1% in 2019 (Figure 1.1), with considerable disparities among countries. These forecasts represent a downward adjustment relative to three months ago, especially in view of the downward revision of growth in Argentina (due to the currency crisis and more restrictive economic policies) and in Brazil (due to financial volatility, the truckers' strike, a weaker government and political uncertainty). This downward adjustment in the two countries could not be entirely offset by the upward revisions in growth forecasts for Mexico, Colombia, Peru and Paraguay triggered by the positive activity data observed in the first half of the year. Latin America's 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

Central banks in South America (except Argentina) will start a cycle of interest rate hikes in 2019. In a context in which inflation remains under control and in line with central banks' targets, domestic demand is recovering, and interest rates are being increased by the US Federal Reserve, central banks will start to raise their base rates, although the tone of monetary policy will continue to be accommodative. Argentina and Mexico will resume interest rates cuts at the end of 2018 and beginning of 2019 respectively as inflationary and exchange rate risks diminish.

The main external risks are centred on protectionism and hardening of international financial conditions (both on the rise), while those associated with the structural adjustment in China are holding steady. On the domestic front, increased political noise is a risk in Brazil in the pre-electoral context, while in countries such as Colombia, Chile and even Mexico it is diminishing. The other significant risk on the domestic front is the delay in public and private investment.

2. Latin America: Uneven recovery

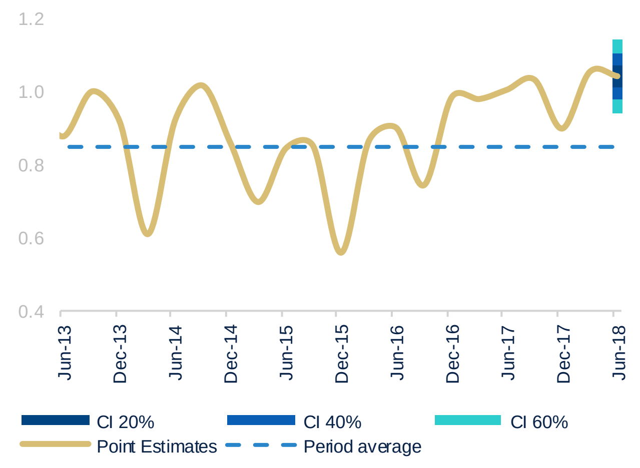
Global economy: Robust growth, but with certain signs of moderation and intensification of risks

The international economy remains subject to the tensions of disparate forces, between the good economic performance in recent quarters, now prolonged by the fiscal stimulus of the US economy and the stability of the Chinese economy, and several potentially negative factors that have been generated gradually in the first half of this year, but which so far have not been directly reflected in activity.

World growth is expected to have slowed slightly in the second quarter of the year (Figure 2.1). Although the pace of expansion remains solid, it is occurring in a less synchronised manner, with accelerating growth in the US that contrasts with certain signs of moderation in China and some emerging economies and in a more intense way in the euro zone.

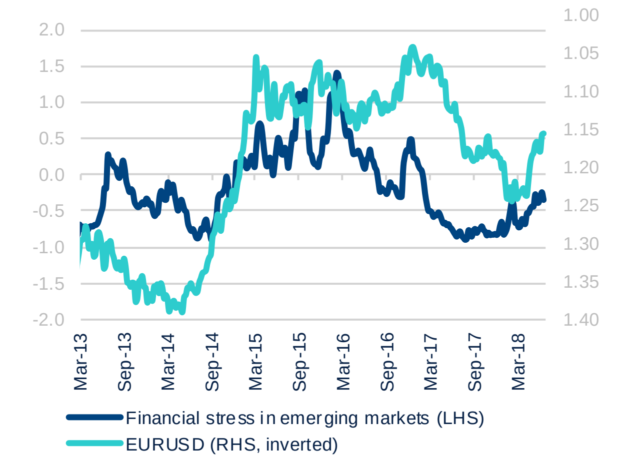
The increased growth of the US economy, driven by fiscal measures and the recovery of global trade at the beginning of the year, continues to sustain the strength of the global recovery. However, some of the supports to growth have been fading in the last few years, while uncertainty has increased.

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



Source: BBVA Research

Figure 2.2 EUR-USD exchange rate and BBVA index of financial tensions in emerging markets



Source: BBVA Research based on EPFR

A prime factor of uncertainty comes from the withdrawal of the United States from the nuclear agreement with Iran, which caused a supply shock in the oil market that has increased the price of oil by around 8% so far this year. This will place additional upward pressure on inflation and has already encouraged the central banks to take another step towards the normalisation of monetary policy. This is particularly the case with the Fed, which so far this year has accumulated a rise of 50 basis points in its reference rates to reach 2% and plans to raise them to 2.50% by the end of the year and to 3.25% by the end of 2019. The interest rate differential and favourable growth in the US compared to the rest of the world has resulted in a widespread appreciation of the dollar.

An additional uncertainty factor during the last few months is associated with the increase in trade tensions. It is still too early to know which measures will finally prevail of those already approved by the US administration, those that were previously announced and the possible countermeasures from their trading partners, nor is it easy to discern their impact on trade and activity. In principle, the direct effect through the trading channel of the measures announced up to now would be limited. However, additional measures by the US are under discussion at this time, as is possible retaliation on the part of the affected countries, with an effect on growth that would already be significant, to which we should add potential indirect effects on the confidence of financial markets and economic agents depending on the magnitude of the trade conflict.

As a consequence of these uncertainties, amid the process of normalisation of monetary policy in the developed countries, there has been a readjustment in the perception of global risk, especially in emerging markets. Financial tensions in emerging markets have increased generally (Figure 2.2), due to the depreciation of currencies and the widening of risk premiums, although in particular countries with higher external financing needs have been differentiated negatively.

The global forecasts for the next two years remain unchanged, at 3.8%, supported by solid US growth. Nevertheless, the lower degree of synchronisation observed recently is reflected in a downward revision in the growth expected for 2018-19 for the euro zone, while we maintain the forecasts for the coming years in US and China, after recording a good economic performance in the first part of the year and with the fundamentals still being solid for domestic demand.

Increase in risks associated with protectionism, and greater financial volatility in emerging markets

The global scenario continues to be subject to mostly negative risks, which have increased in recent months. On the one hand, the risk of a trade war has intensified in the wake of the latest measures adopted by the United States and the response from China, mainly, and to a lesser extent, from the rest of the countries affected. Added to this are new protectionist threats that would involve the interests of important sectors in other regions, such as the automobile sector in Europe, Mexico, Canada and Japan. While the direct impact of the measures, as discussed above, would be limited, the risk of a trade war could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment, with the consequent impact on the potential of global growth.

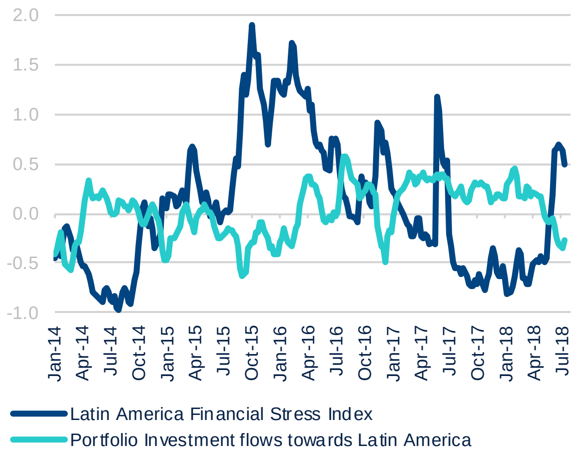
In addition, in a more volatile financial environment, systemic risk would increase in emerging economies. The combination of a greater protectionist risk added to those posed by a more accelerated normalisation of monetary policy in the United States and a possible slowdown in the global economy could trigger the perception of risk in emerging financial markets, raising the likelihood of a sudden-stop or even reversion of capital flows. In this context, the risk of an abrupt adjustment in the Chinese economy remains, since some measures to respond to a possible trade war could limit and delay the process of deleveraging and restructuring of the Chinese economy.

Latin American financial markets: global volatility particularly affects Argentina and Brazil

The increased global risk aversion brought about by factors such as the process of monetary policy normalisation in the US and the threat of protectionism has led to an increase in financial tensions in Latin America and a reduction in capital flows into the region (Figure 2.3), despite the fact that the prices of most commodities (with the exception of soya beans) remained high.

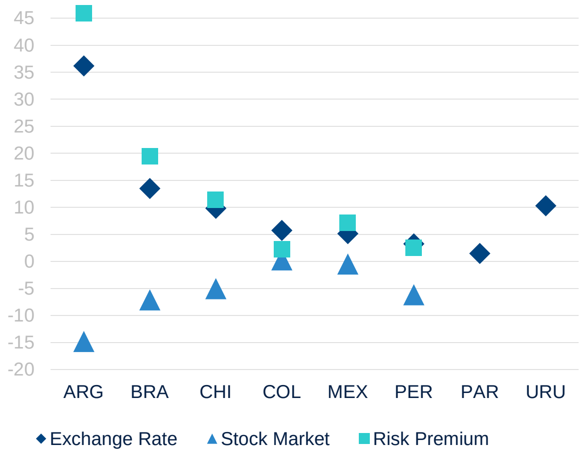
Practically all countries in the region have seen their currencies depreciate, with losses on the stock markets and increases in risk premiums in the past few months (Figure 2.4). The only exceptions to this negative trend in prices of financial assets have been the Colombian and Mexican stock markets, which in mid-July were at levels very close to those of mid-April. In both markets the improved prospects for growth and the relatively high oil prices, among other factors, have offset the negative effects coming mainly from external sources.

Figure 2.3 BBVA index of financial tensions for Latin America and portfolio flows into Latin America (% of assets under management, moving four-week average)



Source: BBVA Research

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



* Changes between 17 April 2018 and 17 July 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

Also, financial volatility has not been uniform among countries in the region. Argentina, mainly, and Brazil have been the most-affected, while the impact on the Andean economies has been limited. In the case of Mexico, the cumulative adjustments in the financial markets over the past three months have not been particularly significant, at least in comparison with Argentina and Brazil. In any case, the Mexican markets have been more focused on the progress of the renegotiation of the North American Free Trade Agreement (NAFTA) and on the political outlook in an environment marked by the presidential elections of 1 July.

In Argentina, the substantial external financing requirements combined with the global markets' reduced risk tolerance led to a sharp depreciation of the peso, mainly from the beginning of May. Apart from this, the severe drought led to a substantial reduction in soya bean production, with a significant impact on exports and economic activity which further weakened the currency. Since the announcement of aggressive domestic interest rate hikes and certain fiscal measures proved insufficient to calm the markets, the government sought the support of the IMF, which at the beginning of June approved the granting of a US$50 billion stand-by arrangement for the country. This loan and the series of measures adopted to improve the workings of domestic markets and reduce both the public deficit and inflation helped to calm the markets, at least for the time being. Thus, in mid-July the exchange rate was relatively stable at around 27.5 pesos to the dollar, 36% higher than three months ago and 46% more than at the end of last year.

Brazil was also affected by the change of mood in global markets, although not as much as its main Mercosur partner. Although Brazil presents relatively positive external indicators, due mainly to its limited current account deficit and large international reserves, growing concern about the deterioration of its public accounts and political uncertainty, with general elections due in October, have further fuelled the volatility caused by the increase in risk aversion. The real has lost 14% in the past three months and 16% so far this year, despite the central bank's forceful interventions on the currency market.

In contrast with the cases of Argentina and Brazil, in the remaining countries of the region the depreciation caused by external factors has not been significantly exacerbated by domestic factors. The perception of the macroeconomic environment as relative solid, in particular as regards the external and fiscal accounts, has spared these countries from the kind of turbulence seen in Argentina and Brazil.

Markets in Mexico were mainly influenced by prospects regarding NAFTA. Markets in the Andean countries held up well in the face of the US interest rate hike

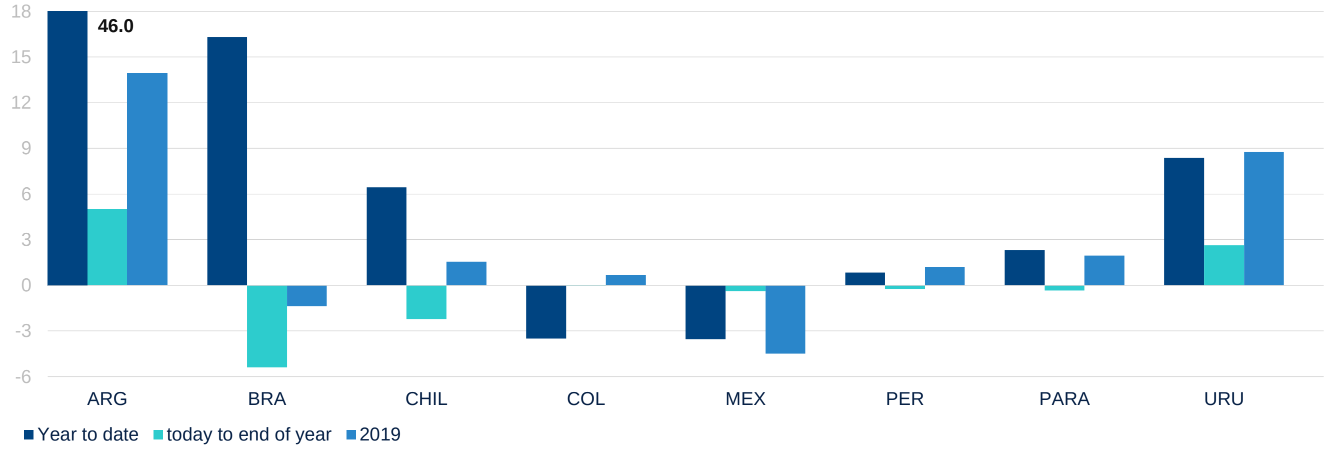
Taking account of the movements seen in the currency markets in the past few months, we have adjusted our forecasts for the Latin American currencies. We foresee them trading in future at more depreciated levels than previously expected, particularly the Argentine peso and the Brazilian real. The exceptions are the Chilean peso, the Colombian peso and the Paraguayan guaraní, for which we are maintaining practically unchanged the forecasts we made three months ago (for current forecasts, see the table of forecasts at the end of this report; for the previous forecasts, see our Latin America Economic Outlook report for the second quarter).

In any case, although in general the outlook is for currencies in the region to remain weaker than previously expected, we see room for them to appreciate in real terms from now on, and even in nominal terms in Chile and, mainly, Brazil and Mexico. This trend will be supported by the process of recovery of growth and the gradual reduction in the expansive tone of monetary policy in the region. The decline in political uncertainty after the presidential elections should also favour the Brazilian and Mexican currencies. The Mexican peso should also be favourably influenced by confirmation that NAFTA is not about to collapse.

These prospects for currencies also based partly on our forecasts for commodities. We see margin for prices of oil, soya beans and copper to move between now and the end of 2019 to US$68 a barrel, US$349 per metric tonne and US$2.90 per lb. respectively. In the case of oil, this forecast is 9% higher than the previous one, in line with the effects of the US withdrawal from the Iran nuclear deal on the supply of crude, but still representing a fall of 5% relative to the current price due to the prospects of increased supply, mainly from the US. With regard to soya beans, the forecast for the end of 2019 is 6% lower than the previous one, reflecting the good harvest in the US, the appreciation of the dollar and the effects of the protectionist measures recently adopted. Also, reaching the price forecast for year-end 2019 would represent an increase of 17% relative to the current price. As for copper, the forecast is unchanged from three months ago; we continue to expect a reduction in prices as a result of the moderation of growth in China and the reduction of speculative positions.

For all that, our forecasts for exchange rates in Latin America have an upward bias in general. There are a number of factors that could lead to currencies showing weaker levels than those projected. Prominent among them are a new increase in global risk aversion related with the process of monetary policy normalisation in the developed economies, intensification of trade disputes (mainly if they affect China and commodity process), an increase in local political noise, failure to correct the idiosyncratic problems that have contributed to the recent turbulence in Argentina and Brazil, and an outcome of the renegotiation of NAFTA that is more negative for Mexico than currently expected.

Figure 2.5 Nominal exchange rate: percentage changes observed YTD, expected for the rest of 2018 and expected for 2019 (%)*



* Increases indicate depreciation. Changes observed YTD are cumulative to 17 July. Those expected for the rest of the year are cumulative from that same date.
Source: BBVA Research

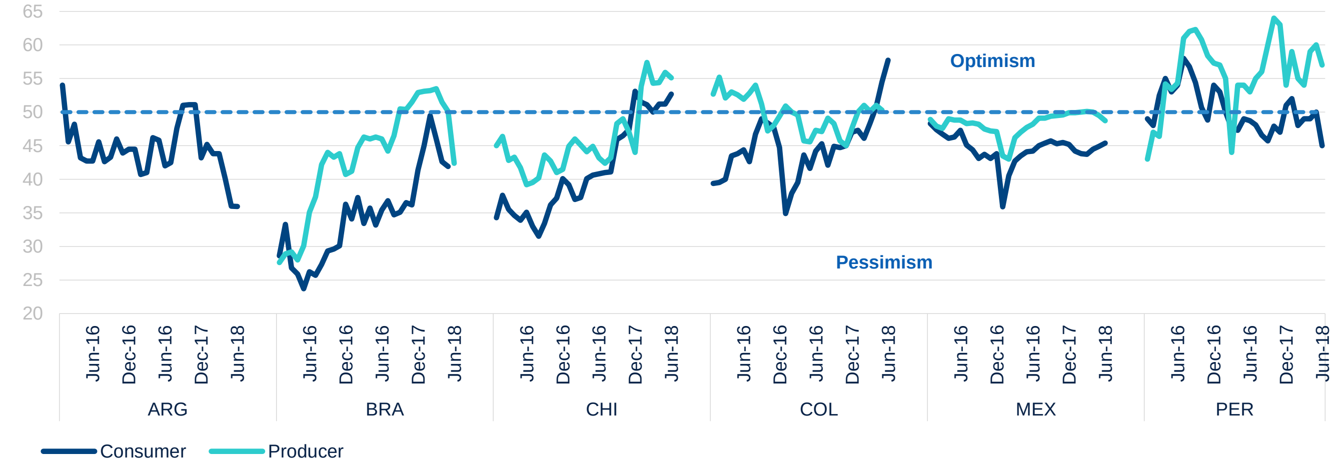
Uneven recovery of growth in Latin America, with relapse in Argentina

Household and business confidence and economic activity have evolved rather unevenly in Latin America in the past few months, with a division between the Andean countries (and to a certain extent Mexico) on the one hand, and Argentina and Brazil on the other.

As regards the former group of countries, confidence continued to recover during the quarter, as can be seen in Figure 2.6. In the case of households, determinants continued to be low inflation and a certain strengthening of labour markets, leading to gradual improvement in disposable income. In the case of businesses, the recovery has been favoured by high prices for the main export commodities, but also by greater political calm in the three Andean countries (Figure 2.7) following the electoral process in Colombia and the change of government in Chile and Peru. In Mexico too, initial sentiment data following the elections seem to point to a downward inflection in the high political tensions leading up to the elections (Figure 2.8), although confidence indicators are still weighed down waiting for the outcome of the NAFTA negotiations. In this context, growth in recent months has been relatively solid in Peru, Paraguay and Chile, and has continued to recover in Colombia, Mexico and Uruguay, although less vigorously than in the former three. In particular, we have had positive surprises in first-quarter growth in Colombia and Mexico, and in second-quarter growth in Peru.

The diagnostics are very different in the case of Argentina and Brazil. The effect of international financial volatility was especially severe for Argentina, as we commented in the previous section, and the sharp depreciation of the currency as well as the increase in (due to the currency depreciation and to the increase in regulated prices) had a very significant negative impact on confidence indices (Figure 2.6). In Brazil, financial volatility, the truckers' strike, the weakness of the government and the political noise left their mark on household and business confidence. Admittedly no resurgence of political noise is observed in either country (Figure 2.8), but there is a risk of social tensions in Argentina deriving from the adjustment policies and a risk of increased political noise in Brazil in the run-up to the presidential elections (see the section on risks at the end of this report). In any case, the aforementioned factors have already started to show their negative effects on the indicators of activity in Brazil in the past few months, while in the case of Argentina we expect to start seeing these effects when the indicators for June are published.

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

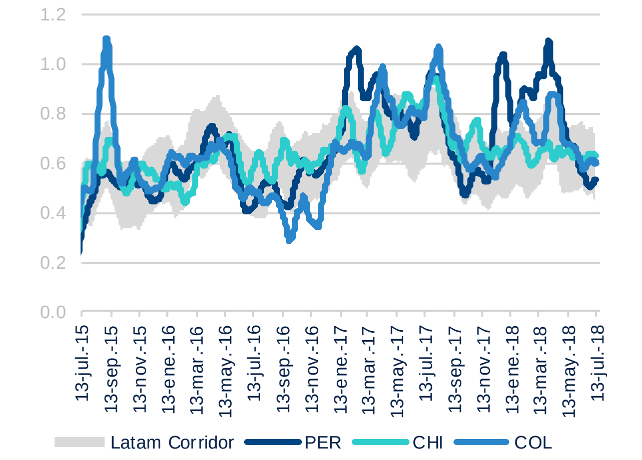


Source: BBVA Research

In this context of uneven performance (as detailed later in the summary by countries), we have revised our growth forecasts for Peru, Paraguay, Colombia and Mexico upwards, in particular due to the positive activity data observed in the first half of the year, added to which, in the case of Colombia, is the support from higher-than-expected oil prices. As for Argentina and Brazil, the impact of financial volatility, and the domestic factors referred to previously, lead us to revise our growth forecasts downwards in 2018 and 2019.

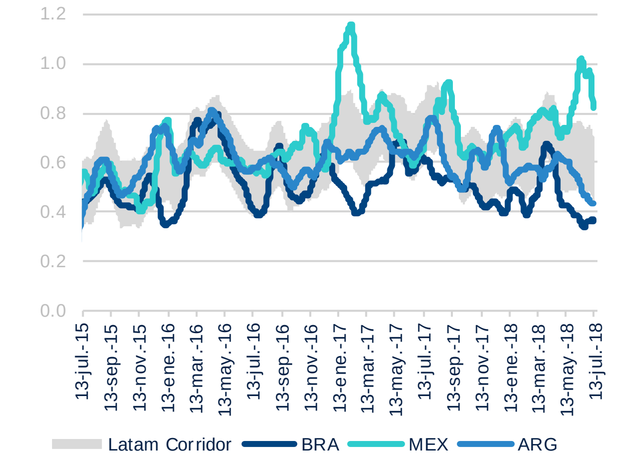
Thus, Latin America's GDP as a whole will grow by 1.3% this year, a very similar figure to the 1.2% of 2017. By 2019 we anticipate that growth will recover to 2.1% and reach a value closer to its potential (between 2.5% and 3%) in 2020 (Figure 1.1). Our new growth forecasts for 2018 are 0.1 pp lower than those we estimated three months ago, while those for 2019 are 0.5 pp lower. The take-off in growth in Latin America that we had anticipated for this year has thus been deferred, in view of the heavy impact on the average of the downward revisions of growth forecasts for the first and third biggest economies of the region. Growth in 2018 and 2019 will continue to be driven by the external sector, with prospects of commodity prices remaining favourable and robust global growth, as mentioned in section one. Investment will be another growth factor, both in the private sector and in the public sector, particularly in infrastructure in Colombia and Peru.

Figure 2.7 BBVA index of political tensions*: Chile, Colombia, 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

Figure 2.8 BBVA index of political tensions*: Argentina, Brazil, 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

We have revised our growth forecasts for Argentina and Brazil downwards, but those for Mexico, Colombia, Paraguay and Peru upwards

Although many countries should reach their potential growth in 2019 and 2020, potential growth for Latin America as a whole is between 2.5% and 3%, less than that of other emerging regions and not high enough to close the per capita income gap with the advanced economies. This highlights the fact that one of the region's main challenges will continue to be pushing the agenda of reforms to promote growth in productivity.

Within the region, the dynamism of Chile, Peru, Paraguay and Uruguay will stand out in 2018-2019 (Figure 2.9). However, in general, we will see growth increasing between 2017 and 2019:

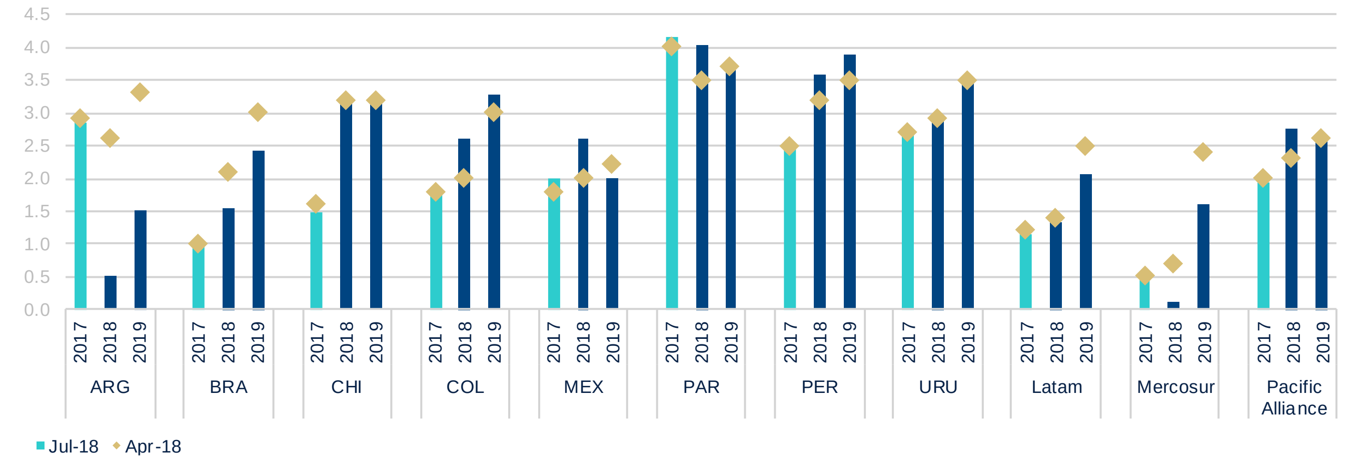
- In **Brazil,** growth in the first quarter of the year was lower than expected. Added to this was the impact of the truckers' strike, financial volatility, increasing weakness of the government and greater political uncertainty, leading to a downward revision of growth forecasts from 2.1% to 1.6% in 2018 and from 3% to 2.4% in 2019. Growth in these two years will continue to be particularly supported by the external sector and investment. In this scenario we assume a much less ambitious reform of the social security system in 2019 than we anticipated three months ago.

- In **Mexico**, we have revised the growth forecasts for 2018 up from 2% to 2.6% in view of the unexpectedly strong growth in the first quarter, driven by manufactured goods and the service sector. Even so, the growth forecast for 2019 has been revised downwards, from 2.2% to 2%, in anticipation of a fall in investment due to the uncertainty around both the NAFTA negotiations and the future course of the new government's economic policy.

- In **Argentina**, the negative effect of the drought in 2018 comes on top of the negative impact on growth of the currency crisis and the necessary monetary and fiscal adjustment policies (more restrictive than before). Also, Brazil's lower growth rate will represent a significant drag. Therefore, we have revised the growth forecast for 2018 down from 2.6% to 0.5% and that for 2019 from 3.3% to 1.5%. Investment will continue to be one of the components most supportive of growth, and it will remain in positive territory thanks to projects already under way in the energy sector and those put out to tender by public-private partnerships.

- In **Colombia**, we have revised our growth forecasts upwards from 2.0% to 2.6% for 2018 and from 3.0% to 3.3% for 2019, with private consumption growing more strongly than previously anticipated, a dynamic that will be maintained going forward. The upward revision of oil prices will also be a positive factor for growth this year and next. The acceleration of domestic demand in the second half of 2018 and in 2019 will be one of the main drivers of growth.
- In **Peru**, the positive surprise of growth in the second quarter of this year and the recovery in business confidence (in a context of reduced political tensions) has led us to revise the growth forecasts up from 3.2% to 3.6% for 2018. Mainly in 2019, construction of the Quellaveco copper mine warrants an upward revision in growth from 3.5% to 3.9% in growth. Growth will continue to be driven by public and private investment.
- In **Chile**, we have held our growth forecast unchanged at 3.2% for 2018 and 2019, in a context in which consumption is holding up well but investment remains in a slow process of recovery. Growth will be driven by both domestic demand and the export sector.
- In **Uruguay**, we have kept our growth forecasts unchanged at 2.9% and 3.5% for 2018 and 2019 respectively, with a certain cooling of private consumption but greater dynamism in public sector investment. Even so, growth will continue to be driven by private consumption and the private and public investment associated with the country's third cellulose plant.
- In **Paraguay**, we have revised the growth forecast up from 3.5% to 4.1% for 2018 and kept it unchanged at 3.7% for 2019. The upward revision is due to the positive performance of services, electricity generation and certain manufacturing segments so far this year. Domestic demand, especially investment, will continue to provide the main support for growth.

Figure 2.9 Latin American countries: GDP growth (%)



Source: BBVA Research

Inflation in line with objectives in South America, with the main exception of Argentina

Inflation has crept upwards in the past few months in practically all South American countries. Contributory factors to this trend included the initial effects of the recent currency depreciation, higher oil and food prices and the gradual process of recovery of domestic demand. Also, recent inflationary pressures have been added to by the effects of the destocking brought about by the hauliers' strike in the last few days of May in the case of Brazil and by the tax adjustment carried out in May in Peru.

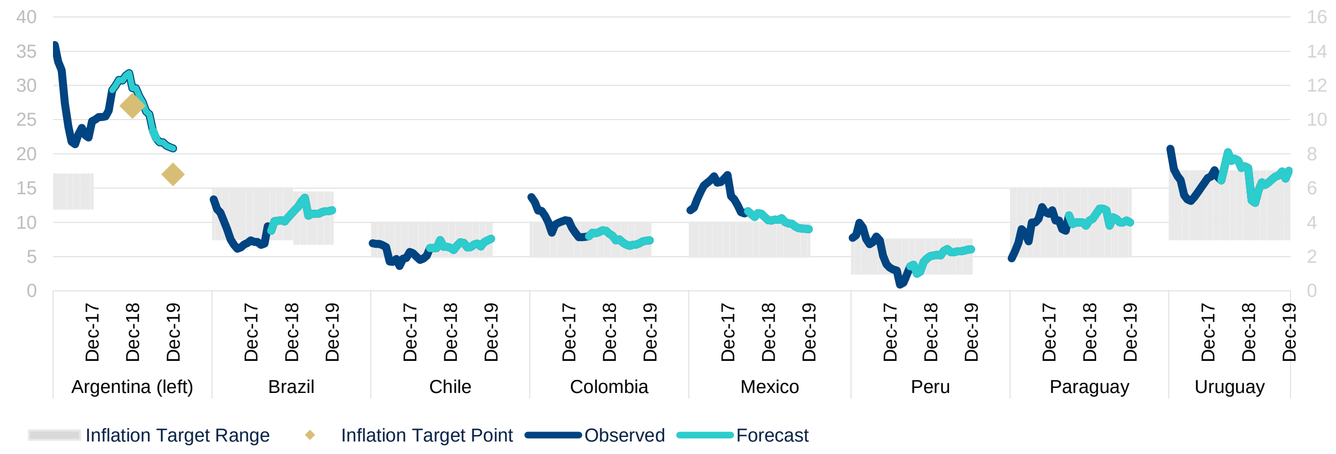
Although inflation in the countries of South America is right now higher than in the first few months of the year, they are in most cases still under control and in line with the respective official targets (Figure 2.10). Such is the case of Brazil, where annual inflation ended the first half of the year at 4.4%, Chile (2.5%), Colombia (3.2%), Paraguay (4.4%) and Peru (1.4%).

Inflation is declining in Mexico, but less than was anticipated

In contrast with most South American countries, in Uruguay, and especially in Argentina, inflation remains high. In the former case, annual inflation reached 8.1% in June, somewhat in excess of the 7.0% upper limit of the target range. In the case of Argentina, inflation in June was 29.5%, above the new target of 27% for 2018 established as part of the recent agreement with the IMF (the previous target was 15.0%), although below 32%, the level which, if reached, would require consultation with the IMF.

In Mexico, June inflation was 4.6%, still above the target range of 2% to 4%, although the trend remains downward. The depreciation of the peso and fuel prices continue to exert pressure on domestic prices, rather more so than expected, although in general less than last year.

Figure 2.10 Inflation: observed and forecast (YoY %)



The left axis corresponds to data on interest rates in Argentina. The right axis, to data of the remaining countries.
Source: BBVA Research.

Looking ahead, inflation will most likely remain within the target range in Brazil, Chile, Colombia, Paraguay and Peru. Our current inflation forecasts are somewhat higher than those of three months ago in the first three cases, largely because of the combined effect of greater weakness of domestic currencies and higher oil prices. In the case of Paraguay the current inflation forecasts are slightly below the precious ones, while in the case of Peru they are unchanged (for current forecasts, see Figure 2.10 and the table of forecasts at the end of this report; for previous forecasts, see Latin America Economic Outlook, Second Quarter).

In Argentina, Mexico and Uruguay, despite the various local peculiarities, the general outlook is for inflationary pressures to ease over the term of the forecast horizon. In the case of Argentina, inflation should start to show clearer signs of slowing from the end of 2018, once the effects of the sharp depreciation of the peso over the past few months have been passed through to domestic prices, at least if the expectations of relative stability in the exchange rate from now on are confirmed. Also, taking account of the significant changes in the country's macroeconomic environment, we have revised our inflation forecasts significantly upwards, from 19.8% to 29.6% for 2018, and from 13.5% to 20.8% for 2019. These current estimates are above the central targets recently agreed with the IMF (27% and 17% respectively for 2018 and 2019), although they do not exceed the upper limits established (32% and 21%).

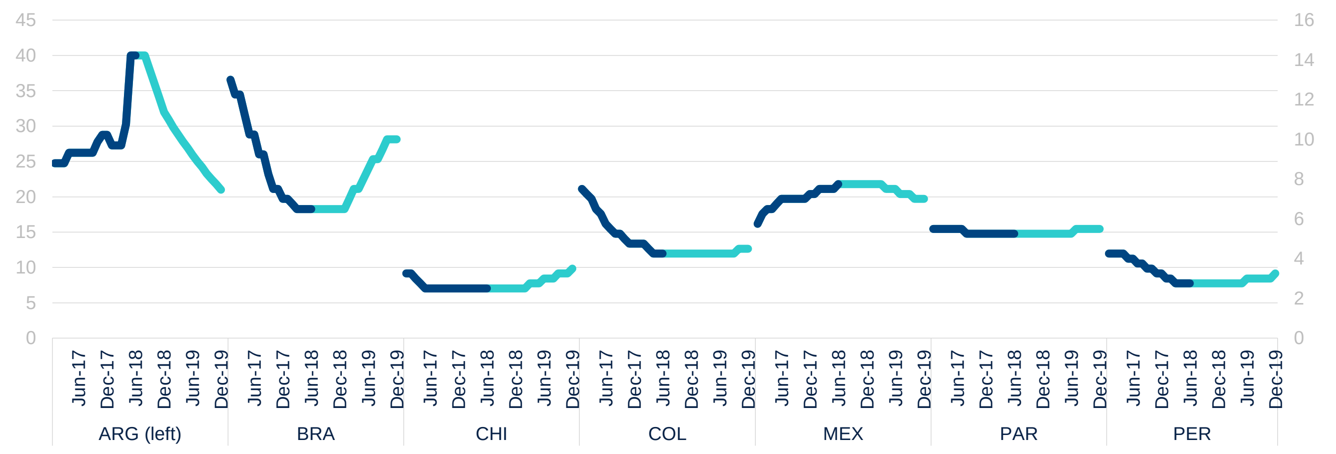
In the case of Mexico, although we still foresee inflation continuing to moderate, we have revised our forecasts for 2018 up from 3.8% to 4.1%, and for 2019 from 3.5% to 3.6%. As in other economies in the region, the increased currency depreciation and the uptick in the price of crude are behind the upward revisions of the inflation forecasts.

Change of monetary cycle and interest rate hikes in South America in 2019, except in Argentina

In the past few months the margin for maintaining expansive monetary policies in Latin America has reduced. This is largely due to the continuing process of monetary policy normalisation in developed countries and the related increase in global risk aversion, which have recently contributed to the depreciation of Latin American currencies and to increased inflationary pressures. Similarly, in the case of Mexico, doubts about the outcome of the NAFTA renegotiation have also weighed. Added to this increased global risk aversion are the return of inflation to the central banks' targets and the strengthening of domestic demand, the combined effect of which will be to incline central banks towards a less accommodative tone in their monetary policy going forward.

As previously highlighted, Argentina has been the country most adversely affected by the recent changes in the environment. The central bank was forced to increase monetary policy interest rates from 27.25% to 40.0% in the space of a single week at the end of April and beginning of May when the peso started to depreciate more significantly. Later, after reaching agreement with the IMF and after a change of direction by the monetary authority, a series of measure were taken to improve the functioning of the currency markets, the strategy of reducing the stock of Lebacs (central bank notes) was started and, more recently, it was announced that the system of inflation targets will be complemented with monitoring of the monetary aggregates and the use of banks' minimum reserve requirements as an additional tool of monetary policy. Considering all this, we foresee rates being held at 40% in the short term, moving to 32% at the end of this year and to 21% at the end of 2019 providing the inflationary and above all the currency risks are reduced (Figure 2.11).

Figure 2.11 Interest rates: observed and forecast (YoY %)



The left axis corresponds to data on interest rates in Argentina. The right axis, to data of the remaining countries.
Source: BBVA Research.

In Brazil monetary policy also had to be adapted to the new context, although in this case the adjustments were not as pronounced. Specifically, the Brazilian central bank decided to hold its key SELIC rate at 6.50% in May instead of cutting it by a further 25 bps as it had previously signalled. In view of the increased inflationary pressures, the process of gradual tightening of monetary conditions must start sooner and be more aggressive than expected: we now foresee it starting in the first quarter of 2019 and reaching 10.0% by the end of the year.

Similarly, in Colombia we now see interest rates as more likely to remain at 4.25% in 2018 and to adjust slightly upwards to 4.50% during 2019 (three months ago or forecast was that they would be cut to 4.0% in 2018 and would remain at that level until at least the end of 2019). Also, in the case of Colombia the greater growth expected will contribute towards the tone of monetary policy being less expansive than forecast three months ago.

Although the environment for conducting monetary policy is now more challenging than before, we still expect interest rates to be held at their current levels in Chile, Paraguay and Peru until mid-2019, when an upward adjustment of respectively 100 bps, 25 bps and 50 bps would bring the rates to respectively 3.5%, 5.5% and 3.25% at year-end.

Thus in 2019, when economic activity will have regained at least some of the dynamism lost in the past few years and interest rates in the developed economies continue to be adjusted upwards, the majority of countries in the region should exhibit a change of monetary cycle: the phase of stable rates will give rise to a cycle of gradual withdrawal of the monetary stimulus injected in the previous years.

Argentina and Mexico will resume the cycle of interest rates cuts in a few months, as inflationary risks diminish

The case of Mexico, like that of Argentina, will be different. Following the significant and to some extent unexpected increases announced by Banxico (the Mexican Central Bank) since the end of 2015, the base rate has risen from 3.0% to 7.75%. This process of hardening of monetary conditions was determined by the sharp increase in inflationary pressures, caused mainly by the depreciation of the peso triggered by the renegotiation of NAFTA and electoral uncertainty. Although we believe that the upward cycle has already come to an end and that the monetary authority may initiate a cycle of cuts in mid-2019, there is a risk that new tensions in the currency markets will oblige Banxico to announce additional doses of monetary hardening. Thus, in our baseline scenario key interest rates would reach 7.0% at the end of 2019 and continue moving towards neutral levels in the following years.

External risks are increasing, especially those associated with protectionism and financial risks

The risks to our forecasts for Latin America have a downward bias, determined by both external and internal factors. On the external front, except in the case of China, we see a resurgence of risks, especially those related to protectionism and its impact on global trade flows, as well as the risk of hardening of international financing conditions. On the domestic front, the risks remain, especially the risk associated with a delay in public and private investment, while the risk of louder political noise increases in Brazil and diminishes in the Andean countries and Mexico.

As for the first group of risks, of external origin, the greatest risk is an increase in trade tensions and their spilling over into an outright trade war. As mentioned in the global section at the beginning of this report, this risk has intensified in the past few weeks following the measures adopted by the US and China's response, and it potentially involves other countries too. A trade war would not only have direct consequences for economic activity but also indirect effects on confidence and risk appetite in the international markets.

Domestic risks on the increase in Argentina and Brazil. Relatively stable in the remaining countries

As well as the protectionist risk, a more volatile and uncertain financial environment (in part due to the possibility of a trade war) in the middle of a process of monetary normalisation in the US and (later) in Europe, could significantly increase global risk aversion and sharply reduce capital inflows. Lastly, there remains the risk associated with an abrupt adjustment of China's economy, since its imbalances and indebtedness remain substantial, while at the same time some of the measures taken in response to trade war waged by the US could delay the country's deleveraging and economic restructuring.

On the domestic front in Latin America, the political noise and uncertainty continues to play a leading role in the case of Brazil in the run-up to this year's elections. All the same, the risk of greater political noise has diminished following the change of government in Chile and Peru, and following the elections in Colombia and Mexico, as can be seen in Figures 2.7 and 2.8. In Argentina there also remains a risk of increased social tensions, in a context of more restrictive monetary and fiscal policies.

Partly related to the political tensions and changes of government, the possible delay in infrastructure projects in Peru and Colombia also poses a significant risk to growth within the forecast horizon, in that investment is one of the main factors underpinning growth, at least in the next two years.

3. Tables

Table 3.1 Macroeconomic forecasts

GDP (% YoY)

	2016	2017	2018*	2019*
Argentina	-1.8	2.9	0.5	1.5
Brazil	-3.5	1.0	1.6	2.4
Chile	1.3	1.5	3.2	3.2
Colombia	2.0	1.8	2.6	3.3
Mexico	2.6	2.3	2.6	2.0
Paraguay	4.0	4.2	4.1	3.7
Peru	4.0	2.5	3.6	3.9
Uruguay	1.7	2.7	2.9	3.5
Mercosur	-3.9	0.5	0.1	1.6
Pacific Alliance	2.5	2.1	2.8	2.5
Latin America	-1.0	1.2	1.3	2.0

Inflation (% YoY, end of period)

	2016	2017	2018*	2019*
Argentina	39.4	24.8	29.6	20.8
Brazil	6.3	2.9	4.5	4.7
Chile	2.7	2.3	2.5	3.0
Colombia	5.7	4.1	3.3	3.0
Mexico	3.4	6.8	4.1	3.6
Paraguay	3.9	4.5	4.1	4.0
Peru	3.2	1.4	2.0	2.4
Uruguay	8.1	6.6	7.2	7.0

Exchange rates (vs. USD, end of period)

	2016	2017	2018*	2019*
Argentina	15.8	17.7	28.9	32.9
Brazil	3.35	3.30	3.65	3.60
Chile	667	637	640	650
Colombia	3010	2991	2880	2900
Mexico	20.7	18.7	18.8	18.0
Paraguay	5718	5515	5700	5811
Peru	3.40	3.25	3.26	3.30
Uruguay	28.8	28.9	32.0	34.8

Interest rates (%, end of period)

	2016	2017	2018*	2019*
Argentina	24.75	28.75	32.00	21.00
Brazil	13.75	7.00	6.50	10.00
Chile	3.50	2.50	2.50	3.50
Colombia	7.50	4.75	4.30	4.50
Mexico	5.75	7.25	7.80	7.00
Paraguay	5.50	5.25	5.30	5.50
Peru	4.25	3.25	2.80	3.30
Uruguay**	n/a	n/a	n/a	n/a

Current Account (% GDP)

	2016	2017	2018*	2019*
Argentina	-2.7	-4.9	-4.7	-4.1
Brazil	-1.3	-0.5	-0.3	-1.4
Chile	-1.4	-1.5	-1.4	-1.5
Colombia	-4.3	-3.3	-2.8	-3.3
Mexico	-2.1	-1.9	-2.0	-1.9
Paraguay	1.5	-1.2	-1.5	-1.0
Peru	-2.7	-1.3	-1.3	-1.8
Uruguay	0.8	1.6	-0.2	-1.5

Fiscal Balance (% of GDP)

	2016	2017	2018*	2019*
Argentina	-5.8	-6.0	-5.3	-3.9
Brazil	-9.0	-7.8	-7.8	-5.8
Chile	-2.7	-2.8	-1.7	-1.3
Colombia	-4.0	-3.6	-3.1	-2.4
Mexico	-2.5	-1.1	-2.0	-2.0
Paraguay	-1.4	-1.5	-1.5	-1.5
Peru	-2.5	-3.1	-2.9	-2.5
Uruguay	-3.8	-3.5	-3.3	-2.8

Average commodity prices

	2016	2017	2018*	2019*
Oil (Brent USD/bbl)	44.8	54.4	72.1	70.3
Soya beans (USD/metric ton)	363	359	352	343
Copper (USD/lb.)	2.20	2.80	3.04	2.91

"Forecasts". ** Uruguay establishes its monetary policy through monetary aggregates, not with a target rate of interest.
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