RESEARCH

Economic Outlook

Latam

Second Quarter 2012
Economic Analysis

- **Global growth will recover gradually in 2012 from the trough in 2011Q4.** The rebound will be more pronounced in Asia.
- **Latin America will grow 3.7% in 2012 and 3.8% in 2013** supported by domestic demand and high commodity prices.
- **Central Banks will maintain a cautious tightening bias, except in Brazil.** They will have to balance inflationary pressures and a strong domestic demand against resilient capital flows and external uncertainty.
- **Risks to growth in the region are focused on the external environment,** especially a new flare-up of the European crisis.
- **Policymakers in the region should take advantage of tailwinds** to reduce their vulnerabilities and replenish monetary and fiscal buffers.

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Closing date: May 11, 2012

1. Summary

Due to the lagged effect of tighter monetary policy in many countries and a more uncertain international environment, growth in Latin America slowed in the final quarters of 2011. Nonetheless, despite the backdrop of volatile markets, confidence indicators remained robust, supporting domestic demand and, in turn, very reasonable growth rates in Q4, around 0.6% quarter-on-quarter. The region grew by 4.4% for 2011 as a whole.

First-quarter data herald the beginning of higher growth rates in coming quarters, which will set the tone for the rest of the year. Positive growth surprises emerged in most countries, with the glaring exception of Brazil, where growth will recover starting in the second quarter thanks to more accommodative economic policies.

In this manner, the region will continue to gradually converge closer to its potential growth rates. Latin America will grow by 3.7% in 2012 and 3.8% in 2013. This slowdown relative to 2011 will be consistent with a global growth slowdown (from 3.9% in 2011 to 3.6% in 2012) and, in many countries, a trend towards a tighter policy stance.

Everywhere in the region domestic demand will outstrip GDP growth, fuelled by the strong performance of credit markets and resilient confidence. This illustrates that much of this strong performance will be shaped by internal factors, though it will also be underpinned by high export prices which will keep trade deficits at manageable levels. Although it has substantially ebbed in the last year, some risks of overheating remain, to the extent that domestic demand growth continues to outpace that of GDP.

With the exception of Mexico, inflation will remain high, which will prompt inflation-targeting central banks to stick to a cautious tightening bias, except in Brazil. Buoyant domestic demand and high commodity prices in many cases will help sustain inflationary risks, and we expect inflation rates to end 2012 near the upper limit of central banks' target ranges. By contrast, Brazil's central bank will continue its monetary easing amid cyclical weakness and a renewed focus on lowering high nominal interest rates. Many central banks have continued to implement macroprudential measures to tweak local liquidity conditions and offset inflationary pressures on their currencies.

The region remains resilient to external uncertainty, and continues to reduce its vulnerabilities. Most vulnerability indicators remain relatively low, reflected in stable or improving credit ratings. Very favorable external financing conditions, thanks to lax monetary policies in developed economies', have also shored up this resistance.

Countries in the region must recoup the capacity of their monetary and fiscal policy buffers to weather potential new shocks. In our view, official interest rates in countries with inflation targets will head towards more neutral levels, which will enable them to claw back some of that room for manoeuvre going forward. Nonetheless, further progress is needed on the fiscal front, where deficits and public spending will remain at manageable levels in 2012 yet still exceed pre-crisis levels. The main domestic risk in many countries is policymakers' complacency in the face of a possible abrupt change in market sentiment.

The region's main risks are linked to the international environment. The major global risk – likewise Latin America's main risk – is a possible rapid and deep flare-up of the European crisis. Such a shock emanating from Europe would affect Latin America through trade links, but also in terms of a sharp increase in risk aversion, a drop in commodity prices and a knock-on effect in other major trading partners, such as the US and (to a lesser extent) China. In any event, such a scenario would significantly impact the region's growth, but not to the extent seen in 2009. Other external factors, such as higher oil prices, a US growth slowdown or a sharp correction in China represent a more moderate risk for the region overall, though some particular countries could be seriously affected.

2. Global recovery, but risks reignite

Global economic activity will gradually recover, with wider growth differentials across the main areas. But the risks to growth are tilted to the downside

After a gradual deceleration during 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex China (including Japan) and Latin America and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will also be quite heterogeneous, increasing the divergence in growth rates between the main economic areas. The increase in growth in 2012 will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and the partial turnaround of policy tightening measures implemented until mid-2011. On the other hand, the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. Still, this will be better than a basically stagnant activity in the euro-area in 2012, dragged in peripheral countries by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, Europe and the US also will continue to increase their growth gaps in the next two years, even as we expect European authorities to continue taking decisive actions which will slowly lower financial tensions.

All in all, our growth projections are not very different from those published in February. We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of that increase in global activity (Chart 1). But, as mentioned before, this scenario is conditioned on the evolution of the crisis in Europe, and thus risks to these projections are still strongly tilted to the downside.

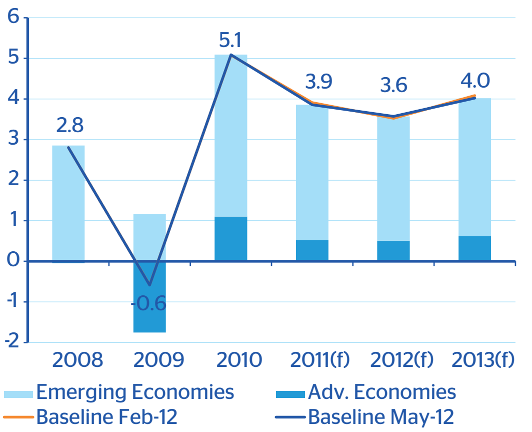
In this context, monetary policies in advanced economies will continue to be very accommodative for an extended period, fulfilling the role of bridging the slump in activity towards the medium and long-run. However, the effectiveness of further intervention (conventional or not) is decreasing, while at the same time the costs increase –including the risk of reduced central bank independence and the collateral damage from unconventional measures–. Thus, it is time for other policymakers and institutions in the US and Europe to decisively take up part of the burden of reviving growth from central banks, implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue supporting an adequate functioning of the monetary transmission mechanism.

Easy monetary policies in advanced economies will mean favorable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect the easing cycle to have ended in much of emerging Asia (except, notably, in China and India), and a cautious tightening bias in most of Latin America, except in Brazil.

There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken. Europe needs a clear roadmap to end the crisis

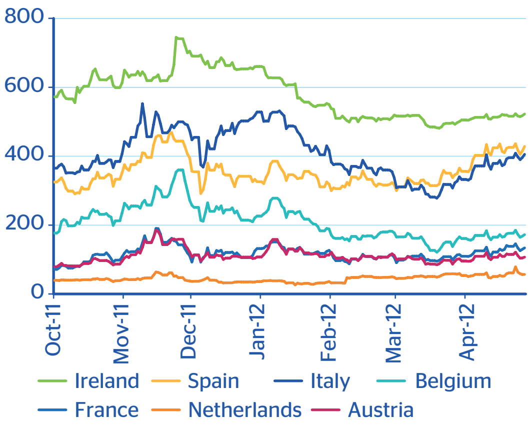
In the last months, there have been some advances towards the solution to the European crisis, but there are still many important pending issues. First, Greek sovereign debt held by the private sector was restructured, although substantial doubts about its long-run sustainability persist, including an unclear majority from recent elections, reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) was provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given its falling short of Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders, thus seriously impairing its catalytic effect on further financing from the private sector. Further, it was not clear to what extent the increase in IMF resources by 430bn USD (approximately 330 bn EUR) could be targeted to European countries. Third, the fiscal compact was sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. This is a significant change towards controlling member's budgets, but the allowance for deviations to the rule under "exceptional circumstances" may depict it as not strong enough to justify a more forceful action by hardliners at the ECB of core countries in Europe. In addition, there have been no advances towards a fiscal union or Eurobonds. All in all, a clear roadmap to where Europe is heading continues to be missing.

Chart 1
Global GDP growth (%qoq)



Source: BBVA Research

Chart 2
European sovereign risk premia (10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries (Chart 2). But these positive effects proved temporary, as markets (i) detected some complacency on the part of policymakers as risk premia decreased in the first quarter of 2012, and (ii) they both doubted the ability of many peripheral countries to reach their fiscal targets and feared the fallout on growth of actually achieving them. Thus, since March, risk premia increased rapidly in Italy and Spain, in the latter to levels similar to the high tensions reached back in November (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. This means that talk of exit strategies for the ECB should not come too soon, but it also implies that economic reforms should be pushed forward, at the same time as demand is rebalanced within the Euro zone, with core countries stimulating it. Second, it is imperative to reconsider fiscal consolidation paths in a coordinated way (to avoid introducing special cases that would be difficult to understand), targeting structural deficits –consistent with the spirit of the fiscal compact– in a more gradual trajectory. In exchange for more gradualism, member states must produce explicit, comprehensive, detailed and multi-annual consolidation plans. This way, sound public finances could be achieved without big damage to short-term growth. At the same time, this will allow to reap the benefits of long-term structural reforms that are being implemented in peripheral countries.

In this context, we still see a new flare-up of the European crisis as the main risk, with potentially very negative consequences for global growth. Increased tensions can come about from reform fatigue in peripheral countries coupled with bailout fatigue in core countries, in the context of electoral processes –and a referendum– in many European countries: Ireland and the Netherlands are holding them in the first half of this year (and Greece will repeat it) after elections in France, and two German states were held in May.

Current oil prices will have only a moderate impact on global growth. However, a big oil price spike constitutes a significant risk to growth

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced back in part to tightening fundamentals (demand and supply) but also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, given tensions around Iran and very reduced market buffers (oil inventories and producer's spare capacity, see Box 1). In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 20% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries will view this as a temporary shock and their weak cyclical positions will prevent them from tightening monetary policy, one of the traditional channels of transmission to lower growth. Nevertheless, should the conflict in the Gulf escalates, there could be a very large spike in oil prices, and even if central banks still do not react, growth could be damaged through the associated increase in global risk aversion. We consider that the probability of an escalation in the Gulf is relatively reduced, but it is a scenario that would have a significant impact on global growth should it materialize.

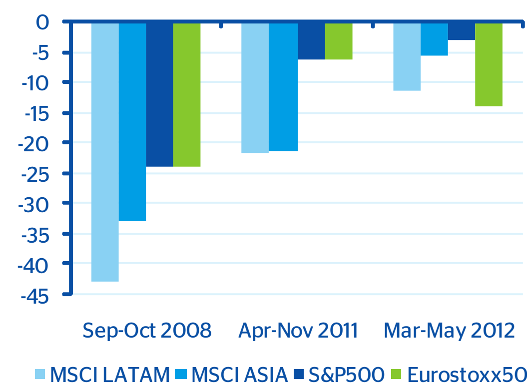
3. Convergence to potential growth continues

Latin America will grow by 3.7% this year and by 3.8% in 2013, fuelled by domestic demand

So far in 2012, Latin American financial markets have largely tracked those of developed economies, which were shaped by waning tensions in Europe in the early months of the year, a trend which reversed beginning in mid-March. The deterioration which began in March wiped out most of the gains registered in the first three months of the year. Specifically, the region's share prices climbed by 16% from January to mid-March, only to decline by 12% from mid-March through early May (Chart 3). Similarly, spreads narrowed by 74 bp in the January-March period, only to spike by 37 bp in the second period (Chart 4).

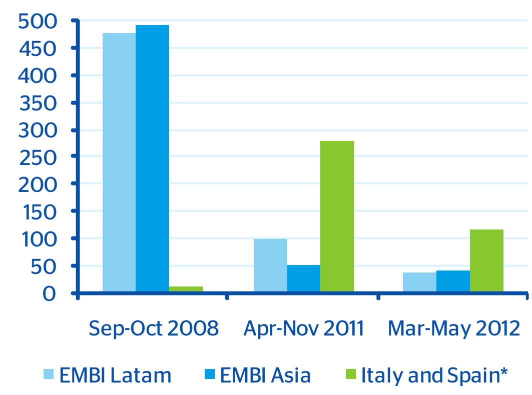
These recent losses pale in comparison with those of previous outbreaks of turmoil (such as the 2008 Lehman Brothers crisis or the spike in tensions in peripheral Europe in late 2011). However, the losses are no less pronounced than those seen in other emerging and developed regions, which suggest that Latin America was not immune to Europe's turbulence. To be sure, this evidence must be viewed with caution, since the region's indicators were starting from a better position than those of other regions and include the negative impact of greater pessimism surrounding the Brazilian economy, which is partly linked to idiosyncratic factors in Brazil and not necessarily to the global economy.

Chart 3
Stock market changes (%)



Source: BBVA Research, Haver and Bloomberg

Chart 4
Change in sovereign spreads (bps)



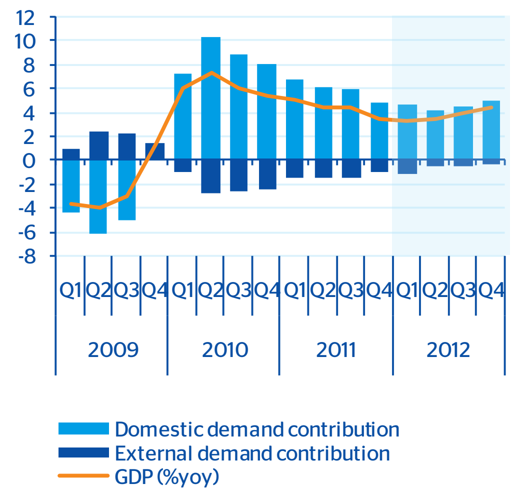
* Average of both countries' 10yr sovereign bond spreads to Germany
Source: BBVA Research and Haver

Due to the lagged effects of many countries' tighter monetary policies and a more uncertain international environment, growth in Latin America slowed in the final quarters of 2011. Despite a complicated backdrop, confidence indicators remained robust in the region, supporting domestic demand and, in turn, very reasonable growth rates in Q4, around 0.6% quarter-on-quarter (3.5% year-on-year, Chart 5). In 2011 as a whole, the region grew by 4.4%.

Domestic demand remained robust in the first few months of 2012. Indeed, in some countries such as Chile, Peru, Mexico and Venezuela, domestic demand in the initial months of the year increased more than expected in our February Latin America Economic Outlook. Meanwhile, the global economy's impact on foreign demand was very limited. The slower-than-expected recovery in Brazil, where the output gap is currently negative, stands in contrast to the positive surprises in this group of countries, but overall, available data for the beginning of the year back up our forecasts for a soft landing in the region. First-quarter data herald the beginning of higher growth rates for the region in coming quarters, which will set the tone for the rest of the year.

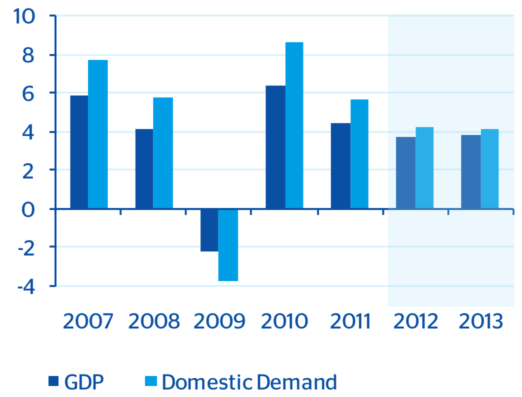
Looking ahead, our forecasts call for Latin America to maintain its high growth rate despite an uncertain global environment. A robust domestic demand, underpinned by strong performance in credit and labor markets, and commodity prices' resilience to international turmoil will continue to ensure that growth hovers around 4% next years (Chart 6). Specifically, we expect the region to grow by 3.7% this year and by 3.8% in 2013, which means that Latin America will converge towards levels closer to its growth potential in coming years, after it grew by 6.3% in 2010 and 4.4% in 2011. The slowdown in economic activity relative to previous years will be shaped largely by a less favorable external environment than in the recent past and by the lagged effect of the partial unwinding of the expansionary policies (particularly monetary policy) enacted since the Lehman Brothers crisis erupted in 2008. In sum, our growth forecasts for the region are slightly more optimistic than those issued in February (3.6% in 2012 and 3.8% in 2013), especially due to positive growth surprises in the first quarter.

Chart 5
Latam: contribution to yoy growth rates (pp)



Source: BBVA Research

Chart 6
Latam: GDP and domestic demand growth (%)



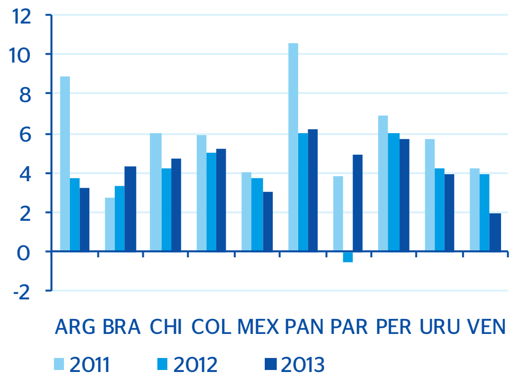
Source: BBVA Research

For nearly every country in the region, convergence towards potential growth in the next two years will entail a slowdown in economic activity (Chart 7). This slowdown will be more subdued in Mexico, Colombia, Peru, Venezuela, Chile and Uruguay, and much more pronounced in Argentina due to slumping consumer confidence and import restrictions. Panama and Paraguay will slow sharply in 2012, in the case of Panama due to a slowdown in one-off investment spending on major projects, and in the case of Paraguay because of a negative shock in the agriculture industry amid a drought and the outbreak of foot-and-mouth disease. However, in Brazil convergence towards output potential will imply higher growth, leaving behind stagnant economic activity in the second half of 2011, which was shaped by the country's higher exposure to the global financial climate and by previously-adopted restrictive policies.

Throughout all of the region's economies, internal demand growth is forecast to outstrip GDP growth, endorsing the view that these countries' recent dynamic performance is driven by internal factors and highlighting the region's ability to weather external shocks. In the region as a whole, internal demand will grow by 4.2% this year and by 4.1% in 2013 (Chart 6). Logically, these aggregate forecasts mask some differences among countries: for the next two years we expect internal demand growth of between 5% and 6% in Peru, Uruguay, Panama, Colombia and Paraguay, and of less than 4.0% in Mexico and Brazil (Chart 8).

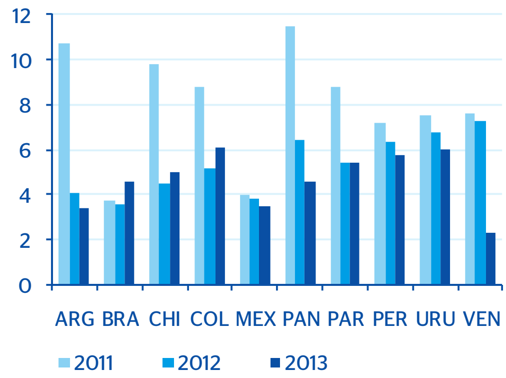
In general, the private sector will drive both consumer spending and investment, but the public sector's contribution will be significant, particularly in countries like Peru, which has ample margin for expansive policies given the country's healthy public accounts, and Venezuela, though its fiscal space is more limited. Highlights on the supply side generally include the positive contribution of sectors linked to commodities and services which, in countries like Colombia and especially Brazil, contrasts with a lower contribution from the manufacturing sector.

Chart 7
Latam countries: GDP growth (%)



Source: BBVA Research

Chart 8
Latam countries: domestic demand growth (%)



Source: BBVA Research

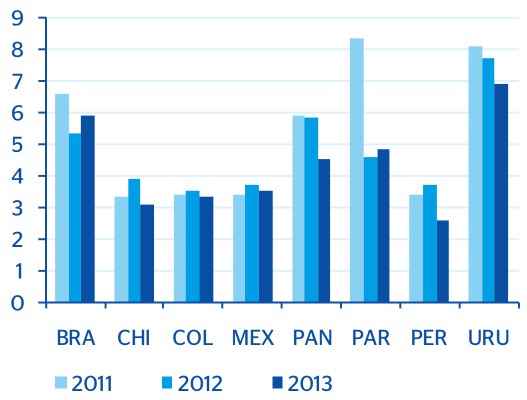
Commodity prices and strong domestic demand keep inflation high

High commodity prices have underpinned strong economic activity in the region, but they have also eroded prospects for inflation to fall further, even with a more restrictive tone of monetary policies in 2011. Expectations that commodity prices will stay high and that growth will remain robust as the year goes on are likely to cancel out positive surprises from inflation figures published in the first quarter of the year in many countries including Brazil, Colombia and Venezuela.

However, it is important to note that the negative impact of rising oil prices will be offset by price stabilization mechanisms or subsidies in many countries. In any event, a dip in fuel prices in early May also partially tempered the risks surrounding this factor. Inflationary pressures will also be partly offset by expectations for currency appreciation (at least in Mexico, Colombia and Peru), a slowdown in economic activity in Argentina and price controls in Venezuela. This is likely to produce a slight turning point in average 2012 inflation compared with levels seen in 2011 (Chart 9).

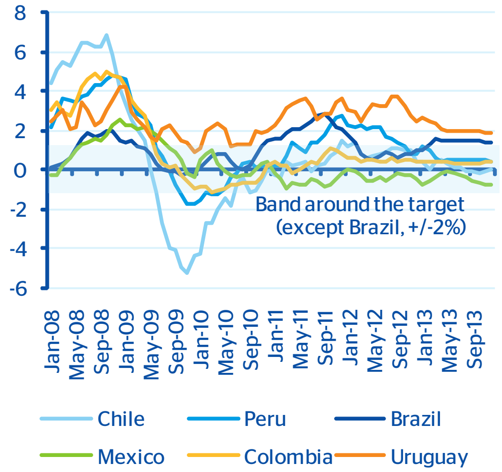
In Brazil, Chile, Colombia, Peru and Mexico, all inflation-targeting countries, we forecast inflation at the end of the year within the ranges established by each central bank, albeit close to the high end in many of them (Chart 10). In Chile and Peru —for which we recently raised our inflation forecasts, due to greater domestic and external pressures— we expect inflation to end 2012 at 3.4% (target range: 2.0%-4.0%) and 2.8% (target range: 1.0%-3.0%), respectively. The inflation forecast for Brazil is unchanged at 5.4% (target range: 2.5%-6.5%) for the end of the year, since positive surprises in the first quarter and a change in methodology implemented at the beginning of the year will neutralize the effects of a monetary policy which is proving much more lax than expected. Finally, in Mexico and Colombia, inflation forecasts have been lowered, to 3.7% and 3.4% (target range: 2.0%-4.0%), respectively, primarily due to positive surprises so far this year. Uruguay will be the only country in the region that will miss its inflation target: we expect inflation to end the year at 7.5%, widely breaching the upper bound of 6.0%.

Chart 9
Latam countries: Average annual inflation (%)



Source: BBVA Research

Chart 10
Inflation targeting countries: difference between inflation and the central bank's target (pp)



Source: BBVA Research and Haver

In all inflation-targeting countries, we expect inflation to slow in 2013 and approach the central targets set by each monetary authority, with the exception of Brazil. In Brazil, while we expect inflation to remain within the central bank's range, recent monetary flexibility suggests a greater degree of tolerance towards inflation.

The strength of domestic demand partly offsets the external environment and prompts central banks to adopt a cautious tightening bias, except in Brazil

Despite weakness in the external front, a robust domestic demand, the strength of commodity prices and expectations that inflation will approach the upper bound of their target ranges are tilting the balance of risks to inflation to the upside. Thus, the domestic environment generally prevents the adoption of more lax monetary policies, even though the international backdrop suggests that monetary authorities are not entirely opposed to lowering official interest rates.

In this context, we expect central banks in Mexico, Chile and Peru to leave their benchmark rates unchanged in coming months (Chart 11). In the case of Mexico, the pause begun in 2009 is likely to last until June 2013, when ebbing external risk and a healthier domestic economy may encourage a hike in the official rate. Nonetheless, we think the short-run bias is for lower rates given the risks surrounding economic activity and inflation.

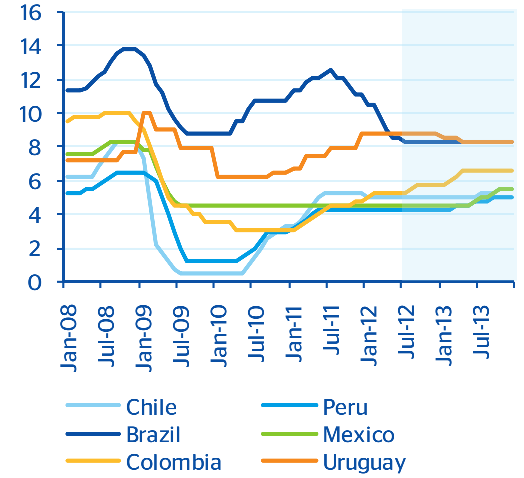
As for Peru and Chile, with a better cyclical position than Mexico, the downward bias has reversed to become slightly more restrictive due to recent inflationary pressures. Chile's central bank at the beginning of the year cut its benchmark rate by 25 bp, and we do not expect such a move to be repeated anytime soon.

In Colombia, the central bank has assigned more importance to domestic factors than to external ones in its balance of risks. Consequently, it adjusted its benchmark rate by 50 bp to 5.25% in the first quarter. Despite the adoption of a more neutral approach recently, we expect domestic factors will predominate and that an additional adjustment will be announced in the second half, which will effect a slowdown and convergence towards potential growth.

Brazil's central bank has taken a significantly different approach from other inflation-targeting central banks in the region (Chart 11). The Brazilian central bank has continued this year the monetary easing begun in 2011. As a result, the current downward cycle has seen rates fall by 350 bps since

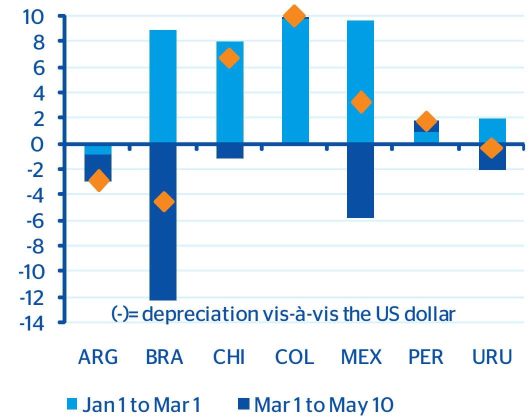
August 2011. For the next two months, forecasts call for additional cuts of 75 bp, leaving the SELIC at 8.25%, a historic low for Brazil. The Brazilian monetary authority's stance may be partly explained by the cyclical weakness, but also by its apparently greater tolerance for inflation and a stepped-up focus on permanently reducing the country's high interest rates. With regard to the latter, we would note the adoption of a new remuneration scheme for savings accounts which, in practice, paves the way for a lower SELIC.

Chart 11
Policy interest rates for inflation-targetting countries



Source: BBVA Research and Bloomberg

Chart 12
Changes in the value of local currencies vis-à-vis the US dollar (%)



Source: BBVA Research

Currencies are likely to continue appreciating against the dollar during the rest of 2012

While in many cases central banks are on hold regarding official interest rates, economic authorities have been using other means to adjust liquidity conditions, both in dollars and in local currencies, without exacerbating appreciating pressures on their exchange rates. Along these lines, the Peruvian central bank raised its reserve requirements in soles and dollars to reduce credit market frothiness, while Colombia's central government has maintained a high balance of deposits in the Banco de la República which, for its part, has announced new regulations which will allow greater scope for intervention in foreign exchange markets should it prove necessary. This activism on the part of Peruvian and Colombian monetary authorities represents a clear reaction to counteract the pressures driving their currencies higher: if not for massive interventions, the Nuevo Sol would have gained by more than the observed 2% and the peso by more than 9% this year alone (Chart 12).

In Chile and Mexico, local currencies have also firmed (by 7% and 4%, respectively) in response to a receding aversion to global risk. However, in both cases the currencies strengthened in January and have been relatively stable ever since, in contrast to the ongoing firming seen in Peru and Colombia.

The Brazilian real performed quite differently to its regional counterparts. Instead of strengthening, the Brazilian currency slipped by 4% against the dollar. This contrasting performance is linked to a new round of tax hikes on capital inflows, the central bank's purchases of dollars (the bank is under less pressure thanks to the recent drop in inflation), a more relaxed than expected monetary policy and threats of the enactment of new measures. Apart from authorities' interventionist stance, we believe the real's recent weakness is due to fading optimism about the country, in line with slowing economic activity and the Brazilian industrial base's loss of competitiveness.

Despite Latin American authorities' concern about stronger exchange rates, we believe that many local currencies, including those of Mexico, Peru, Colombia and Brazil, will gain against the dollar during the rest of the year, at least if global risk aversion remains contained, as forecast in our baseline scenario.

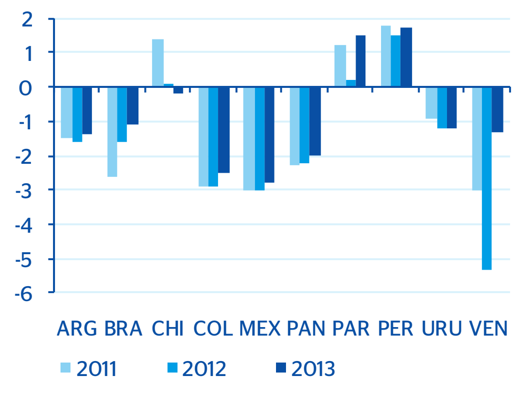
By contrast, we expect currencies in Paraguay and Argentina to weaken. In the case of Paraguay, this will be the result of a worsening trade balance from the shock hitting agricultural exports, while in Argentina the gradual nominal weakening of the peso will partially offset an inflation rate which is higher than the regional average.

External and especially public deficits, remain at manageable levels

The current macroeconomic environment is generally favorable to public accounts in the region as revenue is bolstered by historically high commodity prices and strong domestic demand. Still, with the exception of Brazil, public deficits are not expected to shrink substantially in 2012 from a year earlier (Chart 13), an area which remains a source of concern for the region (see section 4). In Brazil, where interest payments on debt exceeded 5% of GDP in recent years, falling interest rates are very good news from a public accounts standpoint. Additionally, reducing public deficits will facilitate greater monetary policy easing and, at the same time, lower market interest rates.

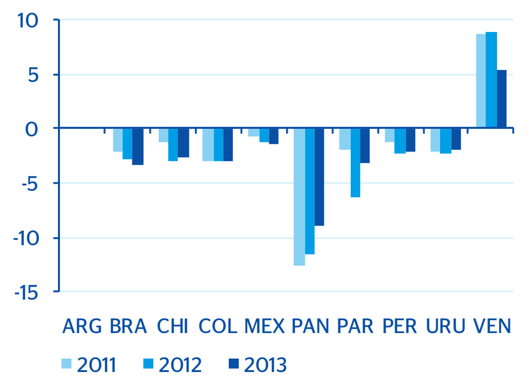
Turning to external accounts, while stubbornly high commodity prices have fuelled export growth by more than expected (except in Paraguay, where agricultural exports have sharply declined), the strength of domestic demand is a significant driver of imports in the region. The latter trend will cause, as outlined in our forecasts, additional deterioration in the current account balance of all countries in the region, with the exceptions of Colombia, Panama, Argentina and Venezuela (Chart 14).

Chart 13
Latam countries: Fiscal balance (% GDP)



Source: BBVA Research

Chart 14
Latam countries: Current account balance (% GDP)



Source: BBVA Research

To be sure, this deterioration is the natural result of the aforementioned gap between the pace of growth in domestic demand and in production. Nevertheless, current account deficits will generally remain at relatively manageable levels compared with those of other emerging economies and compared to accumulated foreign reserves. At the same time, they will continue to be financed largely by inflows of foreign direct investment. In any case, this should not divert attention from the need for reducing vulnerability to an abrupt correction in export commodity prices (see next section).

4. Taking advantage of tailwinds

Latin America remains resilient to external uncertainty and continues to reduce its vulnerabilities

As a whole, the region continues to show signs of improvement in its vulnerability indicators. Foreign reserves have continued to increase in a majority of the region's countries, while fiscal and external vulnerabilities remain at relatively low levels.

In the fiscal front, deficits stand at manageable levels and public debt as a percentage of GDP has shrunk, though in some countries gaps between interest rates and GDP growth may represent a significant challenge in terms of debt dynamics going forward.

External vulnerability is likewise relatively limited, for while current account balances are above the average for the world's emerging regions, low levels of foreign debt (both relative to GDP and to exports) provide some room for manoeuvre for tackling a sudden halt in capital inflows.

Accordingly, vulnerability indicators remain in between those for Asia and emerging Europe (Chart 15), with foreign deficits and the stubbornness of inflation being particularly noteworthy, as mentioned in section 3. This constrained vulnerability is also illustrated by stable credit ratings for countries in the region (Chart 16). Indeed, some countries such as Colombia, Mexico and Brazil may see their credit ratings raised in the short term, judging by the gap between ratings assigned by different agencies and the implied rating suggested by these countries' sovereign CDS.

Still, it is important to stress that the upbeat external indicators depend largely on high export commodity prices, and are occurring against a backdrop of relatively favorable foreign financing conditions thanks to central banks' accommodative policies in developed economies. All of the foregoing underscores the need for expanding countries' room for manoeuvre to ensure that they are better placed to weather a possible collapse of commodity prices or a reversal of market sentiment.

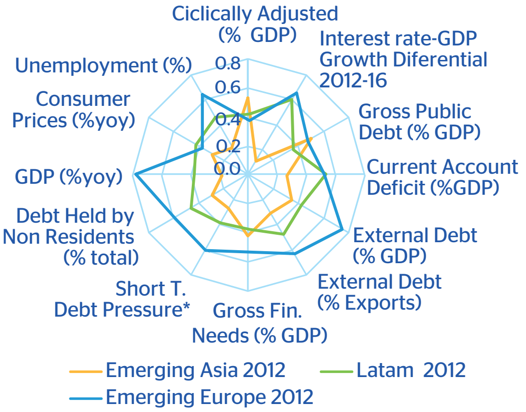
Countries must recoup the capacity of their monetary and fiscal policy buffers to weather a potential new shock. Complacency among policymakers is the main domestic risk

The region has proven that it can capitalize on the economic policy (monetary and fiscal) room for manoeuvre it accumulated during the pre-crisis years to tackle the challenges of a highly synchronized global recession, such as the 2008-2009 downturn. However, now that external conditions have stabilized, especially outside of Europe, it is time to restore the ability of such buffers to cushion the blow of possible new external events, which may emerge from a variety of sources (see below).

On the monetary policy front, inflation-targeting central banks must balance the need, on one hand, for harnessing inflation expectations and strong internal demand and, on the other hand, for moderating capital inflows and leaning against the effect of external uncertainty. Macroprudential policies can help to prevent financial market excesses, especially in a context of heavy short-term capital inflows. Nevertheless, it remains difficult to gauge the success and efficacy of these policies, whose effects tend to be short lived and which are in any event no substitute for a monetary policy approach tailored to the cyclical circumstances of each country.

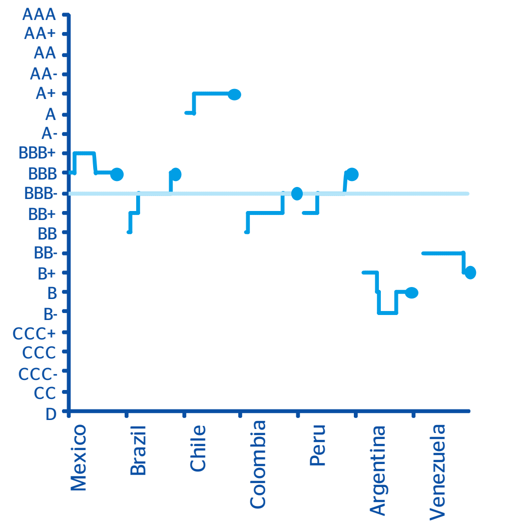
In this regard, forecasts indicate that most inflation-targeting countries will have interest rates closer to their neutral levels (Chart 17) in coming years, though in certain cases further adjustment will be needed, particularly in light of the fact that some countries' inflation rates will remain at the high end of their central banks' target ranges (Chart 10).

Chart 15
Vulnerability indicators for emerging economies



Source: BBVA Research

Chart 16
Sovereign ratings in Latin America (2007-2012)

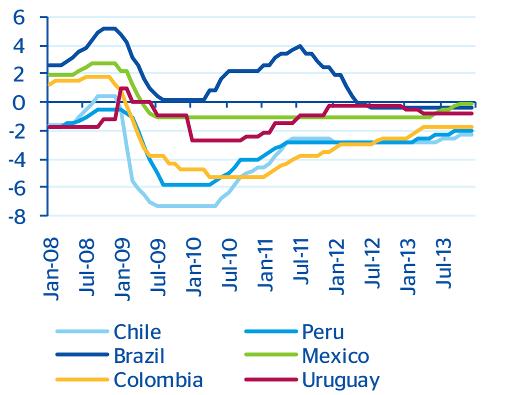


* Average of the three main rating agencies.
Source: BBVA Research

Nonetheless, further progress is needed on the fiscal front, where deficits and public spending will remain at manageable levels in 2012 yet still exceed pre-crisis levels (Chart 18) and, in a majority of countries, are unlikely to shrink this year. As a result, many countries still need to withdraw fiscal stimulus enacted in response to the 2008-2009 global crisis and return to a less pro-cyclical stance on fiscal policy. Additionally, the European crisis highlights the fragility of fiscal credibility, which is one of the region's major achievements of recent years. Finally, fiscal consolidation will also pave the way for greater monetary policy flexibility to enable interest rate cuts and erode incentives to short-term capital inflows, as is happening currently in Brazil.

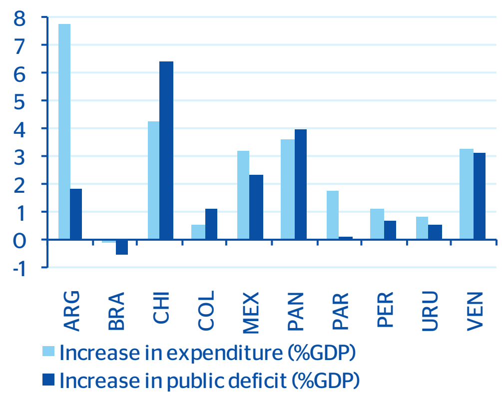
In sum, during a period in which the region is underpinned by favourable foreign financing conditions and improved terms of trade, the greatest internal risk resides in the complacency of authorities, which could delay for too long the region's ability to claw back economic policy's room for manoeuvre for overcoming any possible sudden change in market sentiment or an external shock.

Chart 17
Difference between policy interest rates and long-run nominal GDP growth* (pp)



* Approximated as the sum of the central bank's inflation target plus potential growth
Source: BBVA Research

Chart 18
Increase in public expenditure and fiscal deficits: 2011 versus 2006-2007 average (% GDP)



Source: BBVA Research

A possible shock could emerge from a worsening European economic crisis, which is currently the most important global risk

As noted in section 1, the main risk factor for the world and the region remains a potential deterioration in the European economic crisis, which would have significant repercussions throughout the rest of the world. In such a scenario, financial and liquidity tensions would spike. This would prompt a severe contraction in lending and set off a major recession in the eurozone. The impact on Latin America would come from three fronts. First, a sizeable increase in global risk aversion would spark a rise in the local risk premium, increase financing costs, erode capital inflows and depreciate local currencies. Second, commodity prices and foreign demand would drop, including among the region's major trade partners such as the US and, to a lesser extent, China. Finally, business and consumer confidence would deteriorate. In such an environment, private investment would be the most affected area of spending, a scenario already seen during the 2008-2009 crisis.

While an external shock of this magnitude would have negative impacts at the local level, the region has certain advantages that suggest it may resist the onslaught in relative health, and may even emerge in better shape than it did following the Lehman Brothers collapse. While most countries have less room for manoeuvre than in 2008 (especially on the fiscal side, as mentioned earlier), it is also true that a new shock would not take them by surprise as the Lehman Brothers collapse did. What's more, the experience and efficacy of the stabilization measures enacted in 2009 would help to contain any drop in confidence and would ward off domestic panic.

An additional element to cushion the blow of a shock emanating from Europe is that in Latin America, foreign banks mostly use a decentralized capital and liquidity management model, self-financing in local markets, meaning that they do not depend on the parent company for funding. At the same time, such lenders are subject to the oversight and regulation of each country in which they do business, and are covered by the local market's deposits guarantee fund. While this financing autonomy reduces the profit potential generated by large-scale liquidity management (economies of scale), its advantage is that it acts as a natural firewall and lessens the likelihood of knock-on effects from a possible need for deleveraging during outbreaks of turbulence.

In short, while a worsening of the external environment will have an impact, which could be significant, on the region's economy, it will not be a crisis on a par with those seen in previous episodes in which developed economy turmoil spread to the region. The sole exception would be economies that have more difficulties accessing international financing and less room for manoeuvre for deploying counter-cyclical policies.

Additional external risks include oil prices, a US double dip or a sharp slowdown in China. The likelihood of these risks is more remote

While other external risks apart from a worsening of the European crisis do exist, they are less likely to materialize.

The first of such external risks consists of a possible sudden spike in oil prices. While this is an additional global risk (see Box 1), the effect on Latin America overall would be minimal, albeit not uniform across all countries. In any event, the main risk would centre not on a direct impact from rising energy prices, but rather on a possible increase in global risk aversion and the consequent additional negative effect on financing to the region and on the price of other export commodities.

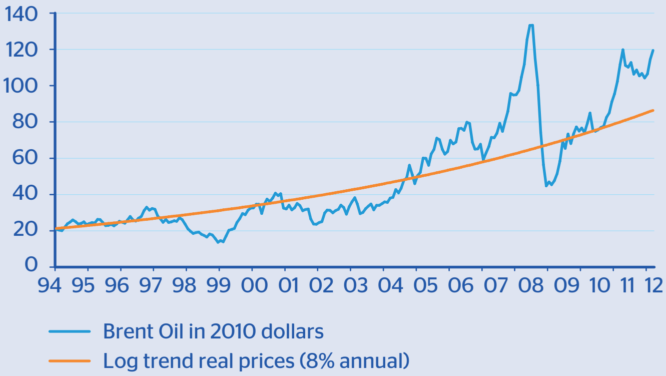
Meanwhile, the US is a very important trade partner for the region, particularly for Mexico. The risks on the US side primarily stem from the inherently fragile nature of the US recovery (slow by historical standards for a recovery from a recession) and the prospect of a sharp fiscal tightening in 2013 caused by the political paralysis surrounding this year's November elections. In any case, our baseline scenario calls for moderate deficit reduction, but without tackling long-term consolidation.

Finally, South America's reliance on high commodity prices makes it very vulnerable to a sharp growth slowdown in China. Our base case scenario does not envisage Chinese growth easing any more than the slowdown registered until the first quarter of 2012, but the risks are firmly skewed to the downside due to uncertainty arising from Europe. The risk is ever present that weak demand from Europe could filter through to produce a slowdown in China's domestic demand, which could hurt demand for commodities and, in turn, impact Latin America.

Box 1. Higher oil prices: a moderate global risk

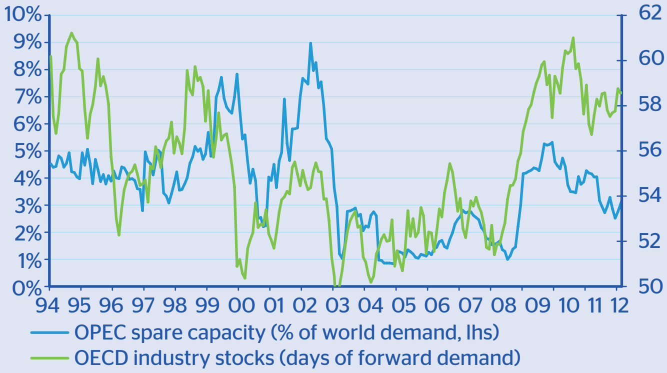
Oil prices have spiked in 2012, dispelling forecasts for a gradual decline this year. In early May, a barrel of Brent oil traded at 120 USD, a level around which it has fluctuated during the first months of 2012. Although these figures are still below the highs reached in dollar terms in 2008 (Chart 19), it has raised concerns about its impact in some economies.

Chart 19
Oil prices in real terms (dollars of 2010)



Source: BBVA Research and Bloomberg

Chart 20
Oil market buffers: OPEC spare production capacity and OECD inventories



Source: BBVA Research and Haver

Part of this unexpected surge in oil prices can be attributed to tightening supply and demand fundamentals. Although the global economy is slowing slightly, emerging economies are showing a great resistance to weaker external environment, offsetting it by the strength of domestic demand. Indeed, changes in market sentiment regarding the recovery in the U.S. or Europe have generated some downward correction in oil prices in early May, which shows the weight of demand as a factor behind price movements.

On the other hand, supply has been affected over recent months due to problems in some key producing areas: social unrest in Yemen and Nigeria, disputes in South Sudan, technical outages in the North Sea, and the embargo imposed on Syria. In addition, Libyan oil has not yet reached the level of production before the civil war.

To these factors, we should add a positive effect on the price resulting from the increased liquidity provided by central banks (especially the two long-term auctions by the ECB).

Moreover, the market has been rocked by geopolitical concerns, resulting from increased tension in Iran which, in an extreme scenario, could shut the transit of oil through the Strait of Hormuz, equivalent to 20% of global oil production and 5% of gas (in particular liquefied gas from Qatar). As a result of rising tensions because of Iran's nuclear program, the EU has banned the import of Iranian oil and the U.S. has imposed restrictions to break ties between Iran's oil revenues and its financial system.

At the same time, traditional buffers to face sharp reductions in supply (crude oil stocks and spare production capacity) are relatively low (Chart 20). OPEC's spare capacity has followed a downward trend in recent years to reach the equivalent of only 3% of world demand, similar to the years before the crisis, characterized by continued increases in prices. If necessary, the U.S. strategic reserves could pump significant quantities, but there is high uncertainty about their ability to do so (between 0.5 and 4 million barrels per day). But even under the best conditions, closing the Strait of Hormuz would leave a gap in the supply of around 10 million barrels a day. On the other hand, stocks in OECD countries (the only data available) have been significantly reduced from the levels of one or two years ago.

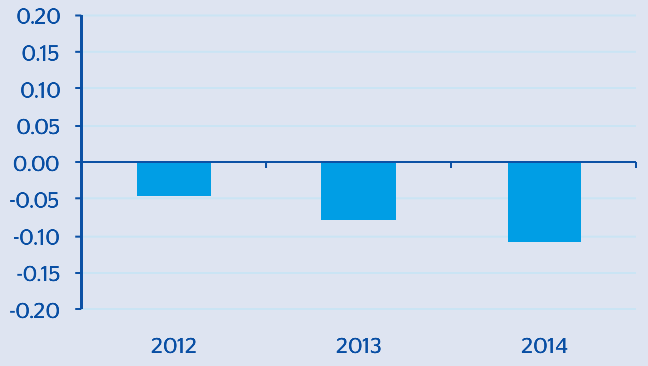
Thus, the hypothetical Iranian ability to close the Strait of Hormuz in retaliation for military action that could be taken against its nuclear facilities combined with very low current buffers have increased the geopolitical risk premium to about 10-15 USD per barrel . This risk premium is likely to continue for most of 2012, so in our baseline scenario we assume oil prices in the vicinity of 120 USD per barrel for most of 2012, representing an increase of 20 % compared to our scenario back in February.

Still, these prices will have only a modest impact on global growth, as central banks in advanced economies are likely to treat this as a temporary shock. Also, given the weakness of the cycle and ample slack they are not likely to react with a tightening of monetary policy, one of the traditional transmission channels from an oil shock to lower growth.

Yhe impact in Latin America would be relatively modest. Regarding growth, it has to be noted that the region as a whole is a small net exporter of oil, and thus the impact on GDP growth will be relatively small (Chart 21), but with a lot of heterogeneity by countries, from a relatively small negative effect in Brazil, Chile and Peru to a very positive effect in Colombia and Venezuela. The main effect of an oil price shock would fall mostly on inflation, especially in those with inflation targeting regimes (Chart 22).

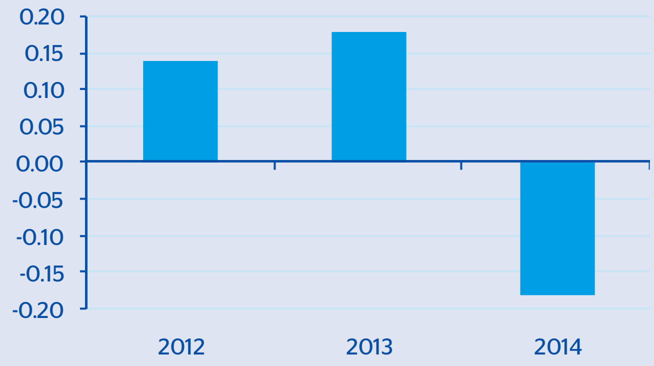
However, the effects on growth are more uncertain if geopolitical tensions in the Gulf increase, leading to open conflict. Although it is a very unlikely scenario in the light of ongoing negotiations with Iran, it would trigger a strong rise in oil prices, and although it is unlikely that central banks would react even in this case, growth could be negatively affected by increased global risk aversion triggered by this shock.

Chart 21
Effect on growth in Latin America of a temporary 20% increase in oil prices (pp)



Source: BBVA Research

Chart 22
Effect on inflation in Latin America of a temporary 20% increase in oil prices (pp)



Source: BBVA Research

5. Tables

Table 1
GDP (% yoy)

	2010	2011	2012*	2013*
Argentina	8.2	8.9	3.7	3.2
Brazil	7.6	2.7	3.3	4.3
Chile	6.1	6.0	4.2	4.7
Colombia	4.0	5.9	5.0	5.2
Mexico	5.5	4.0	3.7	3.0
Panama	7.6	10.6	6.0	6.2
Paraguay	15.0	3.8	-0.5	4.9
Peru	8.8	6.9	6.0	5.7
Uruguay	8.9	5.7	4.2	3.9
Venezuela	-1.5	4.2	3.9	1.9
Latin America	**6.3**	**4.4**	**3.7**	**3.8**

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

Table 2
Inflation (% yoy, average)

	2010	2011	2012*	2013*
Brazil	5.0	6.6	5.3	5.9
Chile	1.4	3.3	3.9	3.1
Colombia	2.3	3.4	3.5	3.3
Mexico	4.2	3.4	3.7	3.5
Panama	3.5	5.9	5.8	4.5
Paraguay	4.6	8.3	4.6	4.8
Peru	1.5	3.4	3.7	2.6
Uruguay	6.7	8.1	8.1	7.1
Venezuela	29.1	27.2	25.0	29.5
Latin America	**6.4**	**6.9**	**6.4**	**6.9**

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

Table 3
Exchange Rates (vs. USD, average)

	2010	2011	2012*	2013*
Argentina	3.91	4.13	4.56	5.19
Brazil	1.75	1.68	1.79	1.85
Chile	510	484	488	500
Colombia	1.899	1.848	1.763	1.760
Mexico	12.63	12.44	12.77	12.23
Panama	1.00	1.00	1.00	1.00
Paraguay	4.739	4.196	4.537	4.725
Peru	2.83	2.75	2.64	2.57
Uruguay	20.0	19.3	19.7	20.2

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

Table 4

Interest Rates (%, average)

	2010	2011	2012*	2013*
Argentina	10.11	13.34	13.57	16.08
Brazil	10.00	11.71	8.85	8.25
Chile	1.54	4.75	5.00	5.19
Colombia	3.13	4.10	5.42	6.38
Mexico	4.50	4.50	4.50	4.92
Panama	2.69	1.86	1.98	2.49
Paraguay	1.46	8.55	7.07	8.50
Peru	2.06	4.04	4.25	4.69
Uruguay	6.31	7.69	8.75	8.31
Venezuela	14.62	14.55	14.51	15.00

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

Table 5

Current Acount (% GDP)

	2010	2011	2012*	2013*
Argentina	0.8	0.0	0.2	0.2
Brazil	-2.2	-2.1	-2.8	-3.4
Chile	1.5	-1.3	-3.0	-2.7
Colombia	-3.0	-3.0	-3.0	-3.0
Mexico	-0.3	-0.8	-1.3	-1.4
Panama	-10.8	-12.7	-11.6	-9.0
Paraguay	-3.7	-2.0	-6.3	-3.2
Peru	-2.5	-1.9	-2.3	-2.1
Uruguay	-1.2	-2.1	-2.3	-1.9
Venezuela	6.1	8.6	8.8	5.4
América Latina	**-0.8**	**-0.9**	**-1.4**	**-1.8**

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

Table 6

Fiscal Balance (% GDP)

	2010	2011	2012*	2013*
Argentina	0.2	-1.5	-1.6	-1.5
Brasil	-2.5	-2.6	-1.6	-1.1
Chile	-0.4	1.4	0.1	-0.2
Colombia	-3.8	-2.9	-2.9	-2.5
México	-3.5	-3.0	-2.8	-2.8
Panamá	-1.9	-2.3	-2.2	-2.0
Paraguay	1.4	1.2	0.2	1.5
Perú	-0.3	1.9	1.5	1.7
Uruguay	-1.1	-0.9	-1.2	-1.2
Venezuela	-3.1	-3.0	-5.3	-1.3
Latin America	**-2.4**	**-2.3**	**-2.1**	**-1.6**

*Forecasts. Closing date: May 3, 2012
Source: BBVA Research

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This report has been produced by the Latam Coordination Unit:

Chief Economist
Juan Ruiz
juan.ruiz@bbva.com

Rodrigo Alfaro
+ 56 2 939 1198
ralfaro@bbva.com

Enestor Dos Santos
+34 639 82 72 11
enestor.dossantos@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Perú
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo.lopez@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo.lopez@bbva.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spian
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Economic Scenarios
Juan Ruiz (i)
juan.ruiz@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Global Equity
Ana Munera
ana.munera@grupobbva.com

Global Credit
Javier Serna
javier.serna@bbvauk.com

Global Interest Rates, FX and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Contact details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel. + 34 91 374 60 00 and + 34 91 537 70 00
Fax. +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com