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Latam: increasing differentiation

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Key messages

1. The global cycle is improving and the risks are more balanced again. Global GDP growth will reach 2.9% in 2013, 3.6% in 2014 and 3.9% in 2015.

2. Volatility returned to the Latam markets, but from now on differentiation will increase depending on the solidity of the fundamentals.

3. Latam GDP growth will expand from 2.2% in 2013 to 2.5% in 2014 and 2.6% in 2015. The divergence in growth within the region will become increasingly marked: the Pacific Alliance will grow nearly 4% in 2014 and 2015, more than double the pace in Mercosur.

4. External deficits will start to decline in 2014, and remain financed by long-term capital. However, the region has suffered a loss of competitiveness in the last five years.

5. The majority of countries have good buffers to protect themselves from the Fed's tapering. However, it is crucial that reforms continue to be pushed through to avoid weakening the long-term growth drivers.

Synopsis

1 Global economy: more growth and more balanced risks

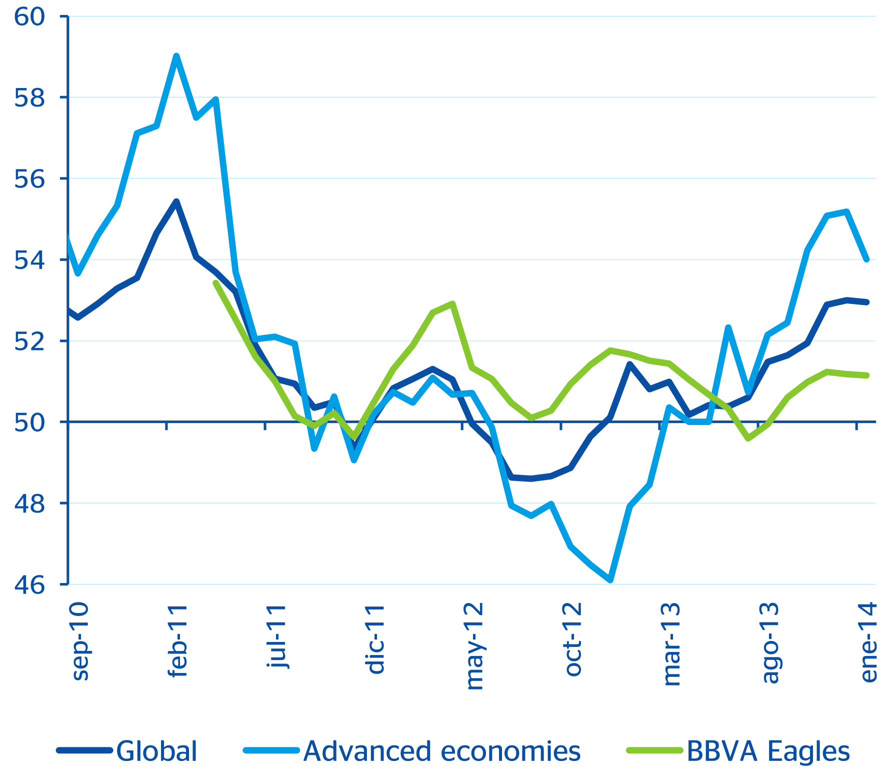
2 Growth expanding in 2014 and 2015, with increasing differentiation within the region

3 Latin America has buffers to protect itself against the Fed’s tapering, but reforms are now even more necessary

Improvement in the global economic cycle, especially in the advanced economies

Manufacturing Confidence Indicator (PMI)

Source: BBVA Research and Markit



EAGLES is the group of emerging economies that will make the biggest contribution to global GDP in the next 10 years. The group comprises China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.

The improvement in the global cycle is largely due to the contribution from the developed economies, particularly the US

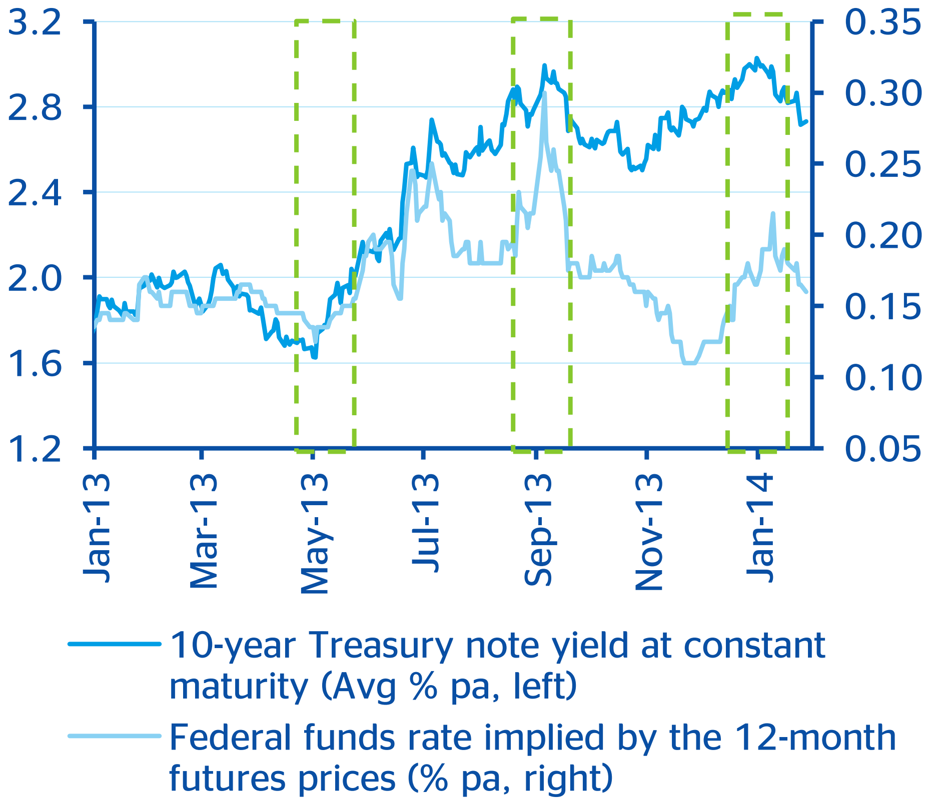
The eurozone is also starting to post moderate growth

The situation in the EMs is more diverse, but some – such as China – are maintaining stable rates of growth

The US starts to unwind monetary stimulus, but in a gradual and orderly fashion

US: Federal funds futures and long-term interest-rates (%)

Source: BBVA Research y Bloomberg



The acceleration in activity has allowed the Fed to start to reduce bond purchases (tapering)

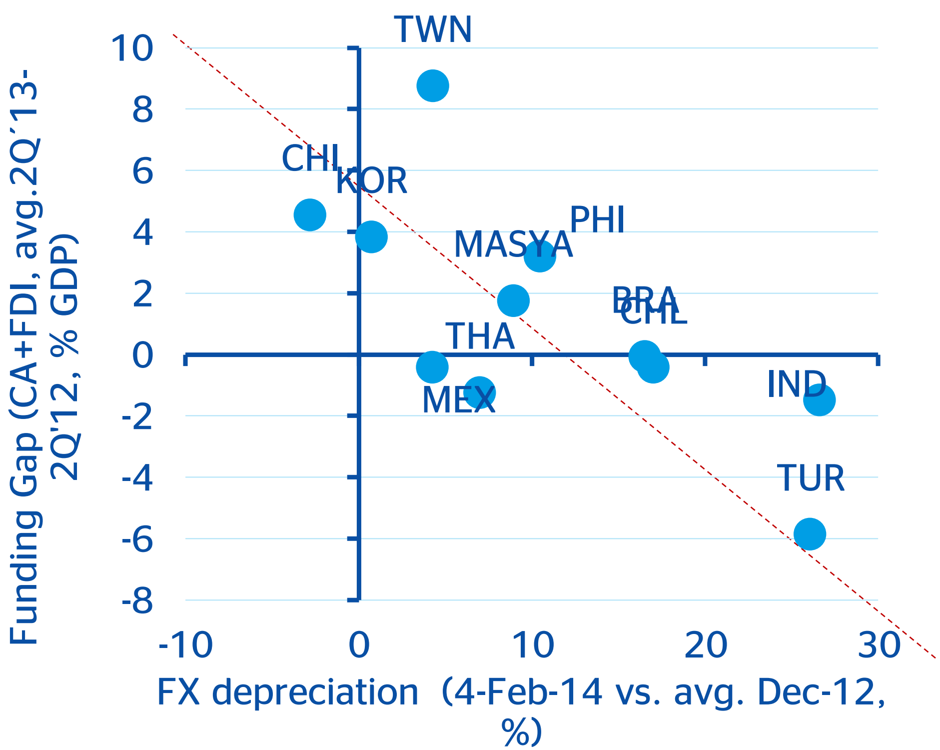
Our scenario includes a first increase in interest rates in the second half of 2015

The Fed's communications policy and its forward guidance have avoided additional increases in long-term interest rates and cooled expectations regarding short-term rates

The reduced liquidity affects all the EMs, but the differentiation will be considerable

EMs: dependency on short-term financing and currency weakness

Source: BBVA Research y Bloomberg



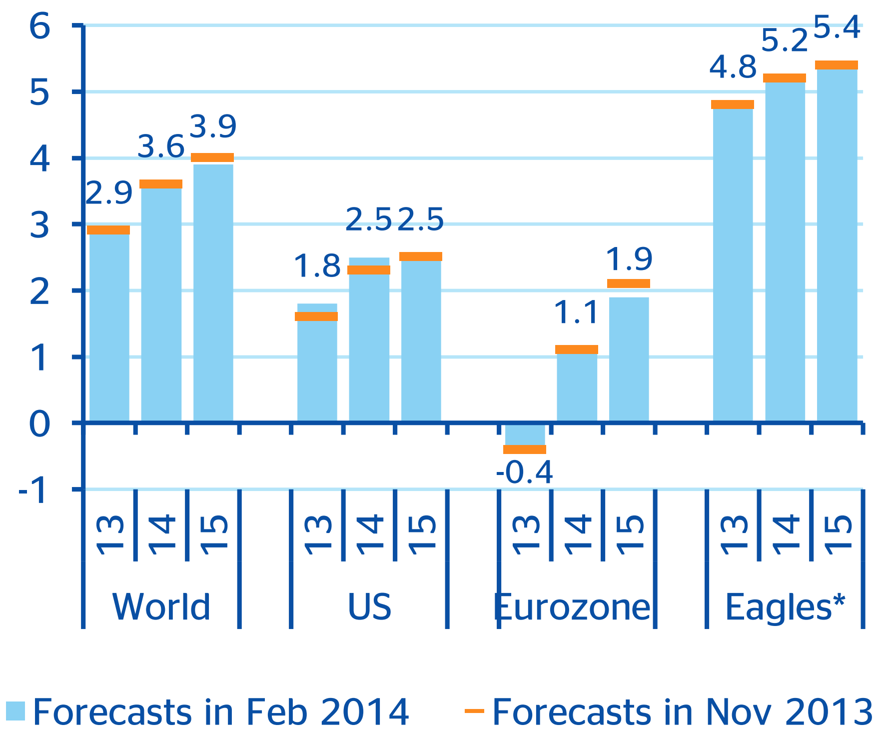
The EMs have suffered a drop in capital inflows, currency depreciation and a fall in their asset prices

Domestic shocks in some of the large EMs have been more to blame for this than tapering

From now on, differentiation will continue to be considerable, with the worst impact on the economies that are more vulnerable to external factors

Acceleration of global activity in 2014 and 2015

Forecasts for global growth (%)
Source: BBVA Research



Upwards revisions for US growth forecasts in 2014

Increased contribution to global growth from the developed economies than in 2013, but the EMs still account for two-thirds of the growth

Growth in China will remain around 7.5% in 2014 and 2015, but the vulnerabilities will become more evident

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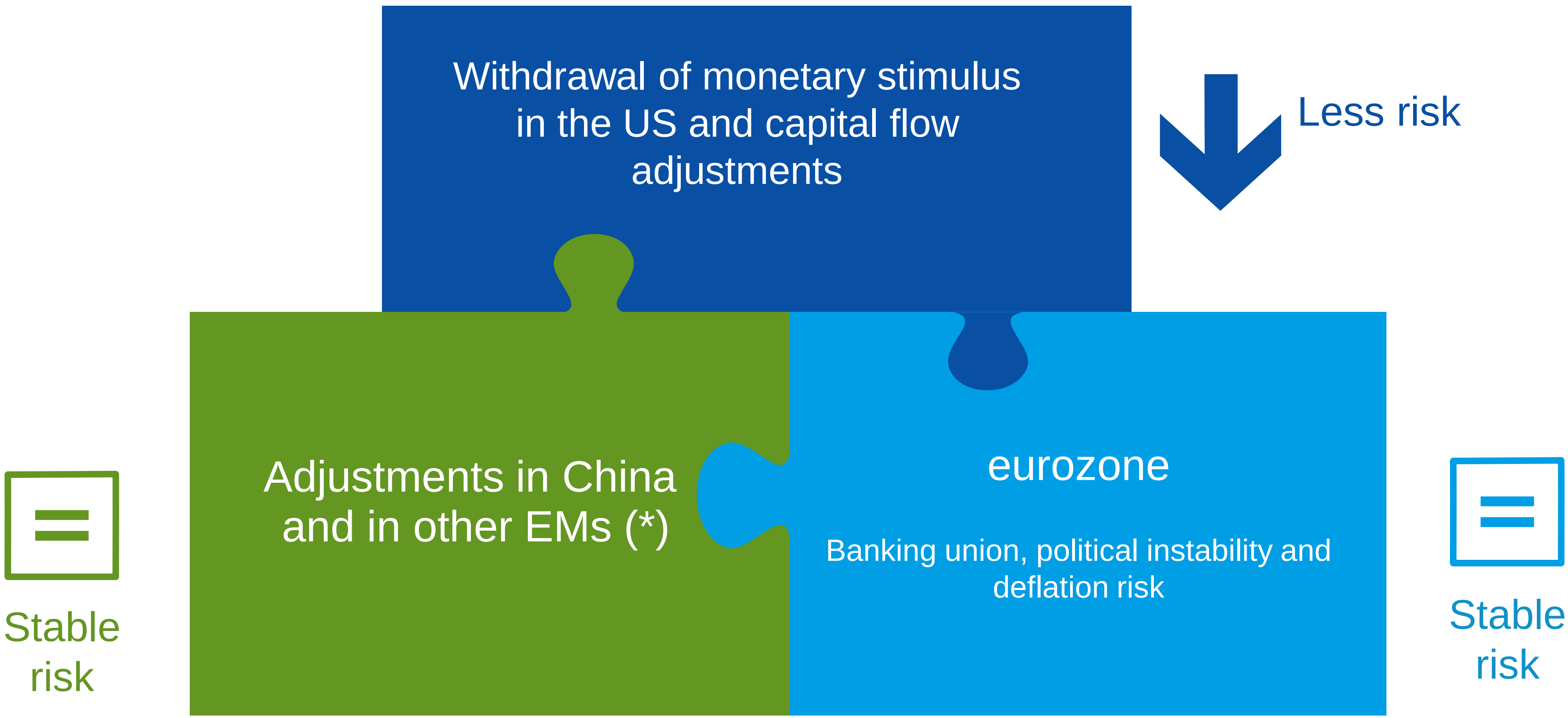
More balanced global risks than three months ago, and fewer risks in the US



(*) Uneven performance from country to country

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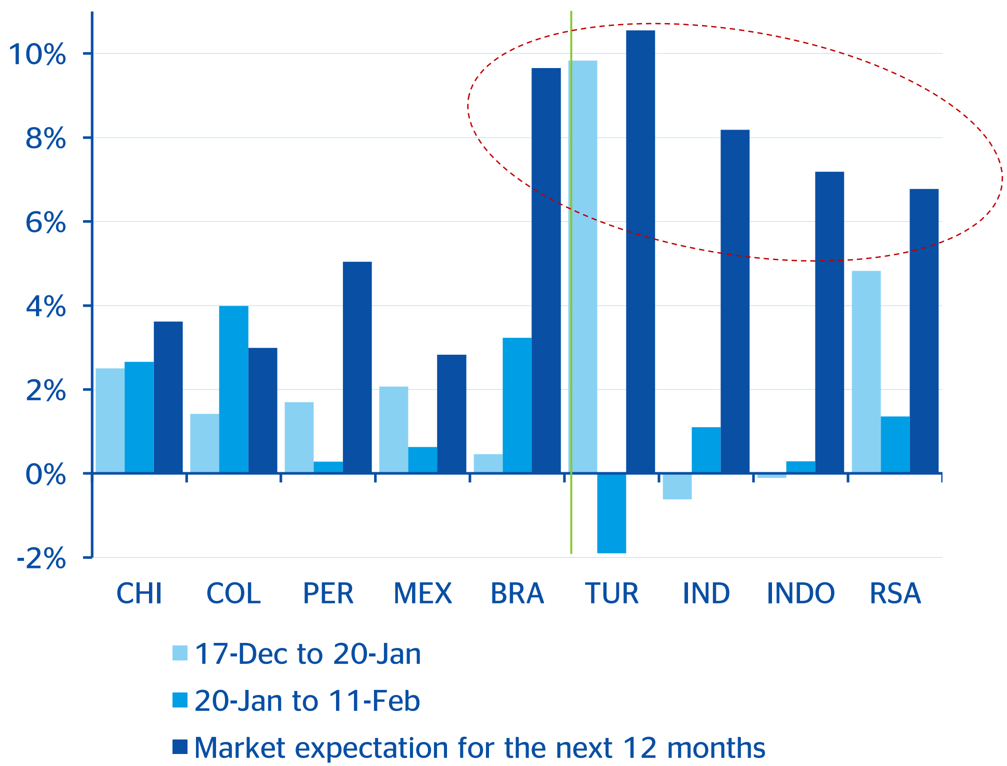
Volatility returned to Latam markets, but we see differentiation from now on

Variations in EM exchange rates (%)
Source: BBVA Research and Bloomberg



Volatility also affected Latam: currency depreciation, higher sovereign spreads and weaker equity markets

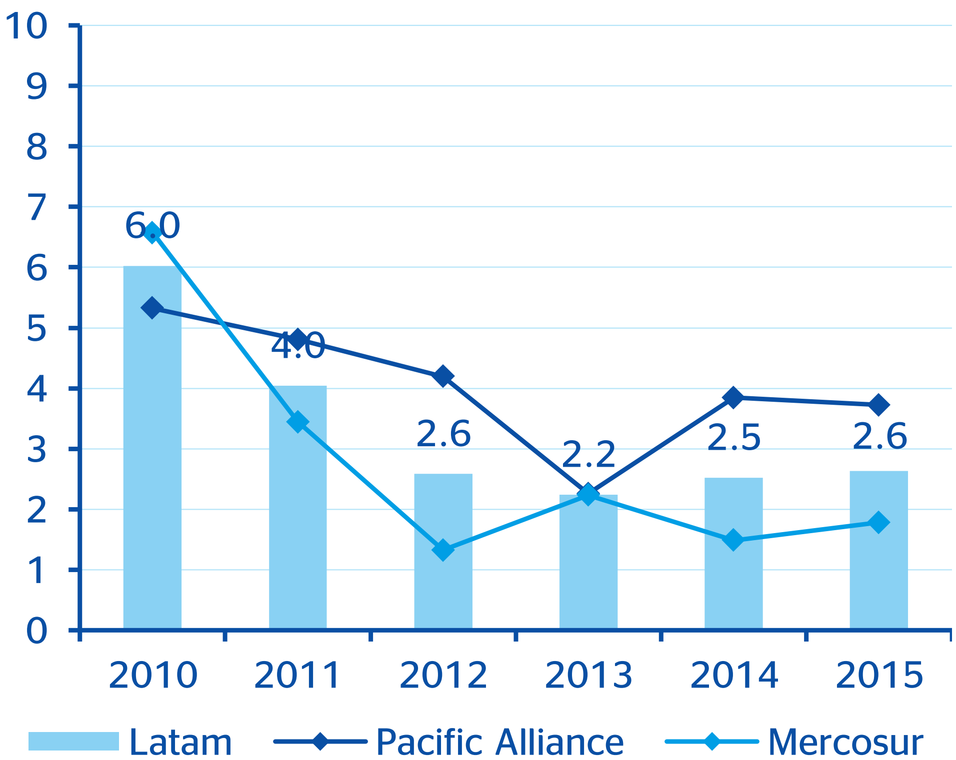
However, capital flows into the region have not reversed, just slowed

We expect contagion from the sharp currency depreciation in Argentina to be limited, with only a moderate effect on Brazil and Uruguay

The markets already appear to be starting to differentiate on the basis of macro fundamentals and solid policies

Growth will increase from 2.2% in 2013 to 2.5% in 2014 and 2.6% in 2015

Latam*: GDP growth (% YoY)
Source: BBVA Research



Activity will accelerate in 2014 as Mexico leaves behind temporary negative shocks …

… and external demand gradually recovers in line with global growth

In the longer term, regional growth will start to converge to its potential, around 3.5%

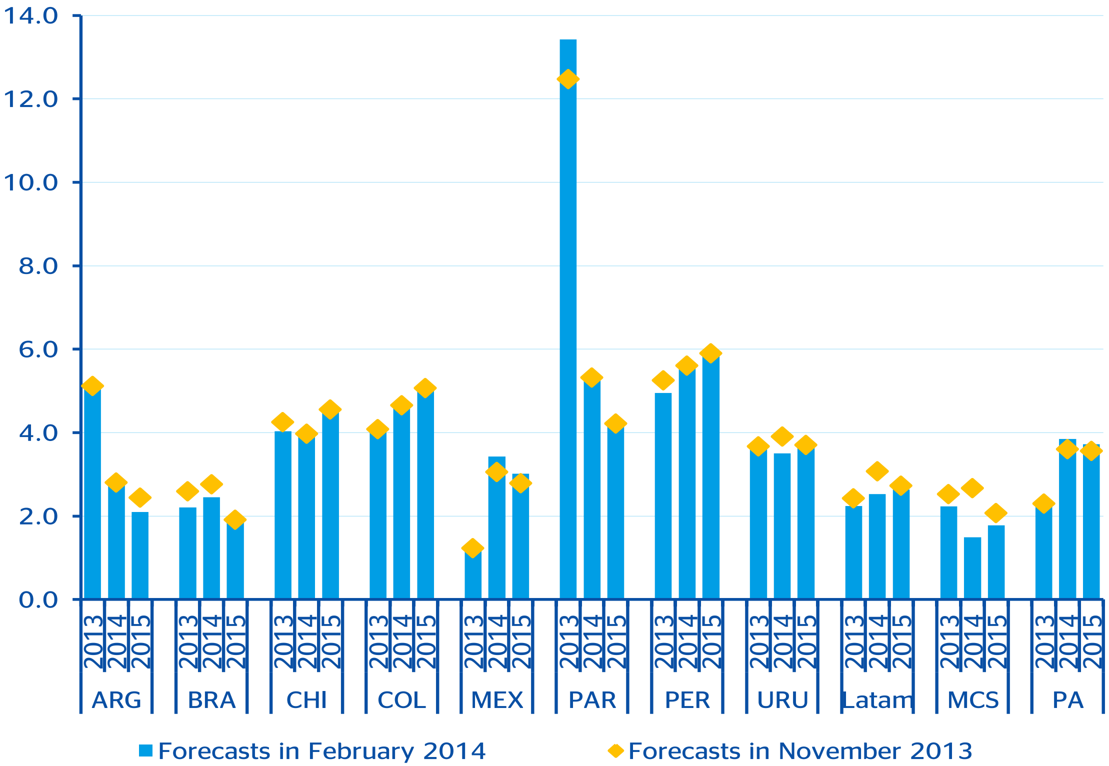
Increasing divergence: Pacific Alliance will grow 3.8% in 2014 and 3.7% in 2015, more than double the rate in Mercosur

* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

The Andean countries and Paraguay will continue to post the fastest growth

Latam countries: GDP growth (%)

Source: BBVA Research



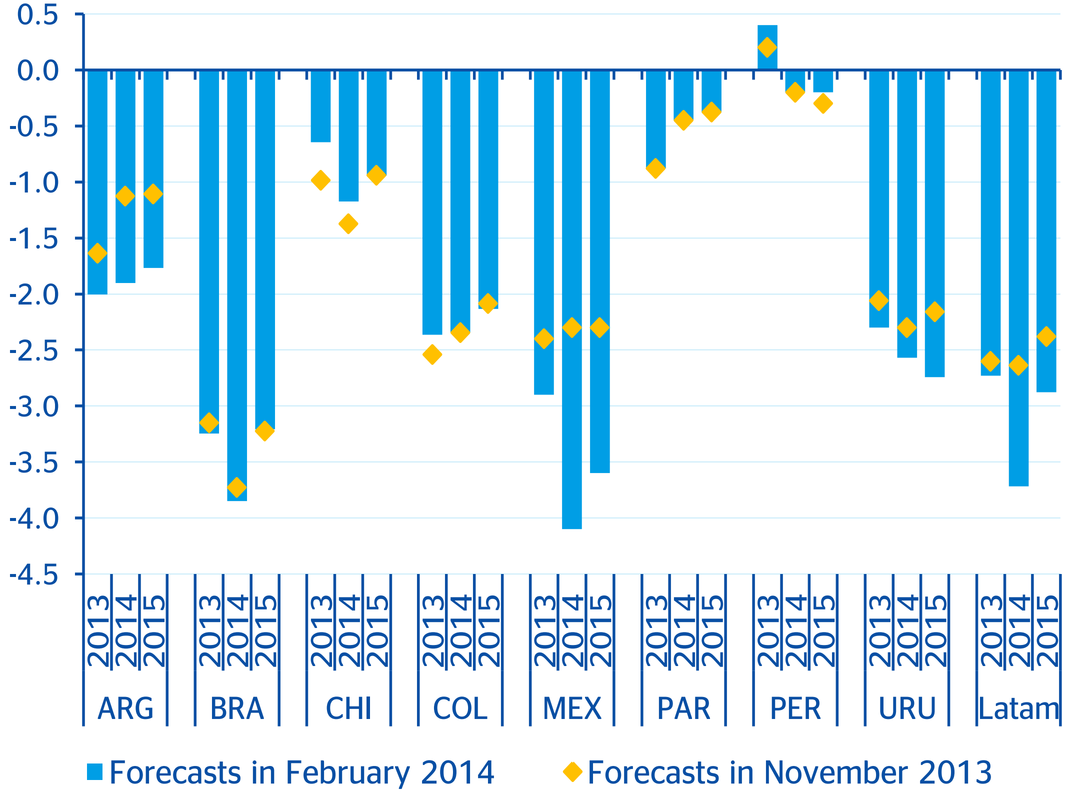
Mexico will see strong growth in 2014 after the downturn in the construction sector in 2013

Brazil will record moderate growth of 2.5% in 2014, reflecting the negative impact of tighter monetary policy and structural problems

Pressure on fiscal deficits will continue, but they will remain manageable

Latam: Fiscal deficits (% GDP)

Source: BBVA Research and Haver Analytics



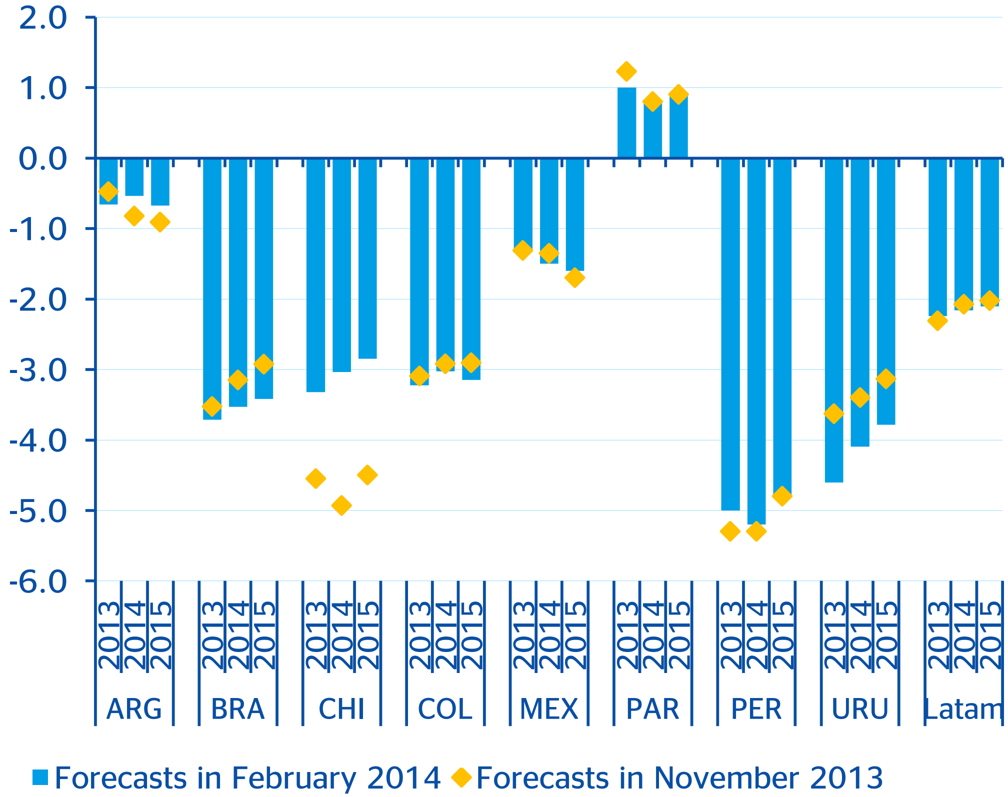
Only moderate growth in internal demand and lower raw materials prices will continue to put pressure on fiscal balances

Fiscal deficits should start to ease from 2015 onwards, as growth and external demand recover

External deficits will start to shrink in 2014

Latam: Balance on current account (% GDP)

Source: BBVA Research and Haver Analytics



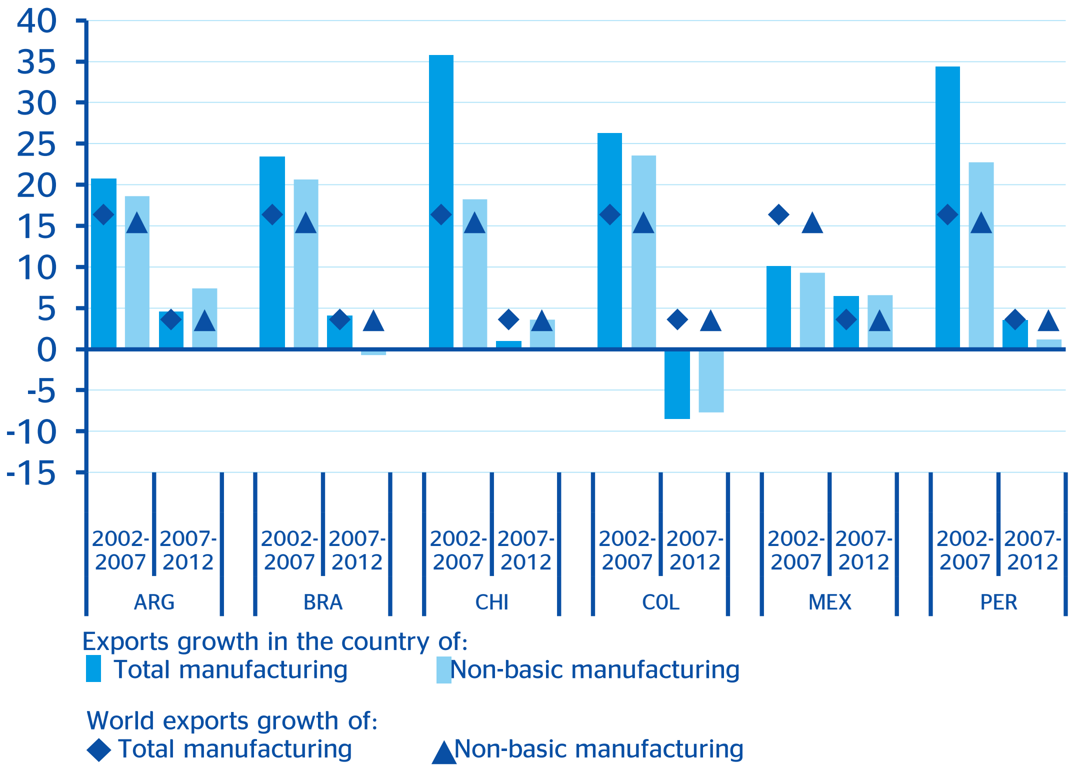
Deficits will start to decline, particularly in those countries with a bigger foreign trade gap (Peru, Uruguay)

The outlook for exports will improve as the supply problems in the export sector in some countries improve …

….as well as due to currency depreciation and the recovery in global growth

As a whole, the region has lost a degree of competitiveness in the last few years

Growth in exports of manufactured goods: Latam vs. world (% YoY)
Source: BBVA Research and WITS



Indicators show a worse performance in the last five years in terms of competitive advantage in more sophisticated manufactured goods

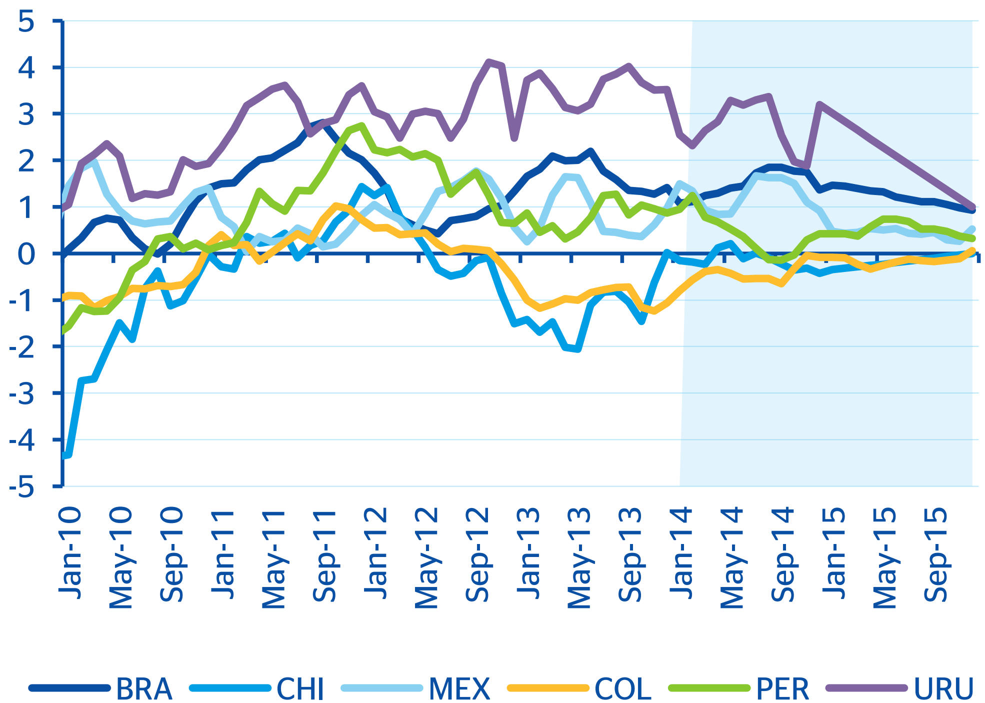
The gains in share of manufactured goods of 2002-2007 gave way to share erosion in 2007-2012, except in Mexico

Recent deterioration related to currency appreciation, pressures on labour costs and insufficient progress in productivity

Inflation is in line with central bank targets, except in Uruguay

Deviation of YoY inflation vs. central bank target (pp)

Source: BBVA Research and Haver Analytics



Gradual convergence of inflation with central bank' central target, except in Brazil and Uruguay

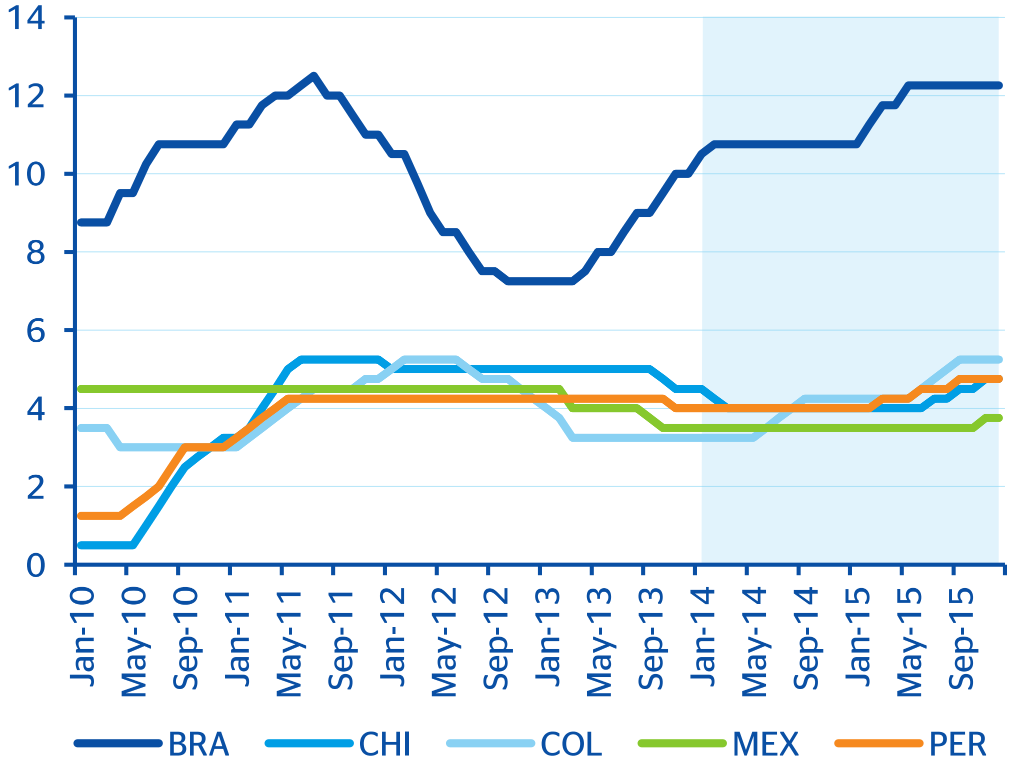
Contained demand pressure and more moderate food prices will help to contain inflation

Currency depreciation will in general terms have a limited pass-through to inflation

Divergence in the tone of monetary policy in 2014 and 2015 due to different rates of inflation and different stages in the cycle

Official interest rates in countries with inflation targets (%)

Source: BBVA Research and Haver analytics



In future, tighter monetary policy in Brazil and Uruguay due to the pressures on inflation

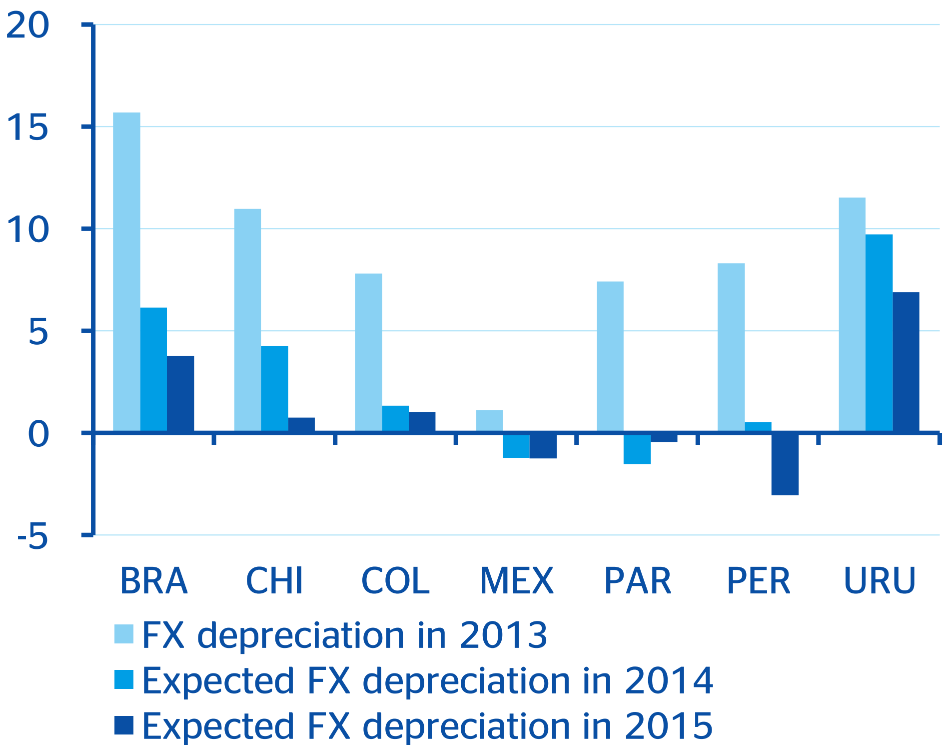
The Pacific Alliance countries will continue to diverge in 2014, in line with their individual stages in the cycle

The divergence between nominal and real interest rates will continue between Brazil and the Pacific Alliance countries

Interest rates will rise in 2015, due to inflation (Brazil) or cyclical improvement (Pacific Alliance)

Relatively stable exchange rates in 2014 and 2015, with the exception of Brazil and Uruguay

Variation in exchange rate vs. USD in countries with inflation targets (% Jan-Dec)
Source: BBVA Research and Haver Analytics



Contained depreciation: most of the impact of tapering in the US was priced-in by the markets in 2013

The principal exception will be Brazil: sharp depreciation in 2014 and 2015 due to higher inflation and efforts to recover part of the loss of competitiveness...

Uruguay will also be dragged by higher inflation than its neighbours and the currency depreciation experienced by its trade partners

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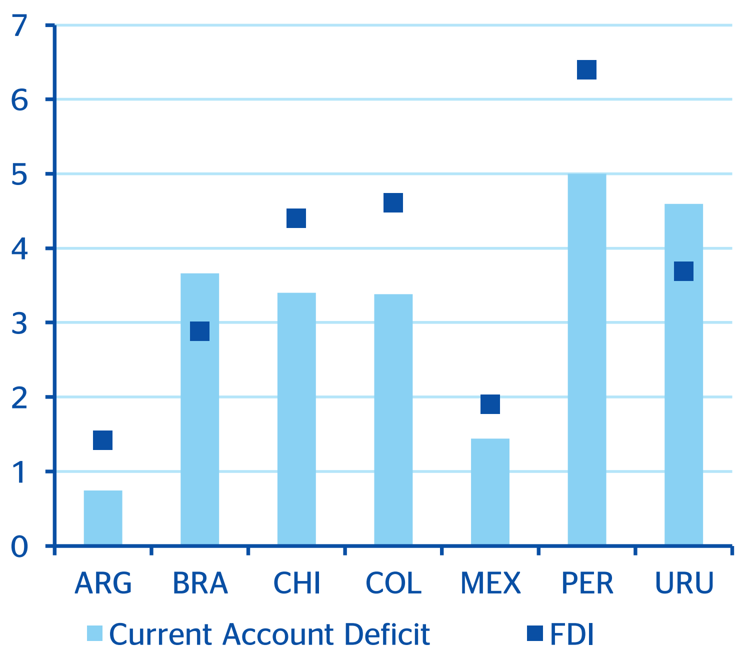
The region has reduced its vulnerability to external shocks, both in terms of flows …

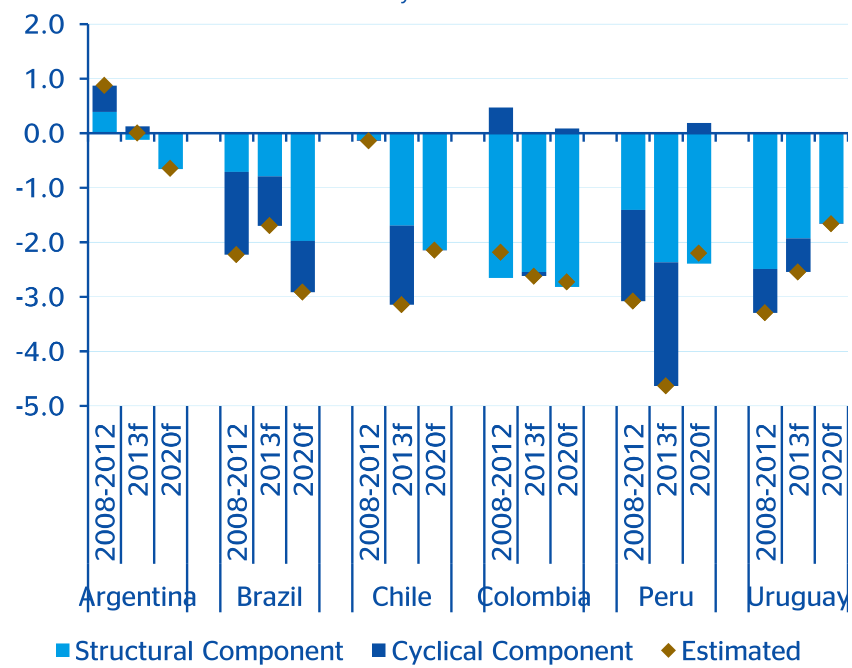
External deficits, in the majority of cases financed by FDI, less volatile in periods of market turbulence

Eliminating the cyclical component, the structural deficits in Latam will not exceed 3% of GDP: sustainable given the outlooks for growth in the region

Deficit on CA and financing with FDI (% GDP)
Source: BBVA Research and Haver Analytics



Balance on current account , cyclical and structural component (% GDP)
Source: BBVA Research and Haver Analytics



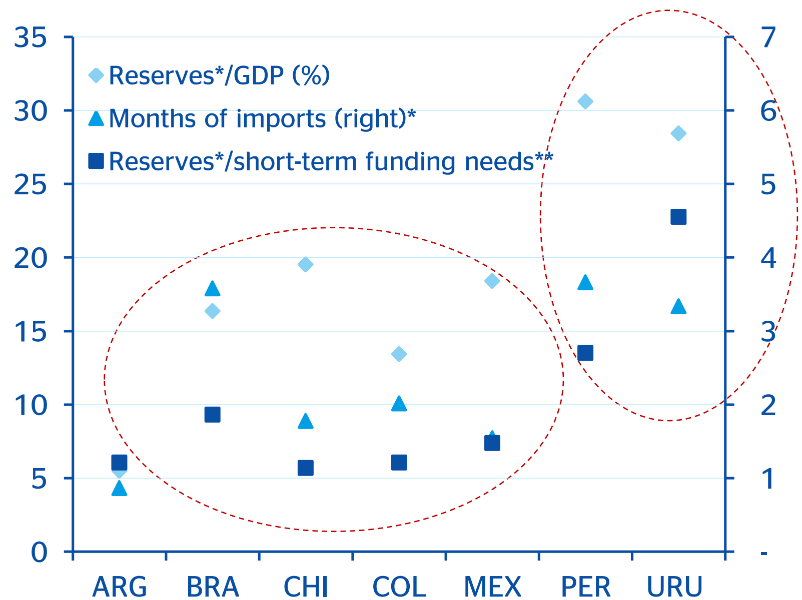
… and in stocks. Also, some countries still have room for manoeuvre for their economic policies

High levels of international reserves …

… and substantial reduction in public- and private-sector debt with less foreign-currency exposure

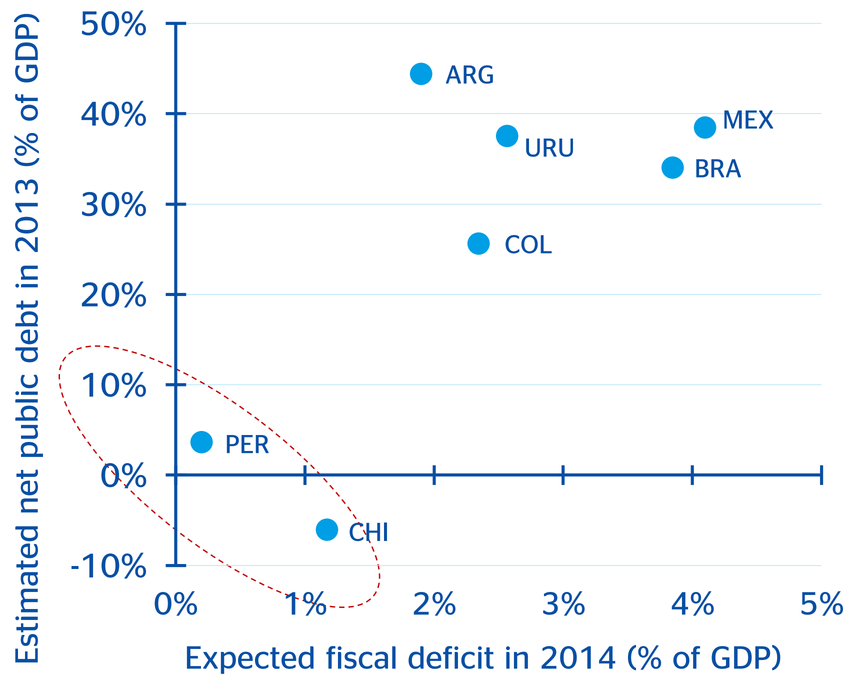
International reserve indicators

Source: BBVA Research, Haver Analytics and national statistics



Deficit and public-sector debt (% PIB)

Source: BBVA Research and Haver Analytics

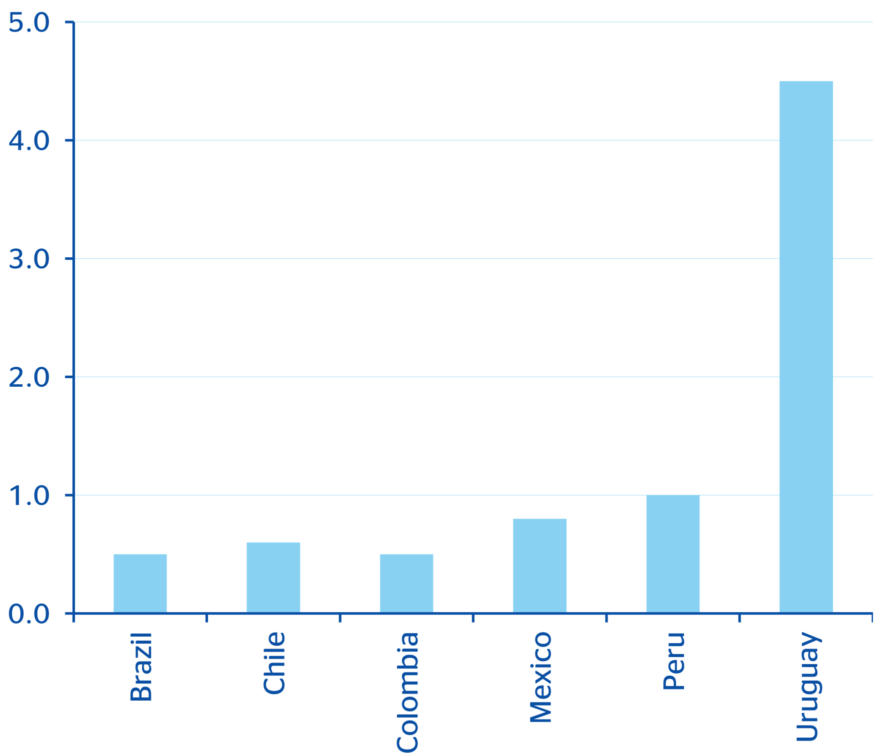


* International reserves include IMF FCL lines in the case of Colombia and Mexico and sovereign funds in the case of Chile and Peru

** The need for short-term financing is the sum of the deficit on current account in 2014, short-term debt and long-term debt maturities in 2014

Flexible exchange rates have already acted as the first buffer against external shocks

Exchange-rate pass-through to inflation: impact on inflation of 10% currency depreciation
Source: BBVA Research and IMF



A flexible exchange rate is the first buffer against an external shock, and has already started to act

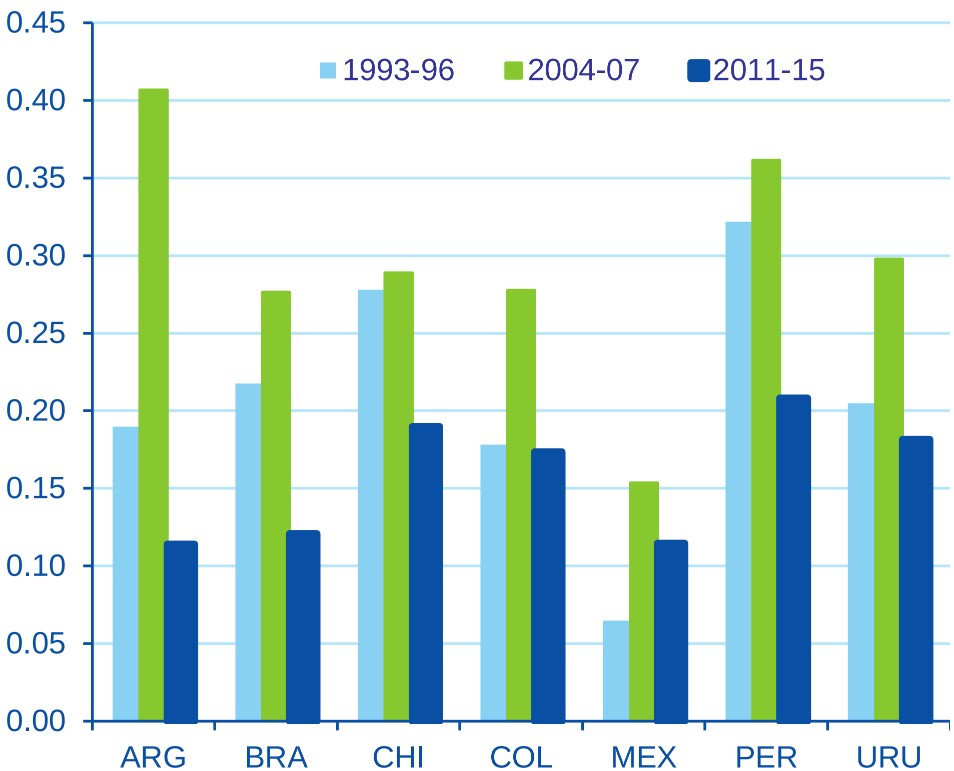
If this is to work as a buffer, it is crucial to reduce dollar exposure, as the region has done

The credibility of monetary policies has also helped to reduce the exchange-rate pass-through to inflation

Attention will increasingly be focused on fundamentals: getting second-round reforms underway is vital

Investment efficiency in Latam: pp of growth for each point in the Investment/GDP

Source: BBVA Research and IMF



Less favourable global financial conditions will focus attention on the different fundamentals in the EMs

Of the countries integrated in the financial markets, Brazil appears to be in a weaker position in terms of fundamentals vs. the Pacific Alliance

The future outlook will depend on progress made in reforms, that will prevent any weakening of the growth drivers

Key messages

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Annex: Latam growth forecasts

GDP growth (% YoY)

Source: BBVA Research

	2011	2012	2013	2014	2015
Argentina	8.9	1.9	5.1	2.8	2.1
Brazil	2.7	1.0	2.2	2.5	1.9
Chile	5.9	5.6	4.0	4.0	4.5
Colombia	6.6	4.2	4.1	4.7	5.1
Mexico	4.0	3.7	1.1	3.4	3.0
Paraguay	4.3	-1.2	13.4	5.3	4.2
Peru	6.9	6.3	5.0	5.6	5.9
Uruguay	6.5	3.9	3.7	3.5	3.6
Mercosur	3.4	1.3	2.2	1.5	1.8
Pacific Alliance	4.8	4.2	2.3	3.8	3.7
LATAM	4.0	2.6	2.2	2.5	2.6