Latin
Economic Outlook

First Quarter of 2011

Economic Analysis

- Latin America will grow at 4.4% and 3.9% in 2011 and 2012, respectively, Supported by the buoyant domestic demand, especially investment.
- Most countries in the region will record GDP levels over their potential at the end of 2011. Overheating pose higher risks in Argentina and Venezuela, where this situation has been dragging on for several years. Colombia and Mexico, still have negative output gaps.
- The forecasts for inflation have been revised upwards, while overheating is perceived to be the main risk for the region. Appreciation of currencies has helped maintain inflation under control, but international price hikes for commodities are adding pressure to the local markets.
- We are seeing greater willingness to act by the Central Banks adhering to inflation targets, which resumed raising official interest rates.
- Chile was the last to join the rest of the region's in intervening on FX markets. In the face of new foreign exchange pressures due to the greater monetary restriction, it is likely that central banks and governments intensify or impose capital controls.
- Fiscal policy remains absent from the adjustment efforts, with the exception of Brazil. Although its example could be followed by Chile and Peru, there are no signs of this occurring in the short term.
- A comparative statistics exercise shows that the vast majority of countries in the region could resist a fall in commodity prices of 33%, bringing more support to our forecast for regional growth close to its potential in the next two years.

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Closing date: 15 February 2011

1. Global outlook: decouplings at play

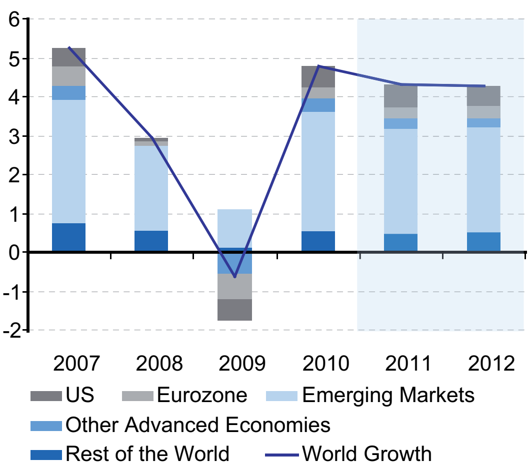
The world will continue on divergent paths, increasing growth and policy decouplings
Growth continues to be strong. After closing 2010 with a growth rate of 4,8%, the global economy is expected to decelerate slightly to 4,4% both in 2011 and 2012, a better performance than what could have been anticipated 12 months ago. This is explained by a better outlook for advanced economies, due to (i) the better growth expectation for the US after the fiscal stimulus, and (ii) a strong performance in core European countries, which have decoupled from those of the periphery, dragged by financial market tensions. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity the region as a whole has been able to accelerate, thus showing –at least temporarily– a degree of decoupling also between the financial and the real side. Overall, the pattern of global economic growth remains broadly unchanged as the real engine of dynamism continues to be the emerging world, led by Asia (China and India in particular, see Chart 1), and developed economies continue losing ground, more in Europe than in the US.

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will intensify policy dilemmas already present in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will –together with financial risk– put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements –together with the different size of central banks' bond-purchase programs and the turmoil around economic governance in Europe– that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US. The difference with market punishment to some countries in Europe could not be starker.

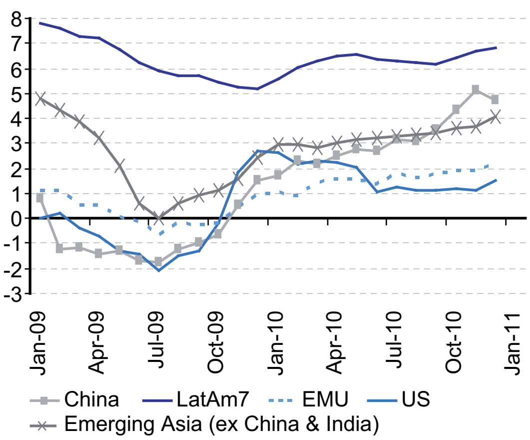
Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially –but not exclusively– in peripheral economies.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
Inflation



Source: Datastream and BBVA Research

Growth in the major advanced economies has picked up, but fragilities remain. Chances of a double dip scenario in the US, which we thought were very low, have faded. But interest rate risks in the long-run now become more relevant

As we expected, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Feder al Reserve, implementing and additional round of asset purchases (QE2) provided support for bond prices in particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package, approved at the end of 2010, will provide a significant boost to economic growth.

We have thus adjusted our growth forecast for 2011 by 0,7 percentage points, to 3%. However, weaknesses have not disappeared. Real estate markets remain feeble and still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. On top of it, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it continues to configure a scenario in which an additional negative shock would harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, will permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens the US will need to show a clear commitment to fiscal consolidation or risk a sudden spike in long-term interest rates. Rating agencies have already started to signal this risk. There is time, but discussions and plans should start as soon as possible to reduce long term fiscal concerns.

Institutional and economic reforms in Europe will be crucial for solving the financial crisis

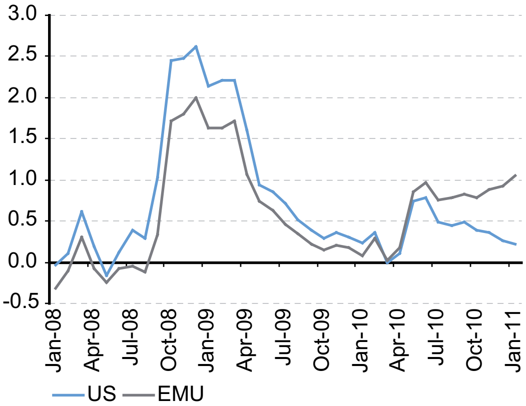
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets right after the summer highlights that markets are increasingly focusing on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

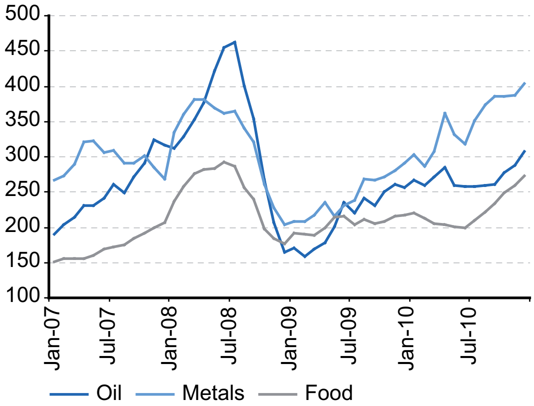
As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
BBVA Financial Stress Index



Source: BBVA Research

Chart 4
Commodity prices



Source: BBVA Research

Commodity prices will level off, but nonetheless inflation risks are becoming more relevant in emerging economies, which will continue to grow strongly

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes.

For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand in Asia will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries –especially in Asia– with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation.

Although the risk has also increased in developed countries, it is smaller than in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident through rapid credit growth and increasing asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities will be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage the policy dilemmas generated by strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing ever more stringent administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

2. Hemispheric Warming

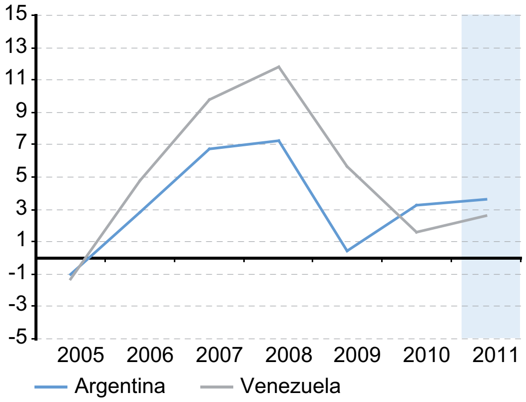
Although growth is moderating and nearing its potential, the slowdown of domestic demand is still quite tenuous, while the output gap dissipates.
South America ended the year with overall growth of nearly 6% in 2010, which more than offset the -2.3% fall the year before. This improvement was generalized in the region, though in Mexico and Venezuela it was not enough to recover the 2009 GDP level. Of the seven largest economies in the region, only in Brazil and Mexico was the year-on-year growth of the last quarter clearly below the accumulated total for the year, thus revealing that the much anticipated convergence towards potential growth is still an incipient phenomenon. The combination of a more favorable external context, with commodity prices that continue to rise and break records and a moderation in risk aversion, with renewed internal confidence, in addition to monetary and fiscal policies that still maintain an expansive tone, has resulted in very vigorous growth in the consumption of durable goods and investment. The real appreciation of currencies in the region has also contributed to this phenomenon by making imports cheaper. At the same time, said appreciations have allowed for the attenuation of potential inflationary pressures, and thus helped to keep inflation expectations contained.

For 2011, we expect the region to continue to grow vigorously and estimate an aggregate GDP increase for Latin America of approximately 4.4% in the year, with Chile, Colombia, Panama, Peru and Uruguay surpassing 5%. In turn, the two regional giants will grow slightly over 4%, which is more consistent with their medium-term potential. Once again, domestic demand will be the primary driver of growth, with a central role in Investment in Fixed Capital, which will increase nearly 8% in 2011 for the region as a whole. In Chile, Colombia, Peru and Uruguay, we expect two-digit growth for this variable (between 10% and 15%) with an strong role by Foreign Direct Investment (FDI) in mining and energy, as well as from high public and private investment in home construction and infrastructure. In Chile and Colombia, the reconstruction of infrastructures damaged by recent natural disasters will be a major factor- Consumption will grow in line with GDP, though we expect significant boosts from higher government spending on consumption in the cases of Argentina, Colombia and Venezuela. Considering the above, we expect a gradual slowdown of the growth of domestic demand throughout the year, such that by the end of 2011, domestic demand in practically all countries in the region will be growing at rates close to or below those of their trend GDP, with the exception of Argentina and Peru, where we still expect annualized growth of nearly 7%.

The economic recovery has allowed the idle capacity gaps to be rapidly narrowed, and already, the majority of the region should reach GDP levels above their trend at the end of 2011. However, as shown in Charts 5a, 5b and 5c, there are significant differences between countries. While Argentina and Venezuela are dealing with a situation of overheating extending over several years now, Brazil, Chile and Peru will be slightly above their trend GDP at the end of the year. At the same time, Colombia and Mexico still have space for growth before meeting their potential. This, in turn, affects the tone of their economic policies, as we will see later.

Chart 5a

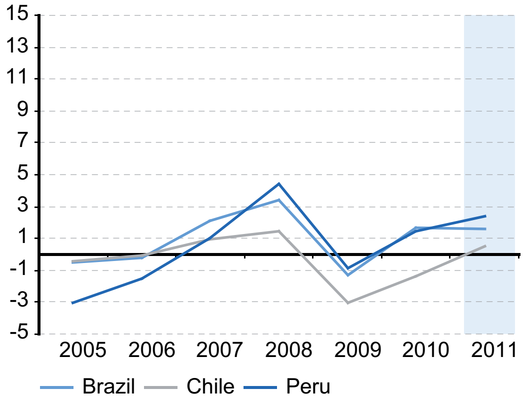
Gap between effective GDP and trend GDP (Percentage of GDP)



Source: BBVA Research

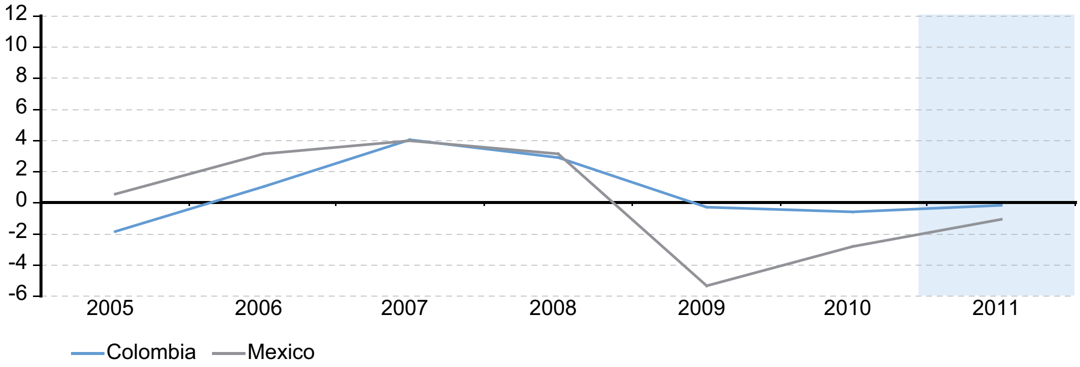
Chart 5b

Gap between effective GDP and trend GDP (Percentage of GDP)



Source: BBVA Research

Chart 5c
Gap between effective GDP and trend GDP (Percentage of GDP)



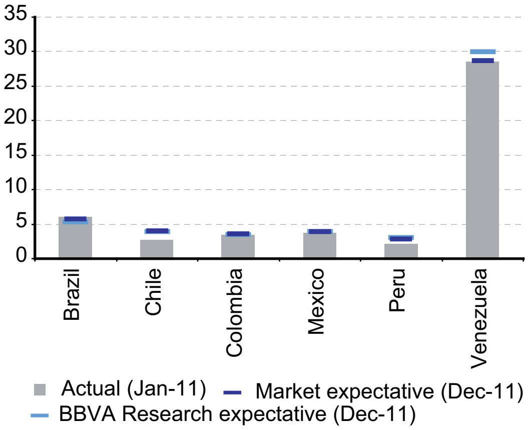
Source: BBVA Research

The fiscal and current account balances will remain at levels similar to those of 2010 (both at nearly -2% of GDP) at the regional level. These figures are modest and not at all a cause for concern, at least in the short-term. However, it should be noted that these figures are highly influenced by the recent rises in the prices of commodities which make them more vulnerable to a sudden adjustment arising from a potential deterioration in those markets. However, except for a few isolated cases, even in the event of a very sharp fall (down 33%, approximately) of the prices of those products, the fiscal deficits and foreign accounts of most South American countries remain at levels that could be financed without major problems.

Inflation and inflationary expectations increased moderately

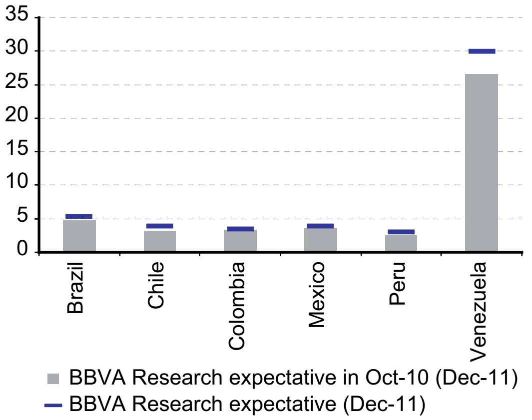
Against this positive backdrop, the problems and risks appear from a well-known source in the region: rises in inflation. In 2010, inflation was maintained within the official target rates, and in the case of those larger countries that do not follow inflation targets in the region (Argentina and Venezuela) it continued to be high, but contained. Nevertheless, towards the end of the year, the situation became more complicated as international prices for fuel and some key foods, such as wheat, corn and sugar, climbed to record highs at an accelerated rate. This compounded the concerns of specialists regarding the strength of domestic demand, affecting the inflationary expectations, which had risen with respect to the forecasts of October 2010 almost without exception. Although they did not veer too far from the official targets, especially in longer-terms, this change will unquestionably make the work of the monetary authorities harder, as they will now be put to the test to demonstrate their commitment to their targets. It is not a coincidence, then, that Brazil and Peru have increased their interest rates in their last monetary policy meetings and that Colombia is showing signs of moving in that direction in the coming months. Chile struck a dissonant note, as the Central Bank maintained its reference rate in January, but it returned to the standard in February with an increase of 25 bps.

Chart 6
Current and expected inflation for year-end 2011 (% yoy)



Source: BBVA Research

Chart 7
Change in the inflation expected by BBVA in the last quarter(% yoy).



Source: BBVA Research

We believe the issue of overheating will dominate the region's economic policy agenda as the international situation gradually returns to the "new normal", with an increasing boost from the developing world.

In this context, we foresee that an aggravation of inflationary pressures will translate into very different economic policy responses in the region. In those countries that adhere to policies based on inflation targets, the weight of the adjustment will be done through monetary tightening, with interest rate hikes and potential increases in the obligatory reserve requirements on deposits to slow the expansion of lending. For countries with more heterodox policies, we expect stricter price controls will be the instrument of choice. In those countries in which the growth of domestic demand, especially in the private sector, has been more moderate, as is the case of Mexico, and to a lesser degree, Colombia, these tensions are lower, which thus implies less urgency in the assumption of restrictive measures. In terms of outcomes, this means that the former face lower risks of inflation, but higher current account deficits, while the more heterodox ones will have to contend with higher inflation, current account deficits and perhaps shortages.

Nature has not collaborated with the economy

When looking back at 2010 and the forecasts for 2011, we cannot leave out the crucial impact of natural phenomena on economic activity. In addition to the earthquake that significantly affected the south-central area of Chile one year ago, leaving an aftermath of destruction and lives lost, and which is significantly impacting the 2011 fiscal policy, we also have to consider climate fluctuations. The year 2010 started in the middle of a positive anomaly in Central Pacific temperatures (El Niño) which complicated Venezuela to a great degree and somewhat affected Colombia and Peru due to low rainfalls there. This had a negative effect on vegetable harvests and energy production, but was a blessing for Argentina, Brazil and Uruguay, which registered record harvests of soy and other grains thanks to abundant rains there. Over the course of the year, said phenomenon reversed and the temperature anomaly turned negative (La Niña) and luck changed: the drought complicated the outlook for the soybean harvest in Argentina and hydroelectric power generation in Chile. Unfortunately, in Colombia, and to a lesser extent in Brazil and Venezuela, the impact has also been negative due to the vast destruction caused by the torrential rains, floods and landslides. In the first case, the impact on fiscal policy will be felt in 2011 with the need to replace the damaged infrastructure.

3. Economic policies are slowly adjusting

The economic policy adjustments have been slower than during the recession phase of the cycle
The rapid recovery of domestic demand and the elimination of excess production capacity seem to have been too fast for the reaction capabilities of the region's economic authorities. Unlike what occurred at the end of 2008 and early 2009, when they reacted very quickly and strongly to combat the impact of the global crisis, now the responses have been deliberate and gradual, with a growing risk in those countries in which domestic demand grows with greater intensity, that they end up being too late and not enough to prevent an inflationary outbreak.

In the defense of said authorities, mention should be made of two most important factors:

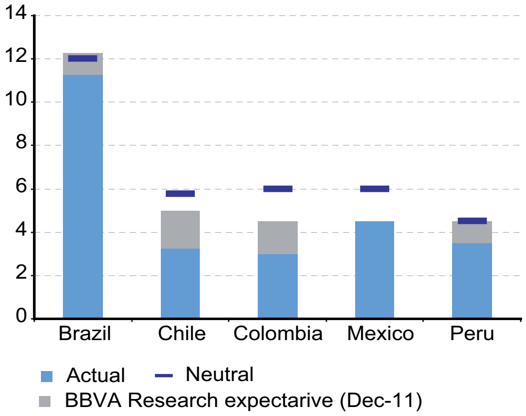
1. Unlike what happened during the crisis, the progress of South American economies has been very different from that of developed countries. Thus, a monetary contraction, for example, has serious risks of sharp adjustments in the exchange rate parities, as has already occurred.
2. Over all this time, a considerable degree of uncertainty has prevailed regarding the situation of the financial markets, especially in Europe, as the concern for the lending portfolio to the private sector has been moving towards the solvency of the public institutions in developed countries.

The combination of an uncertain environment and the reticence to provoke a dangerous overvaluation of currencies explains the different reaction of the central banks in the different phases of Latin America's current cycle. These reasons, however, do not justify the reticence for a faster withdrawal of fiscal stimuli from the 2011 government budgets.

Monetary policy reacts, but slowly
In our previous report, we highlighted the fact that the countries who followed inflation targets and were faced with a strong expansion of domestic demand had initiated the withdrawal of the monetary stimuli, but that said process was interrupted earlier than expected. This happened in a context in which inflation remained at very low levels and the currencies were appreciating under the pressure of strong capital inflows. However, by the end of the year, the currencies tended to stabilize with smaller foreign exchange interventions, and, at the same time, international food and energy prices rose. This has caused the central banks of Brazil and Peru to increase the official interest rates and to apply quantitative credit control measures (reserve requirements, for example) and for the central bank of Colombia to shift its message to raise the rates earlier. The Central Bank of Chile, which had initiated the rate increase process without interrupting it when others did, momentarily detained it in January to back the announcement of foreign exchange intervention days earlier, and possibly had to pay a credibility cost for its commitment to the inflation targets. In fact, the survey of expectations for February marked a 4% increase in inflation expected for December 2011 from the 3.2% expected 2 months prior. Not surprisingly, it resumed increasing rates in February.

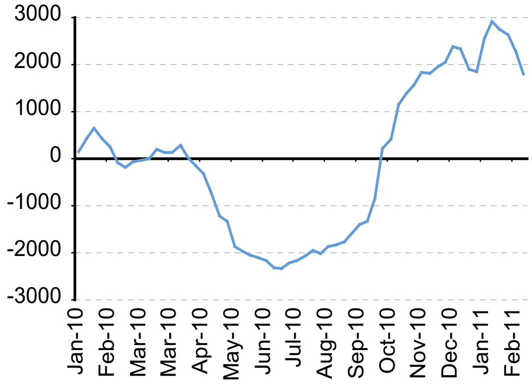
Considering the above, the official interest rates in countries that follow inflation targets are still below their neutral levels, which would just be reached at the end of this year or in 2012. This would make it difficult for the monetary policy to contribute to significantly slowing inflationary pressures, except for its potential effect through expectations. In the case of Mexico, where the recovery has been primarily driven by foreign demand, the situation is very different, and justifies a slower rate of withdrawal of monetary stimuli.

Chart 8
Official vs. neutral interest rates (%)



Source: BBVA Research

Chart 9
Net capital flows to Latin America in equity (Mn of USD, accumulated from Jan-2010)



Source: EPFR

Is upward pressure on a further appreciation of currencies easing?

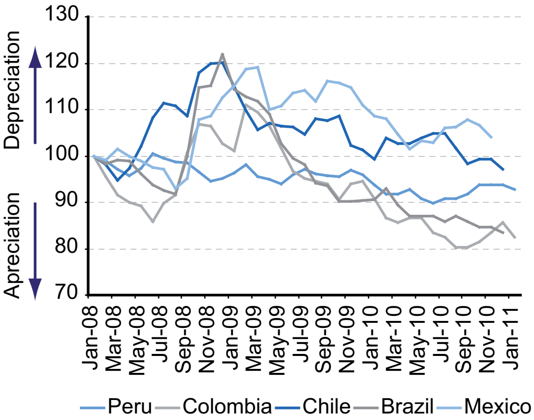
A key factor maintaining inflation rates low in 2010 was the appreciation of most of the currencies in Latin America. There were at least three factors that furthered this process: the rapid upturn in the value of assets in the region as economies experienced a swift recovery; growing interest rate spreads, particularly short-term; and high commodity prices that are key for the external and fiscal accounts in Latin American countries.

Towards the end of the year, following the spectacular increase in stock prices in the region, capital flows to equity investments reversed. However, prices of basic products have continued to increase and short-term spreads have widened (this is not so clear in the case of longer terms). In the case of fixed-income, the comparison is a little more complex, as countries such as Brazil and Peru have introduced measures that increase their cost for investors. In all, pressure on currencies in these countries has eased to some extent over recent months, thus reducing the intensity and frequency of foreign-exchange interventions. The situation of Venezuela and (to a much lesser extent) Argentina is different, as they have much more limited access to international financial markets. In fact, Venezuela unified the official foreign-exchange markets by eliminating the special exchange rate for access to a list of basic products. In practice, the effect has been similar to a devaluation of the bolivar. Argentina has moved in the direction of recovering access to international financial markets. Some provincial governments have even managed to place debt issues abroad, although still at fairly onerous interest rates.

Accordingly, currencies have tended to stabilize, except for the Chilean peso. This led the Chilean Central Bank to launch a program of reserve accumulation for USD 12 billion in 2011. This effectively produced a temporary depreciation of the peso, but at the close of this publication the Chilean peso was already back to levels fairly close to those at the start of intervention. The combination of high and rising copper prices and expectations of new rises in official interest rates has annulled the efforts of the monetary authorities, at least for the moment.

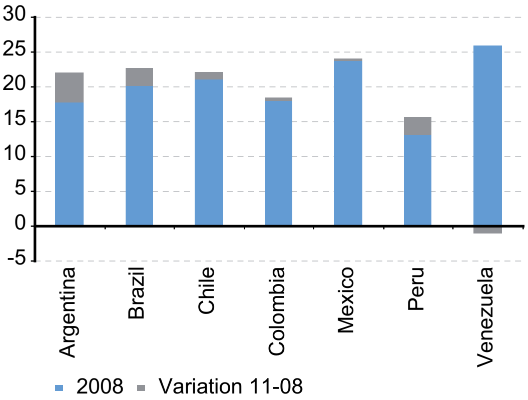
What is clear is that if the monetary stabilization consolidates, as appears to be the case, the contribution of this factor to inflation control will be lower than in 2010.

Chart 10
Real effective exchange rates (%)



Source: BBVA Research

Chart 11
Fiscal expenditure (% of GDP)



Source: BBVA Research.

Fiscal policies are still not helping

What is fairly clear is that fiscal policies have still not adapted to the new environment and continue with an expansive bias. In fact, as can be seen in Chart 10, government spending in Argentina, Brazil, Chile and Peru in 2011 as a percentage of GDP will have grown compared with the last pre-crisis year (2008) by between 1.1 pp of GDP (Chile) and 4.3 pp (Argentina). In Colombia and Mexico the increase is marginal, among other reasons because the fiscal component of stimulus policies was much less pronounced; and in Venezuela it has fallen as financing difficulties have increased.

What is more, the subject of fiscal policy has been practically non-existent in public debate. The exception is Colombia, where legal reforms have been pushed through to strengthen the institutional status of fiscal policy, in contrast to what happened in the first stage of the cycle, when it was delayed in part by the region's election cycle. Although Peru announced an adjustment to its Economic Stimulus Plan mid-way through last year, this has still not really had an effect on the budget execution figures. The only case in which there is clear evidence for a real willingness for fiscal adjustment is in Brazil, where the new government has announced spending cuts of USD 30 billion in the 2011 budget. This represents 7% of budgeted spending and will bring the country close to the total deficit targets for the year.

Chile and Colombia, two countries that are traditionally orthodox in fiscal matters, have opted to increase spending (with some tax increases and the sale of public assets) to tackle the task of reconstruction in the wake of the catastrophes that afflicted them last year. So far they have given no signs of being prepared to implement adjustments. This may change if the risks of greater inflation/ appreciation materialize, but so far the subject has not been on the agenda of public debate.

Meanwhile, the election agenda in Argentina, Peru and Venezuela is also adversely influencing the fiscal agenda in these countries, even in the case of Peru, where a cut of one percentage point in the VAT rate is very close to become law.

One reason why the fiscal adjustments are being delayed is that revenues have grown thanks to higher prices of oil (Venezuela, Colombia, Mexico), copper (Chile, Peru) and soybeans (Argentina, Uruguay). The speedy recovery of these economies has also been reflected in an extraordinary increase in tax revenues, which depend largely on indirect taxes that are very sensitive to the economic cycle. As a result, these countries have been able to maintain high levels of fiscal spending without having to run up much larger deficits, thus weakening the political argument in favor of adjustment. However, this also makes these economies more vulnerable if prices of basic products fall and growth slows.

In the absence of policies, markets are sustaining the adjustment

Despite the above, our forecast points to an ordered slowdown in domestic demand and contained inflation. This conclusion is partly based on the knowledge that a significant part of the increase observed in domestic demand in 2010 is due to temporary factors such as the restocking of inventories. This process has played a very important role in all the phases of the cycle in Chile and Peru, for example, as well as the postponement of decisions to purchase consumer durables (cars, homes) in 2008 and 2009 until last year and the first part of this year. In addition, factors such as increased private spending as a result of natural catastrophes in 2010 will no longer be present in 2011. Such spending ranges from the replacement of durable goods, furniture and homes destroyed or damaged in the earthquake in Chile, to the purchase of electricity generators to deal with energy cuts in Venezuela. Apart from this, if demand does not adjust sufficiently, increased prices will impact the purchasing power of the population, thus in turn increasing the adjustment in domestic demand. This is in fact a slower and more expensive form of adjustment than what would take place if economic policies had reacted symmetrically over the different phases of the cycle.

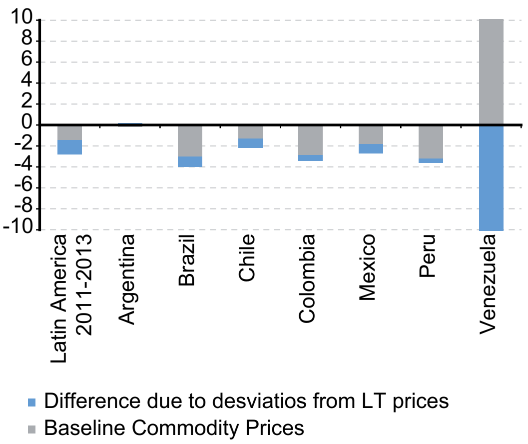
4. Risks and vulnerability remain in check

The most immediate risk of deviation from our forecasts is a limited increase in inflation
As we explained in the above sections, the greatest risk of deviation from our forecasts is a limited increase in inflation. We believe that if such a deviation occurs. it will be limited, as the vast majority of countries and their central banks have taken significant steps to gain credibility in their anti-inflation commitment, so that if inflation increases we have no doubt that official interest rates will rise and help check pressures from demand. In this context, and given the risk of greater appreciation, we believe that governments will also take steps with fiscal adjustments, as Brazil has already done.

A possible cause for concern in this context would be an excessive appreciation of currencies in real terms. This would endanger the sustainability of the external accounts in the long term and at the same time provoke a price bubble in fixed assets, particularly housing. However, this does not yet appear to be happening, and although credit is growing, it is doing so at relatively moderate rates, particularly if we take into account its earlier collapse. In any event, the upshot is that concern shifts from inflation to the sustainability of the external accounts, which today appear very sound, backed as they are by extraordinarily high prices in basic products. The situation is similar in the case of the fiscal accounts, which today are very sound, partly due to the high revenues from taxes on income from natural resources.

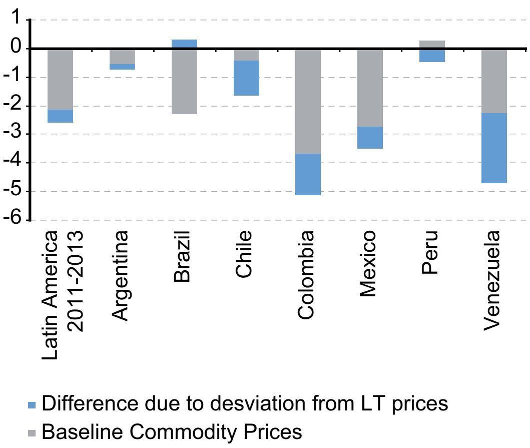
However, even in the event of a strong adverse shock in commodities, the economies of the region appear relatively solid
The most demanding test for the region could come from a strong adjustment in commodity prices, for example as a response to a check in Asian demand, or increases in interest rates on the markets. Although this is not in our core forecast scenario, and we believe that the probability of a major adjustment of these prices in the short term is very low, we have explored the impact on the fiscal and external accounts of a fall in the order of 33% of prices of these products, on both the fiscal accounts and external accounts in these countries (Charts 12 and 13).

Chart 12
Impact on current accounts of a strong correction to commodity prices (% of GDP)



Source: BBVA Research

Chart 13
Impact on the fiscal balances of a strong correction to commodity prices (% of GDP)



Source: BBVA Research.

As can be seen, the impact is fairly limited, except in the case of Venezuela, where the country's major dependence on oil exports leaves it very vulnerable to possible falls in oil prices.

In the case of the current accounts, the deterioration observed in Argentina and Brazil could be a cause fpr concern. In the case of Argentina, this is because its access to capital markets is still very limited, and it could face financing problems if there was capital flight in response to possible concerns about a depreciation of the currency. In Brazil a current account deficit close to 4% of GDP could begin to challenge investors' appetite for risk. In any event, it is worth noting that in both cases if FDI flows remain at current levels, this would be sufficient to finance the deficits in the current account. Colombia and Peru could also face similar pressures as those in Brazil, although in both these countries the size of FDI, which is already heavily committed to mining projects, generates somewhat greater margins of freedom.

With respect to the fiscal accounts, Venezuela and Colombia appear in a more difficult situation, although their access to possible finance is very different. We estimate that Colombia could temporarily finance a deficit of this size by recurring to multilateral loans, while it introduces adjustments to public revenues; this appears more difficult in the case of Venezuela. Although the fiscal accounts in Chile would suffer a blow, we believe that this should not represent serious problems, since the country has hardly any public debt to start with, and it has accumulated savings in sovereign funds that would allow it to finance the deficit with its own resources while the necessary adjustments are introduced.

The exercise is in general reassuring, despite the fact that when these kinds of shocks occur, they are accompanied by other phenomena, such as impacts on exchange rates, expectations and spending decisions by businesses and consumers, etc. In this more complex world, it is possible that the quantitative impacts on the fiscal and external accounts are different to the results of this exercise of comparative statistics, so they have to be taken with some caution.

To sum up, the panorama of risks is relatively balanced, with some bias towards an adjustment with somewhat more inflation if domestic demand does not slow as quickly as expected.

In addition, it is clear that most of the large and medium-sized countries in the region have achieved a structural improvement in their fiscal and current accounts. Although a major real appreciation of currencies could accentuate the dependence of these economies on a few natural resources, we consider that a strong adjustment in commodity prices does not appear to imply a major threat that could prevent their economic growth at potential levels over the next two years.

5. Tables

Table 1

GDP (% a/a)

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10*	Q1 11*	Q2 11*	Q3 11*	Q4 11*	2009	2010*	2011*	2012*
Argentina	-1.8	-2.3	-4.3	0.2	5.7	9.2	7.6	7.6	5.8	3.6	3.1	5.9	-2.1	7.5	4.6	2.8
Brazil	-2.0	-1.8	-1.3	4.4	8.8	9.1	6.8	5.7	4.5	3.8	3.9	4.2	-0.2	7.7	4.1	4.2
Chile	-2.1	-4.6	-1.4	2.1	1.6	6.3	7.0	5.8	9.2	5.3	4.5	5.2	-1.5	5.2	6.0	5.1
Colombia	-0.4	-0.1	0.8	2.9	4.5	4.4	3.6	4.3	4.6	5.3	5.0	5.2	0.8	4.2	5.0	5.5
Mexico	-8.5	-8.1	-5.6	-2.2	5.1	7.3	5.3	3.1	4.4	3.5	4.0	5.2	-6.1	5.2	4.3	3.8
Panama													3.2	6.8	7.0	6.7
Paraguay													-3.9	14.0	4.5	4.0
Peru	1.9	-1.2	-0.6	3.4	6.2	10.2	9.7	8.5	7.5	7.2	7.0	6.7	0.9	8.7	7.1	6.3
Uruguay													2.9	8.8	5.3	4.2
Venezuela	0.5	-2.6	-4.6	-5.8	-5.2	-1.9	-0.4	-0.4	3.9	2.4	2.4	2.0	-3.3	-1.9	2.6	1.5
Latin America													**-2.2**	**6.1**	**4.4**	**4.0**

*Forecast
Source: BBVA Research

Table 2

Inflation (% y/y, average)

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10*	Q1 11*	Q2 11*	Q3 11*	Q4 11*	2009	2010*	2011*	2012*
Argentina	6.6	5.5	5.9	7.1	9.0	10.6	11.1	11.1	11.1	11.0	11.1	11.4	6.3	10.5	11.1	13.0
Brazil	5.8	5.2	4.4	4.2	4.9	5.1	4.6	5.6	5.6	5.3	6.0	5.2	4.9	5.0	5.5	4.7
Chile	5.6	3.1	-0.6	-1.9	-0.3	1.2	2.2	2.5	2.7	2.8	2.9	3.7	1.6	1.4	3.0	3.2
Colombia	6.6	4.8	3.2	2.4	2.0	2.1	2.3	2.7	3.5	3.6	3.6	3.6	4.2	2.3	3.6	3.6
Mexico	6.2	6.0	5.1	4.0	4.8	4.0	3.7	4.2	3.0	3.6	4.2	3.9	5.3	4.2	3.7	4.3
Panama													2.4	3.5	4.7	4.4
Paraguay													2.6	4.6	8.8	8.1
Peru	5.6	4.0	1.9	0.4	0.7	1.1	2.2	2.1	2.3	2.7	2.4	2.9	3.0	1.5	2.6	2.7
Uruguay													7.1	6.7	6.6	6.7
Venezuela	29.6	28.2	28.7	28.1	27.3	31.9	29.8	27.3	27.1	22.9	24.4	27.1	28.6	29.1	25.4	28.0
Latin America													**6.4**	**6.4**	**6.5**	**6.7**

*Forecast
Source: BBVA Research

Table 3

Exchange Rate (vs. USD, average)

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10*	Q1 11*	Q2 11*	Q3 11*	Q4 11*	2009	2010*	2011*	2012*
Argentina	3.54	3.73	3.83	3.81	3.84	3.90	3.94	3.97	4.02	4.11	4.19	4.28	3.73	3.91	4.15	4.82
Brazil	2.32	2.08	1.87	1.74	1.80	1.79	1.75	1.70	1.71	1.72	1.73	1.75	2.00	1.76	1.73	1.79
Chile	607	567	545	518	519	530	511	486	497	501	506	510	560	510	503	512
Colombia	2415	2233	2017	1965	1947	1950	1831	1857	1812	1775	1788	1813	2158	1899	1797	1800
Mexico	14.38	13.32	13.27	13.06	12.78	12.38	12.80	12.22	11.98	11.82	11.98	12.20	13.51	12.50	12.00	12.49
Panama													1.00	1.00	1.00	1.00
Paraguay													4967	4739	4608	4599
Peru	3.19	3.02	2.96	2.88	2.85	2.84	2.81	2.80	2.79	2.77	2.73	2.71	3.01	2.83	2.75	2.64
Uruguay													22.53	20.01	20.11	20.68
Venezuela	2.15	2.15	2.15	2.15	4.30	4.30	4.30	4.30	4.30	4.30	4.30	4.87	2.15	4.30	4.44	

*Forecast
Source: BBVA Research

Table 4

Interest Rate (%, average)

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10	Q1 11*	Q2 11*	Q3 11*	Q4 11*	2009	2010	2011*	2012*
Argentina	13.29	12.83	12.64	10.75	9.62	9.56	9.77	10.83	11.31	11.79	12.30	12.82	12.38	10.11	12.06	14.57
Brazil	12.62	10.33	8.86	8.75	8.75	9.75	10.75	10.75	11.58	11.75	11.75	11.75	10.14	10.00	11.71	10.79
Chile	0.50	0.50	0.50	0.50	0.50	0.67	2.00	3.00	3.50	4.25	4.92	5.00	0.50	1.54	4.42	5.56
Colombia	8.00	5.17	4.33	3.67	3.50	3.00	3.00	3.00	3.00	3.25	4.00	4.42	5.29	3.13	3.67	5.08
Mexico	7.33	5.33	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	5.42	4.50	4.50	4.94
Panama													2.86	2.70	3.00	3.50
Paraguay													28.26	25.75	25.77	26.20
Peru	6.25	4.00	1.50	1.25	1.25	1.50	2.50	3.00	3.42	3.75	4.17	4.42	3.25	2.06	3.94	4.92
Uruguay													8.67	6.31	7.10	7.25
Venezuela	17.10	15.60	14.52	15.05	14.59	14.51	14.51	14.51	14.51	14.51	13.50	13.50	15.57	14.53	14.01	13.50

*Forecast
Source: BBVA Research

Table 5

Private Consumption, Government Consumption and Investment (% y/y)

	Private Consumption (% y/y)				Government Consumption (% y/y)				Investment (% y/y)			
	2009	**2010***	**2011***	**2012***	**2009**	**2010***	**2011***	**2012***	**2009**	**2010***	**2011***	**2012***
Argentina	-4.1	7.2	5.3	3.5	7.2	8.9	7.8	4.2	-10.2	18.6	7.3	3.3
Brazil	4.1	5.8	4.4	4.6	3.7	5.4	3.1	3.2	-10.0	22.5	8.9	7.1
Chile	0.9	12.0	6.5	5.1	6.8	2.7	5.0	4.2	-15.3	17.7	15.2	10.2
Colombia	1.1	4.1	5.0	5.8	13.1	4.0	9.5	5.8	-9.1	7.8	10.3	7.7
Mexico	-7.1	5.4	3.8	6.5	5.3	4.3	2.9	3.0	-16.8	1.0	5.0	3.0
Panama	-0.2	5.0	4.7	4.5	6.4	3.8	4.9	3.0	-6.5	23.0	9.5	8.0
Paraguay	-3.4	9.0	4.6	4.3	13.5	13.6	4.0	4.0	-11.7	20.9	7.7	6.1
Peru	2.4	6.0	6.0	5.2	16.4	9.5	4.0	4.0	-15.1	19.5	13.0	12.7
Uruguay	1.5	9.6	6.5	5.5	5.2	5.5	5.0	4.0	-10.7	8.0	11.0	10.0
Venezuela	-3.2	-2.8	2.7	3.1	2.3	2.7	4.4	4.5	-8.2	-4.8	5.0	2.5
Latin America	**-1.0**	**5.5**	**4.4**	**5.0**	**5.7**	**5.3**	**4.1**	**3.6**	**-12.2**	**12.8**	**7.9**	**5.6**

*Forecast
Source: BBVA Research

Table 6

Fiscal Balance and Current Account (% GDP)

	Fiscal Balance (% GDP)				Current Account (% GDP)			
	2009	**2010***	**2011***	**2012***	**2009**	**2010***	**2011***	**2012***
Argentina	-0.6	0.3	-1.0	-0.2	3.5	1.1	0.7	-0.4
Brazil	-3.3	-2.6	-2.8	-2.3	-1.4	-2.4	-2.8	-3.1
Chile	-4.6	0.3	0.9	0.2	2.6	1.6	0.6	-1.7
Colombia*	-4.1	-4.3	-4.1	-3.7	-2.1	-3.0	-2.7	-3.0
Mexico	-1.3	-3.2	-2.9	-2.7	-0.6	-0.8	-1.2	-1.7
Panama	-1.0	-0.7	-1.0	-0.7	0.0	-7.8	-7.9	-8.0
Paraguay	0.1	1.1	1.5	1.7	0.1	-1.4	2.8	1.7
Peru	-1.9	-0.9	0.1	0.3	0.1	-1.8	-2.8	-3.3
Uruguay	-1.7	-0.7	-0.7	-0.4	-0.9	-4.8	0.8	0.6
Venezuela	-5.1	-3.7	-3.1	-0.9	2.4	5.7	8.9	10.9
Latin America	**-2.6**	**-2.4**	**-2.4**	**-1.9**	-0.2	-0.9	-1.1	-1.4

*Forecast
** Central Government
Source: BBVA Research

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