BBVA | RESEARCH

Economic Outlook

Latin America

Third Quarter 2011
Economic Analysis

- **Latin America will grow by 4.8% in 2011,** slightly above the expected figure due to a surprising increase in domestic demand in Argentina. In 2012-13, it will converge to annual rates in the order of 4%.
- **Domestic demand is moderating in line with expectations,** while inflation is tending to stabilize.
- **The process of withdrawing the monetary stimuli has slowed down as official interest rates reach close to their neutral levels.** In some cases fiscal policy has supported the adjustment in domestic demand, at least until now.
- **If sovereign debt problems in Greece trigger a crisis in Europe,** regional growth would be around 2.5-3% in 2012 and 2013.
- **The risk of overheating remains,** mainly because there have been announcements of major fiscal expansion plans in South American countries for 2012.
- **Very varied surprises in recent months have spread political uncertainty** in the region.

Índice

1. Global outlook: recovery, global shocks and vulnerabilities 3

2. Economies stabilize 4

3. But significant risks remain 8

4. Tables 10

Closing date: August 3, 2011

1. Global outlook: recovery, global shocks and vulnerabilities

The global economy will continue growing strongly, after a soft patch in the first semester

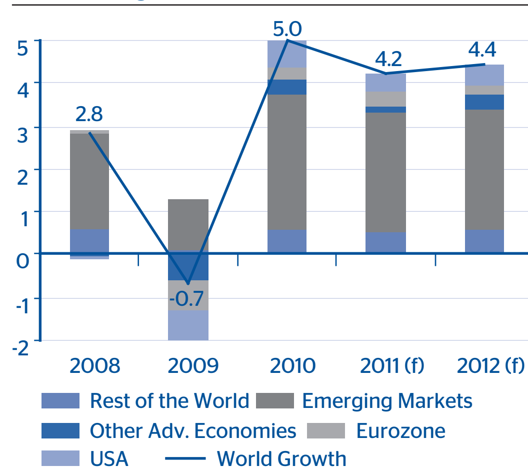
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 and 4.4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and may be prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US has reminded markets of that, and may dent consumer and producers sentiment going forward.

Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 2), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

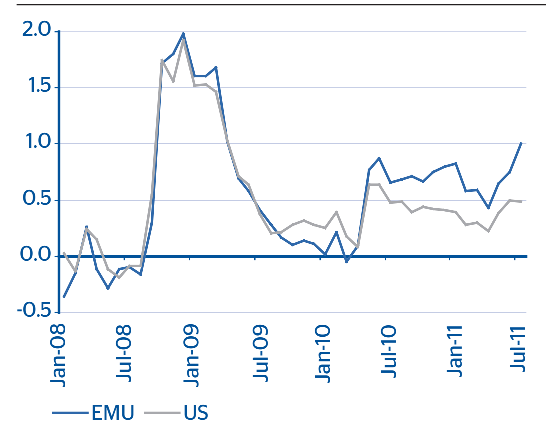
Finally, in emerging economies, overheating concerns have eased slightly as tightening measures continue to ease growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities, at a time when concerns over the appreciation of exchange rates in these economies remain.

Chart 1
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

It is high time to address solvency concerns in Europe, and that requires continued bold actions from EU politicians

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, and thus has increased the chances of the crisis becoming systemic in all Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency concerns in Greece. This lack of resolve in Greece spilled over countries with no solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

In this context, with so much at stake, the Eurogroup agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress –much like the Flexible Credit Line from the IMF– and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a reduction of net present value of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big –and, in some cases, unexpected– steps in the right direction towards solving the financial crisis in Europe. But Europe is not out of the woods, and that has been reflected in only a moderated reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action. First, the EFSF should be expanded and pre-financed. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds, together with fiscal rules and tight control of national budgets. Third, economic reforms should. Fourth, EU authorities should finally decide how they will bring Greece's debt to a sustainable level and end solvency concerns.

Until these four steps are not taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring down the road. In the meantime, Europe will continue to be subject to "accidents" due to reform fatigue or bailout fatigue leading to a disorderly debt restructuring, which could have a global impact.

Fiscal consolidation in the US also focuses the attention on politics

In the US, the political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. Here the risk also lies –as in Europe– in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease slightly in many emerging economies, but global risks and currency appreciation might turn policy tightening more cautious.

Emerging economies continue to show risks of overheating, although as a whole they have receded somewhat given ongoing tightening measures and headwinds (in Asia) from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China were reduced as Q2 growth showed only a slight deceleration, still on track for a soft landing. However, inflation in emerging economies remains a concern, and there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

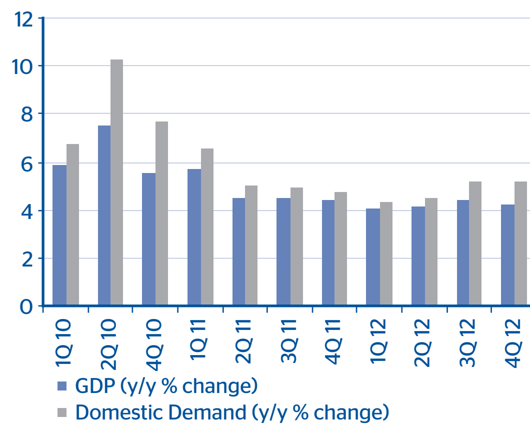
2. Economies stabilize

The slowdown continues at the expected rate

GDP growth in 2011 is within the expected range, and the region will grow at around 4.8% this year. It will then converge to around 4% in 2012 and 2013. This is a slight increase on our previous forecast for this year (4.6%), mainly due to the surprising increase in domestic demand in Argentina in the first half of the year.

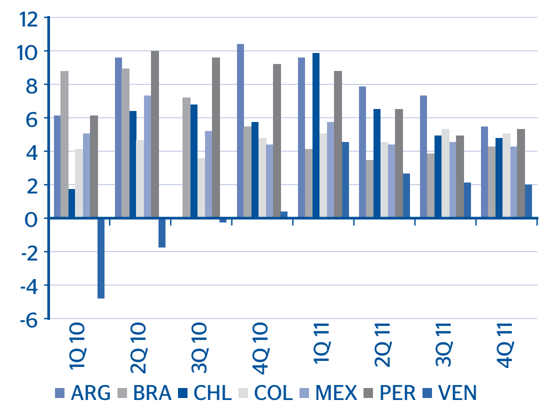
As we highlighted in the previous reports, the major concern was that a delayed adjustment of domestic demand would result in inflationary pressure and excessive increases in imports, which would endanger the process of orderly convergence to trend rates. The evidence from the first quarter and figures available for the second help alleviate these concerns, with a couple of exceptions. As can be seen in Chart 3, aggregate domestic demand at a regional level has begun to slow significantly, and our forecast is that by the end of the year its rate will be very close to trend GDP growth. According to our forecasts, this adjustment is particularly significant in three cases: Brazil, where growth in domestic demand will fall from 10.3% in 2010 to less than half in 2011 (4.8%); Chile, where it will slow from 16.4% to 9.1%; and Peru, where the 12.8% increase in 2010 will drop to 7.4% this year. The most worrying case is Argentina, where we still expect double-digit rates of growth of domestic demand in the first three quarters of the year. In Colombia we see a risk of an increased consumption, which could force a sharper adjustment of monetary policy.

Chart 3
Growth of GDP and domestic demand



Source: BBVA Research

Chart 4
GDP by country, % change



Source: BBVA Research

The main factors behind this slowdown in domestic spending have been the end of temporary effects derived from the postponement of expenditure during the crisis, the closing of capacity margins caused by the crisis, which resulted in very low bases of comparison last year, as well as the gradual increase in official interest rates and successive credit tightening measures; and in some cases, moderation in fiscal expenditure, which in Brazil and Chile was done explicitly through statements by the authorities and in Peru was carried out in practice.

Mexico stands apart from the general pattern in the region, as the recovery there has been mainly boosted by export growth. The increase in domestic demand has been a response to the improved labor-market conditions and has remained moderate, consistent with the medium and long-term growth trends for the economy.

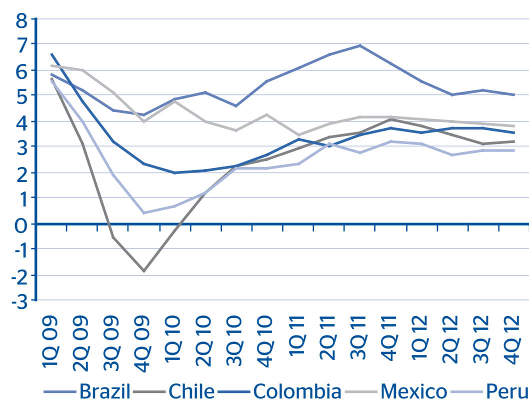
GDP growth has also slowed significantly in response to the slowdown in domestic demand and the combined effect of reduction in the excess capacity margins left by the 2009 recession, together with the real appreciation of currencies. In the case of Chile this is less evident in the year-on-year figures because of the major effect of the low base of comparison due to the earthquake that hit the country early last year.

Inflation converges to the targets

In line with our forecasts, inflation has stabilized in most countries, although there are still cases like Brazil in which there has been an increase due to the low bases of comparison from last year in these months.

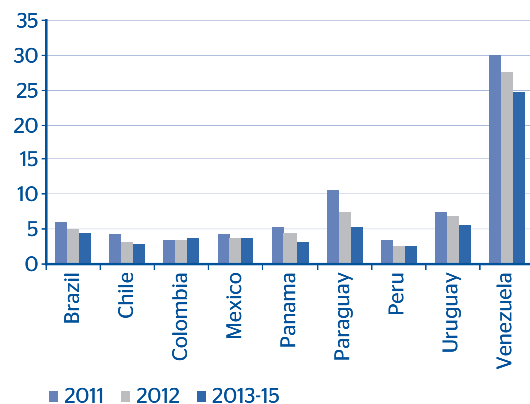
This moderation in inflation has been possible thanks to a growing proportion of excess domestic demand being shifted to higher imports, supported by the favorable scenario of terms of trade. In addition, inflationary expectations have remained in line with the targets of the central banks, thanks to the credibility gained in previous years. The combination of these factors has been fundamental in ensuring that the incipient overheating of which the IMF warned a few months ago has been eliminated in a gradual and orderly way, without any pressure for abrupt adjustments so far.

Chart 5
Inflation: actual and forecast



Source: BBVA Research

Chart 6
Inflation forecast by country



Source: BBVA Research

Although in a number of countries inflation is today at the limit of the bands consistent with inflation targets, or even above them, our forecasts suggest that a convergence towards the targets should begin within the established time horizons.

The biggest risk to the maintenance of the good results observed so far in terms of inflation control is a fall in the prices of commodities exported by the region, which would lead to a weakening of the currencies. Although most countries could maintain this risk within limits thanks to broad-ranging access to finance and a substantial accumulation of external assets by central banks and governments, such a change in the global environment could make things more difficult for those countries that do not have these backups and are extremely dependent on the maintenance of export prices at the current high levels. For countries such as Mexico and, to a lesser extent Brazil, a fall in commodity prices could in fact have the contrary effect, as their export basket has a larger component of manufactured goods and there would be a direct effect of lower commodity prices on the value of the consumer basket.

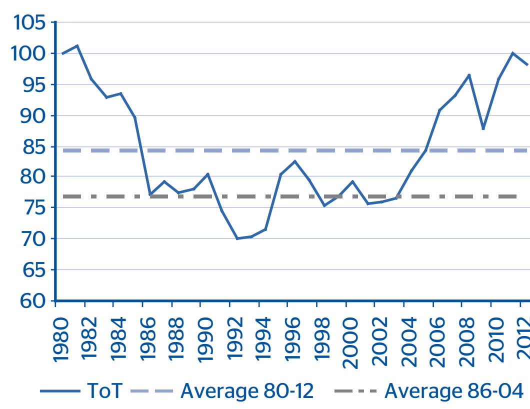
Fears about an excessive appreciation of the currency led central banks in many cases to delay the withdrawal of monetary stimuli. This had an impact on inflationary expectations. However, as the months passed, the confirmed commitment to the inflation targets combined with incipient signs of moderation in domestic demand have been extremely important in rechanneling inflationary expectations. If capital flows increase strongly and upward pressure on currencies returns, the effect of signals given by the fiscal authorities will be very important. In a scenario of this type it is essential to consolidate the moderation of domestic demand and alleviate pressure on interest rates. In this case it appears important that Colombia should limit the programmed expansion of public expenditure, that Panama postpone public investment in infrastructure, that Peru continue the moderation of public expenditure in place so far, and that Chile consolidate the control of expenditure it carried out in the first half of the year, by adopting more ambitious measures to reduce the structural deficit programmed for this and future years.

The important role of terms of trade

In the previous section we pointed out the important role played by the terms of trade in a moderate adjustment of excessive demand, by preventing it from being converted into higher inflation. Terms of trade measure changes in the purchasing power of imported products relative to a basket of each country's exports, so that when the terms of trade are high, the capacity to finance the shift of excess domestic demand abroad increases.

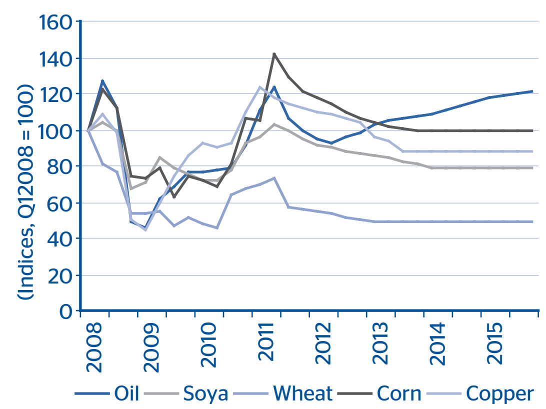
The aggregate index of terms of trade for the region published by the IMF appears in Chart 7. It shows that the index is today at its highest levels for the last 30 years, 19% above its average for the last three decades and 30% above the average for the period that preceded the current rise in commodity prices (1986-2004).

Chart 7
Terms of trade, LatAm



Source: IMF

Chart 8
Commodity prices forecast



Source: BBVA Research

If we examine the situation of individual countries, we see that this average is fairly representative of the overall reality. This can be seen in Table 1, which shows the percentage deviation of the terms of trade in 8 countries in the region, with respect to the average for 1980-2010. It can be seen that except for Mexico and Uruguay, all the others have substantial gains in their terms of trade, in particular Venezuela and Chile. It is worth mentioning that these indices are calculated based on the deflated indices of exports and imports of goods and services in the national accounts. This is why they are affected to such an extent by the movement of the prices of products exchanged abroad and by their relative weight in foreign trade. This explains, for example, the fall in the case of Mexico, as despite the increase in the oil price, its lower weighting in the country's export basket leads to the fall mentioned above.

Table 1
Gains in terms of trade in 2010

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Uruguay	Venezuela
Percentage deviation with respect to the average 1980-2010	30%	33%	74%	37%	-3%	15%	-17%	381%

Source: BBVA Research

These extraordinarily high terms of trade have a positive effect on countries: first, they increase the availability of currencies; and second, they are translated into greater tax revenues, if the duties on exports (or the tax on profits resulting from them) are higher than those on imports. As greater availability of foreign currencies is translated into stronger currencies in each country, this improves the purchasing power of households and companies in the country, but at the same time it helps to transfer demand abroad, thus reducing the risk of inflationary pressure. In other episodes of this type in the past the chance of sustaining higher trade deficits was normally extremely limited by the availability of currencies, which does not occur today.

The high level of terms of trade is due to the cycle of commodity prices, which remain at levels far above their historical averages. Our base forecast includes a downward adjustment, at least in the one-year horizon. Prices, however, should remain above these averages, so this factor will continue to provide positive support, although somewhat more limited, in the coming years.

However, what is now an element of support can become a factor of vulnerability if a swift downward adjustment in these prices occurs for some reason. We will explore this idea in the following section.

3. But significant risks remain

Although the global economy appears to be maintaining aggregate rates of growth of the order of 4% per year, which can only be considered high in any historical comparison, there is a broad consensus regarding the increase in volatility and risks associated with the problems of sovereign debt in developed countries and the possible problems derived from the increasing concentration of the global economic driving force in China and a few economies in Asia.

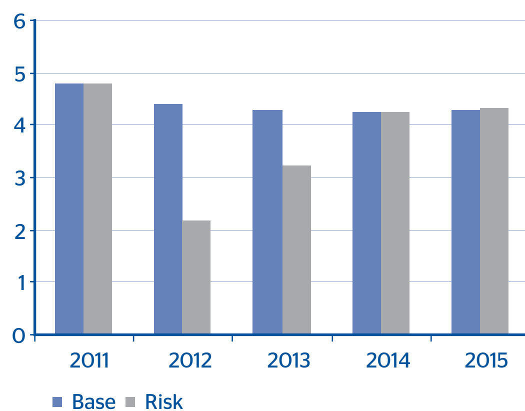
Impacts of a European sovereign debt crisis

One of the important risks for our global scenario is that high risk premiums may persist in Europe, due to the uncertainty regarding the region's capacity to offer a credible response to the problems that Greece faces, and thus putting in doubt its capacity to avoid contagion to other larger countries. Although there has been significant progress in this respect in recent weeks, it is still too early to give a favorable and final verdict on this question.

BBVA Research has constructed a global risk scenario that is characterized by the maintenance of high risk premiums in Europe, which trigger a default episode in Greece at the start of 2012 and a massive crash in credit in the EU. This in turn leads to a recession in Europe that year. This economic slump, combined with a greater global uncertainty (expressed in greater risk premiums) has an effect on growth in countries such as the U.S. and China, pushing it down by about 1 pp on the growth estimates for 2012, and somewhat less so in 2013 as calm returns to the markets.

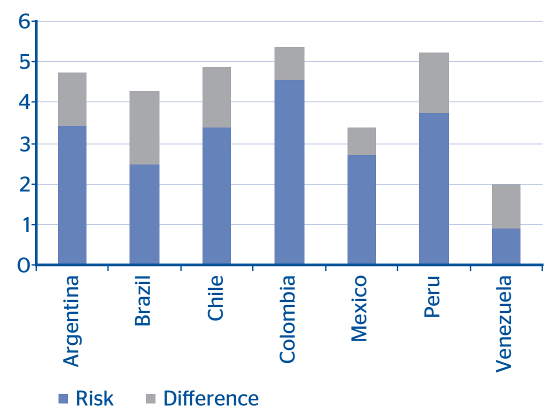
This scenario affects the region directly due to its impact on export volumes and greater risk premiums. It also has an indirect effect derived from the fall in commodity prices with respect to the base scenario (15% in the case of oil and metals and 10% in food) and on consumer and business confidence. The combined effect of all these factors results in growth down by around 1.5% on average (with respect to the base forecast) in 2012 and 2013, as can be seen in Charts 9 and 10.

Chart 9
GDP growth in LatAm, base and risk



Source: BBVA Research

Chart 10
GDP growth in LatAm, base and risk by countries 2012-13



Source: BBVA Research

The transmission mechanisms from the global economy to the region are very similar to those in the 2008 crisis. The difference is that on this occasion there is no sudden stop of foreign credit to the region. In the case of Mexico, most of the lower growth can be explained by the impact of the global shock on industrial activity in the United States, while in Brazil, Chile, Colombia and Peru the adjustment in demand through consumption and investment derived from the shock in confidence plays a very important role. In Argentina and Venezuela, two economies that are relatively isolated from the financial turmoil, this kind of impact is less important. A bigger role is played there by the effect of falling commodity prices (grains and oil) on the fiscal balance and the availability of foreign currencies.

Risk of overheating in LATAM

Although we consider that the risks of overheating have eased, if we analyze whether domestic demand is in line with the forecast rate, there is still cause for concern in this respect. First, we have the case of Argentina and Venezuela, where inflation is high and the balance between expansion of domestic demand and available production capacity puts strong pressure on prices and the balance of trade. This leaves these economies more vulnerable to an adverse shock from abroad, which could manifest itself in an abrupt weakening of their currencies and further price rises. In addition, we expect that expansive fiscal policies will be maintained in both countries, at least until next year.

Then we have the case of Brazil, where the biggest risk is the pressure of costs arising from the labor market. Their origin lies in the major increase in employment, but there is also concern about the entry into force of an adjustment rule for the minimum wage that could lead to an increase of well above 10% in 2012. This could send a signal to the market and have a significant impact on public finances, given that many social benefits in Brazil are indexed to the value of pensions. In Peru there is also some concern regarding the election promises of president-elect Ollanta Humala, including a 25% rise in the minimum wage. However, these promises have now been qualified, and in the case of the rise in the minimum wage, the new authorities have already announced that it will be implemented on a step-by-step basis.

Finally we have the cases where the demand pressures could be more decisive: Chile, Colombia, Panama, Paraguay and Uruguay. There is persistent excess demand in all of them, and this will continue to be exported in part. However, it will also put downward pressure on exchange rates, since it will feed expectations of new interest rate rises. As long as the authorities allow their currencies to gain strength and there are no adverse external shocks that could lead to a steep fall in the price of commodities they export, inflation will remain in check, but the competitiveness of the economies would be damaged and pressure would increase to implement capital controls. In Panama, where there is no exchange-rate adjustment mechanism, the impact of a major increase in public investment in infrastructure, which also coincides with work on the extension of the Canal, will be on prices and wages, and will end up damaging the economy's competitiveness.

It is worth mentioning that in all these countries we can see signs of a slowdown in domestic demand, perhaps with the exception of Colombia, where the initial increase was much less pronounced than in the rest. However, there is still a risk of isolated increases in demand resulting from expansive fiscal policies or the implementation of large-scale investment projects, which could delay or put a halt to this moderation.

Political uncertainty has increased

Since the last report we have had a number of major surprises in the political field that will undoubtedly affect the future economic performance of these countries.

First, in chronological order, was the resignation of the minister Palocci from the government in Brazil. Combined with other subsequent events, it shows the limited capacity for negotiating agreements between the Executive and Congress in the country. This situation could restrict the capacity of President Dilma Rousseff to carry out what is an ambitious legislative agenda.

More notable, at least in terms of its impact on the markets, has been the surprise victory of Ollanta Humala in the presidential elections in Peru. However, statements made by the president-elect and his choice of appointments of new economic and political officials has brought calm back, though doubts persist that will only be resolved when we see the performance of the new government.

In Chile there has also been a great political unrest, with mass popular protests. Although they show a significant level of discontent, they have no direct impact on the political institutions. The government has been severely hit in opinion polls, but the opposition has not taken advantage of this fall and in fact has also seen its support weaken. The biggest risk of a situation such as this is that it opens up the possibility of the entry of populist forces at the margin of the political coalitions that have given political and economic stability to the country for more than 20 years.

Finally, and also very conspicuously, there has been the surprise health problem of President Hugo Chávez in Venezuela, which opens up questions that are difficult to answer in a country where the political scene has been completely dominated by the powerful figure of the president.

Presidential elections are approaching in Argentina and Mexico, which could modify the map of political power, but will possibly not change the situation radically.

4. Tables

Table 2
GDP (%)

	2010	2011	2012
Argentina	8.7	7.5	5.7
Brazil	7.6	4.0	4.1
Chile	5.2	6.5	4.7
Colombia	4.3	5.0	5.4
Mexico	5.5	4.7	3.8
Panama	7.5	7.8	7.6
Paraguay	15.3	5.9	5.2
Peru	8.8	6.3	5.5
Uruguay	8.5	5.3	4.6
Venezuela	-1.5	2.8	2.0
LATAM	**6.3**	**4.8**	**4.2**

Source: BBVA Research

Table 3
Inflation CPI (end of year %)

	2010	2011	2012
Brazil	5.9	6.0	5.0
Chile	3.0	4.2	3.2
Colombia	3.2	3.5	3.5
Mexico	4.4	4.1	3.8
Panama	4.9	5.3	4.4
Paraguay	7.2	10.7	7.5
Peru	2.1	3.4	2.8
Uruguay	6.9	7.5	7.0
Venezuela	27.4	29.9	27.5
LATAM	**6.9**	**7.1**	**6.8**

Source: BBVA Research

Table 4
Exchange rate (against USD, end of year)

	2010	2011	2012*
Argentina	4.0	4.3	5.0
Brazil	1.7	1.6	1.7
Chile	475	488	508
Colombia	1926	1830	1825
Mexico	12.10	11.9	12.3
Panama	0.00	1.0	1.0
Paraguay	4574	4050	4091
Peru	2.81	2.7	2.8
Uruguay	19.89	19.0	20.0

Source: BBVA Research

Table 5

Interest rate (end of year)

	2010	2011	2012
Argentina	11.1	12.5	16.0
Brazil	10.8	12.8	11.8
Chile	3.25	5.75	6.00
Colombia	3.0	5.0	6.0
Mexico	4.5	5.0	5.5
Panama	2.1	2.7	2.8
Paraguay	0.0	0.0	0.0
Peru	3.0	4.5	5.0
Uruguay	6.5	7.3	7.3
Venezuela	14.5	14.5	14.5

Source: BBVA Research

Table 6

Current account (% GDP)

	2010	2011	2012
Argentina	0.9	0.1	-0.9
Brazil	-2.3	-2.4	-3.0
Chile	1.24	-1.1	-2.0
Colombia	-3.1	-2.9	-3.7
Mexico	-0.5	-0.8	-1.1
Panama	-11.0	-11.5	-10.8
Paraguay	-3.3	-3.9	-3.1
Peru	-1.5	-2.6	-2.5
Uruguay	-0.4	-0.7	-0.7
Venezuela	6.1	11.3	7.2
LATAM	**-0.8**	**-0.8**	**-1.6**

Source: BBVA Research

Table 7

Fiscal balance (% GDP)

	2010	2011	2012
Argentina	0.2	-1.2	-1.6
Brazil	-2.5	-2.6	-2.8
Chile	-0.34	0.7	0.6
Colombia	-3.8	-4.1	-3.7
Mexico	-0.8	-0.8	-2.7
Panama	-1.9	-1.5	-0.8
Paraguay	1.4	0.8	0.7
Peru	-0.3	-0.3	-0.7
Uruguay	-1.1	-1.6	-1.3
Venezuela	-3.1	-4.3	-6.1
LATAM	**-1.7**	**-1.8**	**-2.6**

Source: BBVA Research

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