BBVA | RESEARCH

Economic Outlook

Latam

Fourth Quarter 2011
Economic Analysis

- **Two-speed growth will continue in the global economy.** Emerging economies are buoyant, while Europe is immersed in major turmoil.
- **Latin America will grow by 4.4% in 2011 and somewhat below this figure in 2012 (3.7%),** fuelled by domestic demand which is beginning to slow.
- **The monetary authorities are holding back the withdrawal of monetary stimuli longer than expected,** due to a more risky global environment and the danger of recession in advanced countries.
- **Possible overheating is leaving economies more vulnerable to an adverse external shock** because the growing gap between domestic demand and GDP is making them more dependent on the maintenance of high terms of trade.
- **Inflation has surprised upwards in recent months.** This could generate a dilemma for the central banks if the trend is maintained in upcoming months.

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Closing date: November 16th 2011

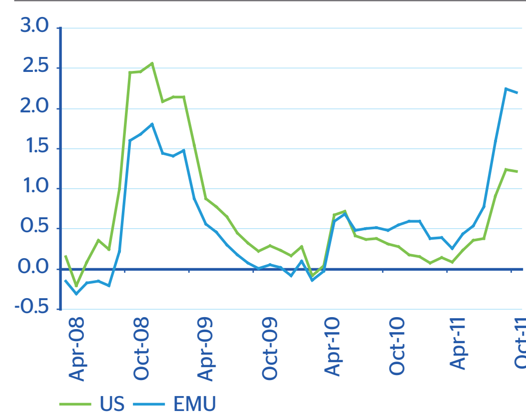
1. Global slowdown with a significant downward risk bias

The world economy is slowing and its outlook depends largely on whether the European debt crisis can be resolved

The prospects for the global economy have worsened in recent months, mainly due to four factors. First, economic growth has been slower than expected, above all - but not only - in developed economies. Although US growth increased in the third quarter, economic activity in Europe is now clearly slowing after holding up in the first three months of the year. Second, the sovereign debt crisis in Europe has intensified and has become more systemic. Although the decisions adopted following the October summit are a step in the right direction, key elements still have to be resolved, particularly with respect to the real power given to the mechanisms that guarantee sovereign liquidity (the European Financial Stability Facility, EFSF, leveraged), the restructuring of the Greek debt in the hands of private investors, and a clear road map to improve European governance and make progress towards fiscal union. Third, the feedback between sovereign fears and the health of the European financial system has intensified. In Europe the level of tension is in many respects higher than that in the wake of the collapse of Lehman Brothers in October 2008 (Chart 1). This increases the risk of a negative impact on economic activity and adds fuel to the vicious circle between the real economy and finance. Finally, the global increase in risk aversion has increased volatility in the financial markets and led to contagion of most of the risk assets and even the emerging economies, for the first time since 2009.

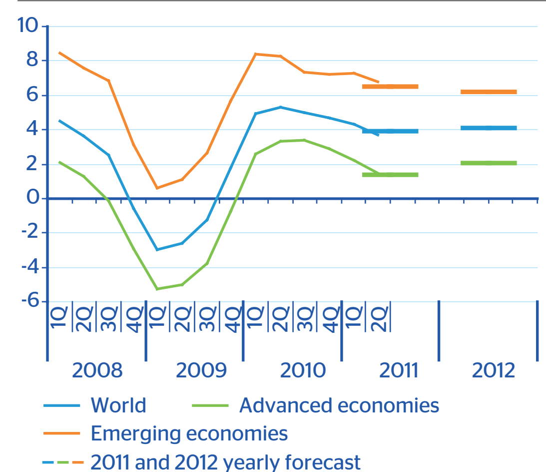
In this context, we are revising down our global growth estimates for 2011 and 2012 by 0.3 pp on the figure given in our last Global Economic Outlook, mainly due to the fall in growth expectations in advanced economies (U.S. and Europe, partly offset by Japan), although growth in emerging markets will also perform below expectations. Thus the global economy should grow by 3.9% in 2011 and 4.1% in 2012, supported by solid growth in emerging countries and discreet growth in advanced economies (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

These growth rates are still robust, but the risks are strongly biased towards the downside and in the short term they will depend on developments in the European financial and sovereign debt crisis. In particular, a swift reduction of financial stress is needed in Europe to ease the negative impact on European growth and contagion to other regions.

The European summits in October have made moves in the right direction, but there are still elements to be resolved

In our opinion, the European summits in October should have acted on five key points: (i) deal decisively with the sustainability of the Greek debt; (ii) create firewalls for sovereign debt in the EMU; (iii) put pressure on peripheral countries to make more reforms; (iv) strengthen the banking system; and (v) improve governance in the euro zone. Significant measures have been adopted in the wake of the latest summits, though some of the more technical details still have to be tackled. However, there has been no decisive resolution of most of the key points. First, the private holders of Greek bonds have been asked to accept a voluntary haircut of 50% (much more than what was agreed in July). There are still doubts about the level of participation in this operation, and even if participation was complete, Greek solvency remains an issue that is closely dependent on the reforms that the country has to adopt. Second, the EFSF will be leveraged as a guarantee mechanism with the participation of external investors (possibly including the IMF, although the G20 summit was not conclusive in this respect), although the operating details of the EFSF will probably not be decided before December. As a result, many weeks will have to pass before we can determine its effectiveness for private investors. The ECB will therefore have to continue to act as "buyer of last resort" of sovereign debt, despite the doubts of central European countries. Third, the increased presence of economic reforms in the agenda of some countries (above all, Italy, where they will be supervised by the IMF) is welcome, as is the fact that assistance from the EFSF will be given in response to requests by countries and under certain conditions. This increases the probability that economic reforms are actually implemented. At the same time, the recapitalization of the banking sector is being carried out inefficiently. The moderate stress tests of the banks' balance sheets, which apply market prices for sovereign portfolios but not for "toxic assets" are being offset by a substantial increase in capital requirements (9% of core Tier 1 capital). This could lead to a sharp deleveraging of banks in the euro zone and affect credit negatively without strengthening their balance sheets. What is more, no mechanism has yet been established to provide long-term liquidity, although this is extremely important if banks are to finance themselves. Finally, progress has been made in European governance, but there is no clear road map for fiscal union or the issue of Eurobonds, which in our opinion is a key element for the long-term credibility of the EMU.

As we have mentioned on other occasions, partial solutions will simply help prevent an escalation of financial tension, but it will remain high. This increases the downside risks for the economy in the euro zone. The agreements reached have not clarified whether the necessary structure is in place to prevent contagion and a possible systemic event derived from the restructuring of the Greek debt; in other words, it is not clear whether there is an adequate EFSF in place with the ECB as a buyer of last resort and strengthened and recapitalized banks with access to finance. Without these measures, the markets will continue to be fatigued in the face of reforms in Greece and new bailouts in core European countries. This increases the probability of a risk scenario with a credit squeeze and recession in Europe and serious consequences for the whole world[1].

Despite increased growth in the third quarter, the weakness of the U.S. and the political stalemate continues

The positive aspect is that U.S. growth appears to have risen the third quarter, at least according to initial estimates. Although this should not lead to euphoria (growth in the first two quarters was very low and the output gap continues to be very wide), market nerves about the possibility of another recession appear to have calmed. However, the U.S. economy remains weak: the level of consumer and business confidence is still low and the real estate market could face further corrections. This would reduce resistance to a possible shock from Europe. In addition, the political stalemate could prevent a "major agreement" from being reached to (i) prevent an undesirable fiscal contraction in the short term; and (ii) to promote reforms for credible long-term fiscal consolidation.

1: See Box 1, "Channels of global contagion in the event of a disorderly default in Europe," in the Global Economic Outlook for 3Q 2011, for a summary of the channels of contagion and the global impact of a disorderly default in Europe.

Emerging economies continue on track towards a soft landing

Emerging economies are still growing strongly, fueled by the strength of domestic demand. Commodity prices in Latin America and the growth of Asian exports are both still high, despite major corrections. This is providing further support to the sound growth outlook, which is moving towards a soft landing that would be received positively in some countries. For both regions, turbulence in Europe and the U.S. is resulting in greater problems in the financial markets, reflected in the increased market volatility, falling exchange rates and a reduction of capital inflows. However, many countries still have a considerable cushion (sounder public finances and better macroeconomic management than in the past) and are in a good position to introduce stimulus policies to counteract weaker foreign demand. In general, a more negative external environment has changed the focus in emerging countries from overheating to downside risks and, increasingly, to the possible need for support policies.

2. The change in the global environment accelerates the slowdown in Latin America

Steep falls in commodity prices, stocks and currencies

Market patience with events in Europe appears to have been exhausted with the end of summer in the northern hemisphere. A major increases in risk premiums has been accompanied by significant falls in commodity prices and stock market indices, while the vast majority of Latin American currencies have lost ground. Most of the central banks in the region intervened to moderate (or even reverse) losses in their currencies. This has led to a cut in the growth forecasts for next year. The regional economic growth forecast for 2012 has fallen from 4.2% in the previous report to 3.7%, while this year should close at 4.4%. .

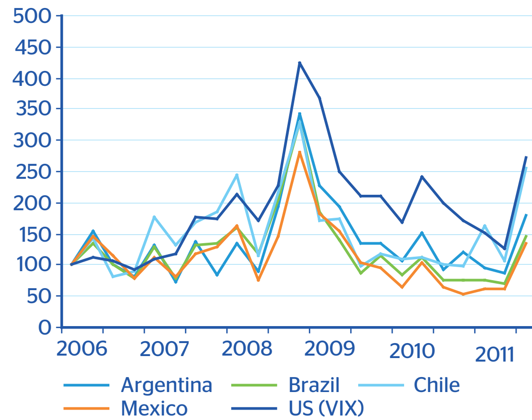
How significant will the scars left by these episodes of volatility be?

From September on, volatility in stock markets and currency markets has been high both globally and regionally. In some cases it has been close to the levels registered in the third quarter of 2008. It is worth asking whether this could leave permanent scars on growth, even if there is a favorable resolution to the current global uncertainty. Raunig and Sharler (2011) show that increased stock market volatility in the U.S. negatively affects growth of investment and the consumption of durable goods. A similar analysis has been applied to Chile and Peru by Carriere-Swallow and Medel (2011), who conclude that the excess of global uncertainty, which corresponds to soaring volatility levels such as those in 2008, reduces these components of aggregate demand by 4%[2].

The above suggests that we may expect a sharper slowdown in domestic demand than we forecast in previous months, thus easing potential inflationary pressure. In addition, unless things get significantly worse over the coming months, the size of the external shock will be much less significant than in 2008, so it is important to maintain vigilance in case the slowdown in endogenous spending is not sufficient. One factor that would help cushion a downturn in the global economy is the experience gained by the government and private sector from the 2008 crisis. This will help limit fear and lack of confidence among consumers and investors, as well as making any reaction by the government more appropriate and effective.

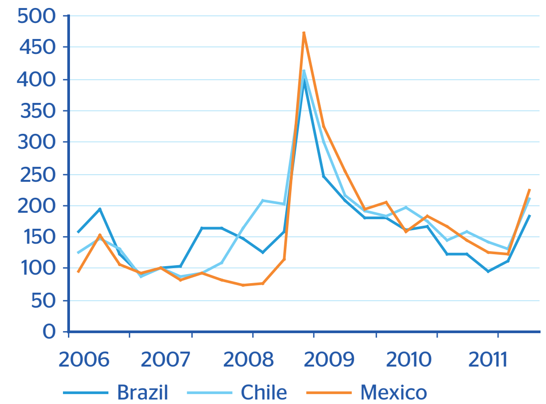
2: B. Raunig y J. Scharler (2011) "Stock Market Volatility, Consumption and Investment; An Evaluation of the Uncertainty Hypothesis Using Post-War U.S. Data", Working Paper #168, Oesterreichisch Nationalbank. Y. Carriere-Swallow and C. Medel (2011) "Incertidumbre Global sobre el Pacífico Sur" Mimeo, Central Bank of Chile.

Chart 3
Actual stock market volatility (2006=100)



Source: BBVA Research

Chart 4
Implied 1-month currency volatility (2006=100)



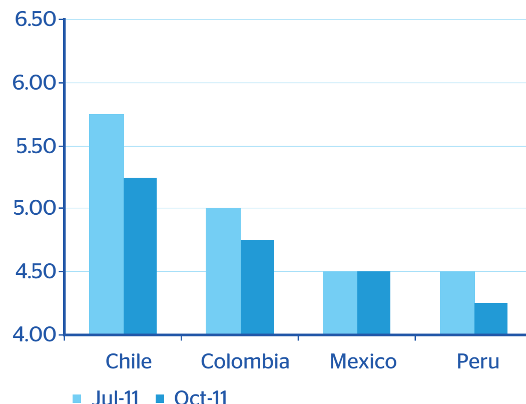
Source: BBVA Research

Interest rate rises on hold

The central banks in countries that follow inflation targets have paused their reference interest-rate rises in response to the increase in global risk aversion. This appears sensible in the light of what we mentioned in the previous section, particularly because domestic demand has already given some signs of a slowdown, above all in Brazil, and to a lesser extent Chile and Peru. Brazil has gone further and lowered its SELIC rate, even though the inflation rate is 7% per year, significantly higher than its official target. The justification is the increasing signs of economic slowdown.

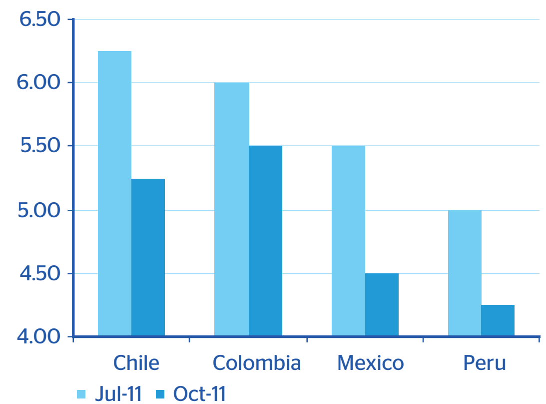
Although initially these events generated expectations of cuts in official rates in other countries, this has not occurred, in part because the latest inflation figures have tended to be higher than expected. The tone of central bank statements is now more cautious and suggests that interest rates will be maintained at current levels for longer, at least in the cases of Chile, Mexico and Peru. The new forecasts therefore reflect the gradual withdrawal of monetary stimuli. However, Colombia is still moving in the opposite direction. This is partly because it raised interest rates less in previous months, and also because there are still no clear symptoms of a slowdown in domestic demand in the country. In this situation, we believe that Colombia's Central Bank will raise its reference rate in the coming months.

Chart 5
Expected interest rate (end of 2011)



Source: BBVA Research

Chart 6
Expected interest rate (end of 2012)



Source: BBVA Research

The pause in reference interest rate rises in a context of increased global risk aversion, combined with the falling prices of some important export products, has probably exacerbated the exchange-rate adjustment, though it has still been much more modest than in 2008. In the future it could lead to complications for the authorities if the continued strength of domestic demand means these losses in currency values are passed on to domestic prices more than normal.

The political dilemma is heightened where exchange rates are "rigid." In this case, the greater uncertainty generates pressure that obliges the monetary authority to intervene, with the resulting loss of reserves and potential falls in liquidity. Argentina has been affected by this type of reaction. It led the Central Bank of the Republic of Argentina to sell USD 1.5 billion in October and then impose some exchange-rate restrictions. These actions managed to reduce the sale of dollars to the public, but slowed the growth in bank deposits, and this is having a negative effect on the availability and cost of credit. We believe that the situation is far from critical and a moderate depreciation in the peso would be enough to resolve the problems. However, for this to be the case, the authorities must take measures that can restore confidence. If they do not do so, the problem could become more acute.

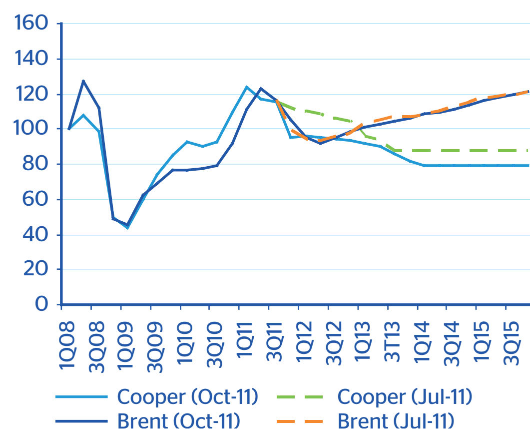
3. The regional slowdown is converging with potential growth

The slowdown is gaining hold through an adjustment in domestic demand

Despite the recent turbulence, we expect growth of 4.4% in the region in 2011. The figures for the first half of the year were somewhat better than expected, and will offset the steeper slowdown in the last quarter. For 2012 our growth forecast has been revised down to 3.7%, with the biggest corrections in Argentina, Panama and Paraguay. In the case of Argentina and Panama, they are partly due to a higher base of comparison in 2011. In addition, the Argentinean economy is expected to slow due to the adjustment in bank credit as the liquidity slack in the banking system disappears. The growth forecast for Paraguay has been revised down due to the closure of foreign markets following the outbreak of foot-and-mouth disease, as well as expectations of a lower soy harvest than in 2011 due to weather conditions. Finally, we have revised down growth forecasts for Mexico, Peru and Uruguay by around half a percentage point in response to lower global growth, particularly in developed countries.

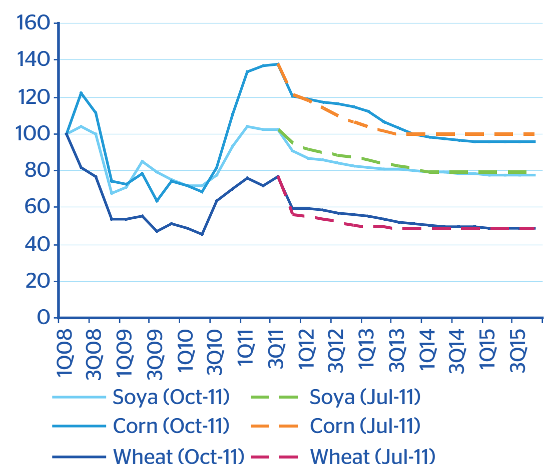
In addition, our current base scenario has revised down commodity price forecasts, with a significant correction in the price of copper. As we explained in the previous report, high commodity prices have provided countries in the region with significant gains in terms of trade. This has improved their current account and fiscal balances, despite the growing gap between domestic demand and GDP (measured at constant prices).

Chart 7
Copper and oil price forecasts (2008=100)



Source: BBVA Research

Chart 8
Soya, corn and wheat price forecasts (2008=100)



Source: BBVA Research

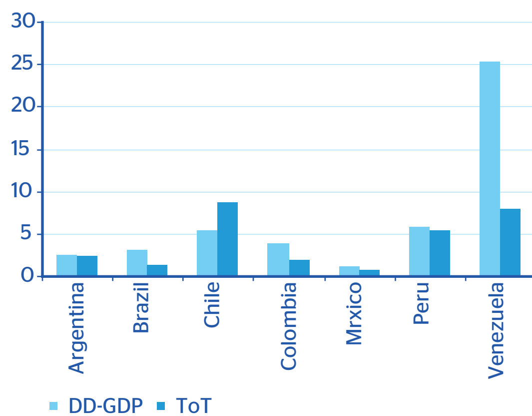
Warning! Inflation is not dead

The slowdown suggested by the base scenario should be accompanied by an adjustment in domestic demand. If this adjustment is not big enough or too late, there will be pressure on imports and prices. In fact, inflation is above the official target (Brazil, Uruguay, Peru) or significantly above historical levels (Panama) in a number of countries. In normal circumstances their central banks, and even governments, would be applying checks to reduce the pressure from domestic demand. Increased global uncertainty should result in an endogenous correction to private spending, but until now there is little evidence of this happening (except in the case of Brazil). There is therefore still a risk of inflation, which could be partly fuelled by depreciation associated with falls in the terms of trade.

The latest inflation figures from Chile, Colombia, Mexico and Peru provided upside surprises. In some cases these changes can be explained by seasonal factors, but the question remains whether these figures are in fact revealing what is a more general trend. One useful indicator worth analyzing in this context is the gap between domestic demand and GDP, measured at constant prices.

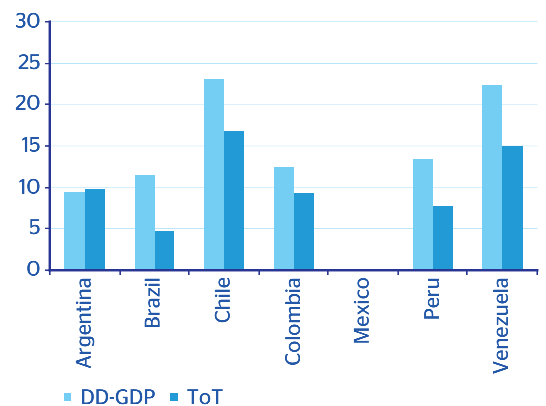
We have taken the year 2005 as a reference for this calculation because GDP levels were then very close to potential in most countries in the region. If we compare the gaps between domestic demand and GDP in 2007 and 2011, we see that the gap between domestic demand and GDP has increased in all countries except Mexico. Although much of this increase has been financed by improved terms of trade in 2011, there is an excess in all the countries except for Mexico. This situation persists in our forecast for 2012.

Chart 9
Gap between domestic demand and GDP and terms of trade (% GDP) in 2007



Source: BBVA Research

Chart 10
Gap between domestic demand and GDP and terms of trade (% GDP) in 2011



Source: BBVA Research

This analysis shows to important things: first, the excess of domestic demand with respect to GDP is now greater than in 2008; and second, a fall in export prices would leave all those countries in which domestic demand does not adjust endogenously to this fall extremely vulnerable. In 2008-09 there was an overreaction in the private sector and slumps in consumption and investment eliminated excess demand. The result was intervention by the authorities to revitalize demand. In contrast, this has not occurred in the current situation of rising risk aversion at a global level. In this context, additional falls in terms of trade would be accompanied by a deterioration in the current account and pressure on currencies.

In an environment of considerable uncertainty, it appears highly advisable for these countries to focus their efforts on reducing their exposure to the terms of trade by cutting excess domestic demand.

4. If things get bad, most countries will hold out

If the European situation is not resolved soon and the high risk premiums end up pushing Europe - and finally the United States - into recession, this would have significant effects on emerging countries. We consider that in this case external financing would become more limited and more expensive. This would delay the return of Argentina to the international financial markets and make the financing strategy of PDVSA and Venezuela's current account more difficult. However, we do not believe that it would lead to a closure of credit facilities or a general collapse in finance, so the effects on the rest of the region would be limited.

A second channel of contagion is foreign trade. This works in a number of ways. In the case of countries that are closely integrated in the chains of production of large partners such as Mexico with the United States, or to a lesser extent, Argentina and Paraguay with Brazil, the fall in volumes exported would have a direct impact on industrial activity and employment. But in most countries in South America, the biggest impact would be from the fall in prices of exported commodities, with a direct effect on the current account and fiscal balances.

Finally, we have the special case of Panama, where the volume of traffic through the Panama Canal has a direct and major impact on the current account and fiscal balance. Panama also starts with a high inflation rate and current account deficit. This situation implies it is highly vulnerable to a deterioration in the global environment as described above.

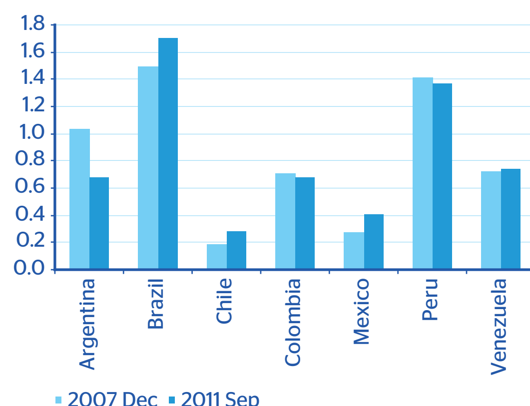
Compared with the position in 2007, we can see that most countries in the region are better off, both in terms of foreign accounts and fiscal spending. In addition, the authorities have accumulated reserves in both local and foreign currencies. They have also learned from the experience of the last crisis, which should help them choose the most effective instruments to use and react quicker. In fact, most countries have a greater capacity to finance their exports through their reserves, except for the case of Argentina, where this indicator is down. Gross public debt as forecast for 2011 is also below the level of 2007, with the exception of Chile, where public debt is still below 10% of GDP. Nevertheless, some countries have public debt levels that reduce their room for maneuver in a new crisis that is marked precisely by aversion to increasing exposure to sovereign risk.

The private sector also has more liquidity now and is better capitalized in nearly all the countries compared with 2008, and with lower currency mismatches in its balance sheets. What is more, we believe that the episodes of foreign-exchange tension in October and November must have convinced even the most unwilling on the advisability of closing open foreign-currency positions.

Finally, we also believe that with the experience of 2008-09 behind it, the private sector would not be affected by fear as much as it was then if there were to be a significant deterioration of the situation in Europe. As a result, the contraction of domestic demand would be much more limited.

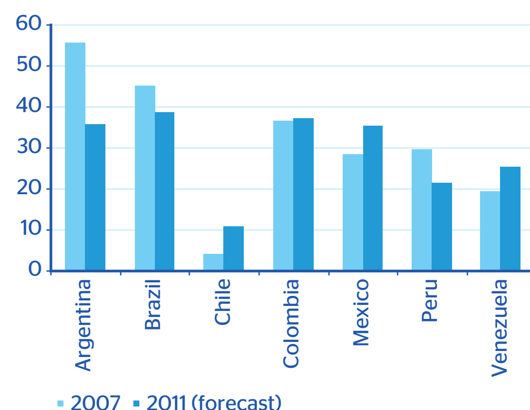
All these factors suggest that adjustments would be much more limited than in 2008 and the region as a whole would continue to grow, although at lower rates (between 1 and 2 pp less than in our forecast). The specter of a recession only hangs over those countries that start with significant initial imbalances, and are more vulnerable due to a combination of high levels of dependence on foreign trade and restricted access to external finance.

Chart 11
International reserves over imports



Source: Haver

Chart 12
Gross fiscal debt (% GDP)



Source: BBVA Research

5. Tables

Table 1
GDP (y/y %)

	2010	2011*	2012*
Argentina	8.7	8.7	4.1
Brazil	7.5	3.2	3.6
Chile	5.2	6.5	4.5
Colombia	4.3	5.0	5.4
Mexico	5.4	3.8	3.3
Panama	7.5	9.1	6.7
Paraguay	15.3	5.5	3.0
Peru	8.8	6.3	5.0
Uruguay	8.5	5.8	4.0
Venezuela	-1.5	2.8	2.0
Latin America	**6.3**	**4.4**	**3.7**

*Forecast
Source: BBVA Research

Table 2
Inflation CPI (end of year %)

	2010	2011*	2012*
Brazil	5.0	6.6	5.6
Chile	1.4	3.2	2.9
Colombia	2.3	3.4	3.3
Mexico	4.2	3.4	3.5
Panama	3.5	5.6	5.0
Paraguay	4.6	9.3	10.7
Peru	1.5	3.3	3.1
Uruguay	6.7	7.8	5.9
Venezuela	29.1	27.5	26.5
Latin America	**6.4**	**6.8**	**6.5**

*Forecast
Source: BBVA Research

Table 3

Exchange rate (against USD, end of year)

	2010	2011*	2012*
Argentina	3.9	4.1	4.8
Brazil	1.8	1.7	1.7
Chile	510.2	482.2	504.3
Colombia	1.899.0	1.834.1	1.790.8
Mexico	12.6	12.0	12.3
Panama	1.0	1.0	1.0
Paraguay	4.739.5	4.149.1	4.071.9
Peru	2.8	2.8	2.7
Uruguay	20.0	19.0	19.5

*Forecast
Source: BBVA Research

Table 4

Interest rate (end of year)

	2010	2011*	2012*
Argentina	10.1	12.7	16.9
Brazil	10.0	11.7	10.5
Chile	1.5	4.8	5.3
Colombia	3.1	4.1	5.3
Mexico	4.5	4.5	4.5
Panama	2.7	2.2	2.8
Paraguay	0.0	0.0	0.0
Peru	2.1	4.0	4.3
Uruguay	6.3	7.6	8.0
Venezuela	14.5	14.5	14.5

*Forecast
Source: BBVA Research

Table 5

Current account (% GDP)

	2010	2011*	2012*
Argentina	0.8	0.0	-0.5
Brazil	-2.3	-2.1	-2.8
Chile	1.9	-1.3	-2.8
Colombia	-3.1	-2.8	-3.6
Mexico	-0.5	-0.8	-1.1
Panama	-11.0	-12.2	-10.9
Paraguay	-4.5	-6.4	-3.6
Peru	-1.5	-2.8	-3.0
Uruguay	-0.4	-0.6	-0.7
Venezuela	6.1	10.3	6.7
Latin America	**-0.8**	**-0.8**	**-1.6**

*Forecast
Source: BBVA Research.

Table 6
Fiscal balance (% GDP)

	2010	2011*	2012*
Argentina	0.2	-1.3	-1.8
Brazil	-2.5	-2.2	-2.2
Chile	-0.4	0.5	-0.3
Colombia	-3.8	-3.6	-3.5
Mexico	-3.4	-3.0	-3.0
Panama	-1.9	-1.6	-1.0
Paraguay	1.4	0.8	0.6
Peru	-0.3	0.5	0.4
Uruguay	-1.1	-1.7	-1.6
Venezuela	-3.1	-4.3	-6.3
Latin America	**-2.4**	**-2.3**	**-2.5**

*Forecast
Source: BBVA Research.

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