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Economic Outlook

Latam

Third Quarter 2013
Economic Analysis

- **The global economy will grow by 3.1% in 2013 and 3.8% in 2014.** However, the slowdown in emerging economies and the uncertainty regarding the withdrawal of monetary stimuli in the USA will be a source of stress to financial markets in the region.
- **Growth forecasts in Latam have been revised downwards to 2.7% in 2013 and 3.2% in 2014** on less favorable external outlook.
- **Foreign and fiscal accounts have deteriorated due to the external outlook and a less buoyant domestic tone.** Even so, both imbalances remain at manageable levels.
- **Foreign and domestic weakness, and subdued inflation, will tend to support a bias towards laxer monetary policy, except in Brazil.** The outlook of withdrawal of monetary stimuli in the US will favor a trend towards devaluation in exchange rates partly contained by central banks.

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Closing date: August 6, 2013

1. Summary

The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions. This less favorable global economic scenario has led us to a revise downwards our global growth estimates for 2013 to 3.1%, 0.2 points down on three months ago. The growth outlook for 2014 remains unchanged, at 3.8%. This deterioration has been the result of i) a sharper slowdown than expected in emerging markets (among them China), which is reflected in a downward revision of its growth forecasts, compared with basically unchanged forecasts in developed economies; and ii) tougher financial conditions at global level, as a result of market reaction to the communication of details of the Fed's plans for a gradual reduction in its monetary stimuli.

The international financial outlook became less benign for Latin America in recent months. Latin America, together with other emerging markets, has been one of the hardest hit regions in this new setting, with -term capital outflows, increases in sovereign spreads, stock market falls and devaluations in exchange rates. On top of which we also have to add an adjustment in the prices of some of the most important export commodities. Nevertheless, it is important to note that in Brazil, these adjustments began to occur at the start of the year, due to the worse cyclical situation and the country's higher inflation.

Looking ahead, while this market volatility is likely to persist, there are some grounds for optimism. There are three reasons for this: (i) we expect to see a slowing or reversal of capital outflows (already apparent in recent data); (ii) investors taking part in the capital outflows have a short term profile, compared with institutional investors, which would have adjusted their portfolios less; and (iii) if there is less liquidity by central banks in developed countries it will only be because the cycle will begin to improve in those countries, and, with it, the global economy.

Over the last three months, domestic demand has also slowed in the region, even though it continued to be the main factor underpinning growth. This is evidenced not only in the worse confidence indicators in most of the countries, but also in indirect indicators of domestic demand, such as retail sales or imports, which have weakened in recent months.

Outlook for foreign balances in South America has worsened due to the correction in raw materials prices and weak foreign demand. Foreign balances are still sustainable, as they are fully or partly financed by long-term flows, such as foreign direct investment. Furthermore, in most of the countries the external deterioration is more the result of greater investment rather than consumption (public or private), which helps to assure sustainability further down the line. However, the increase in deficits makes the region more vulnerable to changes of sentiment in international markets or a substantial reduction in the prices of the main export commodities.

The weakness of the foreign sector and the slowdown in domestic demand are to blame for the fall in Latin American growth forecasts. The region is expected to grow by 2.7% in 2013 and to increase by 3.2% in 2014. However, we expect the trend of growth recovery to continue in the first two quarters of 2013, albeit at a lower than expected pace. Growth forecasts for individual countries in the region should vary considerably: The countries with strongest growth in 2013 will be Paraguay (11.6%), Panama (7.5%), Peru (5.8%), Chile (4.2%) and Colombia (4.1%). Growth is expected to remain relatively weak in Brazil, due to cyclical and structural factors. Therefore, excluding Brazil, the average growth for Latin America would be 3.1%, and 3.5% in 2013 and 2014, closer to the region's potential growth of around 4.0%.

Sluggish foreign and domestic demand should also prompt deterioration in fiscal balances in the region. While in certain countries such as Peru or Colombia, the more expansive fiscal policy will play a role in deteriorating public balances. In Brazil, forecasts of higher interest rates would also end up affecting the fiscal balance. Nevertheless, fiscal balances are still very manageable in most of the countries, and certain countries such as Chile and Peru have a very solid fiscal position with ample leeway for countercyclical policies, if needed.

Inflation should remain under control in the region, in line with the central banks' inflation targets, except in Uruguay, where it should remain above the target during next year. In Brazil's case, even if inflation probably hit a high in June and were to continue to fall, inflationary pressures will continue, partly also because of the heavy devaluation in the exchange rate, which will require greater caution by the Central Bank.

In a less favorable foreign outlook, with less support from the domestic demand and inflation under control, central banks use a laxer bias, except in Brazil, where interest rate hikes will continue for a few more months in view of the looser control of inflation and the more devalued currency. Central banks of countries with inflation targets should be committed to some monetary easing (or, at least, a bias towards easing), but they will have different ways of addressing the dilemma between less dynamic domestic demand and not driving away capital inflows with lower interest rates. At one extreme, Chile would opt for a more orthodox reduction in interest rates, while, at the other extreme, Peru would also choose a laxer monetary policy, but first it would try to reduce bank reserves. While on the other hand, the inflation pressures in Brazil mean that further increases in official interest rates will be inevitable until October 2013.

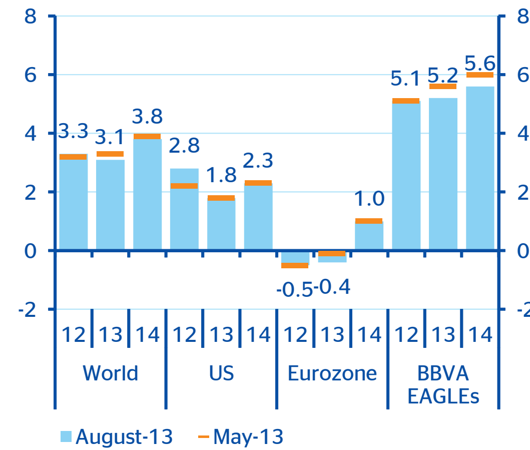
The devaluation in the exchange rate will also help to create laxer monetary conditions in the region. Market outlook for an earlier than expected withdrawal of monetary stimuli in the US, together with a heavier slowdown in China, triggered more or less widespread devaluation in exchange rates in the region. Looking ahead, inasmuch as there is a certain degree of optimism about the pattern of capital flows towards Latin America, we expect to see slight trends towards devaluation in 2013 and 2014, shaped by (i) the trend towards the increase in long term interest rates in the US; (ii) the greater global aversion to risk; and (iii) worse foreign balances. The main exception will be Mexico, due to its having a lower initial degree of appreciation than other currencies in the region, and the positive impact of the recovery in growth in the US expected in coming quarters.

2. Global environment: deceleration in China and uncertainty about the withdrawal of the stimuli in the USA

The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions

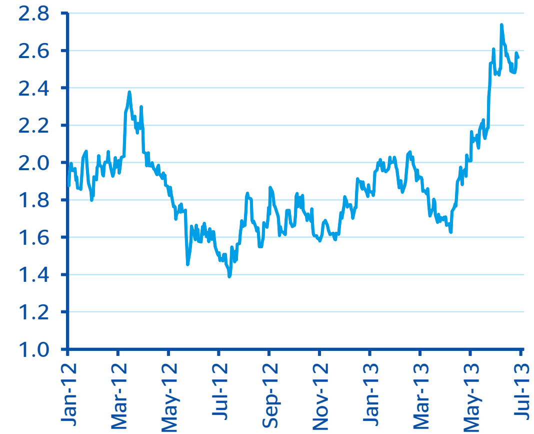
The global economic situation is less favorable than it was three months ago, when we issued our previous growth forecasts. We have therefore revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 pp below the figure we forecast in the last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, the emerging markets are experiencing a sharper slowdown than expected, which is reflected in major downwards revision in its growth forecasts (Chart 1); above all, they include more moderate growth in China, which has a global impact beyond Asia, for example on the South American economies. Second, there has been an unexpected event, at least at the time when it occurred: the tightening of financial conditions at global level. This increased stress has basically been the result of market reaction to the communication of the details given by the Fed of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

Chart 1
GDP growth by region



BBVA EAGLEs: Emerging and Growth-Leading Economies (China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan).
Source: Haver Analytics and BBVA Research

Chart 2
Interest rates on 10-year U.S. public debt (%)



Source: Bloomberg and BBVA Research

Making the market used to less liquidity: the greatest impact will be on emerging economies with larger short-term financing needs

Although the reasons for this may be varied, most of the shift in financing conditions at global level took place in mid-May, with the details announced by the Fed of its plans to limit and then put an end to its program of monetary expansion. The Fed has also reaffirmed its commitment to maintaining interest rates very low for an extended period and, perhaps more importantly, the whole process is conditional on recovery of the economy, i.e. on the economy continuing at "cruising speed".

However, market reaction to this plan (even after being clarified in all its details) has been stronger than probably desired by the Fed. As can be seen in Chart 2, long-term interest rates increased by more than 100 basis points, while futures now discount the first rise in rates for the start of 2015, practically one year before expected two months ago. In our opinion, what is being seen on the financial markets is probably partly an over-reaction, as shown by recent downward moves in both long-term rates and expectations of shorter-term rates. Even so, the implementation of the mechanism has generated a process of restructuring of portfolios in the face of the end of abundant liquidity, and thus of extra demand for bonds that kept interest rates at exceptionally low levels. In our opinion, therefore, we are being faced with the start of a cycle of normalization of financial conditions, with higher interest rates and lower demand for risk assets.

Emerging markets have been the most affected by the recent upsurge of financial stress. The current situation has clearly reversed the positive funding conditions prevailing previously, with capital outflows from emerging markets (Chart 3). As well as falls in the stock markets and bond prices, there has also been a general depreciation in their currencies.

There are various factors behind these major capital outflows. As well as an immediate anticipation of the new global liquidity scenario through a restructuring of portfolios, the cyclical weakness of some large emerging markets and the growing risk of a steeper slowdown in China are factors pointing in the same direction. Moreover, monetary expansion in Japan has done little to generate capital flows to emerging markets in search of higher returns.

Overall, however, although the rate of capital outflow from emerging markets is very high, there are reasons for optimism. First, the most recent data on capital flows show more moderate

outflows over recent weeks. Second, the profile of investors who have headed up the outflows is of a shorter-term investment horizon, compared with institutional investors with longer-term horizons. Finally, the portfolio reorganization has to take into account that if we are moving towards an environment of lower central-bank support for liquidity, this is because the global economic cycle is tending to improve. In addition, we should not forget the fundamentals that emerging markets have constructed in terms of their policy certainty and comparative advantages against the most developed countries with respect to their solvency ratios.

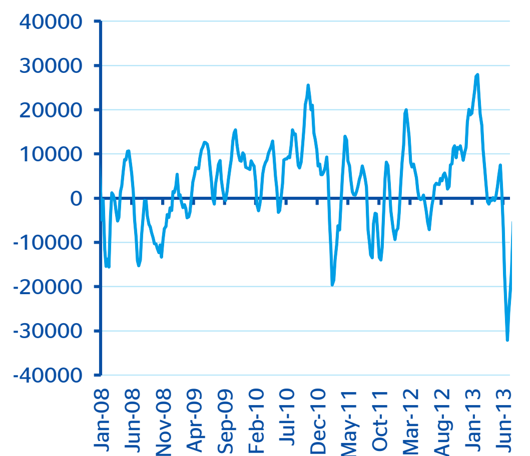
Slowdown in China: sluggish external demand and steps to limit both indebtedness and the scope of shadow banking

The recent tightening of the Chinese interbank lending market is an example of the side effects of the authorities' efforts to limit financial risks associated with rapid credit growth in the official banking sector, and the credit generated within the so-called shadow banking, which is unregulated. Over the last year, the authorities have adopted a variety of measures aimed at restricting the growth of credit and curtailing shadow banking activities.

The baseline scenario continues to be one of a continued moderate slowdown (Chart 4). The measures taken to limit credit growth will act as a constraint on the room for stimulus measures to support growth. In addition, the Chinese authorities appear more comfortable with the current rates of GDP growth as they focus more on the quality of growth and medium-term sustainability. Even so, we still consider that the government has room for maneuver if the growth slips below the official targets. Moreover, we believe the authorities have resources to prevent financial risks from generating a hard landing in the near term.

Chart 3

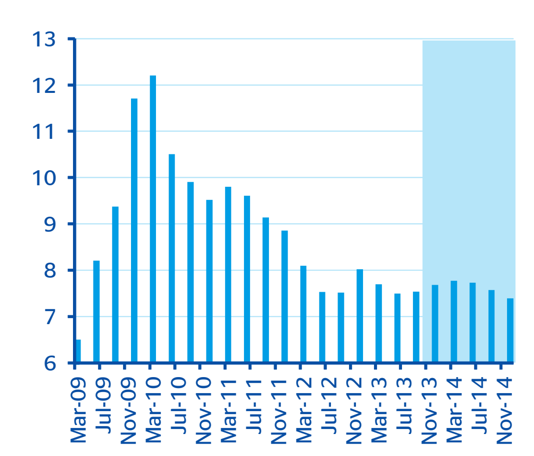
Net flows to EM bond and equity funds (USD million, four-week moving average)



Source: Bloomberg, BBVA Research

Chart 4

China GDP growth (% YoY)



Source: Haver, BBVA Research

More diversified global risk events, but with lower potential impact

This highly likely global baseline scenario still has some uncertainty ranges somewhat more tilted to the downside than to the upside, but with no high probability of disruptive events that would prevent an outlook of, at least, sustained global growth in 2013 and 2014 near 2012 levels. This diagnosis is a sign of a return to normality in the economic landscape.

The downside risks that could once again delay global recovery (relatively less likely than on other occasions) would basically be the persistence of events that complicated the outlook last quarter to the point of generating additional tensions in the conditions for accessing finance

and a decline in the confidence of the economic agents. This could be: i) a new, intense and continued fall in the price of risk-less assets like the U.S. Treasury bond as a result of a market less compliant with the wishes of the Federal Reserve; ii) a resurgence of doubts about the progress towards the Banking Union and the "exceptional nature" of Greece; and iii) a sharper downturn in the Chinese economy, amid the necessary process of economic rebalancing and adjustment of the size of its financial system. Although it is true that the authorities have room for maneuver to prevent "tail" events, the process of change faced by China is notable and requires extensive, ongoing and decisive reforms.

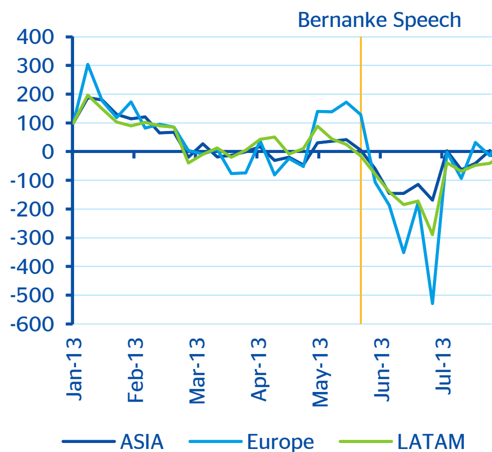
3. Latin America held back by volatility on financial markets and more sluggish domestic demand

The international financial setting became less benign for Latin America over the last three months

As we have stated in the first section, the two events which shaped the international scenario in the last quarter were, on the one hand, the outlook for withdrawal of monetary stimuli by the Federal Reserve in the US, and, on the other hand, the slowing of economic activity in several emerging markets, particularly in China, which are critical for the region. Due to these events, volatility on the international financial markets rose significantly from the end of May onwards.

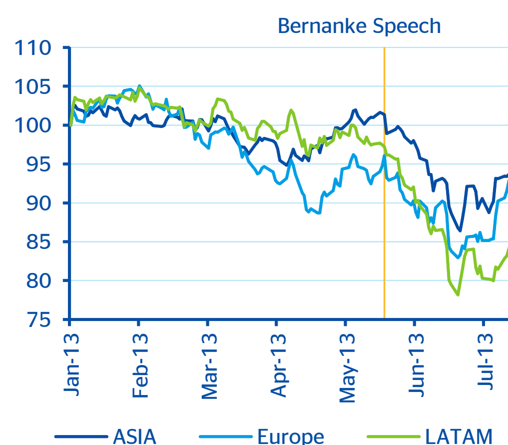
Latin America, like other emerging markets, has been one of the hardest hit in this new environment. This is not particularly surprising, given that Latin America, in particular, and emerging markets, generally speaking, benefited most from the increase in liquidity and the expansion in demand by countries such as China in recent years. Indeed, ever since the Chairman of the Federal Reserve Ben Bernanke's speech regarding the ending of monetary stimuli in the United States, capital outflows, stock market falls, increases in long term interest rates and devaluation of exchange rates have occurred in all emerging regions (see Charts 5 to 8).

Chart 5
Capital flows in emerging markets (index January 2013 = 100)



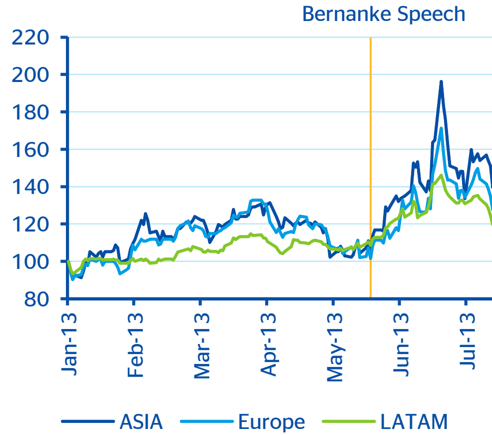
Source: BBVA Research and EPFR

Chart 6
Performance of stock mark indices in emerging markets (MSCI, index January 2013 = 100)



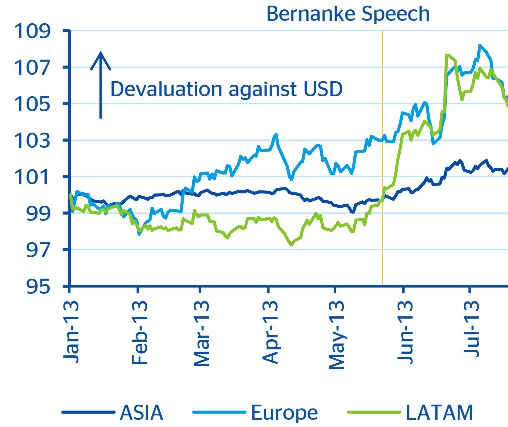
Source: BBVA Research and Haver Analytics

Chart 7
Sovereign spreads in emerging markets (EMBI) (index January 2013=100)



Source: BBVA Research and Haver Analytics

Chart 8
Exchange rate vs. USD in emerging markets (index January 2013=100)

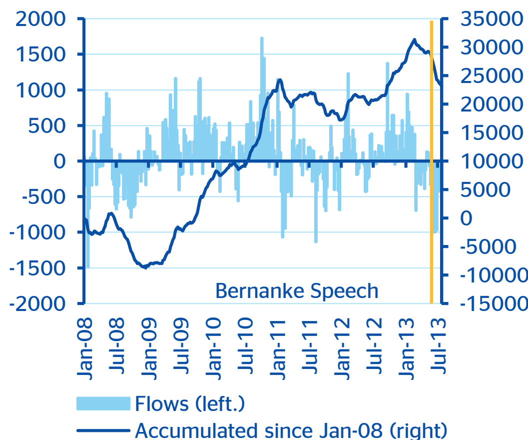


Source: BBVA Research and Haver Analytics

Even though the outlook for the withdrawal of stimuli by the Federal Reserve and concerns about slowdown in China have had an impact on virtually all Latin American countries, the intensity of that impact has varied considerably. Specifically, Brazilian financial markets were harder hit than other Latin American countries' markets. This is due not only to the greater liquidity and openness of Brazil's financial markets, but also, and more importantly, the result of the worse cyclical situation experienced in Brazil due to the heavy slowdown in growth and the ensuing rise in inflation.

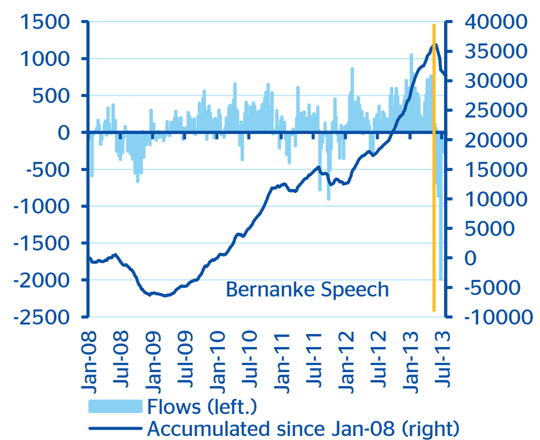
In Brazil's case, capital outflows began before and grew more pronounced after the aforementioned speech by Ben Bernanke (see Chart 9), even though the government has withdrawn many of the barriers to international capital introduced in previous years. In the other countries included in international financial markets (Chile, Colombia, Mexico and Peru), the outflows only began after May 22 (see Chart 10).

Chart 9
Capital flows in Brazil (millions of dollars)



Source: EPFR and BBVA Research

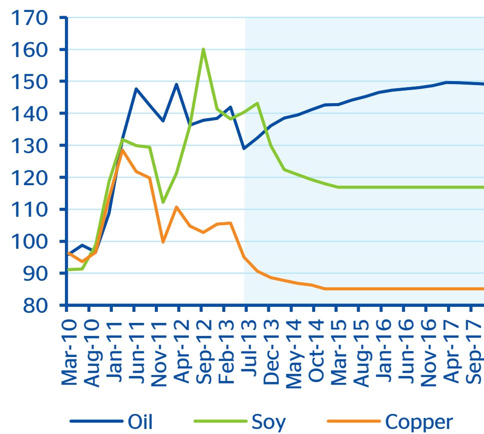
Chart 10
Capital flows in the rest of Latin America (millions of dollars)



Source: EPFR and BBVA Research

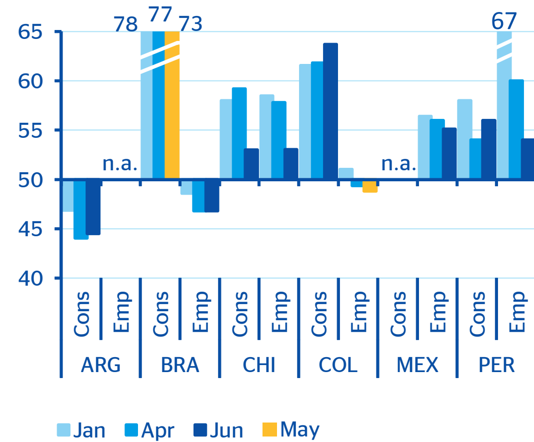
Prices of the main export commodities of Latin American countries have also been affected by the financial turmoil, although with varying degrees of intensity and length (Chart 11 and 13). More in the case of copper (tied to the slowdown in China), less in the case of oil (underpinned on the supply side by OPEC and geo-political tensions in production areas) and in soy (where supply components kept the price above our estimates until very recently).

Chart 11
Forecasts for commodity prices (average index 2010=100)



Source: BBVA Research and Haver Analytics

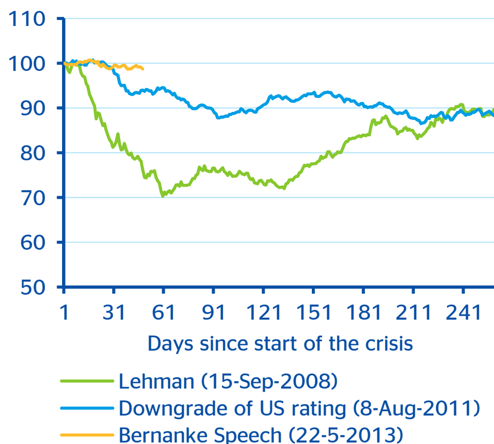
Chart 12
Confidence indicators*



* Values of over 50 indicate optimism.
Source: National statistics and BBVA Research

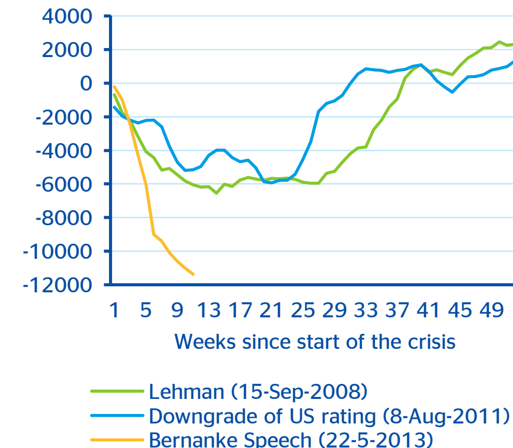
However, if we compare this situation with former episodes of increase in volatility we see that this is an intermediate episode between the tensions observed immediately after the collapse of Lehman Brothers and the volatility episode of August 2011, following Standard and Poors' downgrade of the US credit rating (see Charts 13 to 16).

Chart 13
Changes in commodity prices during episodes of high volatility (index start of volatility=100)



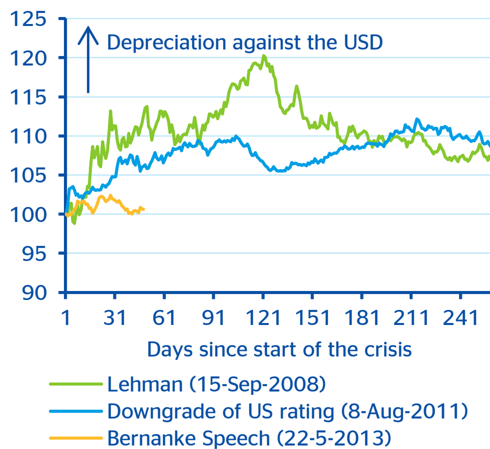
Source: BBVA Research and Haver Analytics

Chart 14
Changes of capital flows to Latin America in episodes of high volatility (aggregate against start of volatility, millions of USD)



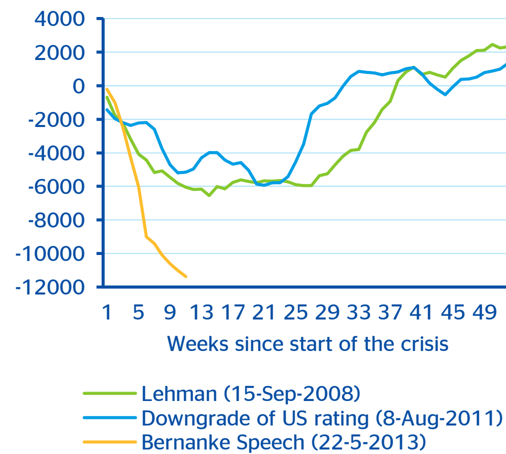
Source: EPFR and BBVA Research

Chart 15
Changes in Latam exchange rates during episodes of high volatility (index start of volatility=100)



Source: BBVA Research and Haver Analytics

Chart 16
Changes in stock market indices in Latam during episodes of high volatility (index start of volatility=100)



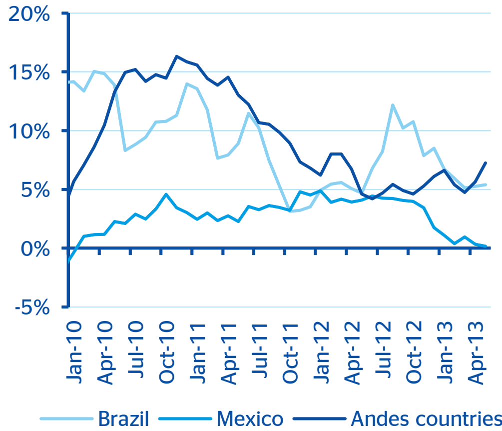
Source: BBVA Research and Haver Analytics

We expect that financial markets will continue being volatile in the near future insofar as the withdrawal of monetary stimuli by the Federal Reserve will strongly depend on the data published on the pace of recovery in the US. There is also likely to be a sustained increase in long term interest rates in the US, so that capital inflows would not revive significantly against recent levels. There are, however, some grounds for optimism. We expect that capital outflows will slow or even be reversed in coming months (this hypothesis is supported by recent data). Second, the profile of investors responsible for the outflows is of a shorter-term investment horizon, compared with institutional investors with longer-term horizons. Lastly, the portfolio reorganization in recent weeks has to take into account that if we are moving towards an environment of lower central-bank support for liquidity, this is because the global economic cycle is tending to improve. We should also not forget the fundamentals that emerging markets have constructed in terms of their policy certainty and comparative advantages against the most developed countries with respect to their solvency ratios. Furthermore, foreign direct investment (FDI) flows to the region are expected to keep relatively stable at relatively high levels, although they might be affected by higher international financing costs. Peru is a good example: although FDI investments remain at high levels and are expected to remain so in the mid-term, there are some uncertainties about some projects from 2016 on.

Domestic demand has slowed in the region, although it continued to be the main factor underpinning growth

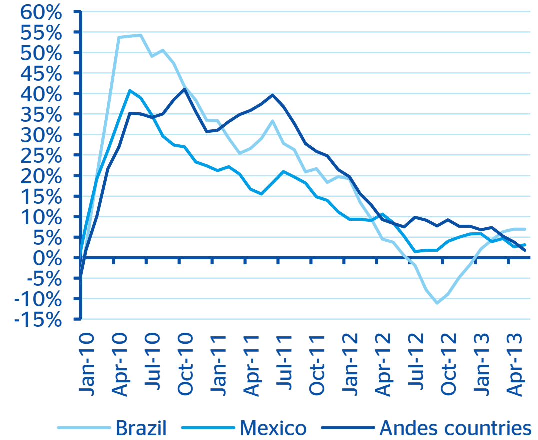
Latin American countries have also experienced deterioration in confidence indicators in recent months, both by consumers and by companies (see Chart 12). In companies, this reflects a slowdown in export markets (at least in the cases of Mexico, Brazil, Colombia and Peru), but also the impact of volatility on foreign financial markets. On the consumption side, this shows, in some cases, a fall in disposable income due to inflation (this is very likely the case in Brazil) and a slowdown in the labor market (such as in Mexico, Colombia and also in Brazil).

Chart 17
Retail sales
(y/y %, moving average for the last three months)



Source: Haver Analytics and BBVA Research

Chart 18
Imports
(y/y %, moving average for the last three months)

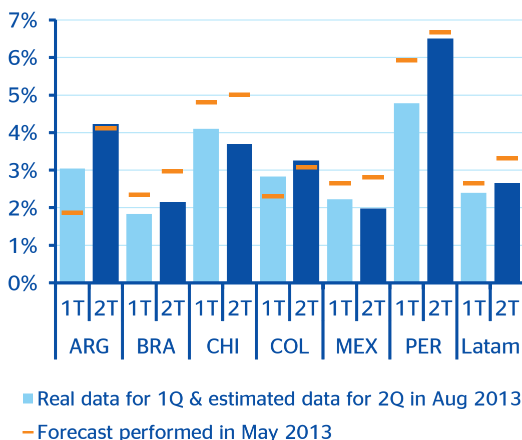


Source: Haver Analytics and BBVA Research

The slowing in the domestic market is not only evident in confidence indicators, but also in retail sales and imports: both indicators show a marked downturn, in both Pacific Alliance countries (Mexico, Colombia, Peru and Chile), and in Brazil (see Charts 17 and 18).

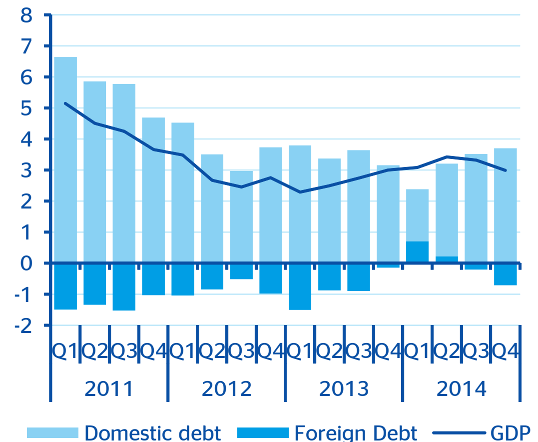
Thus, in most countries growth in GDP has been lower than expected, except for Argentina and Colombia (see Chart 19). Lower than expected growth is due to a sluggish pace of exports (particularly in Peru and Mexico, but also in Chile), a heavy slowdown in private consumption, in Brazil, and less fiscal drive in the case of Mexico. Even so, domestic demand remained as the main factor underpinning growth in the region (see Chart 20).

Chart 19
Surprises in activity forecasts in the first and second quarter of 2013



Source: National governments and BBVA Research

Chart 20
Latam: year-on-year growth in GDP (y/y %)



Source: National governments and BBVA Research

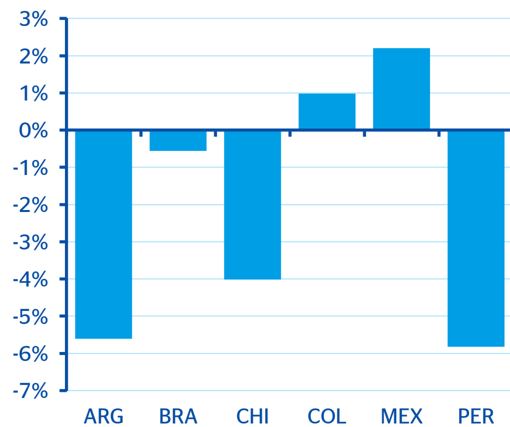
4. The foreign balance, which is crucial for Latam to resist, has deteriorated in most countries

Worse outlook for foreign balances in South America due to the correction in commodity prices and weak foreign demand

Since the start of the year, the current account deficit in annual terms and as a proportion of GDP, has increased sharply in Peru (1 p.p., to 4.6% of GDP), Chile (1 p.p., to 4.0%) and Brazil (0.8 p.p, to 3.2%), and in not such a pronounced way in countries such as Colombia (0.2 p.p., to 3.1%). In only a few Latin American countries does the foreign deficit remain low and without signs of significant deterioration. This is the situation in Paraguay and also Mexico, where the current account deficit is relatively low – around 1.2% of GDP – and there are no signs of significant deterioration.

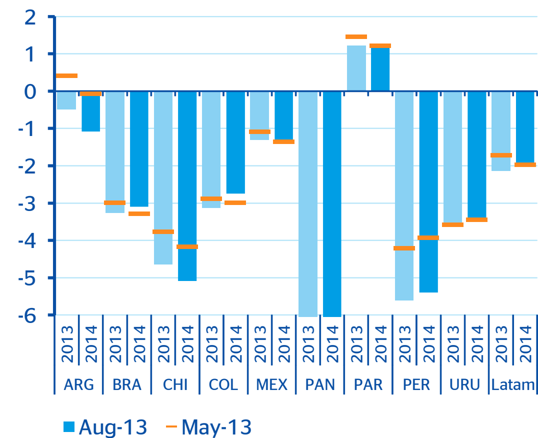
The deterioration seen over the year so far in many Latin American countries, and what are expected to be less favorable terms of trade in the future, together with weaker export volumes (both factors relating to the slowdown in growth in the structural adjustment towards an economy more dependent on private consumption in China) have created outlook for higher current account deficits than we had previously expected (see Charts 21 and 22).

Chart 21
Terms of trade
(change against December 2012*)



* March: Argentina and Chile; May: Brazil, Mexico and Peru; June: Colombia.
Source: Haver Analytics and BBVA Research

Chart 22
Current account (% GDP)



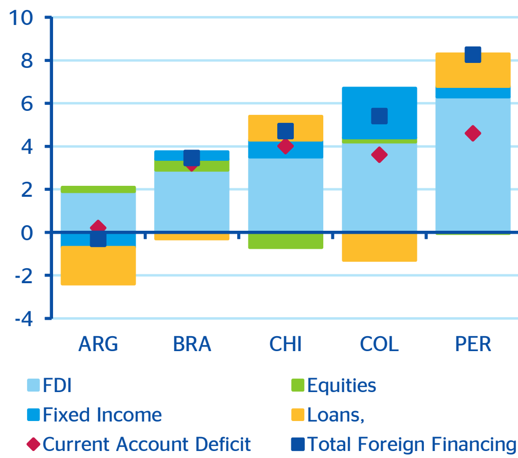
Source: National statistics and BBVA Research

Foreign balances in Latam are still sustainable, but there is a higher level of vulnerability to a change of sentiment in international markets

Generally speaking, foreign deficits are still mainly financed by long-term flows, particularly foreign direct investment (FDI), mitigating concerns about this growing imbalance (see Chart 23). In Colombia and Peru, FDI flows are still higher than the magnitude of current account deficits, and in Brazil and Chile they are slightly below them.

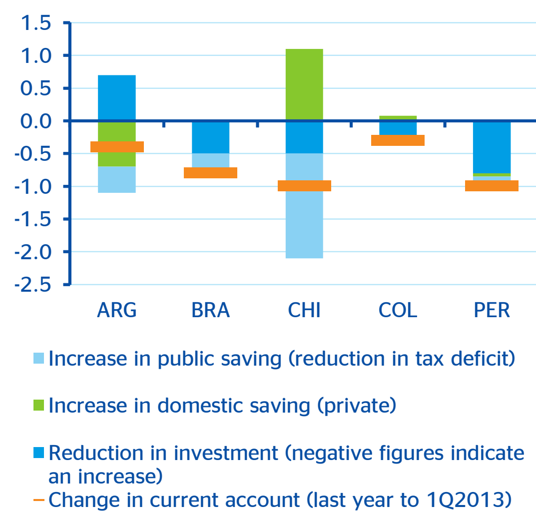
Another factor which justifies the view that current deficits are sustainable is that the deficits have increased more due to an increase in investment, than due to a fall in public or private saving (see Chart 24). In certain countries in particular, such as Chile and especially Peru, the increase in foreign deficits is associated with investment projects in export sectors which would help to reduce the deficits when they begin to occur.

Chart 23
Financing of foreign deficits in South America (last 12 months until June 2013)



Source: National governments and BBVA Research

Chart 24
South America: breakdown of increase in current account deficit in the last year until 1Q2013



Source: National governments and BBVA Research

Nevertheless, it is important to bear in mind that in some countries, the financing of hefty foreign deficits can be jeopardized if short term capital inflows are halted or continue to deteriorate, or in the event that the terms of trade continued to worsen, which could prompt a higher devaluation of the exchange rate and less buoyancy in domestic demand (see Box 1 "Sensitivity of growth and foreign balances to adverse scenarios in commodity prices" for more details of this subject). To a certain extent, this is the situation presently occurring in Brazil: the upturn in the current account deficit and the outflow of capitals have helped to weaken the Brazilian Real, stoking fears of inflation, requiring an increase in official interest rates, which will lead to an adjustment in domestic demand and, lastly, which will enable the current account deficit to slow in 2014.

In any event, indicators of the region's external vulnerability are still good. International reserves remain at high levels, comfortably covering short term debt (the short term reserves / debt ratio varies from 2.4 in Chile to 11.0 in Brazil), while gross foreign debt still stands at relatively low levels (from 19% of GP in Brazil to 43% in Chile).

Box 1. How sensitive are Brazil and the Andean economies to a correction in commodity prices?

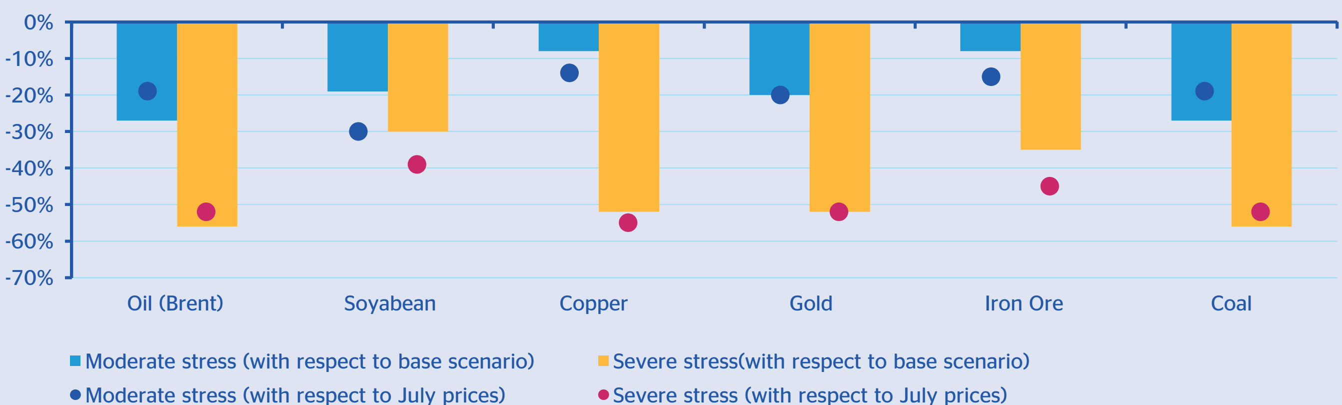
In recent years, Latin American countries have gone through a process of institutional and economic progress leaving them better placed to deal with internal and external shocks. The behavior of the region's economies after the collapse of Lehman Brothers supports this conclusion.

However, the significant weight of commodities in their productive structure and, above all, in their exports, remains a potential source of stress for countries in the region. In this regard, the recent slowdown in growth in Brazil and the Andean countries (i.e. Chile, Colombia and Peru) and the upturn in their current-account deficit could also be related to the recent slowdown in many commodity prices and in growth in China (see the discussion of this subject in our 3Q13 Latin America Economic Outlook).

Although our baseline scenario does not provide for a strong downward correction in commodity prices and we assign a low probability to such an event, in this box we will analyze the impact that a negative shock in commodity prices would have on current account balances and, above all, on economic growth in Chile, Colombia, Peru and Brazil. More specifically, we will quantify the impact of two commodity price scenarios on external deficit and GDP: i) a moderate stress scenario of a permanent fall in commodity prices of between 15% and 30% against the current price, starting in January 2014, to reach a level similar to the average for the period 2006-2012; ii) a severe stress scenario in which prices fall between 40% and 55%, starting in 2014, to reach similar levels in general to those of late 2008, right after the collapse of Lehman Brothers[1,2].

Chart 16 illustrates precisely the price assumptions used in our exercise.

Chart 25
Commodity price falls in the two stress scenarios (%)



Source: BBVA Research

Approximately 50% of exports from Chile and Peru will be affected by the price falls included in our exercise. In the case of Brazil, this ratio is slightly lower (about 45%), and in Colombia it is 65%[3].

The shocks impact on the Andean and Brazilian economies through various channels. Lower prices would lead to a deterioration in the terms of trade and would have a direct negative impact on exports. They would reduce the strength of sectors producing commodities, as well as sectors that depend directly or indirectly on them, due to the reduction of revenues and impaired financing conditions. This would lead to more moderate private consumption and investment (caused by, among other things, a slowdown in the labor market). At the same time, it would generate a fall in fiscal revenue, which would make it difficult to increase public spending. Deterioration in household and business confidence in the economy would certainly accentuate these negative impacts on growth.

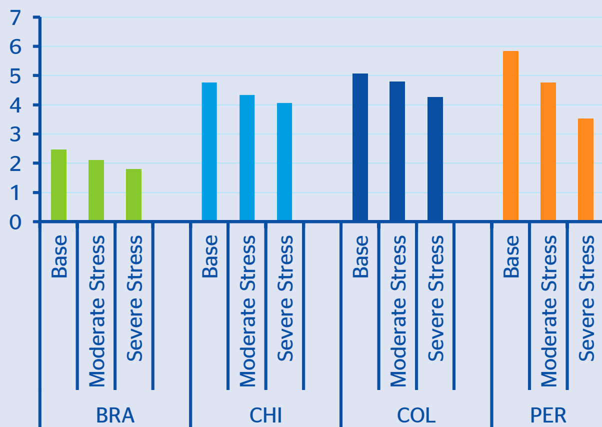
1: Exceptions to this pattern are copper and gold. In the moderate stress scenario, we assumes an ad-hoc drop in copper prices of 8% with respect to our baseline forecasts, which already incorporates a downward correction ahead (see our 3Q13 Latin America Economic Outlook) as current prices are already below the 2006-2012 average. With respect to gold, we assume a 20% decline in prices from 2014 on in the moderate stress scenario. In the severe stress scenario, we assume that gold prices drop about 50% instead of following the general correction pattern, as gold prices increased after the Lehman Brothers crisis.
2: The shocks considered do not incorporate a decline in the demand for commodities, but just a drop in prices.
3: In the case of Brazil, the size of falls in the price of copper and iron on the one hand, and soybeans on the other, were extended, in similar proportions, to other metal and agricultural commodities, respectively.

Although all the countries included in this exercise are net commodity exporters, the impact of lower prices of these products would be lessened by lower expenditure on commodity imports (which represent about 20% of total imports in Brazil and Peru, slightly more than 30% in Chile and more than 40% in Colombia).

We believe that the monetary authorities would react to the fall in commodity prices to reduce its impact on the economy. This reaction would be stronger in Chile and Peru, where there is more room to adopt countercyclical fiscal and monetary policies, and in the severe stress scenario, rather than the more moderate stress scenario.

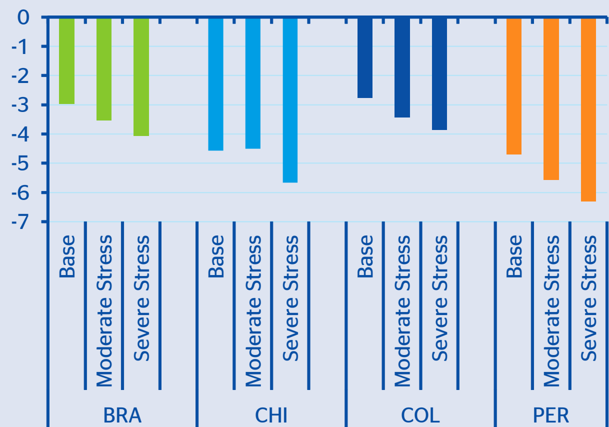
According to our estimates, the impact of the moderate stress scenario on GDP would be a decrease of about 120 basis points on average in 2014, and would fade away during 2015 and 2016. In the severe stress scenario the impact would be stronger (approximately a negative 250 points compared to our baseline scenario in 2014) and longer lasting (-50 points and -30 points on average in 2015 and 2016, respectively). Also, after a strong initial impact, the Andean economies would manage a robust recovery in 2016 (about 4.5% in the moderate stress scenario, and 4.0% in the severe stress scenario), while growth in Brazil –more affected by idiosyncratic problems– would not surpass the 3.0% barrier (see Chart 17 for more details of the impact of the two scenarios on GDP).

Chart 26
GDP growth in the baseline and stress scenarios (average % in 2014-16)



Source: BBVA Research

Chart 27
Current account in the baseline and stress scenarios (average % of GDP in 2014-16)



Source: BBVA Research

In both scenarios, and in all the countries analyzed, the current-account deficit would increase strongly in 2014: to about 4.0% in Brazil and Colombia and above 6.0% in Peru and Chile in the moderate stress scenario; and to about 5.0% in Brazil and Colombia and above 8.0% in Peru and Chile in the severe stress scenario. However, the depreciation in exchange rates and the slowdown in domestic demand would lead to a deficit reduction over 2015 and 2016. In both scenarios, the current-account deficit at the close of 2016 would not be very different from the levels we forecast in our respective baseline scenarios (see Chart 18 for more details of the two scenarios' impact on the current account)[4].

In general, our simulations suggest that the Andeans and Brazil would be heavily impacted by a correction in commodity prices. However, growth would continue at relatively robust levels, at least in the Andeans. In addition, the rise of the current account deficit would be largely temporary, since exchange rates would adjust to offset some of the impact of lower commodity prices.

4: The impact on both growth and on the external deficit would be higher in Peru than in the other countries. This is because i) Peru currently has a higher external deficit and thus a greater need for adjustment to bring it to more sustainable levels, ii) the more significant participation of foreign investors as holders of local assets, coupled with lower liquidity in financial markets than in the other three countries, lead to higher (and probably longer) corrections of asset prices, leading to further depreciation of the exchange rate, with further tightening of monetary conditions.

5. Slowdown in growth in 2013 and possible recovery in 2014

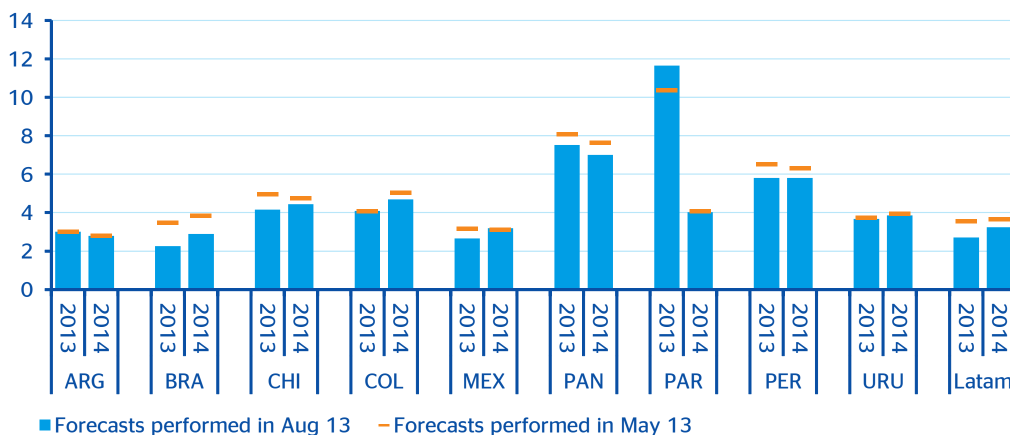
Latin American growth has been revised downwards in 2013 to 2.7%, due to the weak foreign sector and the slowing in domestic demand. Activity is expected to gather pace slightly to 3.2% in 2014

We expect growth of 2.7% in Latin America in 2013, below our forecast three months ago (3.5%) and the rate registered in 2012 (2.8%), and for recovery to occur in 2014, reaching 3.2% (vs. our previous estimate of 3.7%). We have sharply downgraded our estimates for growth in GDP in Latin America for 2013 and 2014, due to a combination of internal and external factors. As we stated in our analysis above, a number of factors have come together to bring about a surprising drop in growth in the first half of the year. Looking further ahead, the outlook of lower growth in the global economy, uncertainty about the end of the monetary stimuli in the United States, as well as a number of idiosyncratic factors, are responsible for the downwards revision of growth outlook in Latin America.

In Brazil, the higher than previously expected monetary tightening and a gloomier outlook about the labor and lending markets account for a significant part of the downward revision of around 1 percentage point in GDP growth in both 2013 and 2014 (see Chart 28). In other countries in the region with a more regulated exchange rate, the greater difficulties in supply of foreign currency will curb their growth. In the Andes region countries - Chile, Colombia and Peru - the less dynamic mood in the world economy should have a negative impact on exports and create a less favorable outlook for domestic demand. In Colombia and Peru, however, a more expansive fiscal policy would prevent a sharper adjustment in domestic demand.

In year-on-year terms, despite the negative surprises at the start of the year, we expect a clear trend of recovery from last year (see Chart 17), which should continue in coming quarters, in our opinion. This gradual growth will be fuelled by a number of factors, including a more buoyant mood in the economies of Mexico (in line with the trend of growth expected in the United States) and Colombia (in line with the greater support from economic policies).

Chart 28
Latam countries: GDP growth estimates, 2013-2014 (%)



Source: BBVA Research

The three Andean countries will remain the most dynamic in the region, together with Paraguay and Panama. On the other hand, we expect Brazil to report a very modest growth

Naturally, the aggregate growth of Latin America masks the varying characteristics of the countries in this region. According to our estimates, in 2013 and 2014 growth will continue at a high range in the Andean countries and in Paraguay and Panama. In particular, we are expecting Peru to report growth of 5.8% in 2013, which would be 4.1% in Colombia and 4.2% in Chile, with similar or higher rates in 2014. While in Paraguay and Panama, growth in 2013 would be much higher (11.6% and 7.5%, respectively). In Mexico, growth should be close to 3.0%, or even higher if the United States manages to grow more than expected or if the reforms are implemented faster than expected. In Argentina, we are expecting growth in the region of 3% for the next two years, while in Brazil our growth estimate is of around 2.5% on average in 2013 and 2014.

Furthermore, the relatively weak growth in Brazil, which is the result of cyclical factors (such as the adjustment in interest rates and the impact of inflation on wage purchasing power) and structural ones (loss of competitiveness of the manufacturing sector and low level of investment) has an important weight in the aggregate growth of Latin America. Without including Brazil, aggregate growth forecasts of Latin America in 2013 and 2014 would be 3.1% and 3.5%, respectively, still lower than, but closer to, the potential GDP in the region (see Box 2 “Outlook for Potential Growth in Latam”).

Sluggish foreign and domestic demand should also lead to a worsening in fiscal balances

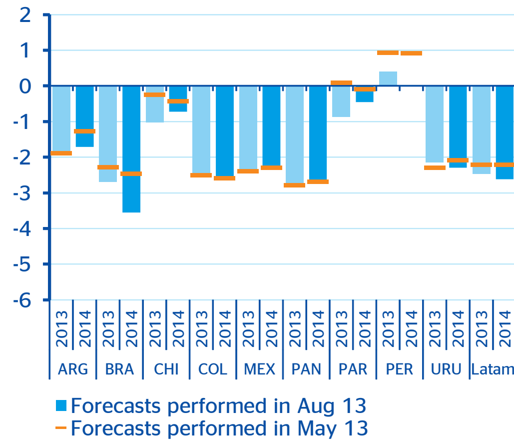
The downward adjustment in commodity prices implies lower fiscal revenue in many of the countries in the region. What is more, the weaker domestic demand also has a negative impact on tax revenue.

The reduction in tax revenue is, generally speaking, a major reason for the downgrading of forecasts for fiscal balances of Latin American countries (see Chart 29). In some countries, the more expansive fiscal policy, used to offset the more sluggish private sector, is another reason for the fall in tax revenue (mainly in Colombia and Peru). In Brazil, on top of the reduced tax revenue and greater support to domestic demand, the public sector deficit is negatively affected by our forecasts of higher interest rates in the short and long term: instead of falling from 5.0% of GDP, interest payments should keep between 5.0% and 6.0% in coming years (thus, at similar levels to those observed between 2008 and 2011 and above the 4.9% reported in 2012).

Despite the recent deterioration, the fiscal situation is, on the whole, largely manageable in Latin America. Some countries, such as Chile and Peru (see Chart 30), have an excellent fiscal position, with levels of gross debt of lower than 20%, offering them the possibility of using a more expansive fiscal policy (something which is apparent to some degree in Peru). Although the Colombia and Mexico indicators are not as good as in Chile and Peru, public debt is also low in these two countries, and this to some extent offers them the opportunity of deploying a more expansive fiscal policy without running much risk. In any event, the fiscal policy in Mexico (and of other countries to a lesser degree) would benefit from a reform which might reduce the public revenue’s dependence on income linked to the production/export of raw materials, a question which is currently being debated in Mexico.

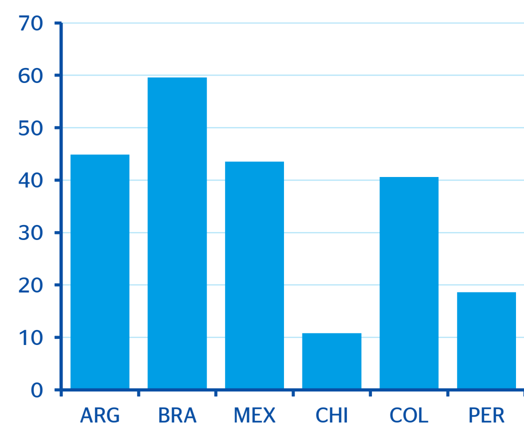
In Brazil, although public debt has not yet reached alarming levels, the deterioration in public balances means that the dynamics of public debt will be much less benign than in the past, a factor which also limits Brazil's capacity to react in more adverse scenarios, and which could even prompt a downgrade of the country's sovereign debt.

Chart 29
Latam countries: fiscal deficit (% GDP)



Source: National governments and BBVA Research

Chart 30
Latam countries: estimated gross public debt in 2013 (% GDP)



Source: National governments and BBVA Research

Box 2. Growth potential in Latin America: momentum for reform has to be regained

Potential Gross Domestic Product (potential GDP) is the highest level of output an economy can achieve without stoking inflationary pressures, given the available factors of production and current technology.

In general, potential GDP is associated with the long-term trend actually recorded in economic activity, such that the difference between the two (the output gap) is considered to be representative of the phase in the economic cycle, the result of temporary shocks, to the relative prices of the factors of production, foreign demand and purely random shocks.

Potential GDP is therefore a useful indicator for economic policy decisions. When faced with a negative (or positive) output gap, policies to support (dampen) economic activity can be pursued through fiscal, monetary or macro-prudential policy. Likewise, what are known as supply-side policies -seeking to permanently change the regulatory framework and markets for the allocation of productive assets- can be applied to try to increase potential GDP or its growth rate.

In the estimates of potential GDP shown in the next section, we used a calculation method based on the production function initially developed; this method began with the work by Solow[5].

In the production function based method, growth potential is typically broken down into the contributions made to it by the factors of capital, employment and total factor productivity (TFP). TFP can be understood as the efficiency with which capital and labor are combined to generate higher growth potential.

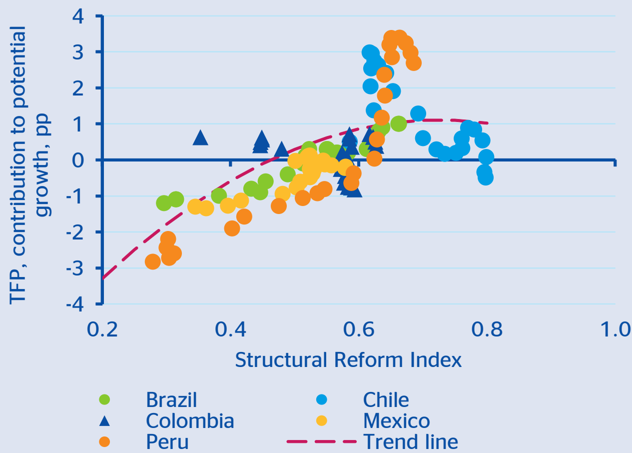
Although significant progress has undeniably been made in the region in terms of macroeconomic indicators, reducing poverty and narrowing the inequality gap, since sustained productivity growth is the means to ensure long-term growth of per capita income, attention should continue to be focused on the issue of structural reforms in the region. There is still ample room for increasing productivity. Not doing so could risk stagnating growth and, ultimately, maintaining wide gaps in living standards compared with developed economies.

There is favorable momentum in the region. Latin America has benefited from positive external shocks and has shown greater resistance than in the past to external slowdown. Prudence in implementing economic policies in most countries in the region has created room for countercyclical fiscal and monetary policies, helping to reduce vulnerability to the external environment. The greater resistance shown in Latin America should be taken advantage of to rethink the issue of the structural reforms pending in the region.

The region's economies are in widely heterogeneous situations, both in terms of the degree to which reforms have already been made and the room and willingness in each country to implement additional reforms. Thus, progress in the structural reform agenda is uneven among countries, although most of them are moving in the right direction, i.e. creating incentives to increase potential through increased productivity (Chart 31). However, although some level of macroeconomic stability has been achieved, the right incentives should be created to ensure long-term growth. In fact, although the process of structural reforms in Latin America began over 20 years ago, these reforms were more intense in the 1990s (Chart 32).

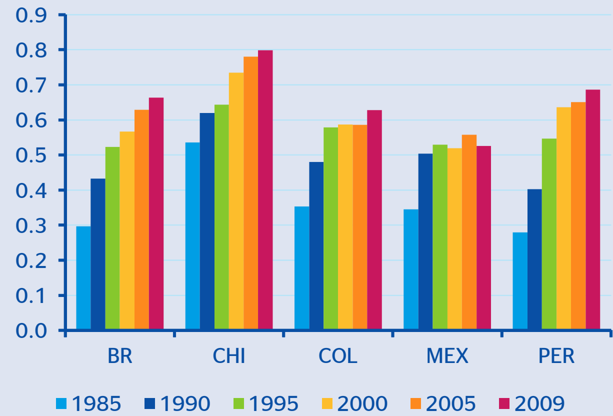
5: "A contribution to the theory of economic growth", Quarterly Journal of Economics No. 70,1956. Since this work was published, a number of attempts have been made to refine its estimates and alternative functional forms have been tested, improving the definition and breakdown of the factors of production.

Chart 31
Latin America: productivity and structural reforms, 1985-2009



Source: BBVA Research for TFP contributions, and Eduardo Lora (2012) for the structural reform index

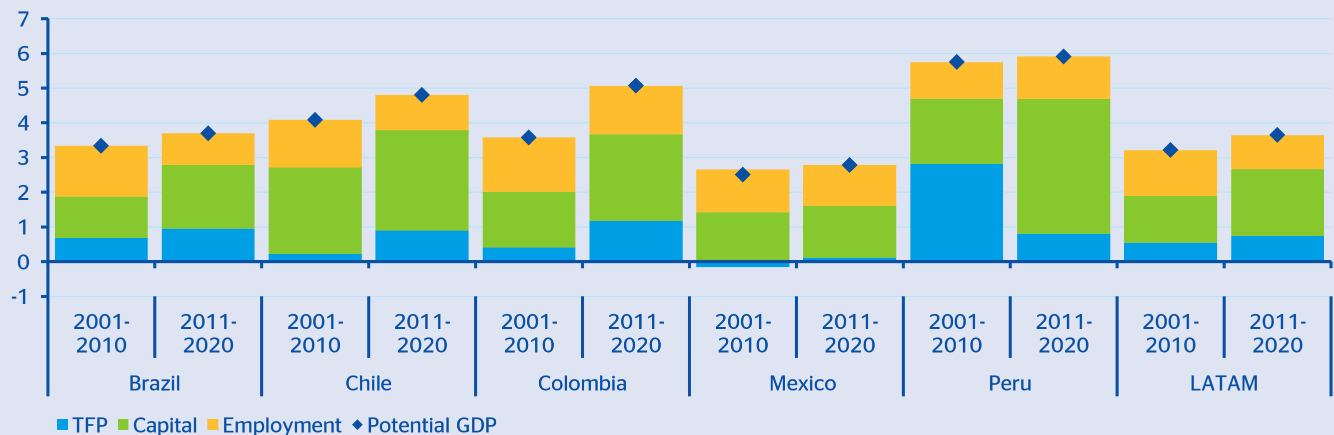
Chart 32
Latin America: structural reform index



Higher levels are associated with more neutral economic policies in terms of distribution of resources.
Source: Eduardo Lora (2012)

Standard estimates of potential growth[6], concur in estimating higher potential growth in the decade 2011-2020 than in the previous decade. The estimated figure for Latin America will increase from 3.2% to 3.6% (Chart 33). This increase will result principally from the higher expected contribution of capital, followed by an improved contribution from TFP. This is a point worth noting, because during the past decade growth in the region was strongly driven by the contribution of labor and capital, influenced by the demographic dividend in several countries. In fact, in the last decade growth was driven by the accumulated factors of capital and labor (85%), while the contribution of TFP to growth was only 15%, well below the contribution of TFP in other regions, particularly Asia (30%) and the United States (44%). For the current decade, the estimated contribution of TFP reaches 20%, as the aggregate contribution of other factors, particularly employment, will be less.

Chart 33
Latin America: contribution to potential growth, 2001-2010 and 2011-2020



Source: BBVA Research

6: These estimates are based on a representation of the economy via a Cobb-Douglas type function with constant returns to scale; $Y_t=A_tK_t^aL_t^{(1-a)}$ where Y is the Product in real terms, L employment and K the estimated capital stock. A is the Total Factor Productivity (TFP) or Solow residual.

The great heterogeneity in the region has to be taken into account, both in terms of room to implement reforms and growth prospects. In this regard, external influences, such as Asian growth in the last decade and the rise in commodity prices (see section 3 of this issue), have had varied effects in the different countries, depending on their productive structure. It should be noted that increases in commodity prices over the last decade, while they benefit growth in the countries in the region (especially in South America), should not to be confused with structural drivers, given that they are probably temporary[7]. The region's heterogeneity involves significant expected growth in the Andean countries. The average growth expected in Chile, Colombia and Peru in the 2011-2020 decade is around 5%[8]. This is supported in part by higher demographic dividends, prudent economic policies and increasing trade openness. However, at the same time these countries face the challenge of their close links to Asia and, in particular, the concentration of their productive structure in natural resources, involving both an opportunity and a risk for the future. Meanwhile, an economy as large as Brazil's requires a rethink to what has been a growth strategy based on consumption and credit, and reforms need to be adopted to raise productivity and investment. If this is not done, growth in the next decade could be lower than forecast (ranging from 3.0% to 4.0%).

Mexico faces key challenges in the next decade, including, crucially, the need to foster increased competition in key areas. In the absence of structural reforms, expansion expected is slightly below 3%.

In all cases, the key elements in the agenda of pending reforms should be improvement of infrastructure quantity and quality, implementation of social policies that encourage greater economic formality, investment in education as a primary source of improved human capital and continued promotion of credit as a support to development.

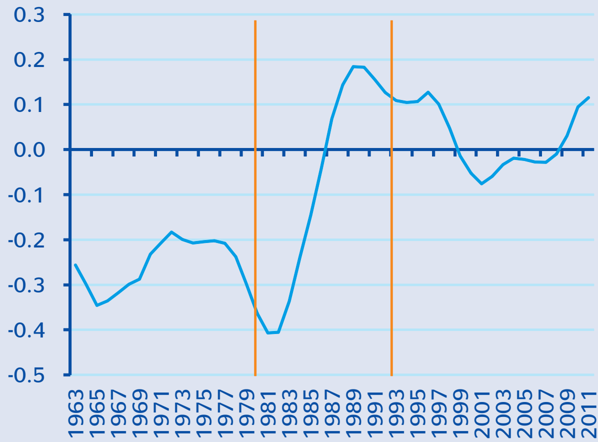
The case of Latin America is thus a good example of how low unemployment rates and high investment rates in the economy are not enough to trigger growth. An efficient combination of these factors (increases in TFP) is needed to reactivate the virtuous circle. An efficient combination in this respect requires institutional changes including increased competition in product and factor markets and reforms to improve the quality of human capital, which in turn will result in lower rates of informality in the economy, as well as investments in highly profitable areas, for which infrastructure investment is essential.

As a specific example of structural reforms resulting in an improved TFP contribution to growth, we can consider the case of Mexico. Mexico's TFP has grown strongly during periods when a large number of structural reforms have been approved. This was the case in the period between 1995 and 2000, when, among other reforms, trade liberalization was consolidated and progress was made in the process of nominal stabilization, financial deregulation and the privatization of companies. In contrast, in the more recent period, the contribution of TFP stagnated and even became negative (Chart 34).

Studies on growth potential in case of a second generation of structural reforms in Mexico being approved suggest it would lead to a return to sustained TFP contributions. In particular, it is estimated that the possible future approval of tax, energy, labor and competition reforms would contribute an additional 0.3 percentage points of TFP to Mexico's growth potential.[9] This, together with the higher contribution of capital and labor factors, would contribute to raising the TFP estimate from the current 2.8% to 3.7% in a scenario of reforms (Chart 35).

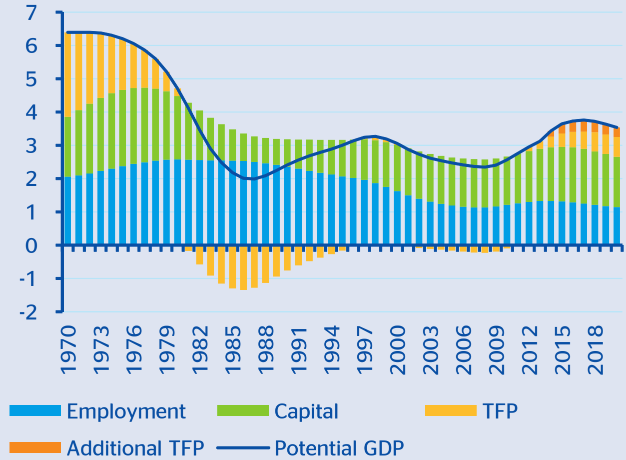
7: For an overview of necessary reforms in the region, see Latam Economic Outlook 2Q13, "Latin America must not lose sight of the long-term picture" http://www.bbvaresearch.com/KETD/fbin/mult/1305_Situacionlatam_tcm346-386502.pdf?ts=2472013
8: For more information on growth in Andean countries, see the presentation "Las economías andinas, dinamismo y retos" (Andean economies, dynamism and challenges) from 2012. http://www.bbvaresearch.com/KETD/fbin/mult/121115_Andinos_Latibex_2012_tcm346-361818.pdf?ts=2472013
9: Mexico Outlook, 2Q13: Impact of possible reforms on Mexico's GDP potential, BBVA Research http://www.bbvaresearch.com/KETD/fbin/mult/1302_SituacionMexico_1T13_tcm346-374661.pdf?ts=2472013

Chart 34
Additional annual TFP contribution in Mexico (points)



Source: BBVA Research

Chart 35
Estimated potential GDP: scenario with reforms



Source: BBVA Research, Bloomberg y CONAPO

When considering the region's growth potential we must think in terms of long-term growth and structural reforms with a long time horizon. Their results will not always be reflected in immediate surges of growth in the countries in the region. However, long-term strategies should be considered as a way of underpinning growth and providing greater long-term internal strength for economies against possible external and temporary shocks.

6. Inflation will continue under control and the central banks will have a laxer bias, except in Brazil

Inflation is in line with inflation targets, except in Uruguay. In Brazil, there are persistent inflationary pressures

After breaking through the ceiling of its respective target ranges, inflation slowed recently in Mexico and Brazil and returned to the limits established by Banxico (between 2.0% and 4.0%) and by the Central Bank of Brazil (between 2.5% and 6.5%).

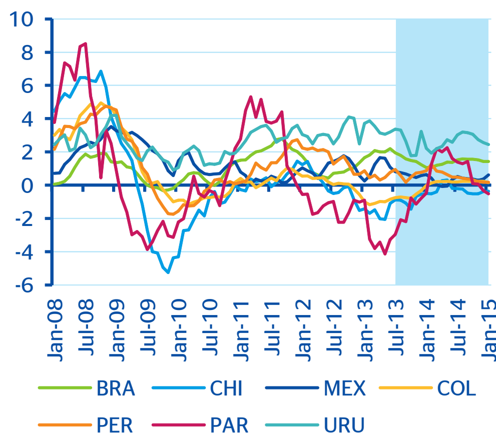
In Brazil, the recent slowdown in inflation is due to a number of factors, which include a positive base effect and a slowing in food prices. In Mexico, it is related to the fading of supply shocks, which recently had an impact on domestic prices, and the very low core inflation. Although the recent pattern is very similar in both cases, in Brazil inflation remains not only at much higher levels (6.3%, compared with 3.5% in Mexico) but is also a source of considerable risks.

At any rate, after the convergence seen in Brazil and Mexico, Uruguay is the only country where current inflation, of over 8.5%, remains above the target range (between 4.0% and 6.0% for 2013).

In the Andes countries, inflation continued under control, within the ranges established by the respective monetary authorities, slightly below the central target of 3.0% in Chile and Colombia and slightly above the central target of 2.0% in Peru (see Chart 36).

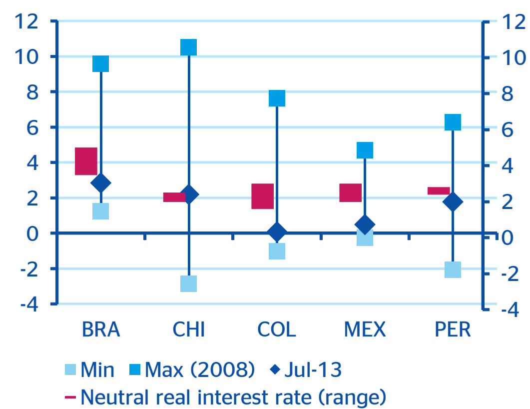
We expect inflation to be kept under control in the Pacific Alliance countries and for pressures on prices to remain strong in Brazil and Uruguay. In these two latter countries, the impact of the recent currency devaluation tends to be stronger than in other countries in the region, not only because pressures on prices are currently a lot more significant, but because in both cases the devaluation tends to be on a higher scale (see Chart 36).

Chart 36
Deviation of inflation (%y/y) against Central Bank target (pp)



Source: National governments and BBVA Research

Chart 37
Latam countries with inflation targets: real official interest rates



Source: Bloomberg and BBVA Research

In a less favorable foreign setting, with less drive by domestic demand and subdued inflation, central banks adopt a laxer bias, except in Brazil

The region's central banks, and other emerging markets, currently face a dilemma between addressing domestic cyclical conditions (less buoyant) and not prompting lower capital inflows by reducing interest rates.

Latin American countries naturally have different ways of resolving this dilemma. In Chile's case, the approach would be to adopt a more orthodox monetary policy, reducing interest rates this year, insofar as portfolio flows are a less important proportion of financing and non-domestic debt holders are a small proportion.

At the other end of spectrum is Peru, which has a more dollarized economy and a higher proportion of non-domestic debt holders, and also less liquidity to be able to dispose of positions. The trend towards laxer monetary conditions will also be implemented, but as the first line of action through reducing reserve ratios, as in fact has been observed in recent weeks.

In Colombia's case, monetary policy is below neutral levels (see Chart 37). There is little margin for further cuts, and we expect authorities to keep official rates at 3.25%, the level reached following the reductions observed in the first quarter.

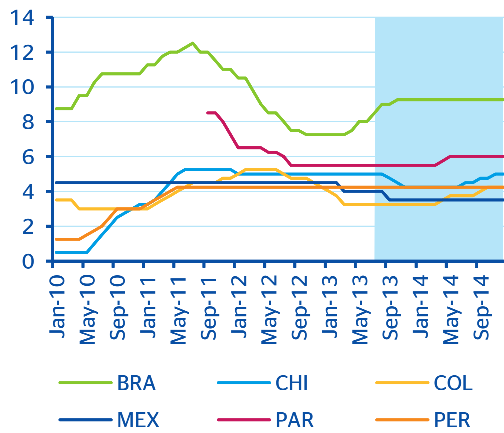
In Mexico, further monetary easing is likely in coming months due to the expected inflation trend and the lack of strong demand pressures. However, an appreciation of the peso (or at least the lack of further devaluations) seems to be a necessary condition to reduce the lending rate.

Brazil's situation differs from that of the other Latin American countries in that pressures on inflation – and the strong devaluation of the real - have been conditioning an adjustment of monetary policy (a 125 point rise in Selic rates over the year so far), which will have to continue over the next few months (until Selic reaches 9.25%, 75 points more than the current value). As in other countries in the region, the devaluation of the exchange rate will be crucial to determine the scale of the future adjustment. In our opinion, the most likely scenario will be for exchange pressures to be mitigated and for the slowing of inflation and lack of drive in domestic demand to prevail and so bring the monetary tightening cycle to an end in October.

In Paraguay, there have not been any changes in monetary policy rate over the last year, given that inflation remains under control despite buoyant economic activity. We expect the monetary authority to continue to keep policy rates at 5.5% at least until the start of 2014. As with other countries in the region, however, the bias is downward.

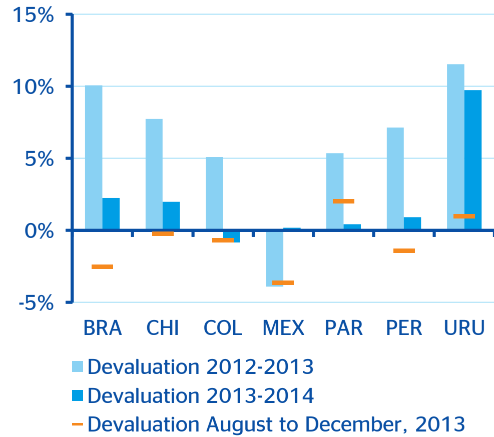
Lastly, a change of monetary policy instrument was announced in Uruguay: abandoning the setting of interest rates in favor of monitoring monetary aggregates. This change is perceived as an acknowledgement that the monetary policy rate is ineffective in putting inflation within the target range. The moderately restrictive bias announced by the monetary authority has not yet a significant impact on inflation outlook.

Chart 38
Latam countries with inflation target: official interest rate (%)



Source: National governments and BBVA Research

Chart 39
Devaluation of exchange rate (%)



Source: Bloomberg and BBVA Research

The devaluation in the exchange rate will also help to create laxer monetary conditions

Since the speech delivered by the Chairman of the Federal Reserve, Ben Bernanke, in late May, currencies of virtually all countries in the region have devalued, particularly in Uruguay and Brazil (10.0% and 9.5%, respectively) and in a less pronounced way in Mexico (1.6%) and in Andean countries (between 2.0% and 5.0%). As we stated above, the greater concern about the slowdown of the Chinese economy is another common factor which helps to explain the recent loss of value of Latin American currencies.

Looking further ahead, we expect a slight trend towards the devaluation of exchange rates (see Chart 36), although not in Brazil (where we expect relative stability around current levels) or in Mexico (determined by an initial level of less appreciation than other currencies in the region and the positive impact of the recovery in growth in the second half of the year on the Mexican economy).

In any event, the trend towards the increase of long term interest rates in the US (which is in contrast with the somewhat laxer position in most Latin American countries), a greater aversion to risk than that observed at the start of the year and the worsening of foreign balances, should create pressures towards weaker currencies in Latin America. However, we are not expecting sharp devaluations, particularly taking into account that certain central banks in the region will continue to intervene in order to slow the volatility and speed of such devaluations, for example in Peru, Uruguay and Brazil, and, to a lesser extent, in Colombia.

7. Tables

Table 1
GDP (% yoy)

	2011	2012	2013*	2014*
Argentina	8.8	1.9	3.0	2.8
Brazil	2.7	0.9	2.3	2.9
Chile	5.9	5.6	4.2	4.4
Colombia	6.7	4.0	4.1	4.7
Mexico	3.9	3.9	2.7	3.2
Panama	10.8	10.7	7.5	7.0
Paraguay	4.3	-1.2	11.6	4.0
Peru	6.9	6.3	5.8	5.8
Uruguay	6.5	3.9	3.7	3.9
Latin America	4.4	2.9	2.7	3.2

* Forecasts.
Source: BBVA Research

Table 2
Inflation (% yoy. average)

	2011	2012	2013*	2014*
Argentina	9.8	10.0	10.4	10.8
Brazil	6.6	5.4	6.3	5.9
Chile	3.3	3.0	1.7	2.7
Colombia	3.4	3.2	2.2	3.2
Mexico	3.4	4.1	3.9	3.3
Panama	5.9	5.7	4.2	3.9
Paraguay	8.3	3.7	2.6	6.1
Peru	3.4	3.7	2.6	2.6
Uruguay	8.1	8.1	8.2	7.5
Latin America	6.8	6.2	7.3	7.0

* Forecasts.
Source: BBVA Research

Table 3
Exchange rate (against USD, average)

	2011	2012	2013*	2014*
Argentina	4.13	4.55	5.43	6.64
Brazil	1.68	1.96	2.15	2.25
Chile	484	486	493	519
Colombia	1,848	1,798	1,860	1,868
Mexico	12.48	13.15	12.58	12.25
Panama	1.00	1.00	1.00	1.00
Paraguay	4,188	4,417	4,318	4,515
Peru	2.75	2.64	2.70	2.75
Uruguay	19.23	20.23	20.22	22.62

* Forecasts.
Source: BBVA Research

Table 4
Interest Rate (%, average)

	2011	2012	2013*	2014*
Argentina	13.34	13.85	16.47	17.34
Brazil	11.71	8.46	8.29	9.25
Chile	4.75	5.00	4.81	4.50
Colombia	4.10	4.94	3.35	3.75
Mexico	4.50	4.50	3.92	3.50
Panama	1.86	1.51	1.54	2.25
Paraguay	8.49	6.00	5.50	5.85
Peru	4.04	4.25	4.25	4.25
Uruguay	7.69	8.81	9.25	n.d.

* Forecasts.
Source: BBVA Researchs

Table 5
Current Account (% GDP)

	2011	2012	2013*	2014*
Argentina	-0.5	0.0	-0.5	-1.1
Brazil	-2.1	-2.4	-3.3	-3.1
Chile	-1.3	-3.5	-4.6	-5.1
Colombia	-2.9	-3.2	-3.1	-2.7
Mexico	-0.9	-1.2	-1.3	-1.4
Panama	-12.2	-9.0	-8.0	-7.2
Paraguay	1.1	1.6	1.2	1.2
Peru	-1.9	-3.6	-5.6	-5.4
Uruguay	-2.9	-5.2	-3.6	-3.4
Latin America	-1.5	-1.7	-2.0	-2.0

* Forecasts.
Source: BBVA Research

Table 6
Fiscal balance (% GDP)

	2011	2012	2013*	2014*
Argentina	-1.6	-2.3	-1.9	-1.7
Brazil	-2.6	-3.0	-2.7	-3.6
Chile	1.3	0.6	-1.0	-0.7
Colombia	-2.9	-2.3	-2.6	-2.6
Mexico	-2.6	-3.1	-2.4	-2.3
Panama	-2.2	-2.1	-2.8	-2.7
Paraguay	0.7	-1.4	-0.9	-0.5
Peru	1.9	2.1	0.4	0.0
Uruguay	-0.9	-2.8	-2.1	-2.3
Latin America	-2.2	-2.6	-2.5	-2.6

* Forecasts.
Source: BBVA Research

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