

# Latin America: the shadow of China

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# Key messages

- 1 The global cycle remains robust, especially in developed economies, while China is slowing down.** The world economy growth will increase from 3% in 2013 to 3.4% in 2014 and 3.8% in 2015.
- 2 Latam's financial markets recovered in March and April.** Looking ahead, they will be shaped by the effects of the Fed's withdrawal of monetary stimulus and the pattern of growth in China.
- 3 Latam will grow by 2.3% in 2014 and 2.5% in 2015, similar to 2013.** Growth will be below the region's potential and very heterogeneous, with the Pacific Alliance countries performing well above the regional average.
- 4 External deficits remain high and the fiscal perspective worsens,** but both deficits continue to be manageable, on the whole.
- 5 An unlikely scenario of sharp deceleration in China would have a substantially negative effect on South America.** The shock would be absorbed better by the Andean countries, which have more scope for countercyclical policies.

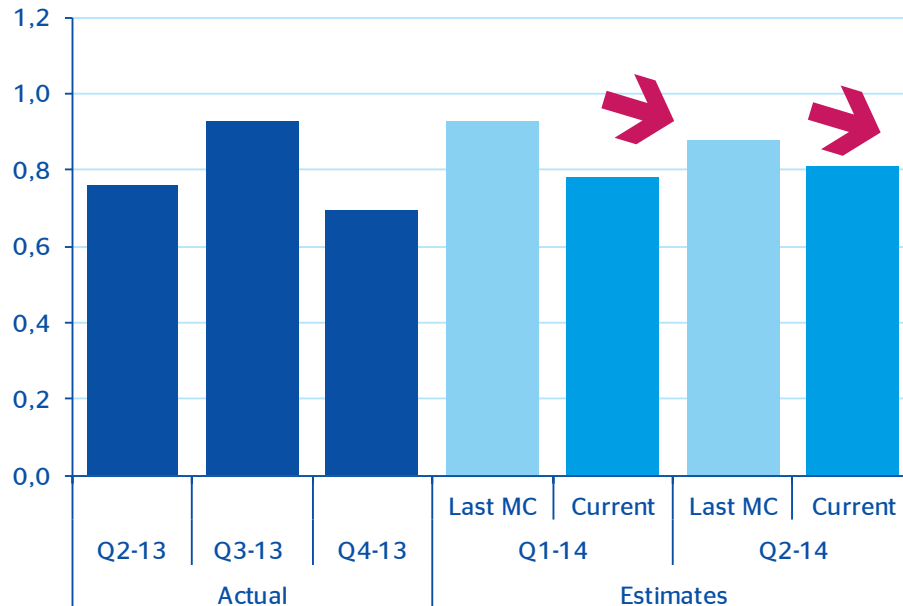
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- 1 Global economy: the recovery continues, hand in hand with developed economies**
- 2 Moderate growth in 2014 and 2015, below the region's potential and very heterogeneous across countries**
- 3 A faster deceleration than anticipated in China would have a significant impact on South America**

# Global cycle: growth remains robust at a quarterly 0.8% in the first half of the year

## World GDP growth (% QoQ)

Source: BBVA Research



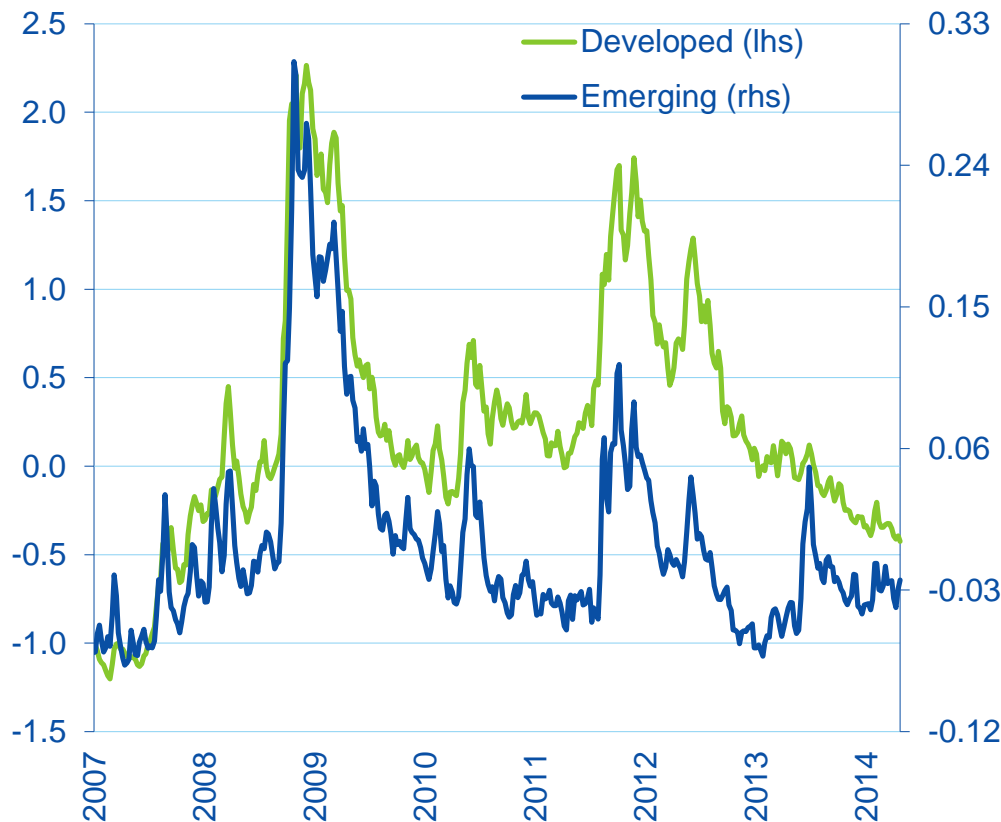
Growth is still solid and financial conditions have improved in emerging economies, but world GDP is not accelerating

Higher growth in developed economies partly offsets lower growth in emerging economies

# Tensions have fallen in financial markets since the beginning of the year

## BBVA financial tensions index in developed and emerging economies

Fuente: BBVA Research



Markets have moved to the tune of expectations of rises in US interest rates ...

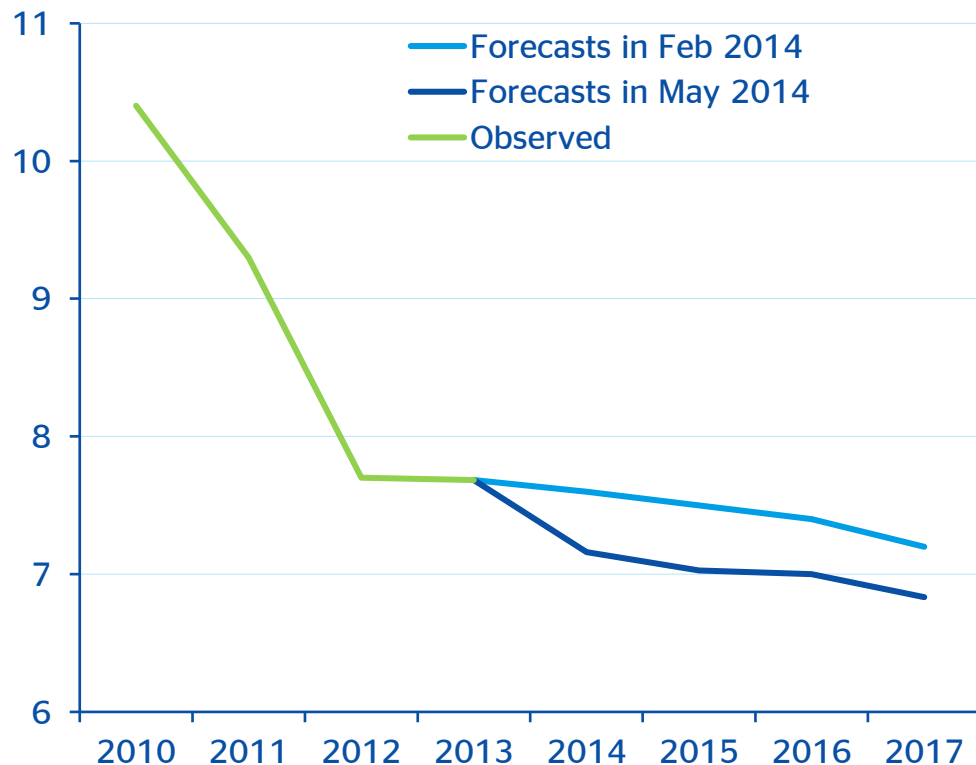
... and growth expectations in China, as well as idiosyncratic factors.

The Fed's communication policy and forward guidance has side-stepped further increases in long-term interest rates and has reduced financial tensions

# Deceleration in China is confirmed, although growth is still above 7%

## China: GDP growth (% YoY)

Source: BBVA Research



Doubts about the cyclical strength of the Chinese economy have made themselves felt in 1Q14, but less than anticipated

Greater loss of cyclical inertia in investment than in consumption

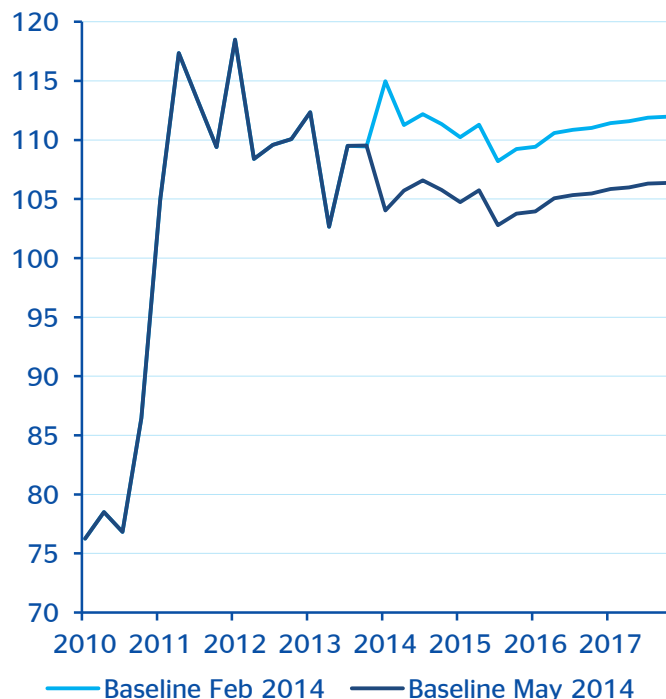
In turn, the authorities are taking measures to contain the vulnerabilities caused by the boosts in 2008-09

# Raw material prices adjust downwards, especially industrial metals

- Adjustments in the medium- and long-term growth scenario in China are impacting on long-term price changes in copper and oil
- This adjustment is limited as long as the production costs continue to set a lower limit to prices
- Soy bean prices are higher than expected because of the poor harvest in Brazil, while convergence to the downside is expected in the medium-term

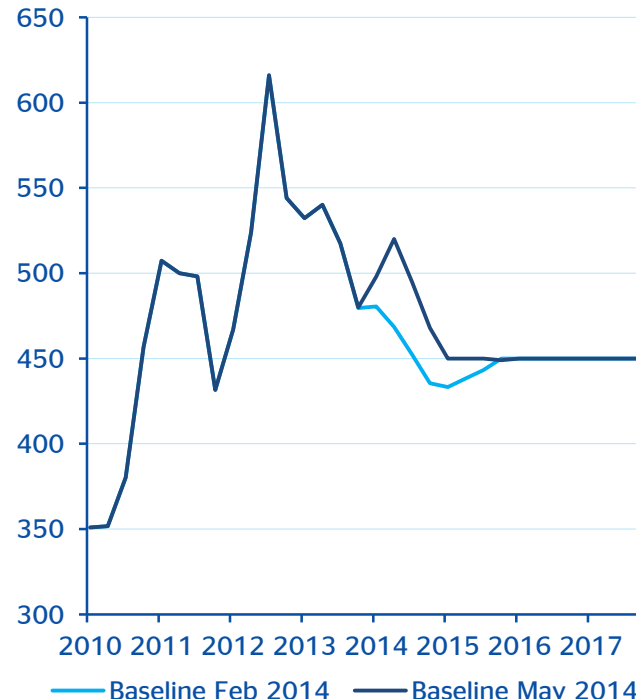
**Brent Crude (USD/b)**

Source: Bloomberg and BBVA Research



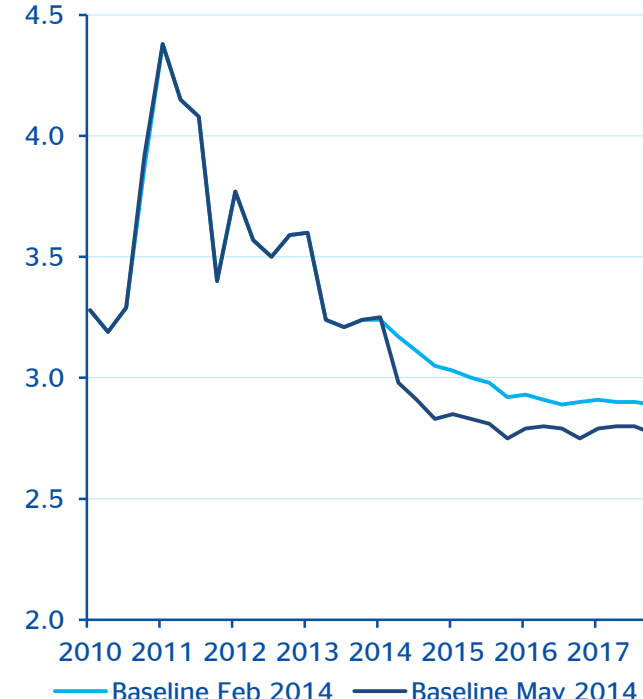
**Soy bean (USD/mt)**

Source: Bloomberg and BBVA Research



**Copper:(USD/lb)**

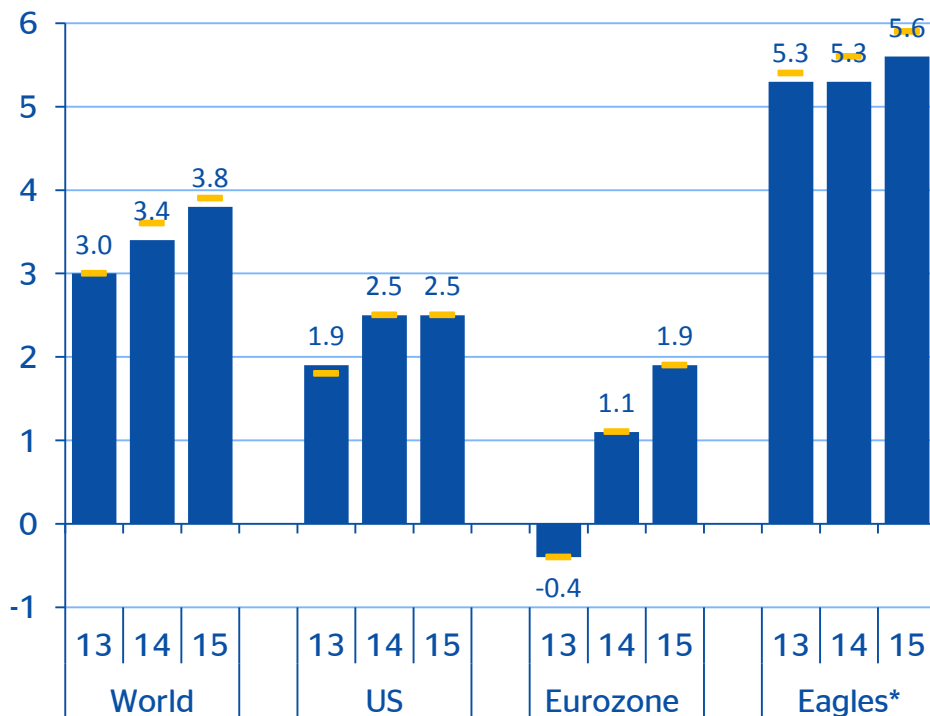
Source: Bloomberg and BBVA Research



# Aceleration in world activity in 2014 and 2015, with the help of developed countries

## World growth forecasts (% YoY)

Fuente: BBVA Research



■ Forecasts in May 2014    ■ Forecasts in Feb 2014

Forecasts in US and Europe remain steady. Growth is on an upward path

Greater contribution to world growth from developed economies than in 2013, but emerging markets still make up 2/3rds of growth

Revision to the downside of growth forecasts in the main emerging economies

EAGLEs is the group of emerging economies which will contribute most to world GDP in the next 10 years. The group is composed of: China, India, Indonesia, Brazil, Russia, South Korea, Turkey, Mexico and Taiwan.



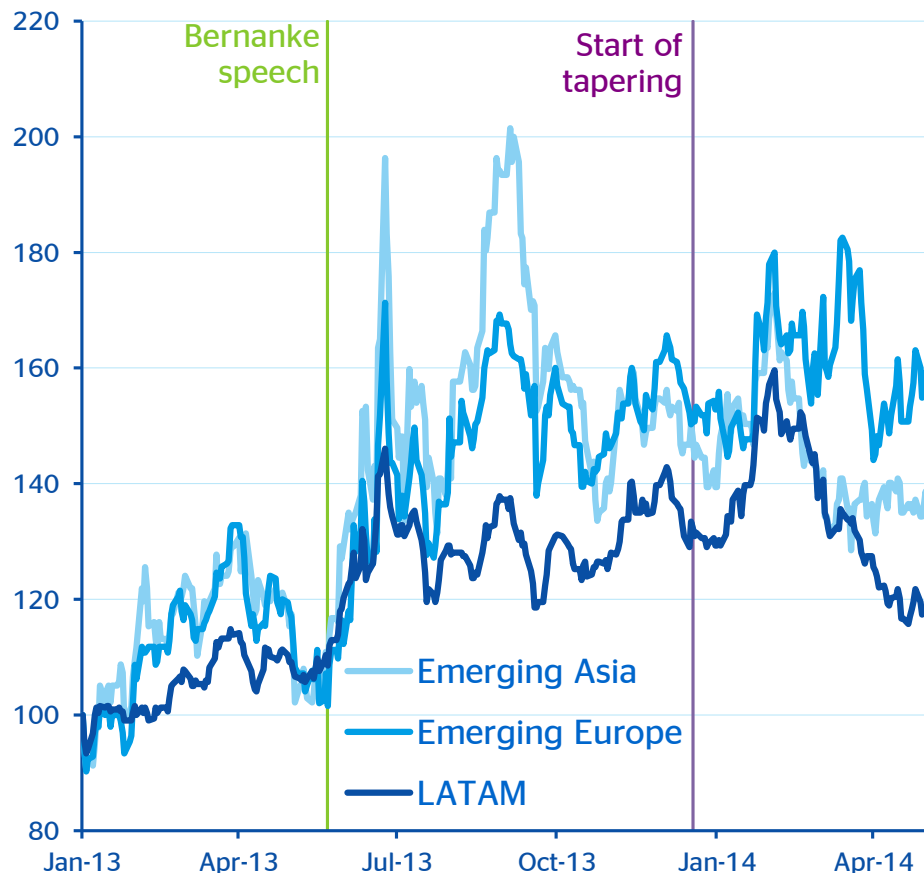
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# In Latin America, the markets forget (for the time being) about tapering

## Sovereign differentials in emerging markets (EMBI, index January 2013=100)

Source: Haver and BBVA Research



After the idiosyncratic shocks of January-February, there has been a widespread recovery in asset prices in Latam

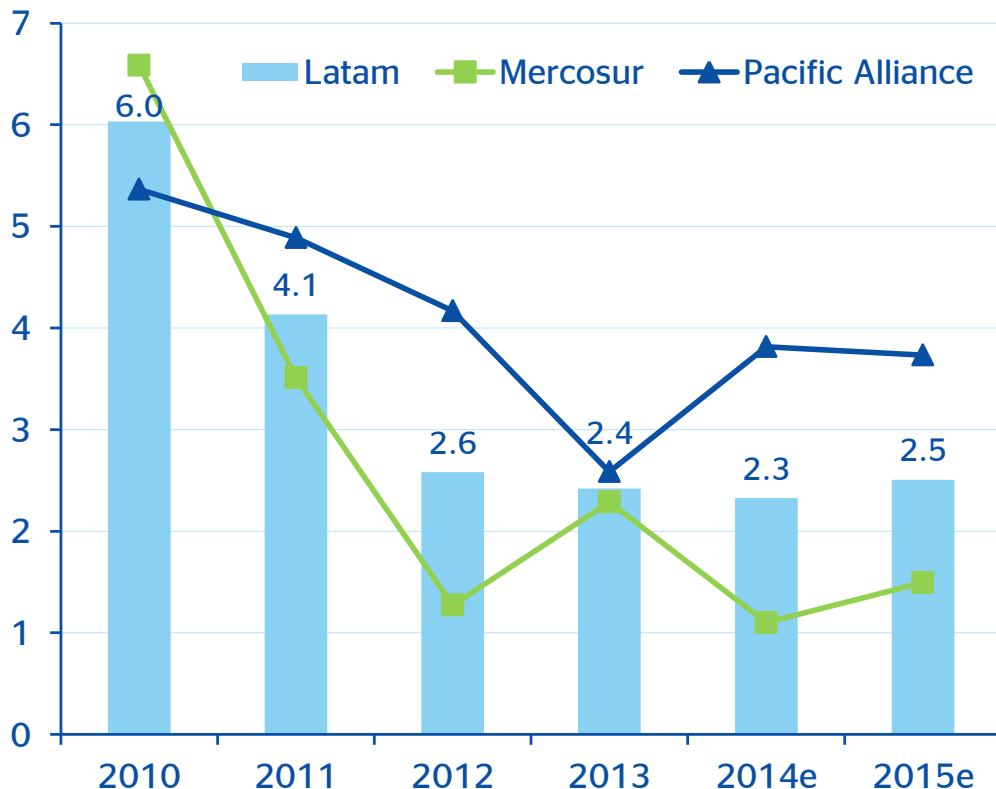
Asset price recovery has virtually recouped the losses since January, but not since May 2013

Capital flows to Latam are back on track, after the weakening in January

# Latin America will grow 2.3% in 2014 and 2.5% in 2015, rates similar to 2013

**Latam\*: GDP growth (% YoY)**

Source: BBVA Research



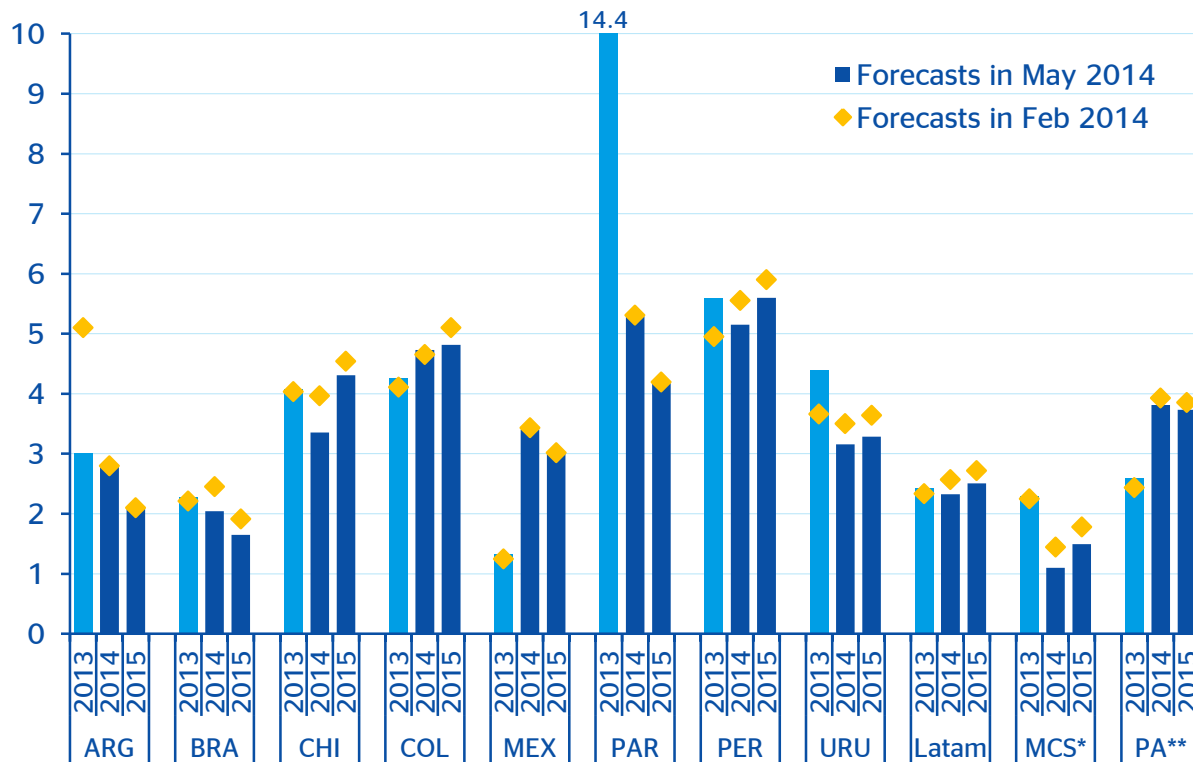
- Internal demand has moderated in the last few quarters, particularly investment
- Activity will gradually recover in 2014-15, supported by an increase in world growth
- In the longer term, regional growth will start converging towards its potential, at around 3.5%
- Increasing heterogeneity: the Pacific Alliance will grow around 4% in 2014 and 2015, well above the region as a whole

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

# Peru, Paraguay and Colombia will continue to grow the most

## Latam countries: GDP growth (% YoY)

Source: BBVA Research



Mexico's growth will rise strongly in 2014, after the rough patch in the construction sector in 2013

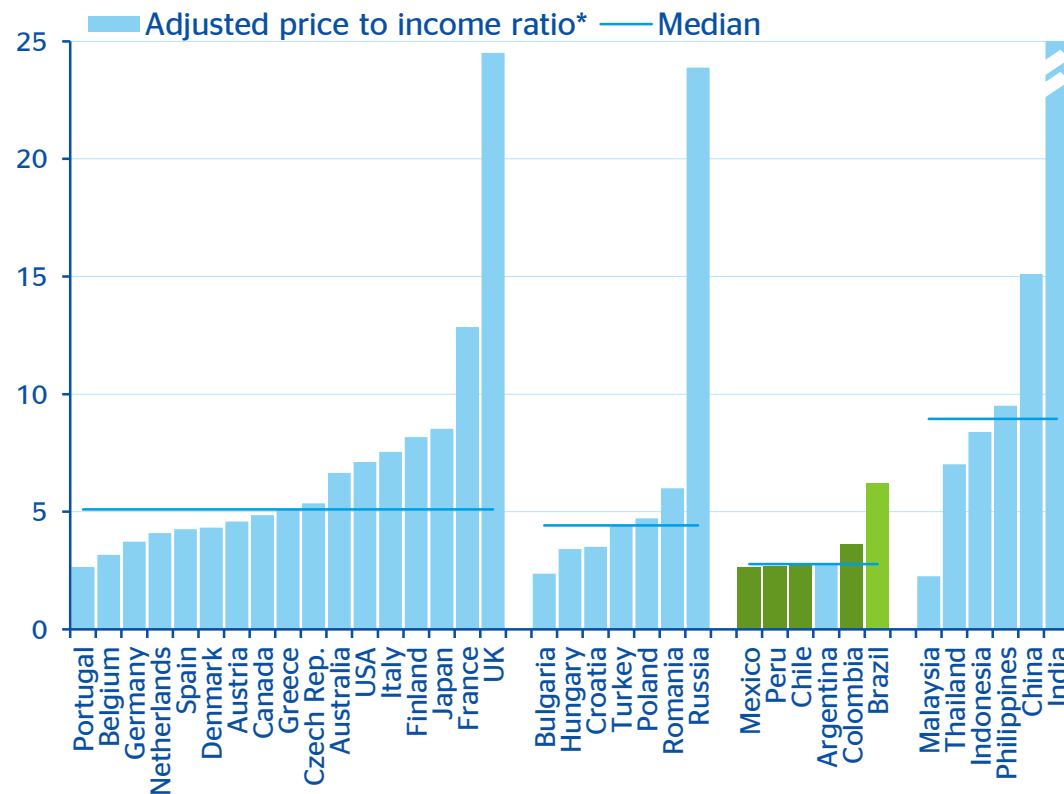
Brazil will show moderate growth, of 2% in 2014, held back by monetary tightening and structural problems

\*MCS: Mercosur. \*\*PA: Pacific Alliance.

# Box 2: Highly dynamic house prices , but no significant risks

## Housing affordability: Price to family income ratio

Source: Global Property Guide and BBVA Research



Step increase in housing prices in the region. Signs of overvaluation in Brazil and, to a lesser degree, in Colombia

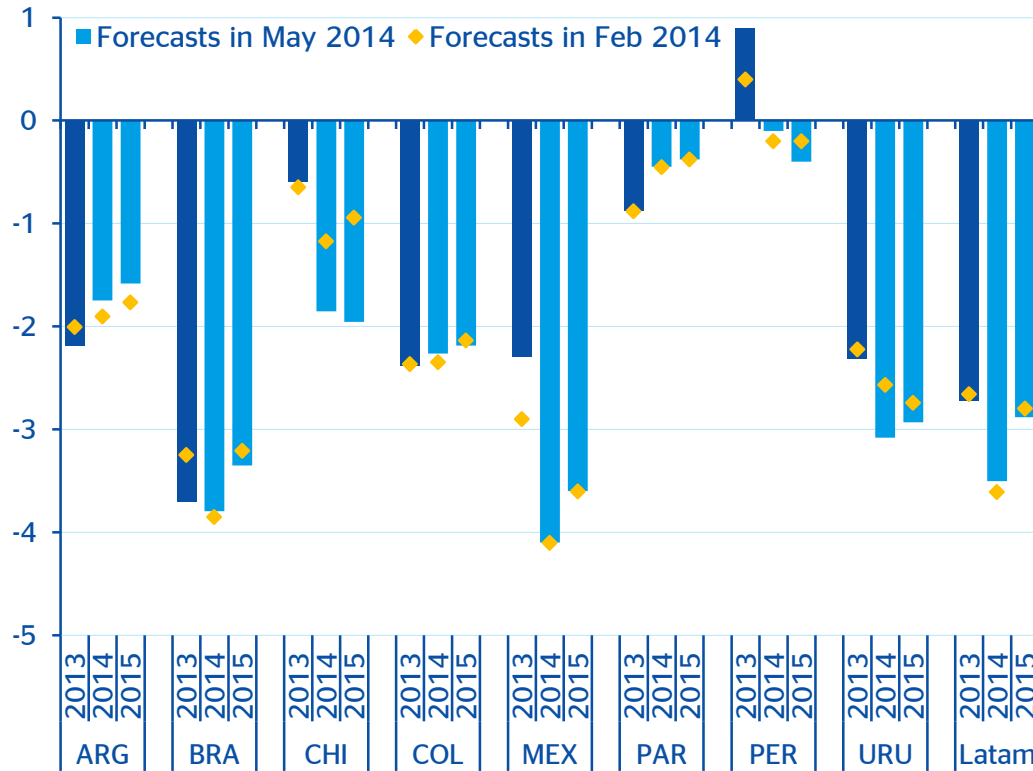
All in all, higher housing prices have been closely linked to improved income and, in some countries, land supply problems

Macroeconomic risks in the event of a price adjustment are low. Mortgage lending is very limited (except in Chile)

# Fiscal outlooks worsen in the region, but deficits will be manageable

## Latam: Fiscal deficit (% GDP)

Source: Haver and BBVA Research



Fiscal balances pressured to the downside by moderation in internal demand and lower raw material prices

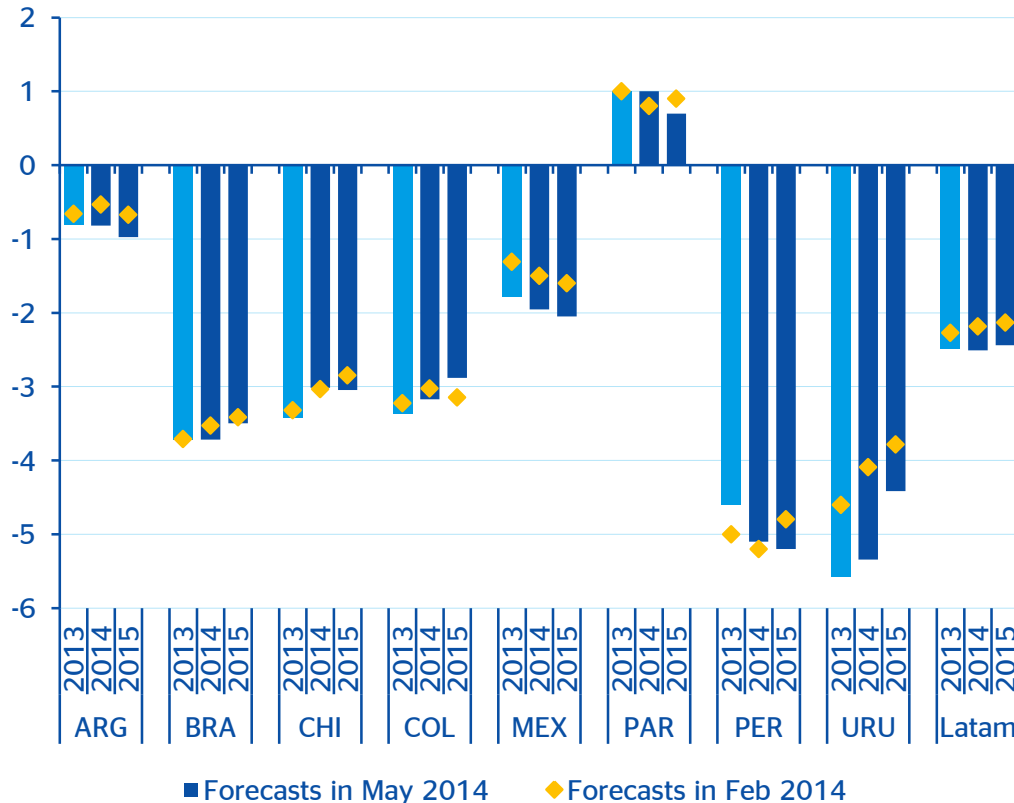
Fiscal deficits in some cases will not go down until after 2015

Public debt is at sustainable levels

# External deficits are high, but will start to diminish in 2014

## Latam: Current account balance (% GDP)

Source: Haver and BBVA Research



Deficits will start to fall, especially in countries with a larger external gap (Peru, Uruguay)

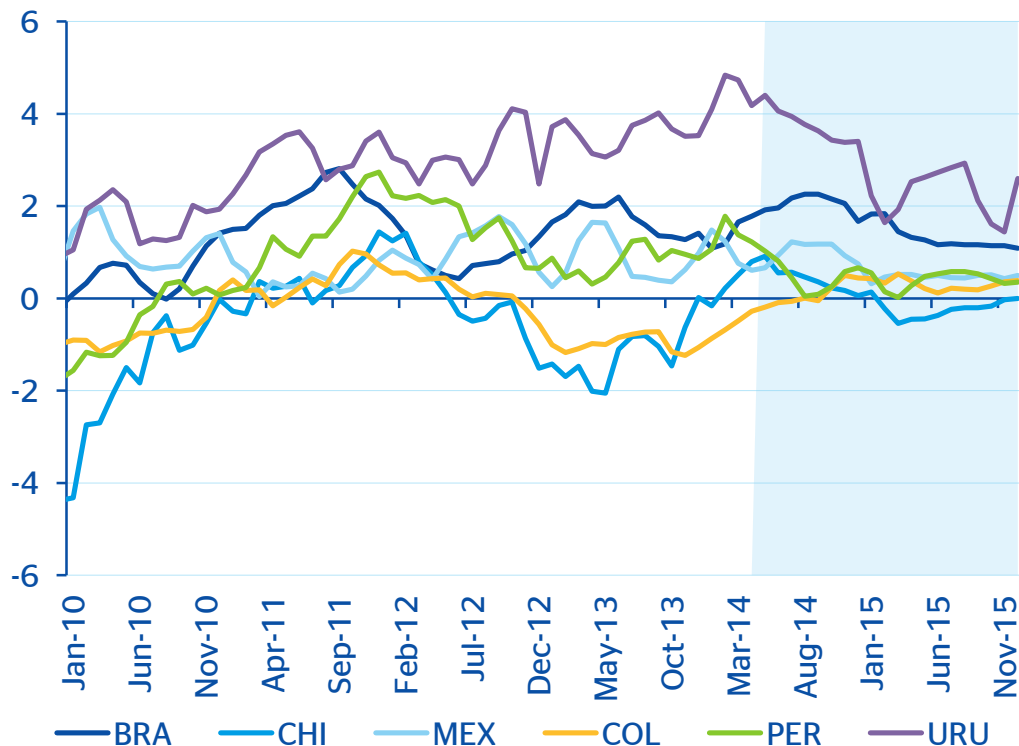
Worse terms of trade and less demand from China...

... are partly offset by less dynamic internal demand and increased growth in the US

# Inflation in line with central bank targets, apart from Brazil and Uruguay

**Deviation of YoY inflation from central bank target (pp)**

Source: Haver and BBVA Research



Inflation driven by shocks to food prices and depreciation in the exchange rate

Inflation will converge on central bank targets at the end of 2014, with the exception of Uruguay and (although less so) Brazil

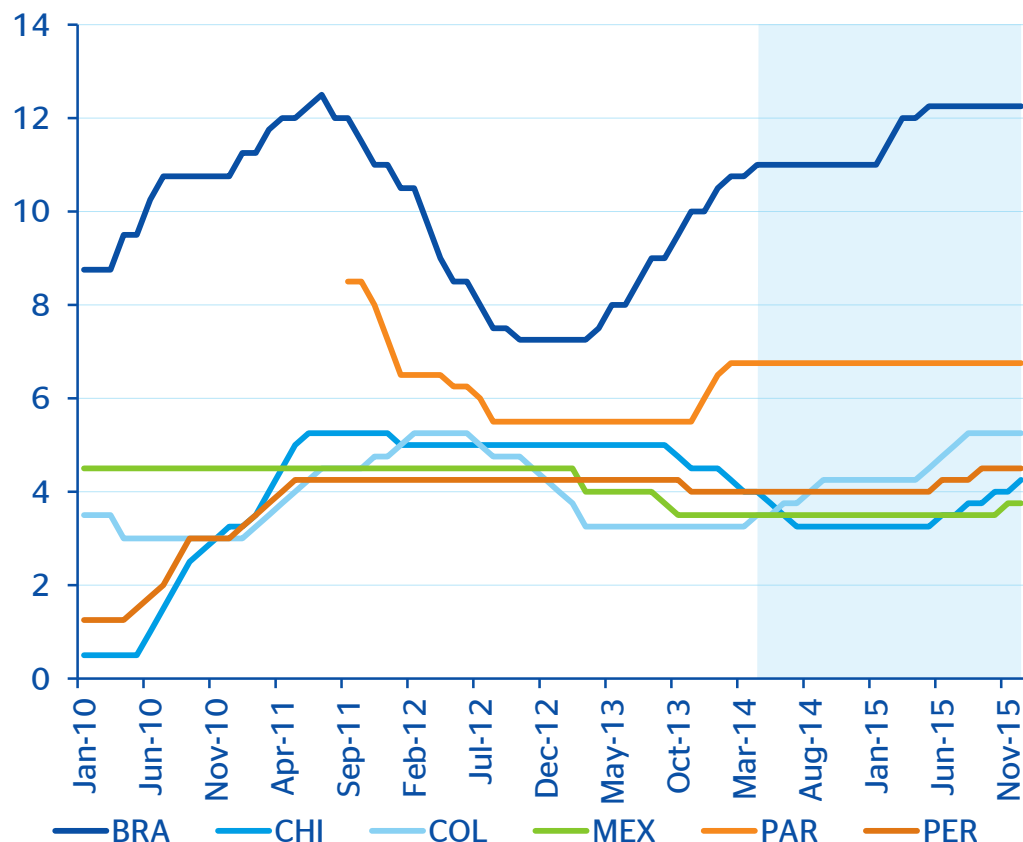
The depreciation in the exchange rate will generate a generally limited pass-through to inflation



# Monetary pause in Latam for the rest of 2014, apart from Colombia and Chile. Generalised tightening in 2015

## Official interest rates in countries with inflation targets (%)

Source: Haver and BBVA Research



Heterogeneous monetary policy in the region conditioned by inflationary pressures (high in Brazil and Uruguay)...

... and economies' different positions in the cycle, with Colombia and, to a lesser degree, Mexico, on the rising part of the cycle

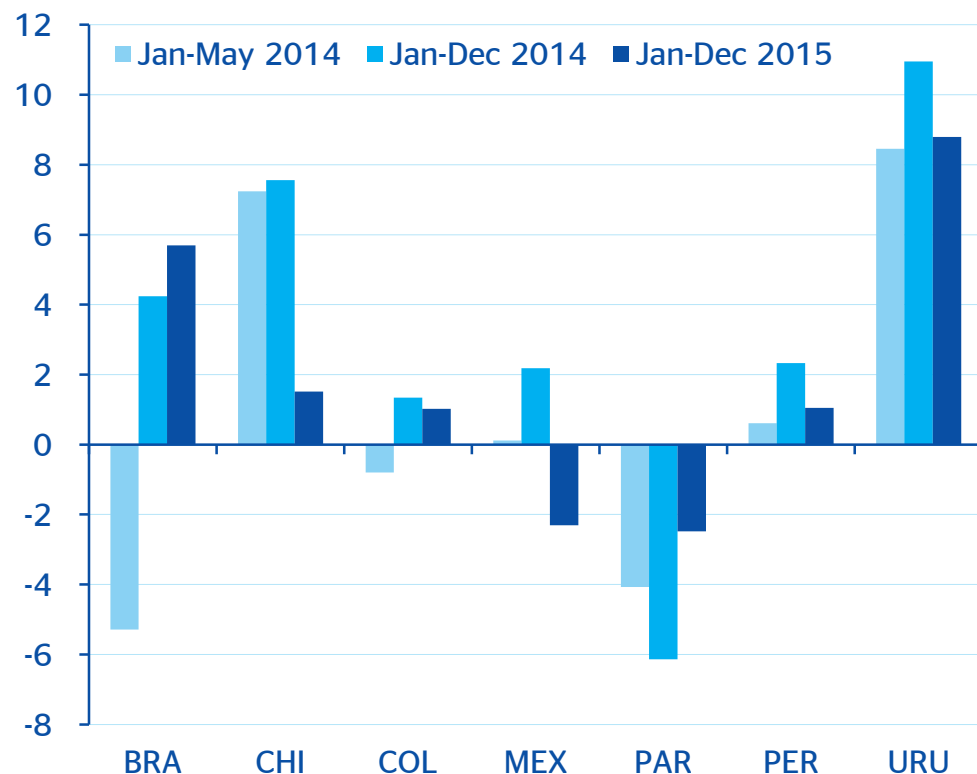
Increased interest rates in Colombia and cuts in Chile in 2014. Stability in the remaining countries for the rest of 2014

Rises in interest rates across the board in 2015, due to inflation (Brazil & Uruguay), improvement in the cycle (Pacific Alliance) and increases by the Fed

# Exchange rates will depreciate in 2014 and 2015, with very heterogeneous intensities

## Variation in the exchange rate against USD in countries with inflation targets (% Jan-Dec)

Source: Haver and BBVA Research



- Greater depreciation in countries with:
1. Greater inflationary pressure (Brazil, Uruguay)
  2. Greater exposure to fall in raw material price (Chile, Peru)
  3. Greater exposure to China (South America)
  4. Less central bank intervention (Chile)
  5. Higher external deficits (Peru, Uruguay)

Among countries with floating exchange rates, the greatest exchange depreciations in the future will be in Brazil and Uruguay ...

... and very moderate in the rest of countries

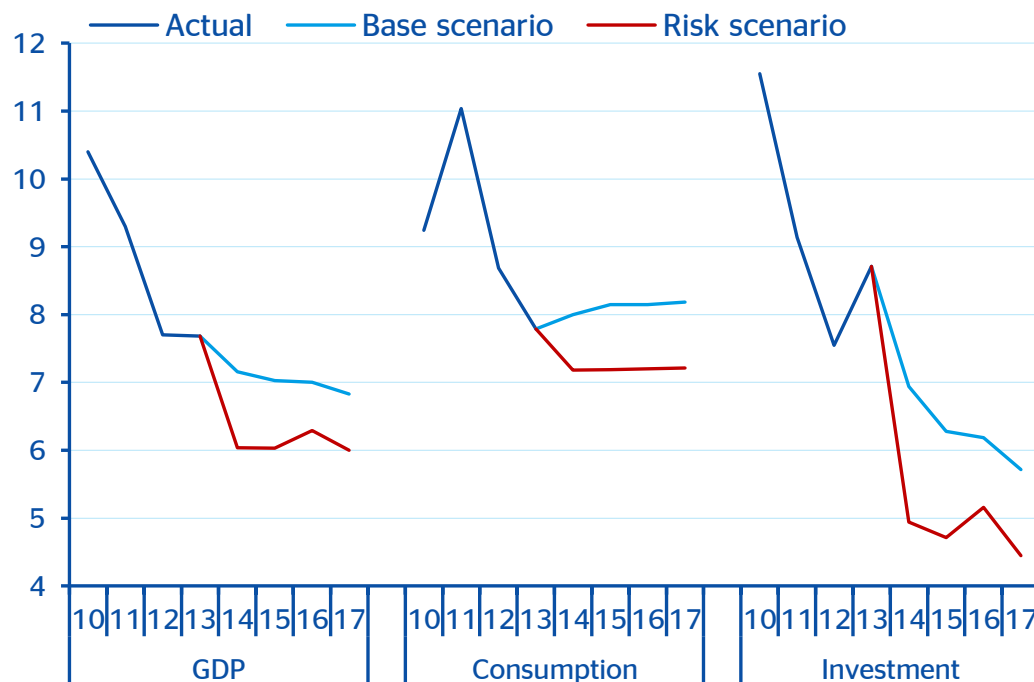
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# A sharp deceleration in China is one of the principal risk scenarios for Latam

## China: baseline and risk scenarios (% YoY)

Source: BBVA Research



A very significant risk for Latam is a possible scenario of sharp deceleration in China, although it is unlikely

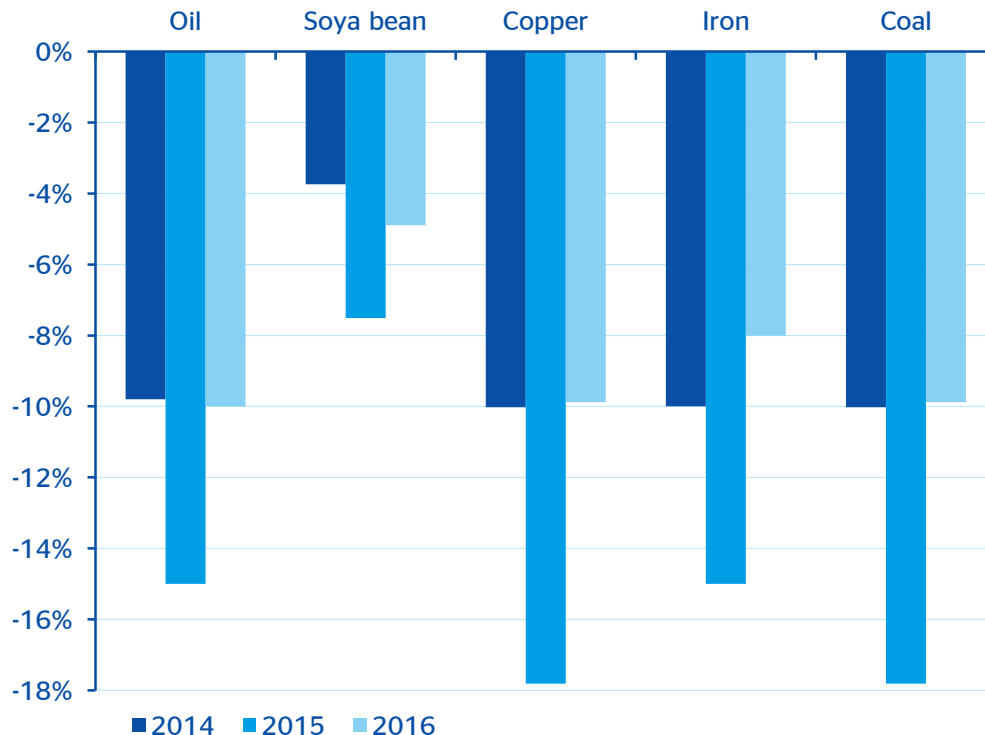
This could be the result of excessive pressure on the parallel banking system, or a sudden tightening in lending conditions

Main impact on investment, but also negative effects on consumption

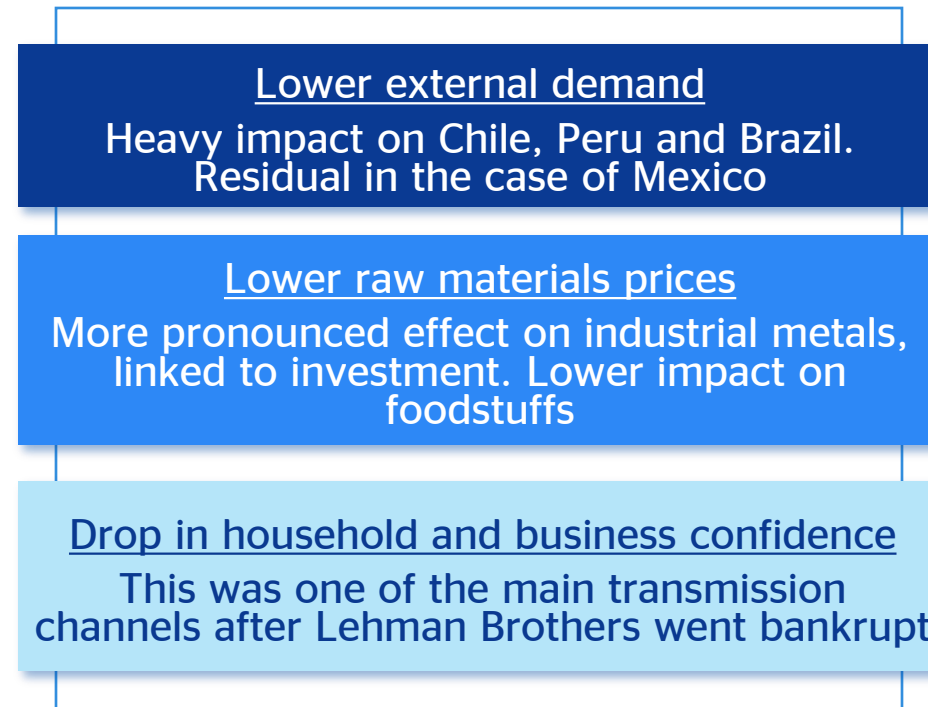
# A negative shock in China would affect Latam through three channels

**Effect of the risk scenario in China on the price of raw material exports (% change from the baseline scenario)**

Fuente: BBVA Research



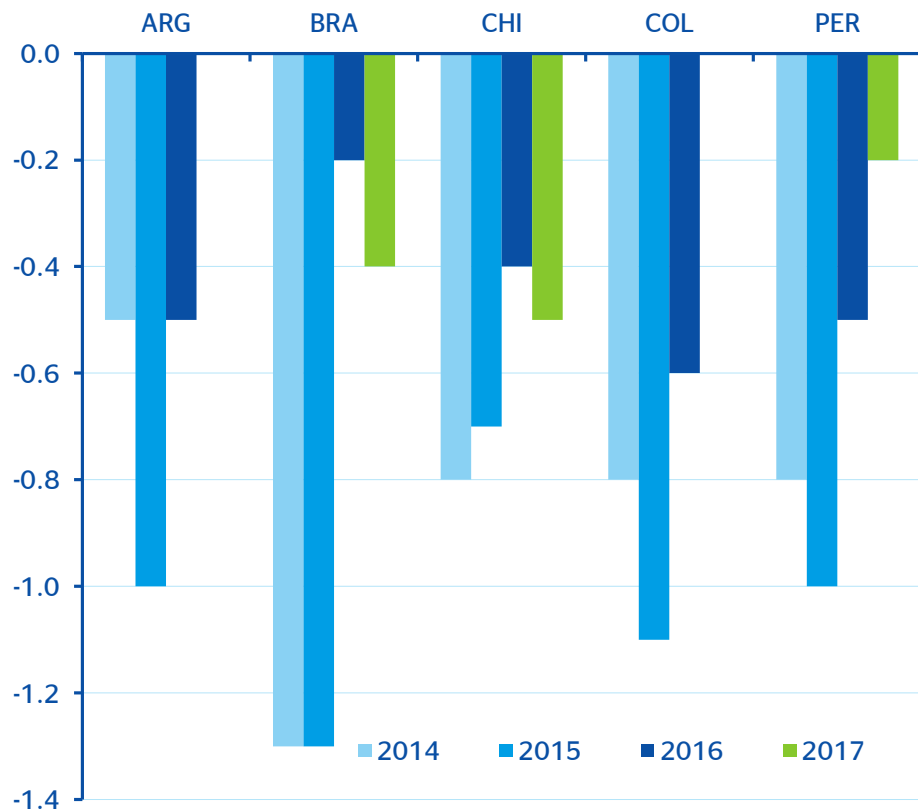
## Transmission channels to Latam



# The impact on South America would be substantial, better weathered by the Andean countries

## Latam: impact on growth of the risk scenario in China (difference in pp from baseline scenario)

Source: BBVA Research



Substantial impact in the region, apart from Mexico. Reduction in South American growth of around 1pp in 2014 and 2015

Internal demand strongly affected by the fall in confidence. Effect mitigated in countries with leeway for countercyclical policies (Colombia, Chile, Peru)

Relatively low impact in Argentina because of the smaller drop in foodstuff prices compared to metals and energy

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# Appendix: Growth forecast in Latin America

## GDP growth (% YoY)

Source: BBVA Research. \*Forecasts

	2011	2012	2013	2014*	2015*
Argentina	8.6	0.9	3.0	2.8	2.1
Brasil	2.7	1.0	2.3	2.0	1.6
Chile	5.8	5.4	4.1	3.4	4.3
Colombia	6.6	4.0	4.3	4.7	4.8
Mexico	4.0	3.7	1.3	3.4	3.0
Paraguay	4.3	-1.2	14.4	5.3	4.2
Peru	6.5	6.0	5.6	5.2	5.6
Uruguay	7.3	3.7	4.4	3.2	3.3
Mercosur	3.5	1.3	2.3	1.1	1.5
Pacific Alliance	4.9	4.2	2.6	3.8	3.7
Latam	4.1	2.6	2.4	2.3	2.5