RESEARCH

Latin America Outlook

Third Quarter 2014
Latam Co-ordination Unit

- Low volatility in international financial markets during the second quarter also extended to those in Latin America, with a rise in asset prices, notwithstanding the significant slowdown in the region's economic activity.
- Growth in Latam will climb from 1.6% in 2014 to 2.5% in 2015, led by a rise in global growth and by the recovery in investment, especially public-sector. The Pacific Alliance will grow 3.1% in 2014 and 4% in 2015.
- The economic slowdown eases the pressure on external deficits, but raises it on fiscal accounts.
- The weakness in growth has tended to bias the region's monetary policies toward a more accommodative tone, even in economies where high inflation leaves doubts about room for further monetary stimulus.

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Closing date: 1 August 2014

1 Summary

The global recovery will be slower than expected, in a complex environment. The financial markets remained free of overt stresses over the course of the last three months, and the good momentum in activity kept up, after the first-quarter slump in the US caused by extreme weather. While world growth moderated in the first half of 2014, we still think it will continue climbing, from 3.3% this year to 3.8% in 2015. On a regional basis, we stand by our positive outlooks for the advanced economies in 2015, while expecting a very limited slowdown in China, down to 7% in 2015 from 7.7% in 2013, supported by economic policy tools for both demand and shadow banking risk control.

The calm in international financial markets also extended to those in Latin America. The region's markets clung to the bullish trend and managed to recoup a fair share of the cumulative corrections seen since May 2013. This positive behaviour in assets occurred in spite of the slowdown in economic activity, undoubtedly assisted by the region's good fundamentals (with sovereign ratings raised in Colombia and Peru), but also driven by the moderation in international financial stresses, ongoing risk appetite and the still abundant international liquidity, which favoured renewed capital inflows. For its part, Argentina's default at the end of July failed to impact the region as a whole, due to the country's limited financial relations and the idiosyncratic nature of the event.

The region's activity data surprised to the downside over the first half of the year, except in Colombia. The significant moderation in household and business expectations, as well as the weakness in domestic demand indicators, marked the first half of 2014. Thus, except for Colombia, the year's first quarter growth data came in lower than expected three months ago, and the weak partial activity indicators for the second quarter led us to a downward revision of our growth estimates for that period. Also of note is the region's strong moderation in investment, which actually contracted in the first quarter of 2014, due in some countries to greater uncertainty in the private sector (Brazil, Chile, Mexico), and in others to an under-execution of public investment plans (Chile, Peru).

That said, the slump in the region appears to be behind us, and growth should increase beginning in the third quarter. The acceleration in growth starting in the third quarter of this year should be driven by a rise in world growth and foreign demand, as well as by a recovery in investment, especially by the public sector (Mexico, Chile, Peru, Colombia). Thus, our forecasts suggest that growth in Latin America would slide from 2.5% in 2013 to 1.6% in 2014, recover to 2.5% in 2015, and gradually converge over the following years toward the region's potential, which we place at slightly above 3% (see Box 1).

The momentum in the region will remain very heterogeneous, with the Pacific Alliance countries standing out above the regional average. In particular, the Alliance countries will grow 3.1% in 2014 and 4% in 2015, more than three times the growth expected for the Mercosur block (0.4% and 1.2%). Notwithstanding the downward revisions to our 2014 growth forecasts (with the exception of Colombia), the countries with greater momentum in 2014 will remain Paraguay and Colombia (4.9%), Peru (4.1%) and Chile (2.9%). Furthermore, while we expect the strong momentum in Colombia to continue in 2015, and we also expect a significant increase in growth in 2015 vs. 2014 in some countries, of around one percentage point in Mexico and Chile (led by the recovery in the US and public investment, respectively), and of roughly two percentage points in Peru (driven by exports and public investment). On the other hand, growth in Brazil will remain very moderate in 2014 (1.3%) and 2015 (1.6%) as long as public policies remain unable to mitigate uncertainty and improve confidence.

The economic slowdown reduces the pressure on external accounts, but raises it on fiscal accounts. External deficits in most countries will gradually decline over 2014 and 2015 due to the weakness of domestic demand, but also because of weaker currencies (which will partially offset lower terms of trade) and the end of a series of negative supply shocks in the export sector in countries such as Peru, Colombia, Uruguay and Argentina. On the fiscal side, the slowdown in demand and the lower prices of export commodities (copper and soy bean) will continue to pressure tax revenues to the downside, although this will be offset in Chile and Mexico by higher revenues from their ongoing tax reforms (see Box 2 for the case of Chile). This will be accompanied by greater fiscal stimulus in many of the region's countries (Chile, Mexico, Peru, Colombia) and higher debt burdens in Argentina and Brazil.

Upward pressures persist, but inflation will remain around central banks' targets, except for Uruguay. The push to inflation, stemming from currency depreciation and a rise in the price of energy and food, has started to give way, reflecting the moderation in domestic demand. That said and going forward, with the exception of Chile, we expect inflation to remain at the high end of central banks' targets (significantly above in the case of Uruguay), casting doubts on central banks' scope to ease the tone of their monetary policy.

The weakness in growth has tended to bias the region's monetary policies toward a more accommodative tone, even in economies where there are doubts about room for further monetary stimulus. With inflation rates at the high end of the target range or even slightly above (in some cases coupled with a high foreign deficit such as in Peru and Uruguay), there would indeed seem to be little room for further interest-rate cuts. However, over the last three months there has been a certain tendency among central banks to give priority to growth stimulus, with cuts in Chile that were expected and others in Peru and Mexico that came more as a surprise. This was also combined with the use of macroprudential measures such as the reserve ratio cut and the increase in banking system liquidity in Peru, measures which Brazil will apparently also start to employ.

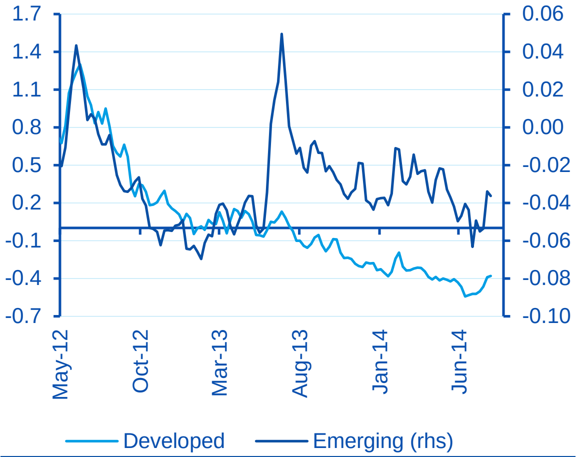
The region's currencies will remain in a mild depreciatory trend, due to lower relative growth, lower commodity prices and interest-rate hikes by the Fed. That said, the intensity of the currency depreciation going forward will be uneven, higher in those countries with greater inflationary pressures (Brazil, Uruguay, Argentina) and in those whose currencies may reveal a greater sign of overvaluation vs. their fundamental values, such as Brazil.

2 Global scenario: a slower global recovery in a complex environment

Low financial tensions, dominated by the Fed, support a favourable scenario for growth

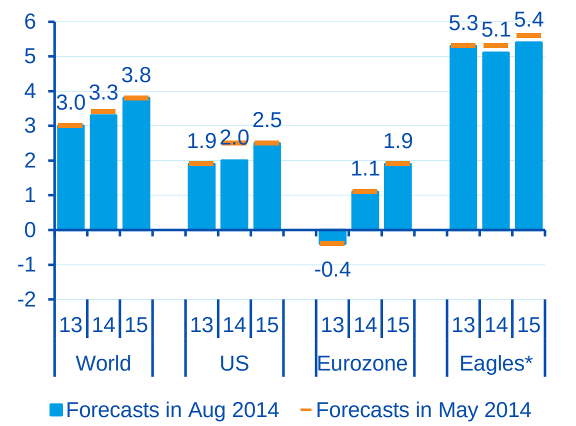
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging and developed markets (Figure 2.1) – the recent uptick is due specifically to Russia. Second, industrial activity and global trade are keeping up a good momentum. All of this is taking place in a global environment in which geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere, and as such increasing uncertainty. For the moment, financial volatility is at historically low levels, since the factor dominating the behaviour of global financial markets is the Fed, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years.

Figure 2.1
BBVA Research's Financial Stress Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



* EAGLEs is the emerging markets group which will contribute most to world GDP in the next 10 years. The group consists of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

In China, the risk of a hard landing is receding and growth will remain above 7%

The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in relation to the increase in infrastructure spending.

All in all, our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an economic rebalancing, with a moderate increase in debt, for which the authorities have the room for manoeuvre provided by their high level of reserves, the control of their current account with high levels of private savings and relatively low public-sector debt.

Transitory hiccup in US growth. The Fed's communication policy will be key in lowering market volatility

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction made us revise our growth forecast downward for 2014 from 2.5% to 2% (Figure 2.2). The 2.1% quarterly drop, in annual terms, of US GDP is one of the sharpest of the historical series in a cyclical growth phase. The most recent data show that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of stocks.

There is greater uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy will become more important; as such, an increase in global financial market uncertainty and volatility is also a possibility.

The outlook in the Eurozone is improving thanks to supportive domestic demand policies and progress in banking union

Leading indicators in the Eurozone are consistent with a slight recovery in GDP, in line with our forecast of 1.1% for the year as a whole, the first positive annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the Eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and a more positive external environment. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the euro area authorities to strengthen the single market in the financial sector, and the support of the monetary policy implemented by the ECB, which goes beyond what might have been foreseen just a few quarters ago. Second is the anchoring of global financial tensions at minimum levels. In addition, the reforms undertaken in the markets of productive factors in some economies, designed to improve competitiveness, are another positive factor.

All in all, although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015 (Figure 2.2), the bias for these is to the upside if the potential impact of the measures announced by the ECB is taken into account. All this does not, however, rule out the existence of risk to the downside which could be triggered by the worsening crisis in the Ukraine and the knock-on effects of economic sanctions imposed on Russia, to which the Eurozone would be far from immune.

In summary, global growth will strengthen from the second half of 2014 onwards

In our most likely scenario, the slowdown in global growth in the first part of 2014 has already ended. The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013 (Figure 2.2). Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years.

The uncertainty within this baseline scenario continues biased to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US.

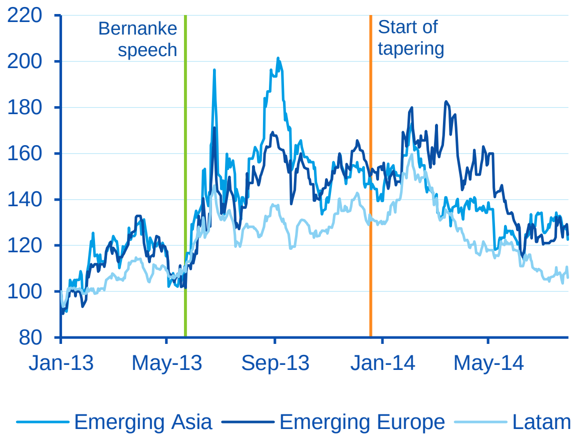
3 Optimism continues to prevail in Latam's financial markets

The bullish trend in Latin American asset prices continued over the last three months, notwithstanding the slowdown in economic activity

After the losses recorded at the start of 2014, mainly due to a series of shocks of an idiosyncratic nature in some emerging countries, Latin American asset prices started to recover from February of this year (see the figures below and our Latin America Outlook for the previous quarter). The recovery consolidated over the last few months, even though economic activity continued to slow in most of the region (see next section for an analysis of this moderation).

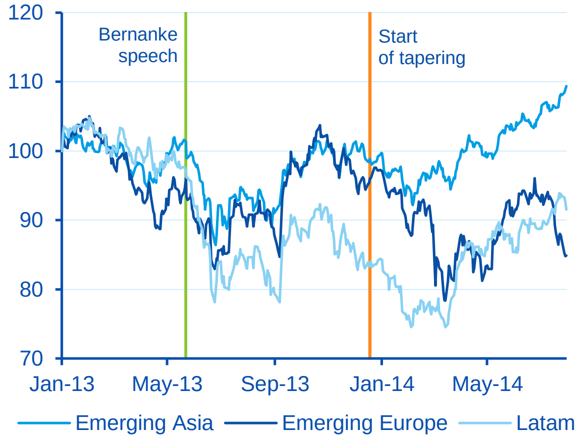
Latin American sovereign spreads, for example, continued to tighten over the last few months. While this tightening is shared by other emerging regions, it was more pronounced in Latin America, in part because this region is more isolated from the recent geopolitical turbulence in the Middle East and Eastern Europe (Figure 3.1). Latin American share prices displayed a similarly positive behaviour (Figure 3.2).

Figure 3.1
Sovereign spreads in EMs (EMBI, Index Jan 2013 = 100)



Source: Haver Analytics and BBVA Research

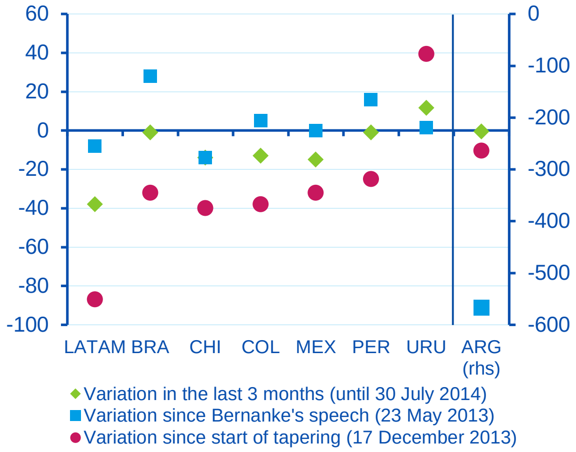
Figure 3.2
Share prices in EMs (MSCI, Index Jan 2013 = 100)



Source: Haver Analytics and BBVA Research

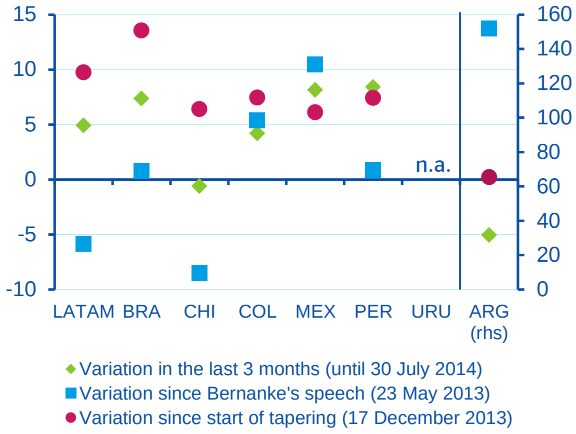
The positive tone of the financial markets was widespread across the region. The sovereign risk premium, for example, fell in all of the main economies except Uruguay (Figure 3.3). Reduced sovereign risk was practically nil in Brazil, possibly due to the greater uncertainty over the October presidential elections. Share prices have risen over the last three months in all countries, albeit only mildly in some cases (such as Brazil, Chile and Colombia, Figure 3.4).

Figure 3.3
Sovereign spreads in Latam (EMBI, bp)



Source: Haver Analytics and BBVA Research

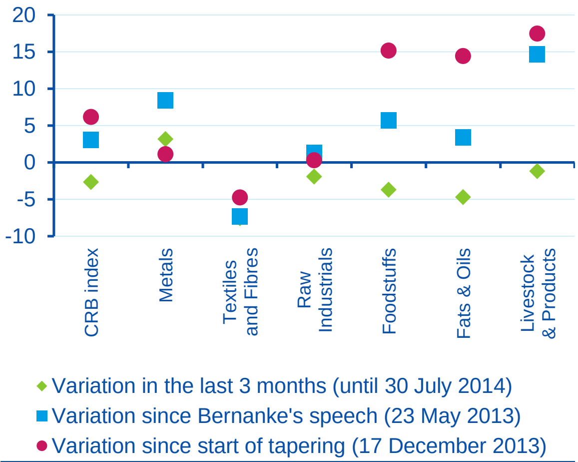
Figure 3.4
Share prices in Latam (% var. in local currency)



Source: Haver Analytics and BBVA Research

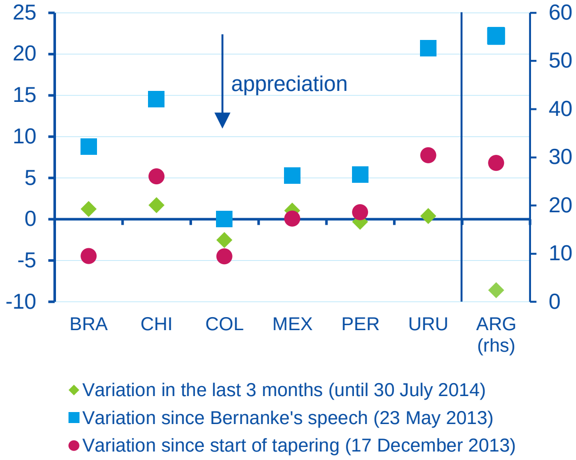
Note that the optimism in the financial markets over the last few months is taking place in a context of moderating domestic demand and commodity prices in global markets, even though the growth stimulus policies announced by China and the relative strength in activity revealed by recent data from that country supported the prices of metals such as copper (Figures 3.5 and 3.9). These factors, however, do seem to have played a major role in preventing the optimism in financial markets from spreading to the currency markets, which have been stable over the last quarter (Figure 3.6).

Figure 3.5
Commodity prices (% var.)



Source: Haver Analytics and BBVA Research

Figure 3.6
Latam exchange rates (% var.)



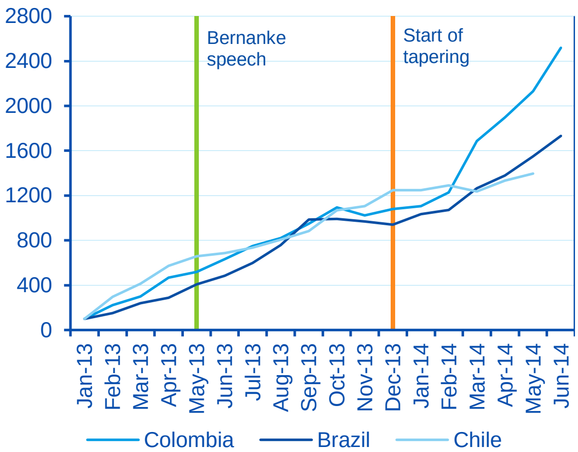
Source: Haver Analytics and BBVA Research

In our opinion, the optimism in the markets is related to factors such as the strong fundamentals of many of the region's economies. Note the improvement in Latin American country risk ratings, highlighted by Moody's recent upgrades of the ratings of Peru and Colombia, the former by two notches from Baa2 to A3, the latter by one notch from Baa3 to Baa2. On the other hand, S&P downgraded Argentina's rating to Selective Default.

Furthermore, the circumscription of the risks associated with monetary normalisation in the US and the moderation of activity in China, as well as the still high global liquidity, have contributed to the rise in capital flows toward the region (Figures 3.7 and 3.8), and to the relatively positive performance of Latin American financial markets over the last three months.

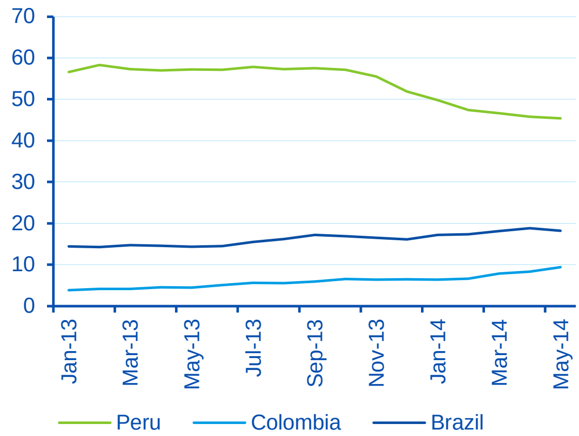
Additionally, and as we highlight below, there are considerable risks that the markets' optimistic tone (which contrasts with the concurrent moderation in economic activity in many of the countries in the region) could give rise to a new period of turbulence and corrections in the region's financial markets in a not too distant future, especially in a context of the Fed proceeding with its gradual withdrawal of monetary stimulus, now through a rise in interest rates.

Figure 3.7
Non-resident portfolio flows (aggregate balance of payments data, Index Jan 2013 = 100)



Source: National Statistics and BBVA Research

Figure 3.8
Non-resident sovereign bond holdings (% of total)



Source: National Statistics and BBVA Research

Lastly, we should note that at the end of period analysed in this report, specifically 30 July, news sources reported that Argentina and the holdouts (the holders of Argentine bonds that refused to accept the debt swap the country proposed in 2005 and 2010) had failed to reach an agreement that would unblock payment to holders of the restructured debt (that is, those that accepted the debt swap). While this lack of an agreement led Argentina to default, it will be less serious than that of 2001, because the financial system is sound, the country has less debt and has not had access to credit markets since 2007, and the peso is not significantly overvalued. At any rate, neither its solvency nor its willingness to pay is in question, as on the previous occasion.

Upon the news of default, while potential problem resolution scenarios were being drawn up, Argentina's stock market erased a portion of the gains it had accumulated over the last days prior to 30 July, but held on to a fair share of the strong rises of the last months; the sovereign risk premium also deteriorated. Not surprisingly, contagion to the rest of the financial markets was quite limited, and centred on Brazil. This reaction is in line with our view that there is little room for turbulent events in Argentina to significantly impact other markets in the region. Contagion through the trade conduit, due to a greater depreciation of the ARS and a loss of momentum in the country's economic activity, could have a more significant impact, but centred on Argentina's main regional trading partners, such as Brazil and Uruguay (see, for example, Box 1 of our Latin America Outlook for the first quarter of 2014).

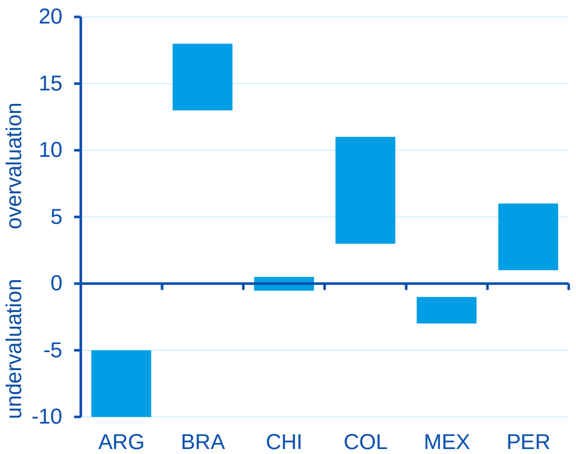
The recent recovery offsets the cumulative losses since May 2013, but the Fed's interest rate hikes in 2015 represent a downward risk

After the recovery seen over the last three months, the region's financial assets are generally trading well above the levels of 17 December, when Fed tapering began. In other words, the losses recorded at the end of 2013 and the beginning of 2014 were offset by the gains registered since the middle of the first quarter.

Furthermore and in general terms, the recent recovery also erased the cumulative losses since May 2013 when, after the speech of then Fed Chair Ben Bernanke, markets began to discount the effects of monetary normalisation in the US (see previous figures). The main assets are currently trading at levels just shy of those recorded in May 2013. The main exceptions lie in the currency markets: Latam currencies are currently weaker than in May 2013, with the exception of the Colombian peso, which remains stable due to the stronger economic activity in this country and the increase in Colombia's weighting in investment bank J.P. Morgan's fixed-income indices (Figure 3.6).

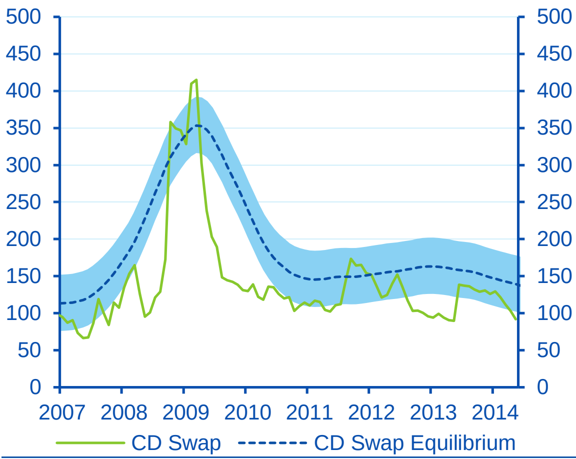
The depreciation of Latam currencies since May 2013 is also related to the moderation in economic activity and the consequent relatively accommodative tone of monetary policy in many countries, to the fact that they were somewhat overvalued at that time with respect to their equilibrium levels, and also to the maintenance of persistent foreign deficits in some cases. In fact, Latin American currencies are probably still slightly overvalued, notwithstanding the cumulative depreciations since May 2013 (Figure 3.9).

Figure 3.9
Currency overvaluation in Latam vs. equilibrium level (%)



Source: BBVA Research

Figure 3.10
Latam: Sovereign CDS, 5-year*



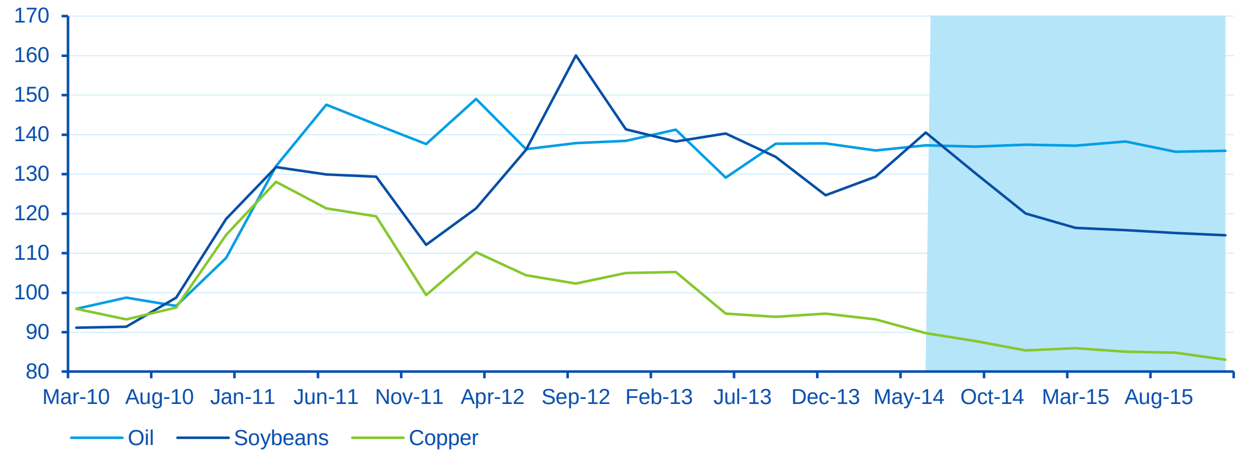
*Equilibrium is calculated as the average of four alternative models, with a confidence interval of 0.5 standard deviations. For further details, see our BBVA Research Country Risk Report.
Source: BBVA Research

The signs that in some other markets prices could already be above their equilibrium levels (Figure 3.10), the decoupling of the (upward) trends in the region's financial markets from the (downward) trends in growth and domestic demand and, also, the outlooks for Fed normalisation of monetary policy, could generate turbulence in the region's markets, erase the recent optimism and lead to at least a partial correction of the gains seen since the start of the year.

The expected moderation in the price of commodities, which will nevertheless remain at historically high levels, may also favour a downside correction in the region's financial markets

Compared with our forecasts of three months ago, we have applied mild upward revisions to our year-end forecasts for soy bean (1.0%), oil (3.2%) and copper (1.8%). These revisions lead us to postpone the convergence toward long-term values to the end of 2015. Copper's recent positive surprises underlie the upward revision to our forecast, although bearish risks still exist due to potential Chinese government regulations to discourage the use of metals in the financial system as collateral against loans. In the case of oil, the upward revision was motivated by geopolitical factors arising from the conflict in Iraq and the accumulation of demand imbalances, while OPEC's low response capability conditions supply. Our forecasts for the soy bean markets remain practically stable, but we expect a downward price adjustment due to the impact of the higher production expected this season.

Figure 3.11
Latam: Prices of main commodities (average index 2010 = 100)



Source: BBVA Research

All in all, the recovery in the economic activity of the key economies in the region (and the world) should provide a boost to the region's asset prices.

4 The sharp slowdown in Latin America in the first half of 2014 will reverse

Disappointing activity data in the first and second quarter, below our expectations of three months ago

In most of the region's countries, the prevailing factor was the disappointing activity data for the first half of the year, particularly as regards domestic demand, such as retail sales and consumer confidence, but also supply-related data such as industrial production and producer confidence. Indeed, in most countries except Colombia, confidence indicators continued to moderate, entering into mildly pessimistic territory (Figure 4.1) with slowing retail sales (Figure 4.2). As reported further below, the strong moderation in investment was also of note. It should be mentioned that the disappointing data for the most part reflect idiosyncratic shocks, which we believe will be transitory.

The main disappointments in Chile and Mexico were in investment and consumption. Chile's business confidence and industrial production indicators, the latter affected mainly by the mining sector, have already suffered from the effect of domestic uncertainty associated with the tax reform (see Section 5). More recently, consumer confidence and retail sales have also moderated considerably (Figures 4.1 and 4.2). It should be noted that in Chile and Mexico alike, the moderation in the retail sales indicator is to a large extent associated with the weakening of household income in real terms, which displayed ongoing moderations over the last quarters. The loss of real income in both countries is proof of the growing job weakness, given that the improvement in this indicator mainly took place in the low-quality job segment ("self-employment" in the case of Chile and jobs with wages of between zero and three minimum wages in the case of Mexico). In Chile, the total wages bill in real terms has gone from growing by around 6.0% in 2013 to 5.0% yearly in the first quarter of 2014. In the case of Mexico the same comparison is more dramatic, with variations between 2013 and 1Q14 from 0.10 to -3.8%, impacted by the effect of the tax reform on the prices of some goods and services in the first quarter of the year.

The negative surprise in the first quarter was particularly significant in the case of Mexico, where 1Q14 growth, which we (and Banxico) expected at 0.6%, came in at 0.3% QoQ. The surprise was related to several factors: unforeseen negative effects of the tax reform[1] on investment and on the real income of wage earners, in addition to its effect on the prices of some goods and services, which in turn had a negative effect on consumption. With respect to the tax reform, some of the worst affected sectors would appear to be mining and *maquiladoras*, in addition to the SMEs, due to a higher tax burden and lower allowable deductions. For its part and among other factors, the extraordinarily adverse winter conditions in the US resulted in a contraction of its output, which also affected some sectors of Mexican manufacturing. This was compounded by the delay in passing the budget over 2013 and the start of 2014. For example, note that public investment over the first three months of the year was 6.5% less than in the previous quarter, in addition to a significant shortage of gas in the second half of 2013 that affected industrial production.

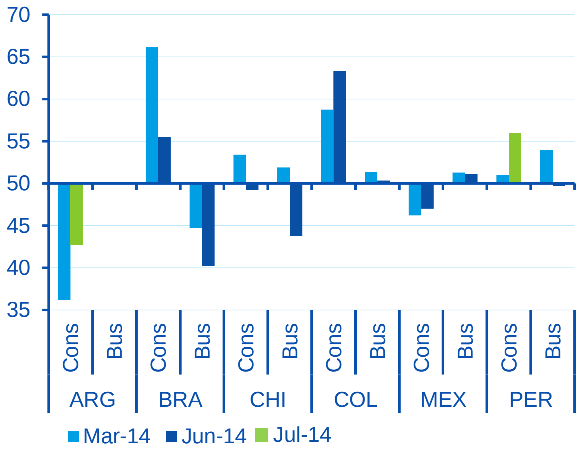
For its part, activity growth in Peru has surprised steadily to the downside so far this year. Particularly intense were the moderations in mining, construction and non-primary manufacturing, a situation that has intensified due to supply factors such as the delay in the start-up of the Toromocho mine. The data available for the second quarter, such as producer and consumer confidence and industrial production, point to a significantly lower growth scenario than we expected one quarter ago.

1:The percentage of responses in the sense that the fiscal policy that is being instrumented is the main factor that could hinder growth went from 2% in January 2013 to 17% in December; 12% in the June survey.

In the case of Argentina, the available second quarter indicators, retail sales and industrial activity in particular, suggest that, after two quarters of contraction, the economy contracted once again over the April to June period. The situation deteriorated in Brazil, where the revisions in terms of producer and consumer confidence were significant, swayed by the uncertainty associated with future economic policies, the impact of the slowdown in China and Argentina on exports and the persistently high inflation, which has discouraged investment.

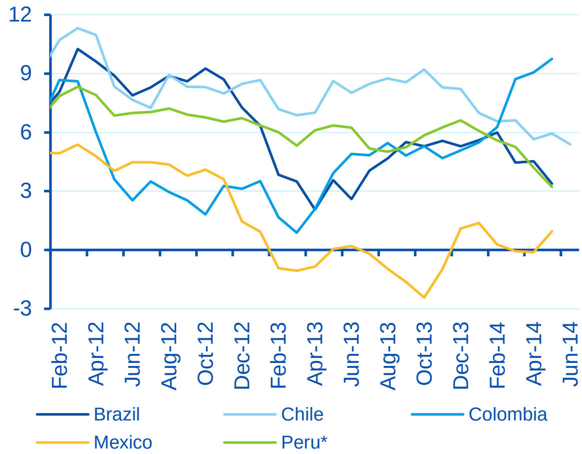
Of special mention is the case of the Colombian economy, whose cycle remains decoupled from the rest of the region. Growth was higher than expected, particularly in the first quarter, mainly due to the pick-up in the public and private construction sector. Also of note were the confidence indicators and the growth in retail sales of 7.2% YoY, vs. 4.2% en 2013. Although the second quarter data suggest that the strong dynamics will continue, growth appears to have moderated slightly in comparison with the first months of the year, and will be more consistent with its potential growth (see Box 1).

Figure 4.1
Consumer and Producer Confidence, 50-point Index Threshold of Optimism (+) Pessimism (-)



Source: Haver Analytics and BBVA Research

Figure 4.2
Latam: Retail sales, % YoY

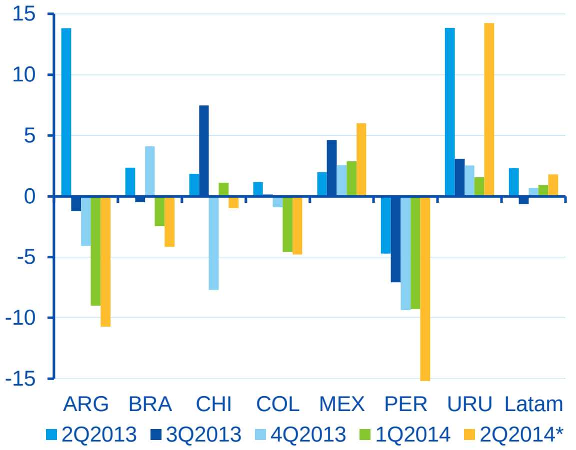


*Value added to GDP by the trade sector (also includes wholesaling).
Source: Haver Analytics and BBVA Research

The external front has also displayed moderate momentum, although to a lesser degree than in the domestic demand data. Exports suffered particularly striking contractions in the cases of Argentina and Peru, while the slowdown was less pronounced in Brazil and Colombia, with few changes in Chile and growth in Mexico (in response to the US recovery) and Uruguay. Argentina's industrial sector was affected by the moderation in Brazil. In Peru, the drop in mining operations had a major impact on the export sector. Consequently, the already weak growth momentum in the value of Peru’s goods exports (-9.0% in 2013) intensified over the first months of the year, falling 11.9% YoY over the first five months of the year. In Colombia, exports were impacted by the effect of lower demand for industrial exports and the shocks in oil and coal prices. For their part, in the ensuing months after the negative effect of the harsh first quarter weather conditions in the US, Mexico's manufacturing exports reported a significant pick-up, particularly in the automotive sector (Figure 4.3).

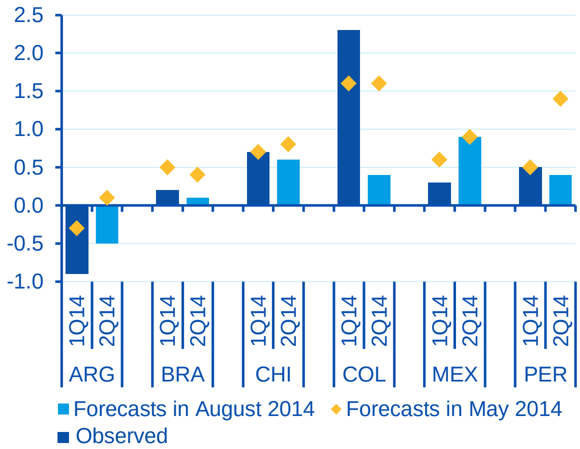
As a result of the above, the surprises over the evolution of the region's economic activity were mainly negative, with first quarter growth coming in below our expectations of three months ago, except in the case of Colombia (Figure 4.4), and partial indicators for the second quarter of 2014 that lead to a downward revision of our growth forecasts for that quarter (and for 2014 overall, as described below).

Figure 4.3
Latam: Exports (% YoY)



*Colombia and Peru only include the data for April and May.
Source: BBVA Research

Figure 4.4
Latam: GDP growth % QoQ, expected vs. observed



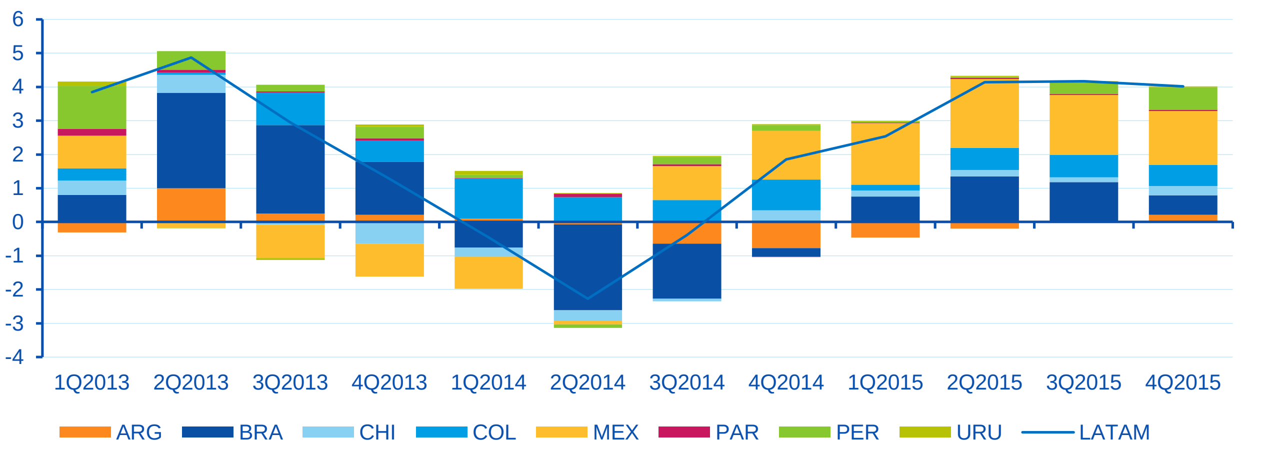
Source: BBVA Research

Notable among the weakest indicators is the moderation in investment, which actually contracted in the first quarter of 2014

Investment recorded the most severe adjustment within aggregate demand components. In fact, the dynamics have gone from growth of around 3.2% YoY on average in the region in 2013, to an average fall of 0.5% YoY in the first quarter of 2014, which seems to have deepened to an estimated 2.3% in the second quarter (see Figure 4.5). Behind this widespread fall (except for Colombia) lie a variety of factors. In the cases of Chile and Mexico, for example, the sharp drop in private investment was partially related to the uncertainty associated with the tax reform process, about which more details are now known. Mexico was also influenced by the above-mentioned slow execution of public spending, which led to less public investment. This uncertainty, which has negatively affected investments since the end of last year, is coupled in both cases with the slow execution of public budgets (the fall in Chile's public investment in the last quarter of 2013 helped explain 25% of the drop in total investment). In the case of Chile, we should note that the most recent indicators of capital goods imports (investment-related) reveal a contraction, while the flow of credit to businesses and households has slowed considerably. For its part, the elimination in the second week of July of the investment incentive based on instantaneous depreciation could hinder some of the additional investments that were expected for the fourth quarter.

Investment also surprised to the downside in Peru, a situation mainly associated with the drop in business confidence, fewer investment projects in mining and fossil fuels (the main sector component of investment in Peru) and also with the delay in executing public investment projects, especially by the regional authorities. For its part, Brazil still has problems associated with infrastructure quality and deteriorating competitiveness. Investment came in at -2.0% over the first months of the year, after growing 5.1% in 2013.

Figure 4.5
Latam: Total investment (% YoY) and contributions



Source: BBVA Research

That said, we expect investment to recover going forward, led by public-sector investment in practically all Latam countries. In the case of Peru, the higher growth confidence was led by the expected improvement in infrastructures, in line with a series of recently-awarded concession projects, in addition to the higher spending expected for the second half of 2014, in connection with prevention works related to the El Niño phenomenon. Furthermore, the Toromocho and Antamina mines will be at full operating capacity in the second half of the year, which will lead to a rise in exports. In Mexico, the higher budget for 2014 passed by Congress and up to now unexecuted implies significant growth in public investment in the second half of the year and in 2015, which goes hand in hand with the start-up of the infrastructure works provided for in the recently-approved 2014-2018 National Infrastructure Plan. Furthermore, the base-case scenario for Chile projects a considerable improvement in public spending and capital.

Investment in Brazil will pick up toward the latter part of the year, reflecting less uncertainty with respect to global growth, and in light of the upcoming presidential elections in October. Lastly, investment in Colombia maintained strong growth of around 6.2% in 2013 and 14.6% in the first quarter of 2014. For the remainder of the year and in 2015, demand will be spurred by the continuation of the ambitious 4G infrastructure project, which will imply an average annual investment growth of close to 10%.

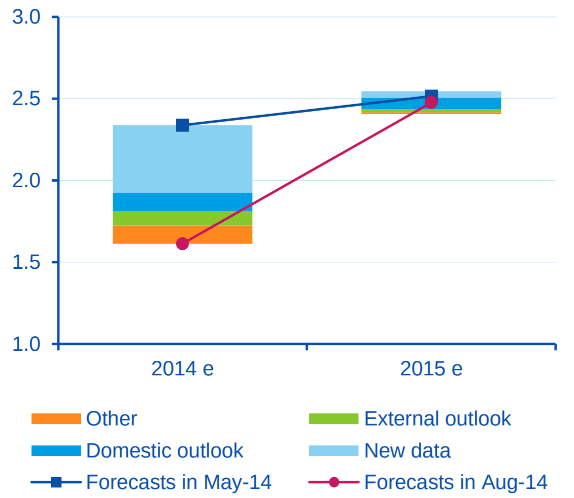
The poor data seen in the second quarter, as well as the slower than expected pace of improvement in domestic and foreign demand, lead to a downward revision of our 2014 growth forecasts

Within a context of moderation in both expectations and activity indicators over the last three months (with the noteworthy exception of Colombia, whose cycle seems to have decoupled from the rest of the region), we have revised our 2014 growth forecast significantly to the downside, by magnitudes ranging from 40bp in the case of Paraguay to 1.1pp in the case of Peru.

For the region overall, the factors behind the 0.7pp adjustment to our growth forecast are, on the one hand, the negative surprises seen in the data over the last three months (0.4pp, see Figure 4.6) and, on the other, our expectation that the pick-up in domestic and foreign demand over the coming months will be somewhat lower than anticipated three months ago.

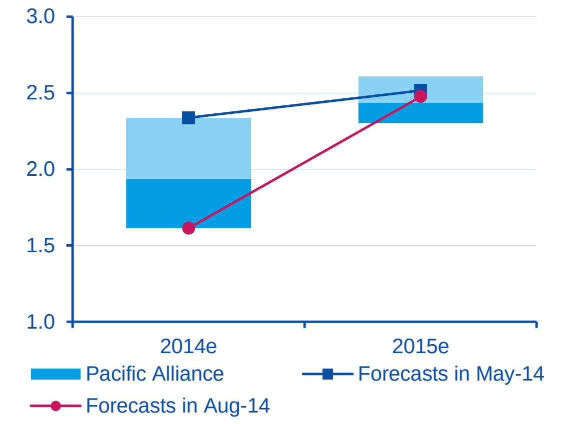
Although the revision is significant, some points should be made: first, all estimates suggest that the economies will regain momentum toward 2015 (we have not changed our 2015 growth forecast for the region), and that in the following years growth will once again approach the 3.1% potential estimated for 2016-20 (see Box 1). Second, we should note that the differentiation in the region will continue, and we confirm that those countries with historically orthodox economic policies are better-positioned to face periods of internal moderation and external shocks. Consequently, most of our revision stems from the deterioration in the outlook for the Mercosur block, (see Figure 4.7), while among the Pacific Alliance countries, the revision centres on Mexico. As previously mentioned, we have revised our growth forecast for growth in Colombia to the upside. Meanwhile, in 2015, while some Mercosur countries will carry some negative momentum which will lead the downward revision to also involve that year, in Peru and Mexico we expect a significant pick-up from the end of this year extending into the next, implying an upward revision for that block. Both effects are mutually offsetting, which means that in aggregate the outlook for 2015 remains unchanged.

Figure 4.6
Latam: Determinants of change in GDP growth forecasts



Source: BBVA Research

Figure 4.7
Latam: Contribution to GDP growth forecast revisions by country blocks



Source: BBVA Research

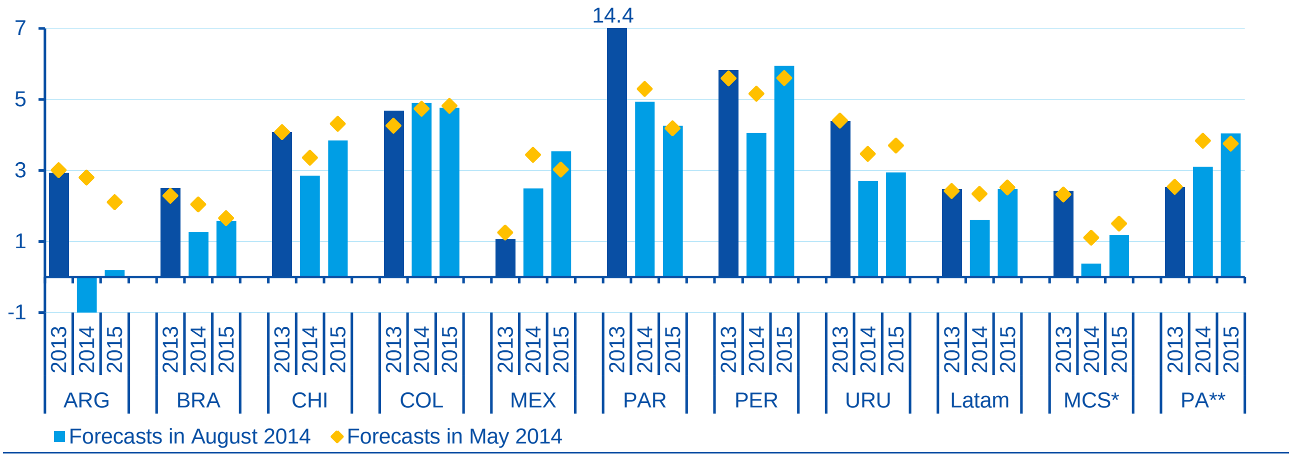
The region will grow 1.6% in 2014 and pick up to 2.5% in 2015, gradually converging toward its potential in the following years

Specifically, Colombia and Paraguay will stand out for their growth in 2014, with rates of close to 5%, although with very different trends. On the one hand, Colombia has managed to post sound growth over the last years, a reflection of the success of recent economic policies, which have implied stable growth of around 4.8% (very close to potential) over the last four years. In this regard, the positive growth outlooks supported by appropriate fiscal management, reflected in moderate deficits, led Moody’s to upgrade the country's sovereign debt rating to Baa2 from Baa3, with a stable outlook. On the other hand, the scenario in Paraguay has been one of great volatility, related to its high exposure to the price of soy bean (and to weather variations and their effect on crops) and to the importance of livestock. Growth in Peru will be noteworthy in 2014 and, particularly, in 2015 (4.1 and 5.9% in 2014 and 2015, respectively), where private consumption will remain key. Moody’s upgraded the sovereign rating in March, citing fiscal policy and extending a vote of confidence for the structural reforms in progress. We expect Peru to remain at the head of the region's growth over the coming years (see Figure 4.8).

In 2014, the largest economies are those that will grow the least: in Brazil, the moderation in private consumption, investment and exports in the first quarter, as well as the scenario for the rest of the year, lead us to change our forecast, from our previous estimate of 2% to the current 1.3%. This major revision is due our limited confidence in a sustained recovery over the coming months, stemming from structural problems such as the exhaustion of the consumption-based growth model, together with competitiveness problems associated with the delay in the structural reforms agenda. Argentina was affected by the uncertainty associated with the resolution of the holdouts' debt, which will imply half a point less growth in 2014. In Mexico, first quarter GDP implied a major negative surprise that led to a revision of our 2014 forecast from the 3.4% estimated one quarter ago to the current 2.5%. In the case of Peru and Chile, affected by worse domestic demand data, particularly in the investment component, we have revised our forecast to the downside from the previous 5.2% to the current 4.9% in the first case, and from 3.4% to 2.9% in the case of Chile.The revision for Uruguay stems from the lower demand on the part of its neighbours and from the delay in starting up the Montes del Plata paper mill. Lastly, the moderation in Paraguay will be somewhat less, given that the negative impact of lower demand for its products in Brazil will be offset by the development of the infrastructure works that began last year.

In the case of Colombia, note that the revision to 2014 growth was to the upside, from the previous 4.7% to the current 4.9%, all of which results from the outstanding public demand data, while private components have maintained the expected dynamics. Note that over the last few quarters the public component of demand was particularly significant in the country, mainly associated with infrastructure works.

Figure 4.8
Latam: GDP growth by country (%)



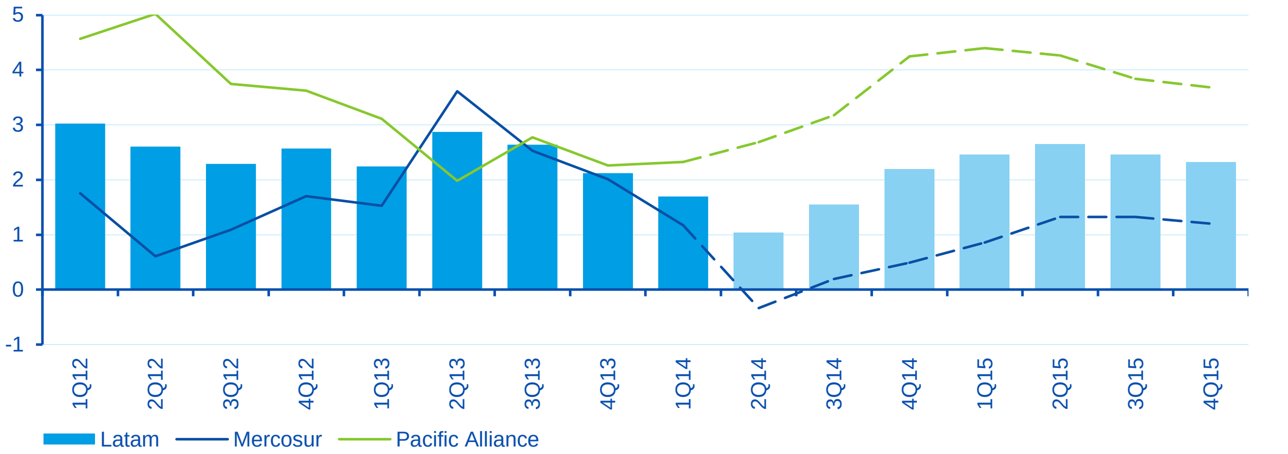
*MCS: Mercosur. **AP: Pacific Alliance.
Source: BBVA Research

Pick-up in economic activity to be led by global growth and the boost of public investment

We expect higher growth in most of the region's countries toward the second half of the year and in 2015. The improved outlook of investment, supported by public spending, will boost growth in domestic demand, while moderate inflation will lead to pick-ups in real income, which improves the outlook for consumption. Furthermore, the improved outlooks for world growth will combine with the positive effect of the currency depreciation on exports to manifest as a positive growth factor in the latter part of the year.

Of note are the expected pick-ups in growth in the Pacific Alliance countries. We have probably already seen the toughest phase of the moderation in the Alliance's growth in the second quarter of 2014 (Figure 4.9). From this point forward, growth should recover in most countries and approach their potentials.

Figure 4.9
Latam: GDP growth (% YoY)



Source: BBVA Research

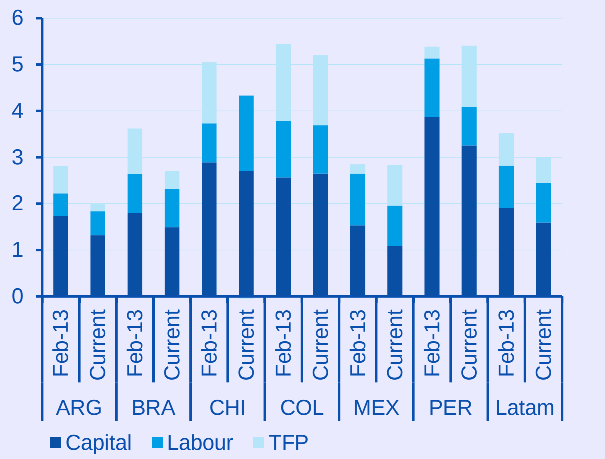
Thus, not only do we anticipate that Colombia's strong momentum will continue in 2015, but we also expect a significant rise in growth in 2015 vs. 2014 in some countries, of around one percentage point in Mexico and Chile (respectively led by the recovery in the US and in public investment), and of around two percentage points in Peru (driven by exports and public investment). Additionally, this implies an upward revision to 2015 growth vs. our forecast of three months ago, from 5.6% to 5.9% in Peru and from 3.0% to 3.5% in Mexico. In the case of Chile, although investment will be spurred as the uncertainty associated with the tax reform fades over time, we expect the deterioration of the labour market will imply a significant moderation in consumption extending into 2015, which leads us to revise our forecast for said year from the previous 4.3% to the current forecast of 3.8%, given that it would be difficult for the pick-up in public spending execution and the effect of monetary stimulus to make up for the negative effects associated with the deterioration in private consumption.

Brazil and Uruguay will also be characterised by a mild improvement in growth in 2015, although to a lesser degree than the other countries in the region. In the case of Argentina, we anticipate little growth in 2015. However, in the event the dispute with the holdouts is resolved, the qualitative improvement government initiatives have implied (regularisation of statistics, settlement with Repsol, start of negotiations with the Paris Club) would lend an optimistic bias in the medium term. Lastly, and in spite of the positive surprises in domestic demand and the above-mentioned boost to investment by the 4G infrastructure plan, we have not revised our 2015 growth forecast for Colombia, given that we expect oil production to drop and there to be a negative basis of comparison effect, which implies that the effects will tend to offset each other, leading to 2015 growth of 4.8%, in line with our forecast potential.

Box 1. Slight downward revision to Latam's heterogeneous potential growth

Potential GDP is the maximum output level an economy can achieve by using the available factors of production and existing technology without placing upward pressure on inflation. This potential output level depends on aggregate capital stock, available labour, the non-accelerating inflation rate of unemployment (NAIRU) and so-called Total Factor Productivity (TFP), which can be understood as the efficiency with which the factors of capital and labour combine. Therefore, fixed capital investment, the behaviour of demographics and technological innovation, all of which are closely associated with structural reforms, are some of the factors behind the evolution of an economy's potential GDP.

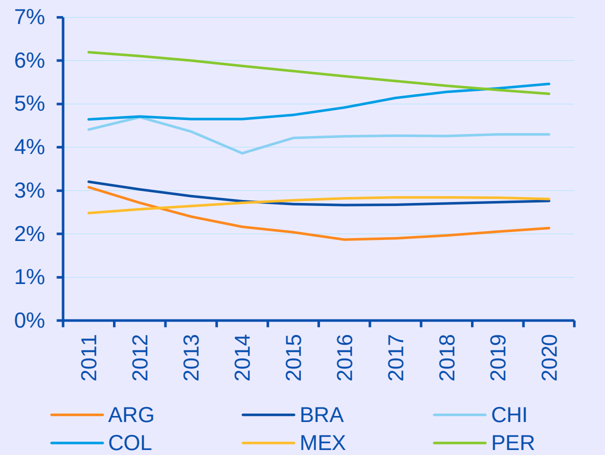
Figure B.1.1
Long-term potential growth (%, current estimation vs. Feb 2013, annual average 2016-20)



Source: BBVA Research

Our long-term potential GDP estimates, defined as the average of the five-year period from 2016 to 2020, point to an average annual growth of 3% for Latin America overall, although with high heterogeneity among countries: higher potential growth in the Andean countries (from 4% to 6%) and lower in Mexico, Brazil and Argentina (from 2% to 3%; see Figure B.1.1). The relative contribution of TFP is higher in Mexico, Colombia and Peru (from 24% to 31% of potential growth) and lower in Brazil, Argentina and Chile. When looking at the potential GDP growth profile for 2016-20, we see that potential GDP will pick up in Colombia (and very slightly in Argentina after the slump in the first half of the decade), and decelerate from very high levels in Peru (see Figure B.1.2). Potential growth rates in the rest of the region's countries remain practically stable from 2016 to 2020.

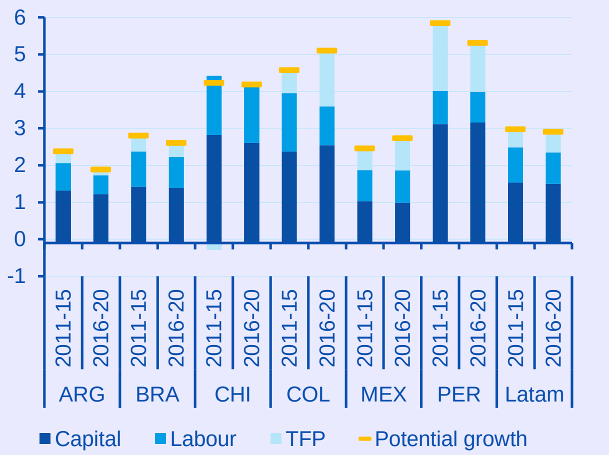
Figure B.1.2
Annual potential GDP growth 2011-20 (%)



Source: BBVA Research

Current estimates are lower than those made in February 2013 (0.5pp less for the regional aggregate), due to a considerable downward revision for Argentina, Brazil and, to a lesser extent, Chile; in all three cases due to a lower expected contribution of Total Factor Productivity (TFP). On the other hand, we now expect a higher contribution of TFP in Mexico and Peru, although offset by a lower contribution of the factors of production, which means that the potential growth estimation for these two countries barely changes. In general, if we look at the contributions of the two factors of production, the largest downside revisions take place in the capital factor. In most countries, such as Argentina, Brazil and Peru, this is due to a cut in investment growth forecasts for the coming years.

Figure B.1.3
Average annual potential GDP growth in 2011-15 and 2016-20 (%)



Source: BBVA Research

When comparing the five-year period from 2016 to 2020 with the immediately prior period (2011-15), potential GDP growth will remain practically stable at around 3%, but TFP will provide a greater contribution (see Figure B.1.3). By country, potential growth will be higher in Colombia and Mexico (0.5pp and 0.3pp, respectively), thanks to the greater contribution of TFP. This comes as a result of the reforms these two economies are adopting. In the case of Mexico, if the reforms are appropriately executed and progress is made, they may end up bring about an even higher rise in the contribution of TFP to long-term growth.

In the case of Colombia, the expected rise in TFP and in potential growth depends on achieving the expected results in infrastructure improvement and formalisation of the economy. On another note, potential growth will be practically the same in Chile[2] and lower in Argentina, Brazil and Peru (with significant falls in the contributions of both TFP and the labour factor). In the case of Peru, however, potential growth will remain the highest among the region's countries in the long term.

The concept of potential GDP, which is relevant in both economy theory and economic policy praxis, underscores the need for countries to drive structural reforms and supply-side policies, to raise the potential level of output and growth through increasing productivity. In this regard, we see a historical correlation between a country's Structural Reform Indices and the contribution of TFP to its potential growth (see the Latin America Outlook for 3Q13 for further details on this issue). In the specific case of Latin America, the main reforms should be oriented toward raising investment in physical capital (especially infrastructures) and human capital (higher quality of education and healthcare). At the same time, higher savings must be fostered to finance these investments and reduce the high rates of informality, which undermine the incentives for businesses and households to undertake both types of investment.

2: In the Chilean case, much uncertainty still remains over the impact of the reforms Michelle Bachelet's new administration has started to implement. In theory, they could theoretically stimulate TFP growth over the coming years.

5 External deficits to drop in 2014, but the slowdown pressures fiscal accounts

External deficits will progressively shrink in 2014 and 2015, in part due to the weakness in domestic demand. They will remain financed by long-term capital flows, though with less leeway than in the past

Current account deficits will gradually decline from 2014 onwards in most countries, but particularly from 2015, due to the effect of (i) less robust domestic demand; (ii) a weaker currency; and (iii) the end of a series of negative supply shocks that affected the export sector in the first half of 2014 in some countries such as Peru (mining), Colombia (coal and oil), Uruguay (paper industry) and Argentina (corn and other crops). These factors will offset a certain weakness observed to date in export demand and the terms of trade (see Figure 5.1). That said, foreign deficits will decline at a more leisurely pace than we expected three months ago, with average deficits in the region that should converge from 2.5% of regional GDP in 2014 to 2% of GDP in 2018, levels that we consider sustainable.

In Chile and Peru, the slowdown in the economy has also implied a moderation in imports, while exports have sustained growth. In Chile, the current account for 2014 will close with a significantly lower deficit than we projected three months ago (3% of GDP then, 2.3% currently), which we estimate will remain below 3% beginning in 2015, as a result of a context of lower domestic demand and a weaker currency, which will buttress exports. This confirms the speedier convergence toward sustainable current account levels of around 2-3% of GDP. The major adjustment in Peru's exports (particularly mining) contributed to increasing the already high current account deficit. For the rest of the year, however, we expect a certain correction due to an improvement in exports, influenced by the Toromocho and Antamina mines' entry into full operating capacity, together with improved copper price forecasts vs. three months ago. Based on this outlook, we have revised our expected deficit to the downside from the 5.4% estimated three months ago to the current 5.0%. In Mexico, the improvement in exports led by higher growth in the US from the second half of 2014, as well as improved revenues from remittances, will contribute to make the external balance in 2014 somewhat less negative than we expected one quarter ago (see Figure 5.2).

Brazil's current account deficit has grown since 2013 (3.7% in 2013 vs. 2.4% in 2012), and we expect it to continue in the same vein in 2014. This expansion was impacted by worse terms of trade which, in turn, were influenced by commodity prices, in addition to an increase in repatriation of dividends and profits by foreign companies. However, note that Brazil's current account deficit narrowed slightly over the last few months. In this regard, note that the currency outlooks and the expected improvement in the global environment will help prevent further deficit growth, and instead we expect it to beginning narrowing in 2015 to 3.5% of GDP.

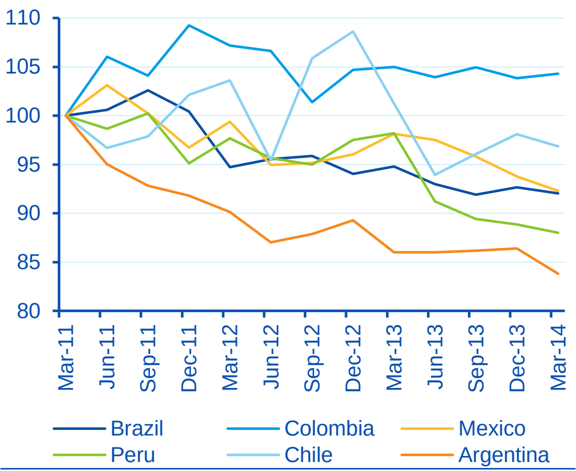
In the case of Uruguay, we expect a significant rise in the current account deficit in 2014, from the 5.2% estimated three months ago to our current estimation of 6%. The bigger gap is influenced by delay-related problems in connection with the Montes de Plata cellulose plant, whose operational start-up was postponed to the end of the second quarter of this year, after the last environmental permits were secured.

In the case of Paraguay, we do not expect changes in the current account balance, which has showed a surplus since 2013, and which we forecast at 1% in 2014 and 0.7% in 2015. Key in Paraguay have been the positive results in the volume of food and agriculture production, which have made up for the moderation in prices, mainly of soy bean.

In contrast to other countries in the region, Colombia's higher domestic demand, together with the reduced demand for industrial exports, contributed to an increase in the trade deficit. We have revised our expectation for this year's current account deficit from the 3.1% of one quarter ago to our current estimate of 3.5%, which will gradually narrow to close to 3% over the coming years.

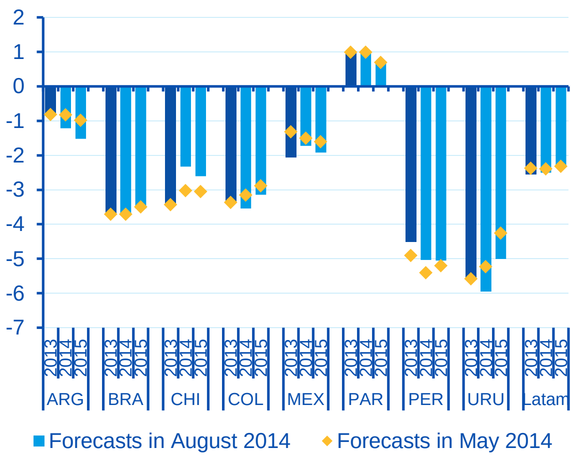
Although the region's current account deficits continue to be mostly financed by long-term foreign investment (mainly targeted toward the export sector), the share of this type of investment is smaller than in 2013, as in the cases of Colombia, Brazil and, particularly, Peru (Figure 5.3).

Figure 5.1
Latam: Terms of Trade (Index 1Q11 = 100)



Source: BBVA Research

Figure 5.2
Latam: Current account balance (% GDP)



Source: BBVA Research

Fiscal balances will remain under pressure from lower domestic demand, lower commodity prices and, in some countries, by higher public spending

The slowdown in domestic demand, together with commodity prices that should tend to the downside, at least for copper and soy bean, will continue to put pressure the region's tax revenues. The main exceptions will be Chile and Mexico, where non-commodity tax revenues should rise after the recently-implemented tax reforms. In addition to the pressure on the deficit from lower tax revenues, in some countries there will also be pressure from increased public spending (in Chile and Mexico) and from higher debt burdens (in Brazil and Argentina).

The tax reform is expected to lead to higher tax revenues in Chile, of around 0.1% of GDP in 2014. We expect spending to grow in the order of a real 7% (especially in the second half of the year) and an effective fiscal deficit of 1.8% of GDP (1% structural). 2015 is more uncertain, but the scenario of domestic moderation and lower commodity prices portend a somewhat higher deficit scenario, and a structural deficit of around 0.75% of GDP, including higher revenues from the tax reform.

There is a significant divergence in Mexico between oil and non-oil tax revenues. In the case of the former, we have seen considerable falls due to both price and volume, while standing out among non-oil are the higher tax revenues from the tax reform of the end of 2013 (a rise of 10.7% YoY in the first quarter of 2014). On balance, budget revenues increased but did not make up for the higher spending, at least in the first months of 2014. In the second half of the year, we expect the government to be capable of meeting a deficit target of around 3.5% of GDP, which includes the Pemex investment (Figure 5.4).

In Colombia, we expect a structural fiscal deficit for 2014 in the order of 2.4%, which is slightly higher than we expected three months ago, and in accordance with the fiscal rule. We expect a similar adjustment for the coming years, influenced by lower revenues from oil production, which somewhat higher oil prices will not be sufficient to offset. Note that this fiscal scenario for Colombia assumes an effect from the tax reform, which includes the elimination of the 0.4% tax on financial transactions and of the wealth tax.

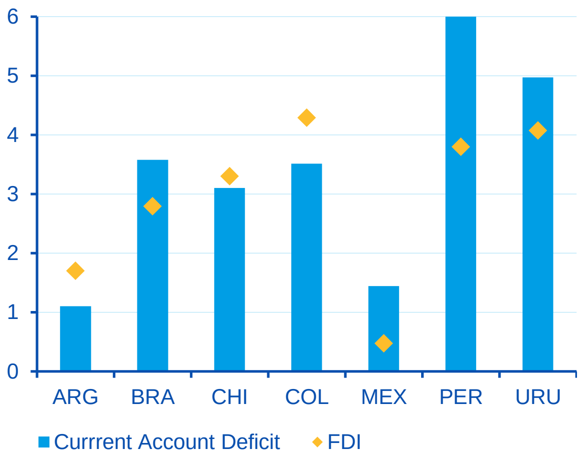
We expect lower local government spending in Peru, which will lead to an expected fiscal surplus for 2014 and a balanced budget in 2015. Bear in mind that Moody's recent decision to upgrade the country's sovereign debt rating is closely related to the strength of its fiscal accounts, particularly the downward trend in the public debt ratio.

From 2011 to 2013, Brazil rolled out several fiscal stimulus measures, which were introduced at the time to boost consumption and specific sectors, such as vehicles and construction. The estimated impact of these stimulus measures implies fiscal costs in 2013 and 2014, which compound the low revenues in the economy. The initially estimated fiscal deficit of 3.3% of GDP in 2013 will widen to -3.9% in 2014, and then subsequently begin a gradual downward trend.

The fiscal deficits in Argentina and Uruguay will both expand slightly, with increases in public spending and subsidies not offset by higher revenues. In the first case, we expect the fiscal deficit to widen from the 1.7% expected in May to the 2.4% currently expected for 2014, and shrink to 1.5% in 2015. In Uruguay, we expect the deficit to expand to 3.4% in 2014 (vs. the 3% estimated one quarter ago), and remain unchanged in 2015. Lastly, we expect public-sector revenues and expenditure in Paraguay to remain at manageable levels, which suggests a deficit of close to half a point of GDP in 2014 and 2015.

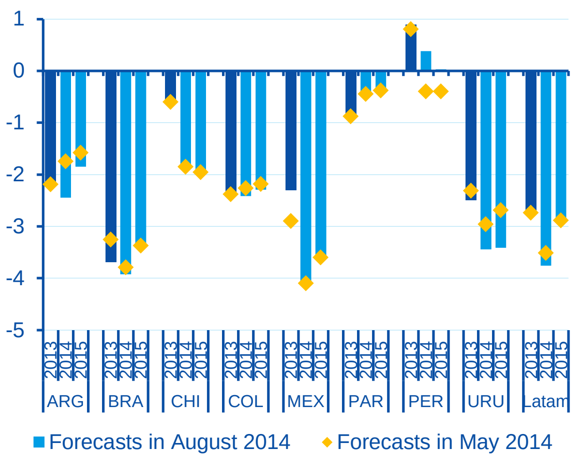
All in all, and notwithstanding a slight worsening of the outlooks for fiscal accounts, the region's deficits will remain manageable, especially from the structural point of view.

Figure 5.3
Latam: Current account deficit and FDI (% of GDP)



March 2014 data for Chile, Colombia, Mexico and Peru. For June in Brazil, Argentina's current account June 2014, FDI December 2013.
Source: BBVA Research

Figure 5.4
Latam: Fiscal balance (% of GDP)



Source: BBVA Research

Box 2. Chile's economic reform programme

Chile's GDP per capita is close to USD19,000 PPP, the highest in Latin America, but recent social movements in the country reveal unmet demands in education, healthcare and policy. To face these issues, the current administration headed by Michelle Bachelet has proposed a tax reform which seeks to raise revenues by 3% of GDP. Concurrently, the first bills to conduct a reform of the education system have been submitted to Congress. In addition to the latter, to support growth and tackle the sluggish productivity of recent years[3] (Magendzo and Villena, 2012), agendas were also launched to improve competitiveness, reduce energy costs and strengthen workers' bargaining ability, and which will become future bills.

Tax reform: A commitment to redistribution and higher revenues, but uncertainties remain over the impact on savings and investment

The goal of the tax reform is to permanently increase revenues by an amount equivalent to 3% of GDP, to finance higher public savings (converging toward a structural balance of 0% of GDP in 2018), education reform and higher healthcare spending. Furthermore, policymakers are considering making the tax system more progressive, to help reduce inequality. Chile has the OECD's highest level of income inequality[4,] and recent studies have revealed that the tax system would appear to be regressive[5].

Chile's current tax system is integrated, that is, taxes paid by companies serve as a credit toward the taxes paid by their owners or shareholders. Income from capital and labour is subject to the personal tax called "Global complementario", which has a rising marginal rate from 0 to 40%. Non-distributed after-tax profits are recorded in the Taxable Profits Fund (Fondo de Utilidades Tributarias / FUT), and may be reinvested in the company. There is no limit on the number of years profits may remain in the FUT before being distributed (when they are subject to individual income tax), nor by a minimum amount that must be withdrawn each year. According to Ministry of Treasury estimates, there are USD250bn in company FUTs.

In essence, the original bill submitted to Congress included a rise in the corporate tax rate from 20% to 25%, and the payment of taxes on an accrual basis (attributable income) instead of on a cash basis (received income). This would lead to the elimination of the FUT, which was introduced as an incentive to reinvest company profits in the mid-1980s. The top marginal individual income tax rate would also be reduced from 40% to 35%. That said, this would end up taking the tax rate for the owners of companies with the highest incomes to 35%, after having enjoyed effective tax rates of close to 20% (Table 1, second column). The main concerns included the negative impact this might have on savings, investment and, consequently, on long-term growth. On another note, there were concerns over the effects on the real estate and construction sectors, and over the reduced support for SMEs. As a compensatory way of supporting investment, the bill included an instant depreciation benefit, but only for physical investments. Also questioned was the impact the reform would have on the wine and beer industry and on the financial markets, as time deposits were markedly favoured over other instruments.

3: Magendzo, Igal and Marcelo Villena (2012). "Evolution of Total Factor Productivity in Chile," Technical Report, Adolfo Ibáñez University, March.
4: OECD (2014), Society at a Glance 2014: OECD Social Indicators, OECD Publishing.
5: See Fairfield, Tasha and Michel Jorratt (2014). "Top Income Shares, Business Profits, and Effective Tax Rates in Contemporary Chile." ICTD Working Paper 17. See also Agostini, Claudio (2012). "An Efficient and Equitable Reform of Income Tax in Chile," in the book "Criteria for Tax Reform," CEP-Cieplan.

All in all, since the end of 2013, the Chilean economy has seen a marked slowdown, a considerable drop in investment and a significant fall in business expectations. While we acknowledge that external factors are central to explaining this dynamic, the role played by the uncertainty generated by the debate on the tax reform was also clearly important.

Within this context, on 8 July, the government and the opposition signed a Protocol of Agreement (summarised in column three of Table 1), which seeks to mitigate the negative impacts of the reform on savings and SMEs, without changing the revenue target of 3% of GDP nor the above-mentioned destination of the resources. The main changes include: (1) the attributable income system for corporate taxes with a rate of 25% becomes optional, and a partially-integrated system with a business tax rate of 27% is added, with the option to use 65% of the tax paid by the corporation as a credit toward individual income; (2) a series of new measures which favour SMEs and the reinvestment of profits; (3) the measures that affect the real estate market are reduced, but not eliminated.

The changes agreed to in the Protocol are on the right track, but questionable elements still remain. The effects on the real estate market and on savings are mitigated, and greater benefits provided to SMEs, but the adverse impact on investment would be maintained. For example, under the new semi-integrated regime, the final tax rate would come in above 40%, which is high in international terms. Furthermore, there is some uncertainty over the ability to collect 3% of GDP, which could imply a sacrifice in public savings, in spending associated with education reform and/or a new tax adjustment in the future. Additionally, there are the concerns over the rises in the tax on alcoholic beverages and on imported diesel vehicles, which could violate the country's double taxation agreements.

Education reform: Doubts over whether the focus on raising quality is sufficient

There are currently three bills before Congress which constitute the first part of the Education reform, notably the bill that introduces changes to school education.

There are three major types of schools in Chile: municipal (public and local government), subsidised private (run by for-profit or non-profit corporations, which receive a government subsidy but also often collect a co-payment from the parents), and paid private. Since a few years ago, subsidised private schools have attracted the highest number of students, accounting for close to 50% of enrolments. Eighty percent of these schools have admittance requirements for students, such as selection tests and parent interviews.

The bill mainly targets subsidised private schools, and seeks to modify their operations in three aspects: (1) elimination of required monthly co-payment from parents, with the goal that the operations of all these schools be 100% subsidised by the state within 10 years, and that they be free for families; (2) elimination of the for-profit category, requiring all corporations to become non-profit entities within a maximum period of two years, and with a maximum 12-year period for the state to become owner of the properties; and (3) elimination of the selection criteria, whether tests, parent interviews or other, introducing a random assignment of places in the event of excess demand.

The education reform has the potential to increase human capital in the long term and, consequently, Chile's productivity and investment appeal. That said, the main criticism is that the proposals put forward do not necessarily imply a rise in the quality of education, but rather focus mainly on the ownership of the means of education. However, this bill has not yet been debated in Congress, and thus may be amended, as was the tax reform. Furthermore, in accordance with the commitments of the government's programme, there are still issues outstanding, such as the strengthening of public education and the changes to higher education.

Energy and competitiveness agendas point in the right direction, but remain to be specified, together with the labour reform

Some of the challenges in Chile's energy sector are the high costs of generation, the scarce competition, the low diversification of energy sources, the high reliance on international markets and the problems with connectivity. The Energy Agenda deals with these problems with a proposal based on seven pillars, which features measures such as the strengthening of the state oil company (ENAP), a higher share of LNG in the power grid, decentralised development of non-conventional renewable energies, a greater role of the state in matters of energy efficiency education, development of a regulatory framework for connectivity, increasing energy infrastructure and the creation of agencies for civic participation.

With respect to the Competitiveness Agenda, a number of sectors have found it valuable. In particular, it covers aspects such as increasing joint public-private action, intensifying support for SMEs through state funds, encouraging the generation of clusters, proposing the creation of a large-scale port together with an improvement in the operational logistics of the country's current ports, and establishes a commitment by the state to protect free competition, among other factors.

The main concern over both agendas is that, for the time being, the measures have only been announced, and the details of the bills that will implement them are yet to be known. In more specific terms, the Energy Agenda has been criticised for failing to make a statement on nuclear energy, for the greater role it would give to LNG, a fossil fuel that is not cheap and maintains foreign reliance, and regarding ENAP's administrative and financial capability to adopt its proposed new role. The Competitiveness Agenda has been criticised for the potential discrimination that a clusters policy might imply, and for the more political than technical position of the Committee of Ministers, who would earmark the state funds for the proposed initiatives.

The government has also considered putting through a labour reform, which centres around strengthening trade union activity and collective bargaining, measures that seek to increase worker protection but at the cost of making the labour market even more inflexible, and with potential negative effects on long-term unemployment.

Conclusion: Reforms with the potential to drive the long term, but yet to be fully defined

There may be questions over the short-term effects of the tax reform, particularly because its debate had a negative impact on expectations in the midst of an economic slowdown scenario. However, these negative effects are mitigated by the positive impact education reform could have, were it well-designed and implemented. This is why it is so important to follow the debate closely, and inform readers as to whether or not the end result will result in higher-quality education.

For their part, the energy and competitiveness agendas arose to deal with problems that have reduced the country's growth over the last years, such as higher energy costs and some difficulties smaller companies have when it comes to raising investment in their businesses. An appropriate approach to these problems would imply a vital boost to long-term growth.

Table B.2.1

Main aspects of tax reform in Chile

Measures	Current tax situation	Bill in the Chamber of Deputies (March 2014)	Agreement Protocol (July 2014)
Tax regime	Integrated (received income)	Integrated (attributed income)	Two options: I. integrated (attributed income) II. semi-integrated, 65% of the corporate tax is used as a credit toward individual tax (received income).
Company tax rate	20%	25%	I. 25% II. 27%
Taxable income for individual tax	Received income Non-distributed income goes to FUT	Attributable income Elimination of FUT Cumulative historical FUT is maintained	I. Attributed income II. Received income FUT is eliminated in both cases, but cumulative historical FUT is maintained
Top marginal individual income tax rate	40%	35%	35%
SME aid	Diverse sections of the income law which enabled companies to not pay taxes	Mainly a regime for SMEs, which allowed them to use simplified accounting, together with instant depreciation of physical assets	Original project is amended to include the options to not pay tax on a percentage of reinvested profits, not pay corporate tax below a certain level of sales, and defer VAT payments for up to two months.
Sin taxes	Rate of 15 or 27% for alcoholic beverages Rate of 13% for non-alcoholic beverages Tax on cigarettes by amount and ad valorem	Rate of 18%, +0.5% per degree of alcohol in alcoholic beverages Rate increase to 18% for high-sugar non-alcoholic beverages Increased cigarette tax rate at specific component	Fixed rate of 22.5% on wine and beer, and 18% +0.5% per degree for all other alcoholic beverages 18% for high-sugar non-alcoholic beverages and 10% for the rest Higher cigarette tax at specific component and reduction at ad valorem component
Real estate sector	Credit of 65% on Construction VAT for homes valued at less than UF[6]4,500(approx. USD200,000), with a limit of UF225(approx. USD10,000) Exemption of VAT intermediate stages prior to final consumer sale Exemption of tax payment on capital gains	Credit of 65% on Construction VAT limited to homes valued at less than UF2,000(approx. USD87,500), with a limit of UF100(approx. USD4,400) VAT on frequent home sales (more than one per year) Capital gains tax on homes sales by individuals owning more than one property.	Credit of 65% on Construction VAT limited to homes valued at less than UF2,000(approx. USD87,500), with a limit of UF225(approx. USD10,000) VAT on frequent home sales (more than one per year) except for foreclosures Capital gains tax on incomes of more than UF8,000(approx. USD350,000), regardless of how many homes owner possesses.
Tax on financial operations	Top annual rate of 0.4%	Top annual rate of 0.8%	Top annual rate of 0.8%, keeps current rate for mortgages
Capital gains tax	Received income Exemption for stocks with "stock exchange presence" and other instruments Exemption of tax on interest income from time deposits	Attributed income Exemption for stocks with "stock exchange presence" Broadening of tax exemption on interest income from time deposits	Received income Exemption for stocks with "stock exchange presence" Broadening of tax exemption on interest income from time deposits and similar instruments

Source: BBVA Research

6: UF accounts for “Unidad de Fomento”, an inflation index currency.

6 A laxer monetary policy bias in Latam, due to weak growth

Pressures on inflation are heightening in South America, but inflation will remain around central bank targets, with the exception of Uruguay

Inflation figures have remained at the high end of the target ranges of the central banks that target inflation. However, the upward surprises recorded in the first quarter of the year, which in some cases extended into the second quarter (Figure 6.1), have led to higher inflation expectations for the close of the year. These surprises were related to factors such as higher expected prices for oil, gas and some grains, as well as somewhat weaker currencies. Up until now, most of the pass-through of currency depreciation to prices already occurred in countries with a flexible exchange rate. Over the rest of the year, we expect that the effect of weaker domestic demand will become more significant and that the inflationary trend will start to reverse, while convergence toward central banks' targets in most countries in the region will gather pace.

Inflation has already started to recede in most countries, reflecting the considerable moderation in domestic demand, although the potential strike of El Niño in early 2015 could lead to increases in some food prices. In Mexico, upward inflationary surprises were seen mostly in the first months of the year, and were a one-off case associated with some price rises caused by the tax reform at the end of 2013. The effect having passed, the weakness in domestic demand manifested as prices that are still at the high end of the target range, but with contained increases, which has led us to revise our year-end inflation forecast slightly downward to 3.7%.

The surprises of the first months of the year in the Andean countries, influenced to a large extent by currency pressures (in the case of Chile) and rises in food and electricity prices (in the cases of Peru and Colombia), have led to upward revisions of our 2014 inflation scenarios for the three countries of around half a percentage point.

Annualised inflation in Brazil remained on a steady upward path over the first months of the year due to climbing food prices, and was also influenced in June by the effect of the World Cup on some goods and services. However, as we expect statistical effects and the moderation in activity to cause a resumption of the downward trend in inflation, our 6.2% year-end forecast remains unchanged.

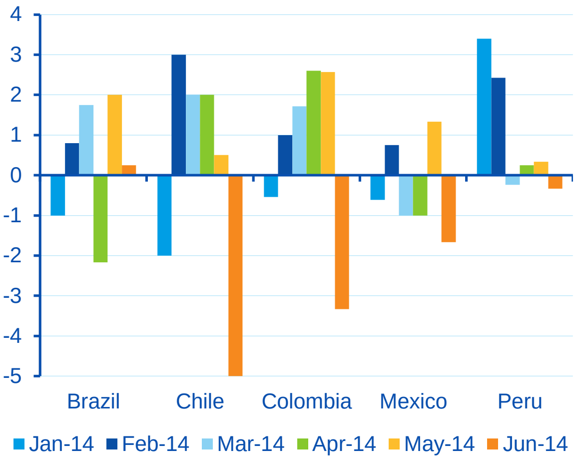
We expect that the inflationary trends will tend to converge toward central bank targets in 2015, with the exception of Uruguay, where price variations remain high and with no indicators suggesting the target range will be met within the forecasting horizon (Figure 6.3).

Inflation rates will remain high in Argentina in 2014 and 2015, with a turnaround starting in 2016.

The region's currencies will remain on a slightly depreciatory trend, due to less growth and lower commodity prices, combined with Fed interest rate hikes in 2015

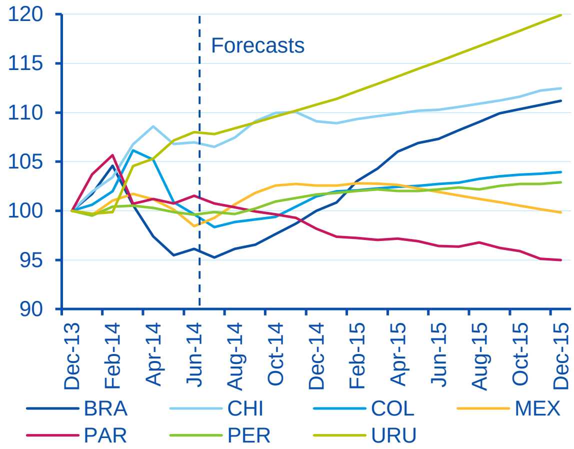
With respect to currencies, we expect a slightly depreciation trend in countries with inflation targets, due to a certain deterioration of the fundamentals: lower FDI flows, lower prices in some export commodities (copper and food), and Fed monetary policy normalisation, particularly interest rate increases. These would begin in mid-2015 and tend to strengthen the USD (Figure 6.2).

Figure 6.1
Latam: Inflation Surprise Index*



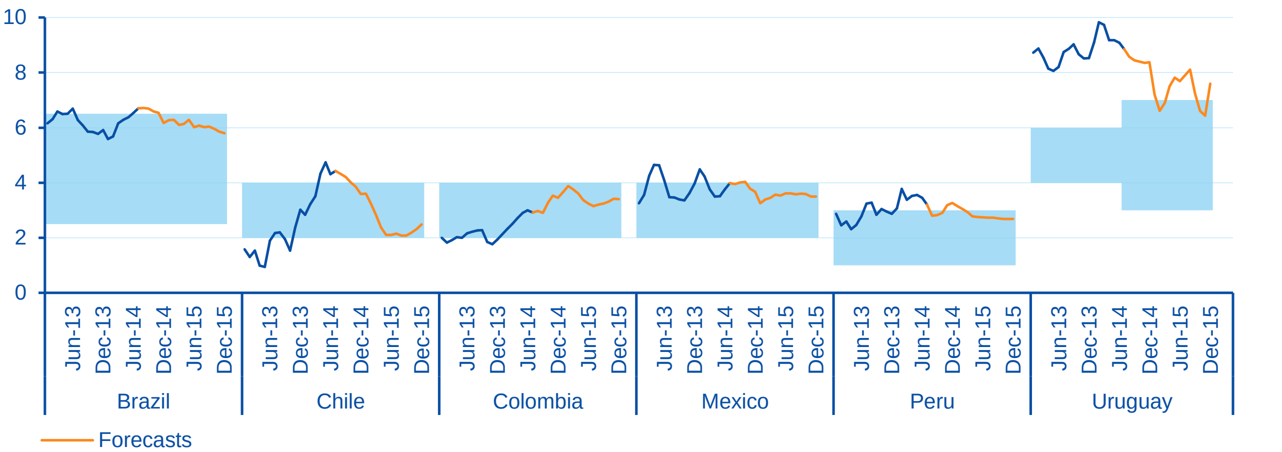
* Difference between observed and expected inflation by analysts' consensus. Standard deviations in accordance with dispersion between analysts.
Source: BBVA Research

Figure 6.2
Exchange rate, Index Jan 2012 = 100



Source: BBVA Research

Figure 6.3
Latam: Inflation (% YoY) and central bank target ranges



Source: BBVA Research

That said, the intensity of currency depreciations going forward will be quite uneven, greater in those countries with higher inflationary pressures (Brazil, Uruguay, Argentina) and in those where the currency may currently reveal a greater sign of overvaluation vs. the fundamentals (such as Brazil, see Figure 3.9). We expect the depreciation trend to continue in most countries in 2015, particularly in Brazil and Uruguay (10 and 8% respectively), and to a lesser degree in Chile, Colombia and Peru. For Mexico and Paraguay we expect a mild appreciation (of around 2%), in line with the greater strength of the fundamentals (Figure 6.4).

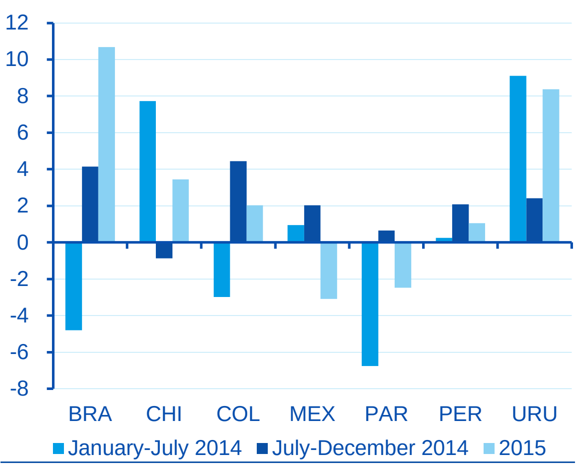
Toward the second and third quarter of the year, the BRL was trading at more higher levels than originally expected, due to the central bank maintaining its currency intervention programme unchanged. Although the programme will continue, we expect the BRL to depreciate over the rest of the year.

In Chile, we expect a currency scenario of contained depreciation and that for the end of the year, as monetary policy rate cuts take place, and the Fed continues to withdraw stimulus, the year to end at around USD&CLP575.

In Peru, in contrast with the stability hitherto seen, we now expect currency pressures over the coming months, related to worsening fundamentals and lower long-term capital flows (mainly FDI). We expect the depreciation to continue in 2015 and stabilise at around USDPEN 2.88, 13% higher than in January 2013, and consistent with the reduction of the external gap over the next years. We expect the central bank to smooth the trajectory with interventions in the currency markets.

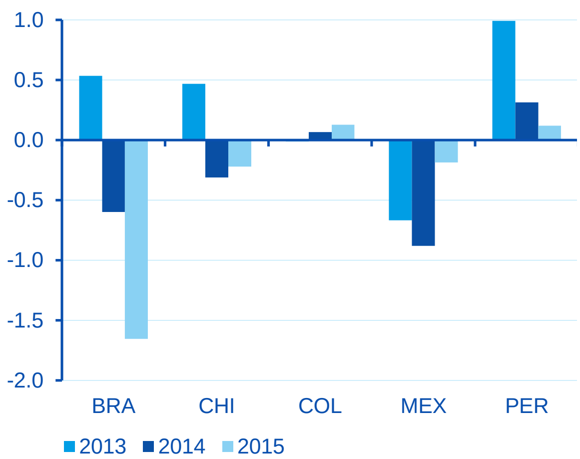
Higher capital inflows favoured currency appreciation in Colombia, led by the country's higher weighting in J.P. Morgan's public debt investment index. In this context, the central bank continued accumulating international reserves, coming in at close to 12% of GDP. Going forward, we expect less room for reserve accumulation and a moderation of the J.P. Morgan reweighting effect starting in September. We thus believe the COP is trading at highs, with a tendency to depreciate going forward.

Figure 6.4
Currencies: depreciation (+) or appreciation (-) observed and projected (%)



Source: BBVA Research

Figure 6.5
Output gaps (%)



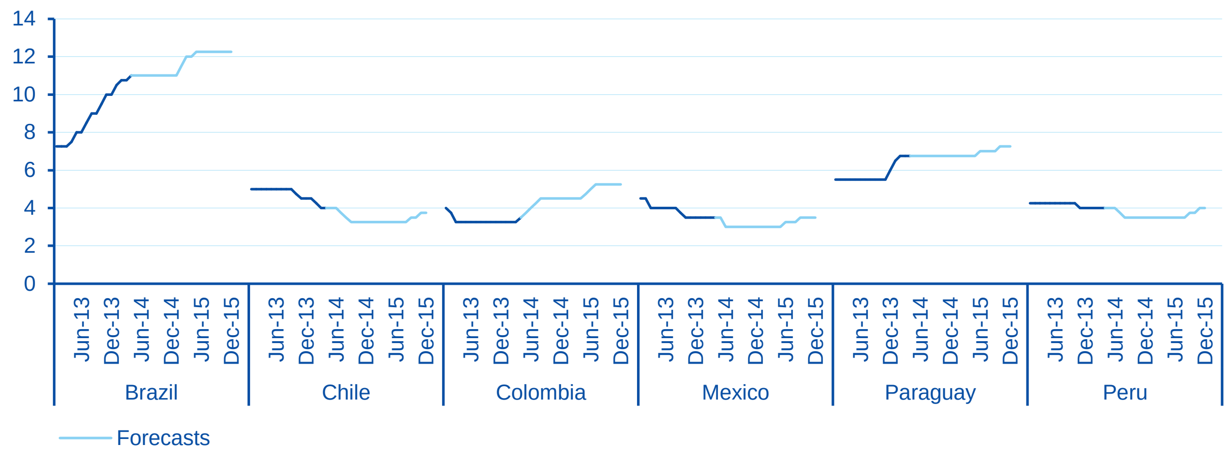
Source: BBVA Research

Central bank monetary policies tend to be more accommodative due to the weakness in growth

In a context where inflation rates remain toward the high end of target ranges (and with high foreign deficits in some countries such as Peru and Uruguay), there would seem to be little room to ease monetary policy in the region. That said, over the last three months we have seen a certain tendency by the region's central banks to prioritise boosting growth by cutting interest rates, some of which the market already expected (Chile), while others came more as a surprise (Mexico, Peru). Furthermore, due to the scant leeway for further cuts, some central banks are following through with the use of macroprudential policies, such as cutting reserve ratios and raising banking system liquidity, as has been the case over the last few quarters in Peru, and now seems to be the case in Brazil.

Further ahead, and to the extent that the output gap in most countries tends to narrow, that inflationary pressures continue in Brazil and Uruguay, and that the Fed starts to raise interest rates, we expect official interest rates in the region to rise (Figure 6.5).

Figure 6.6
Latam: Monetary Policy Rate (%)



Source: BBVA Research

In the case of Brazil, after the central bank's decision in April to raise the Selic rate to 11%, and inflationary pressures notwithstanding, it decided to keep the rate unchanged at its June meeting. We expect it to keep the rate unchanged to the end of the year, which is consistent with a difficult scenario in terms of growth, and in which the monetary authority is counting on the effects the last official interest rate hike should have on moderating inflation.

In Chile, within a context marked by a domestic slowdown, monetary policy rates will continue dropping. We expect a minimum 75bp cut over the coming months. However, given the economic slowdown, the timing of these cuts will to a large extent depend on the pace at which inflationary pressures ease. We expect a process of monetary normalisation to begin in the second half of 2015. A similar situation is occurring in Peru where, after the 25bp cut in official interest rates, we expect another cut in August, given the persistent weakness revealed by the economic activity data, in spite of the scenario of inflation at the high end of the target range and a high current account deficit. We believe that the cycle of official interest rate increases will begin in 2015, in line with the expected actions from the Fed and in a context of higher growth (Figure 6.6).

Last June's unexpected 50bp cut by the Mexican central bank is explained by the first quarter's unexpectedly low GDP growth, and by a seasonal context in which inflation would temporarily begin to rise in July due to the basis of comparison effect. Over a medium-term horizon, inflation should tend to converge at a faster pace toward the central bank's main objective, as early as January 2015. The action by the central bank reveals that economic slack prevails and will continue: the output gap will take longer to close.

In contrast, in Colombia the monetary authority already raised the monetary policy rate by 25bp in June and July, given the currency pressures and the good news in terms of growth. Going forward, we expect monetary policy rate hikes to continue at the meetings in August and subsequent months, until reaching a neutral rate in 2015.

7 Tables

Table 7.1
GDP (% YoY)

	2011	2012	2013	2014*	2015*
Argentina	8.6	0.9	2.9	-1.0	0.2
Brazil	2.7	1.0	2.5	1.3	1.6
Chile	5.8	5.4	4.1	2.9	3.8
Colombia	6.6	4.0	4.7	4.9	4.8
Mexico	3.9	3.8	1.1	2.5	3.5
Paraguay	4.3	-1.2	14.4	4.9	4.3
Peru	6.5	6.0	5.8	4.1	5.9
Uruguay	7.3	3.7	4.4	2.7	2.9
Mercosur	3.5	1.3	2.4	0.4	1.2
Pacific Alliance	4.8	4.2	2.5	3.1	4.0
Latin America	4.1	2.6	2.5	1.6	2.5

*Forecasts
Source: BBVA Research

Table 7.2
Inflation (%YoY, avg.)

	2011	2012	2013	2014*	2015*
Argentina	9.8	10.0	10.6	25.0	22.6
Brazil	6.6	5.4	6.2	6.3	6.1
Chile	3.3	3.0	1.8	3.9	2.5
Colombia	3.4	3.2	2.0	2.9	3.4
Mexico	3.4	4.1	3.8	3.9	3.5
Paraguay	8.3	3.7	2.7	5.3	4.3
Peru	3.4	3.7	2.8	3.2	2.8
Uruguay	8.1	8.1	8.6	8.9	7.3

*Forecasts
Source: BBVA Research

Table 7.3
Exchange rate (against USD, average)

	2011	2012	2013	2014*	2015*
Argentina	4.13	4.55	5.48	8.44	11.50
Brazil	1.68	1.96	2.18	2.28	2.51
Chile	484	486	495	560	576
Colombia	1848	1798	1869	1944	1982
Mexico	12.4	13.2	12.8	13.2	13.2
Paraguay	4188	4417	4312	4457	4271
Peru	2.75	2.64	2.70	2.81	2.87
Uruguay	19.2	20.2	20.4	23.0	24.8

*Forecasts
Source: BBVA Research

Table 7.4
Interest Rate (%, avg.)

	2011	2012	2013	2014*	2015*
Argentina	13.34	13.85	16.92	23.66	22.10
Brazil	11.71	8.46	8.44	10.92	12.04
Chile	4.75	5.02	4.90	3.75	3.38
Colombia	4.10	4.94	3.35	3.98	4.94
Mexico	4.50	4.50	3.94	3.21	3.23
Paraguay	8.49	6.00	5.54	6.73	6.96
Peru	4.04	4.25	4.21	3.77	3.63
Uruguay	18.97	18.59	17.70	20.89	18.39

*Forecasts
Source: BBVA Research

Table 7.5
Current Account (% GDP, end of period)

	2011	2012	2013*	2014*	2015*
Argentina	-0.5	0.0	-0.8	-1.2	-1.5
Brazil	-2.1	-2.4	-3.7	-3.7	-3.5
Chile	-1.2	-3.4	-3.4	-2.3	-2.6
Colombia	-2.9	-3.2	-3.4	-3.5	-3.1
Mexico	-1.1	-1.3	-2.1	-1.7	-1.9
Paraguay	0.4	-0.9	1.0	1.0	0.7
Peru	-1.9	-3.3	-4.5	-5.0	-5.1
Uruguay	-2.9	-5.3	-5.6	-6.0	-5.0
Mercosur	-0.6	-1.3	-2.4	-2.5	-2.2
Pacific Alliance	-1.5	-2.0	-2.7	-2.5	-2.5
Latin America	-1.0	-1.7	-2.5	-2.5	-2.3

*Forecasts
Source: BBVA Research

Table 7.6
Fiscal balance (% GDP, end of period)

	2011	2012	2013*	2014*	2015*
Argentina	-1.6	-2.4	-2.2	-2.4	-1.8
Brazil	-2.6	-2.5	-3.7	-3.9	-3.4
Chile	1.3	0.6	-0.6	-1.8	-1.9
Colombia	-2.9	-2.3	-2.4	-2.4	-2.3
Mexico	-2.7	-2.6	-2.3	-4.1	-3,6
Paraguay	0.7	-1.4	-0.9	-0.5	-0.4
Peru	2.0	2.3	0.9	0.4	0.0
Uruguay	-0.9	-2.8	-2.5	-3.4	-3.4
Mercosur	-2.5	-2.8	-3.5	-4.3	-3.0
Pacific Alliance	-1.8	-1.7	-1.8	-3.1	-2.8
Latin America	-2.2	-2.3	-2.7	-3.8	-2.9

*Forecasts
Source: BBVA Research

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