BBVA | RESEARCH

LatinAmerica Economic Outlook

1ST QUARTER 2016 | LATAM COORDINATION UNIT

01
Commodity prices, oil in particular, are being pushed down by market volatility and supply factors...

02
...as well as domestic factors, further restricting growth. We expect -0.9% in 2016 and 1.9% in 2017

03
Inflation remains high, except in Mexico. Monetary policy in the region has had to be tightened due to inflation and the Fed's hike in interest rates

04
In most countries, the outlook in fiscal balances worsens, although trade deficits have begun to be corrected

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Closing date: 17 February 2016

1 Summary

Growth in the global economy will continue to grow, albeit at a lower pace and with higher risks. Growth in early 2016 is expected to be more modest than was estimated last quarter due to business confidence indicators and the rise in financial tensions. Thus, global GDP will grow by just 3.2% in 2016 (as in 2015), postponing the recovery to 2017 when it should reach rates of around 3.5%. Hence, the world economy faces a 2016 of limited growth, with a balance of risks showing a negative bias and concentrated in the emerging block, although the expected recovery in developed economies is also fragile. Indeed, the volatility which flared up on international markets in January and February 2016 appears to have been triggered by the increased probability of a risk scenario with lower growth in China and emerging economies as well as a further slide in oil prices, with negative impacts on oil sector companies and exporter countries.

Doubts about China's growth and other emerging markets, as well as persistently high oil supply, led to further downward pressure on commodity prices (Box 1). Volatility on international markets and falls in commodities prices are factors which also made their mark on important financial assets in Latin America. There were significant corrections on stock markets, sovereign spreads and exchange rates, on a similar scale to those already seen in the volatility spike of July and August 2015, i.e. corrections very seldom seen over the last 10 years. Looking ahead, how China's economy evolves, both as regards the degree of slowdown in activity and how the authorities manage the financial imbalances that exist, will continue to have a significant influence on capital flows and commodity prices in general, not just oil. On top of that, it is important to consider the pace of increase in official interest rates in the US, which might have to be slowed in light of doubts about the international setting.

Confidence indicators remained feeble, except for Argentina. Some countries remain pessimistic (Brazil, Chile) or very weak (Mexico, Colombia, Peru), no doubt negatively impacted by political “noise” and the adverse international environment, and persistently weak employment data and high inflation. The main exception is Argentina, where confidence indicators have remained positive, albeit slightly lower due to the new government's necessary adjustment measures. Due to this relatively pessimistic tone in households and companies, both investment and consumption remained weak, and in general they are expected to remain constrained at least in the first part of the year. The export sector in the region also remains sluggish, shaped by question marks concerning growth in China, the slowdown in Latin America's own markets and further correction in prices of staple export commodities.

Against this background of domestic and external weakness, growth in Latin America will hit bottom in 2016 and should recover in 2017 (-0.9% and 1.9%). These estimates are significantly more pessimistic than the ones made three months ago. When considering the regional average, it is important to note the important differences between individual countries, with the deep recession in Brazil (-3.0% in 2016) in marked contrast to the performance of Pacific Alliance countries (Mexico, Colombia, Peru and Chile), which will grow at an average of approximately 2.5% in 2016 and 2017. There are three factors which we expect to drive growth in 2017. First, the momentum of the export sector, underpinned by recovery in global growth, the depreciation of the exchange rate and some improvement in terms of trade. Second, on the domestic front, we expect to see a sharp rise in investment in countries such as Argentina, Peru and Colombia. Lastly, we expect political uncertainty in Brazil to fade and for the country to get back on track in terms of growth.

Inflation remains high (except in Mexico and Paraguay), despite cyclical weakness. It would converge more slowly than expected to central banks’ target ranges, largely due to a sharper than expected depreciation (as well as the bout of volatility in December and January) and to the rise in food prices, driven

by the El Niño weather phenomenon which affects most of the region. Mexico and Paraguay are the most important exceptions to this pattern. These countries have also experienced slightly increases in inflation, but it remains within their central banks' target ranges - in Mexico's case, because of the impact of reforms in the telecommunications and energy sectors. Nevertheless, the main risk is the unanchoring of inflation expectations, more obvious in Uruguay's case, but also a significant risk in Brazil, Peru and Colombia.

Central banks in the region were forced to tighten monetary policy due to the gloomier outlook for inflation and the Fed's interest rate hike. Central banks in Colombia, Chile, Paraguay and Peru were forced to increase interest rates in recent months due to the rise in inflation and the risk of inflation expectations becoming unanchored. Needless to say, this decision was also affected by the pressure on exchange rates in the region, partly due to the Fed's hike in interest rates. Mexico implemented a surprising increase in interest rates to calm volatility on its financial markets. Looking forward, insofar as the pressure on inflation continues and the Fed maintains its policy of successive interest rate hikes, we expect further interest rate rises in the three Andean countries (a more restrictive trend than we expected three months ago). Brazil, on the other hand, may keep its monetary policy rate unchanged for a long period of time, until the point that inflation would fall to such a degree that it might be able to lower interest rates, a scenario that would probably not occur until 2017.

Exchange rates should remain at relatively depreciated as a result of the Fed's increases in interest rates and a less positive international setting. Looking forward, further market volatility is expected due to uncertainty about China and about US monetary policy. In fact, we expect further depreciation of exchange rates in most countries, albeit to a lesser extent than in 2015. The main exceptions would be Chile, Mexico and Colombia, where we would expect a slight rise in exchange rates over the course of 2016, insofar as their fundamentals strengthen and there is steady recovery in commodities prices, such as copper and oil.

Trade deficits have begun to be corrected in most countries, although greater pressure is expected on fiscal balances. Exchange rate depreciation and the slowdown in domestic demand are bringing down trade deficits, although they remain high in some countries. However, the slowdown has worsened fiscal outlook in the region.

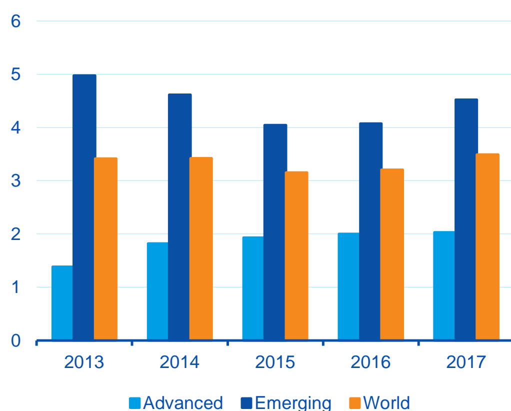
Moderate staple commodity export prices will keep high external deficits in the region (except for Chile) and also exert upward pressure on fiscal deficits. Trade deficits should begin to ease off in 2016 in some countries, through exchange rate depreciation, sluggish domestic demand and some degree of recovery in the terms of trade. That said, FDI will probably also be adjusted due to the lower return in the primary sector, which could trigger the risk of increased dependency on short-term funding right at a time when this is harder to find. Fiscal outlook, meanwhile, continues to deteriorate (particularly in Brazil and Colombia) prompted by slowing domestic demand and lower commodity prices.

2 Global environment: anaemic and more fragile growth

The intensification during the last quarter of 2015 of some of the risk clusters with a global impact led to a further downward revision of world economic growth forecasts for this year. The transition to a lower growth pattern in China, with economic reforms and changes to key objectives such as the exchange rate, is being accompanied by bouts of intense financial volatility and falling commodity prices. All this leads to a much less favourable global panorama for large commodity-exporting economies, but also for those perceived as more vulnerable financially.

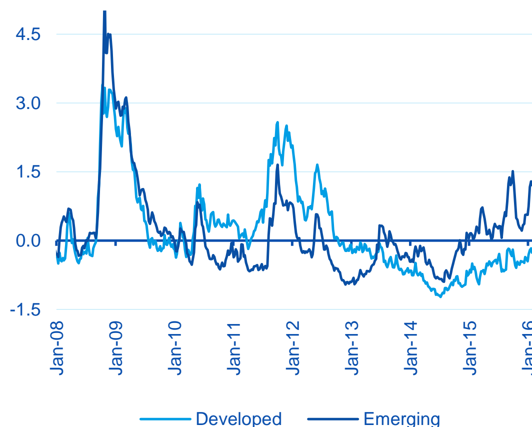
In fact, the leading indicators (confidence indices) and the increase in financial stresses point to more moderate growth in early 2016 than as foreseen three months ago. Therefore, world GDP will grow by just 3.2% in 2016, repeating the advance of 2015 and postponing recovery to 2017 when it should reach rates of around 3.5% (figure 2.1). This lower growth rate reflects slackening demand in emerging economies. Recovery in developed economies is still fragile and highly dependent on the possible impact of the slowdown in world trade and the increase in financial instability on industrial output, capital investment and consumer spending. With the US growing at 2.5% and the Eurozone by less than 2%, the tenuous improvement in activity in developed economies as a whole will not be enough to offset emerging markets' deceleration.

Chart 2.1
World GDP, % YoY



Source: BBVA Research

Chart 2.2
BBVA financial stress index (normalized values)



Source: BBVA Research and Bloomberg

The recent behaviour of the financial markets is largely explained by doubts about the strength of the world economic cycle. Activity indicators continue to show the greatest degrees of deterioration concentrated in manufacturing and trade. Activity in services, which until now had benefited from the recovery of private consumption in major developed economies, is also starting to show signs of less dynamism. Then, the BBVA Research's Financial Stress Index for emerging countries has climbed back up to the levels seen in July and August of 2015 (first wave of the Chinese stock exchange crisis), reaching the stress levels of 2011 (Figure 2.1). Volatility remains contained in developed economies, in a context in which capital seeks refuge in financial assets with a lower risk profile such as sovereign bonds of countries like Japan, the US and Germany.

All the same, the world economy faces a 2016 of limited growth and with a balance of risks showing a negative bias and concentrated in the emerging bloc. How China's economy evolves, both as regards the degree of slowdown in activity and how the authorities manage the financial imbalances that exist, will

continue to have a significant influence on capital flows and commodity prices in general, not just oil. The level of corporate indebtedness in emerging countries most vulnerable to the external environment constitutes an additional source of instability, in a context of lower profits and higher funding costs (high-risk premium?). Allied to this, geopolitical tensions in certain parts of the world and the risk of a scenario of low growth and low inflation in major developed economies complete the outlook for the world economy in 2016.

USA: moderate growth and dependent on consumer spending

In the second half of 2015, US economic growth steadied at around 2.5%, the level we estimate it to grow this year and next. However, activity deceleration in the fourth quarter, as well as the leading signals from business confidence signals, increase the chances of a lower-than-expected growth this year. Meanwhile, the Federal Reserve has repeatedly stressed that the path of interest rate increases will be gradual and subject to the continuation of the dynamic of domestic demand and inflation. In a context of relatively low inflation and considering the recent fall in oil prices, we expect at most two interest rate hikes in 2016.

China: the challenge of eliminating financial instability

Doubts about China's ability to successfully manage the transition to a more moderate and balanced economic growth model resurfaced in the last quarter of 2015 following a new bout of financial instability deriving, as last August, from the stock and currency markets.

While maintaining financial stability is crucial in order to avoid any repetition of episodes of risk aversion such as the recent one, the growth dynamic shown by China in the short and medium term continues to be of decisive importance for the world economic cycle. For the time being, growth continues to gradually moderate and to recompose itself, as has been occurring since 2011. Our base scenario holds GDP growth for 2016 at 6.2% and at 5.8% for 2017. Additional monetary stimulus measures during 2016 in the form of key interest rate cuts cannot be discounted, although they will be constrained by the impact they might have on capital flows. Finally, it is quite likely that this scenario will lead to a situation of greater risk given the doubts about the pace of rebalancing of the economy and the authorities' room for manoeuvre for managing it smoothly.

Eurozone: no changes to expected growth

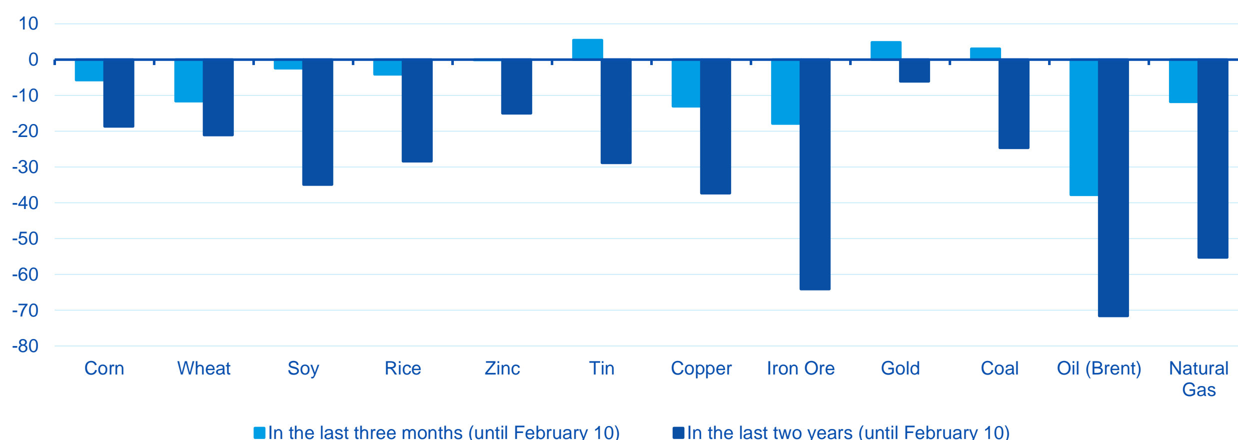
If the recent recovery dynamic is maintained, the Eurozone could grow this year by 1.8% and 2.0% in 2017, the same figures as forecast last quarter. The positive effect of the fall in energy prices, a more expansionary fiscal policy and the continuation of loose monetary conditions would be partly offset by the negative impact of the slowdown in international trade on the export of goods and of increased financial and political instability on investment decisions.

3 Volatility still the order of the day in Latin American financial markets

Fresh falls in commodity prices, prompted by doubts about growth in emerging markets, and, in some cases, supply resistance

The downturn in commodity prices, which began in mid-2014 amid heightened concern about slowing growth in China and in other geographic areas, has continued over the last three months (Charts 3.1 and 3.2). Indeed, from the end of October to early February, prices of most primary products had been adjusted downward, except for tin, coal and gold (the latter because of its status as a safe haven in times of turmoil). The adjustment in oil prices has been even greater, prompted by uncertainty regarding the slowdown in the Chinese economy, in particular, and about emerging markets, in general, and also by the fact that supply has held up relatively firmly: output and profitability on shale oil, Iran's return to the global oil markets and the persistent high supply by OPEC member countries. The price of crude oil has dropped by almost 40% since the end of October (for further details of the recent pattern on the oil market, refer to Box 1 below).

Chart 3.1
Commodity prices (% chg.)



Source: Bloomberg

Corrections have not been so acute in other markets, although they are also significant. Turning to metal commodities, the price of copper - which is so important for Peru and mainly for Chile - has fallen by around 13% over the last three months. This adjustment brings the copper price below the average cost of production. Despite the fact that global growth estimates have been lowered, that there are more fears about the future of the Chinese economy and that the dollar's rise in value on global markets is putting downward pressure on prices (not only on copper, but on all commodities in general), the recent fall in the copper price cannot fully be explained by fundamental variables. The current pattern in prices has also been shaped by non-commercial agents acting on the derivatives market, largely of a speculative nature.

Meanwhile, the sharpest fall in agricultural commodities, which are more isolated from the impact of the slowdown in China - as the adjustment is above all in investment, which is less intensive in foodstuffs - has been in wheat (approx. 12%), though soy, corn and rice prices also fell recently. In certain cases, the abundant recent harvests play some part in the downward corrections in recent months.

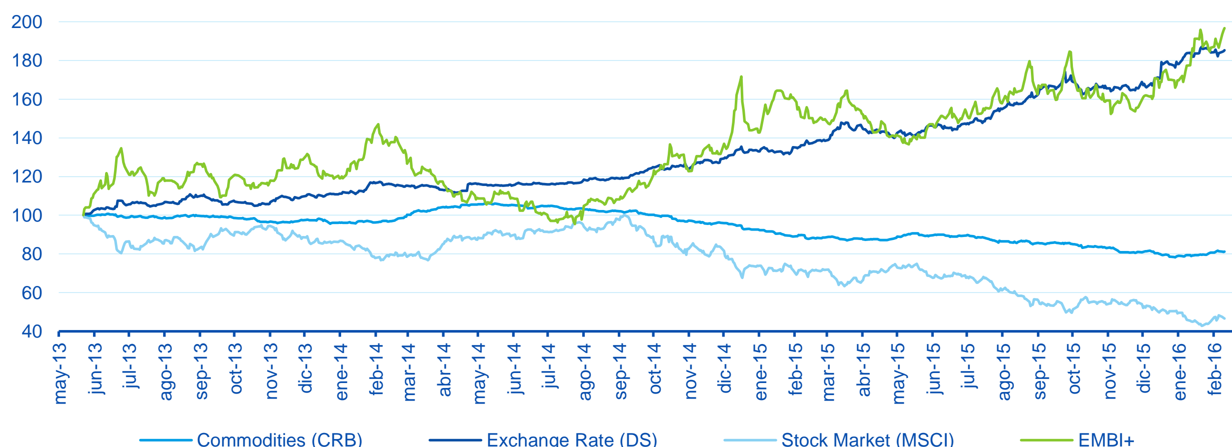
After these recent adjustments, commodity prices now stand at levels much lower than they were not that long ago. Oil, copper and wheat prices, for example, are now at levels 72%, 37% and 35% respectively, lower than those observed two years ago, in early 2014, when the slowing growth in the Chinese economy began to have a stronger impact on the commodities markets (Chart 3.1).

Volatility on financial markets has depressed main assets in the region

As noted in section 2, we have not only observed sharp correction in commodity prices, but also a slump in global markets and a spike in financial tensions in recent months. The most probable conclusion to be drawn is that the recent volatility is the result, as it was in mid-2015, of underlying doubts about the reshaping of the Chinese economy and fears that the Chinese authorities might be unable to achieve a “soft landing”. Part of this has to do with the fact that markets appear to be concerned about the impact that cheaper oil may have on the macroeconomic balance of exporter countries and on the corporate sector most exposed to commodities.

Although the Fed’s raising of interest rates and the slowdown in the global economy are not conducive to stability on the global markets, they do not appear to be the main reasons for the recent turmoil. On the one hand, the launching of the monetary normalisation process in the US was not only widely discounted by the market, but, in addition, at the same time as the stock market corrections, the expectations for interest rate hikes by the Fed are being revised downward, and this does is not calming the markets’ jitters either. On the other hand, financial tensions do not appear to be springing from the slowdown in global growth. In the second half of 2015, business indicators were basically in line with expectations, and even higher than expected in certain developed economies. Furthermore, although global growth is relatively low and improvement is proving to be too sluggish, it is certainly not an unfamiliar scenario and thus cannot justify recent market corrections.

Chart 3.2
Latam: Stock market prices, sovereign spreads and exchange rates (index 23 May 2013=100)*



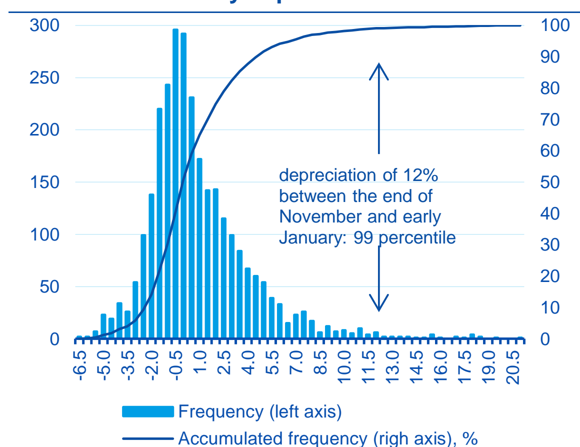
* Exchange rate: average for Latin American countries. Stock market indicator: MSCI. Sovereign risk: EMBI Latam. For exchange rates, an increase in the index indicates depreciation.
Source: Haver Analytics, Datastream and BBVA Research

In any event, global financial turmoil is depressing Latin American financial asset prices. Over the last three months, from the end of October to early February, the exchange rate depreciated by approximately 12% on average, the main Latin American stock markets shed 14% and the EMBI Latam, which measures sovereign risk in the region, rose by around 24% (Charts 3.2, 3.4, 3.5 and 3.6).

The recent corrections in local financial asset prices are reminiscent of those observed in the summer of 2015, due to their causes and also their magnitude. The adjustment on the currency markets is a good

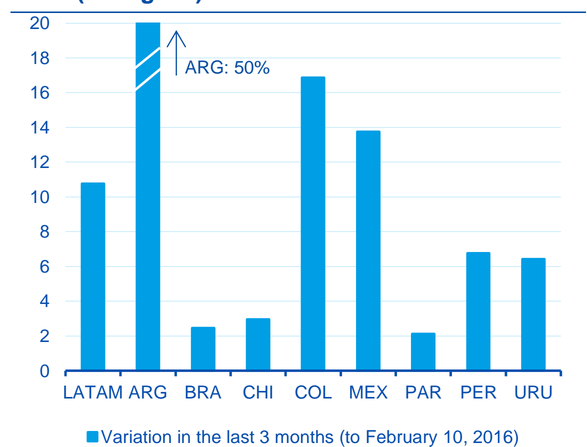
reflection of what has happened in other financial markets in the region: in the first two weeks of January, average 45-day cumulative depreciation was 12%. Since 2005, the only time the Latin American currencies had depreciated on such a scale was during the start of the Lehman Brothers crisis in 2008. In 99% of cases, currency adjustments in Latin America have been less pronounced than those observed in early 2016 (Chart 3.3). In particular, recent corrections are slightly higher than those observed in the previous bout of turbulence, between June and August 2015. At that time, the main regional currencies devalued by an average of 10%.

Chart 3.3
Frequency distribution of average 45-day cumulative currency depreciation in Latam*



* Cumulative 45-day currency variation calculated daily between January 2005 and February 2016. The positive (or negative) numbers on the horizontal axis show currency depreciation (appreciation). Simple averages of the currencies of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
Source: Datastream and BBVA Research

Chart 3.4
Latin American exchange rates: change over time* (change %)



* Positive variations represent currency depreciations.
Source: Datastream and BBVA Research

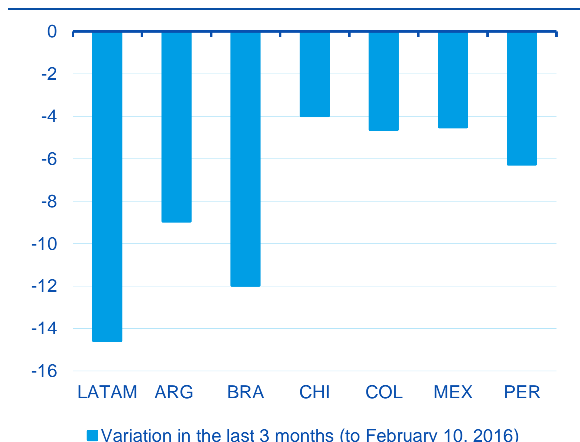
It is also important to bear in mind that certain idiosyncratic factors also contributed to recent volatility. In the currencies market, for example, it is important to bear in mind that the Argentinian peso depreciated by around 45% after the new economic authorities removed the “dollar clamp”. In fact, if we strip out Argentina from the analysis, Latin American currencies would have depreciated an average of 5% in early 2016, even higher than 98% of the period of time between 2005 to now, but lower than the 10% depreciation observed in the summer of 2015.

Apart from the adjustment in the Argentinian peso, the strongest corrections in recent weeks have been in Colombia and Mexico, economies which have greater exposure to falls in oil prices (Chart 3.4).

On the stock markets (Chart 3.5), the greatest losses were in Brazil, hardly surprising in view of the macroeconomic decline, political problems and the fact that the country recently lost its investment grade rating (Fitch downgraded it in December, three months after S&P had done so).

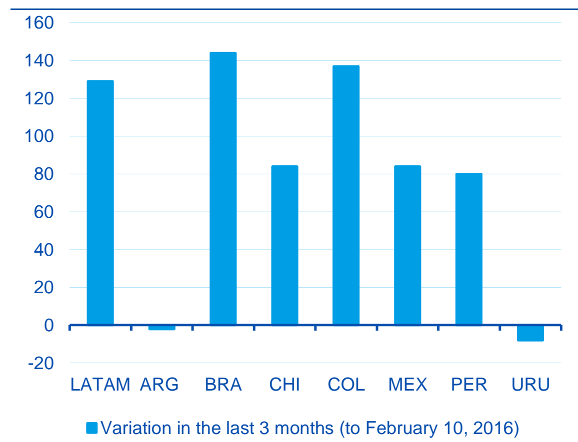
Argentina and Uruguay were the only countries which did not report a significant decline in their sovereign spreads over the last three months. The sharpest adjustments to sovereign spread were in Brazil and Colombia. In Brazil's case, this was due to the sharp decline in the economic and political situation; and in Colombia's, due to the slump in the oil price. After these latest corrections, Argentina's sovereign spread is now lower than Brazil’s.

Chart 3.5
Latin American stock markets: change over time (chg. %, in local currency)



Source: Haver Analytics and BBVA Research

Chart 3.6
Sovereign spreads in Latin America: change over time (EMBI, basis points)



Source: Haver Analytics and BBVA Research

Lastly, it is important to note that the Fed's increase in interest rates and the greater aversion to global risk, helped by the slowdown in Latin American economies, is prompting a slowdown of capital flows towards the region and even, in some cases, such as Brazil, an outflow of capital. Corporate and sovereign issues to foreign investors also fell by 33% in 2015, largely due to the slowdown in the former, especially in Brazil.

Looking forward, volatility will persist, but losses should be offset by recovery in commodities

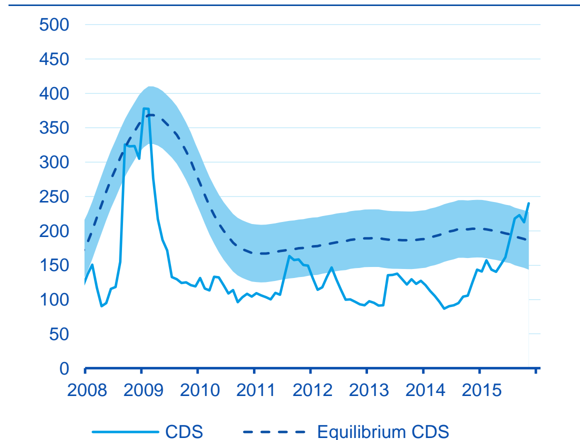
As we have repeatedly warned in recent reports, the pattern of global economic activity and the performance of the financial markets will continue to be shaped by the process of recovery in the US economy, which marks the pace at which the Fed normalises monetary conditions, and the reshaping of the Chinese economy towards lower rates of growth which are less dependent on investment and more on domestic demand. Even if the US economy manages to steadily regain strength and the Chinese economy is able to avert a “hard landing”, further turmoil - such as that observed in early 2016 and between June-August 2015 - is very likely because of the complex nature of these two processes and the fact that the market closely follows short-term indicators in these two geographical regions.

Judging by these perspectives for the international setting, taking into account that the slowdown process in at least certain Latin American economies is not over yet, and that, in certain cases, political problems and uncertainties will play a significant role in how events unfold, we cannot state categorically that Latin American financial markets will recover quickly and significantly.

Future losses should be limited, however, taking into account that in some cases, the prices of financial assets, such as exchange rates (see section 6) and CDS (Chart 3.7) are below the value determined by fundamentals.

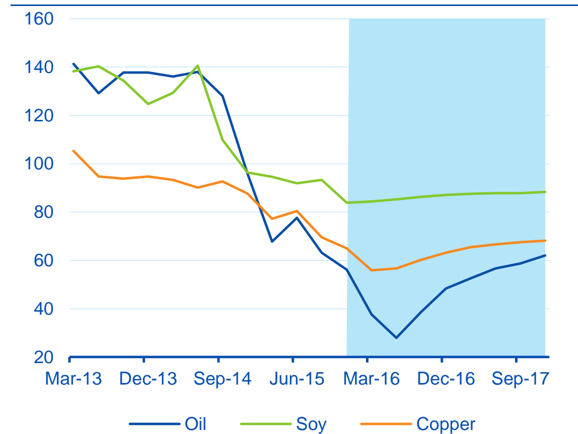
Commodity prices are another factor that should bolster regional assets to some extent. Current market conditions should lead supply to be reduced, albeit gradually, allowing prices of products such as oil and cooper to converge at relatively stronger levels at the end of 2017 of around 10% higher than the end of 2015, in the case of oil, and of 5% in the two other cases (for further details refer to Chart 3.8, and for the case of oil, Box 1). Although this recovery in commodity prices is limited, it should play a role in driving higher economic activity over the next two years.

Chart 3.7
Risk premium in Latam: Observed and equilibrium CDS (basis points)*



* Shaded area: average of four alternative models + 0.5 standard deviation. For more details on the equilibrium calculation, refer to our "Flows & Assets Report 3Q15" report.
Source: BBVA Research

Chart 3.8
Estimated prices of staple commodities (average index 2010 = 100)



Source: BBVA Research

Box 1. What's next for oil prices?

The End of an Era

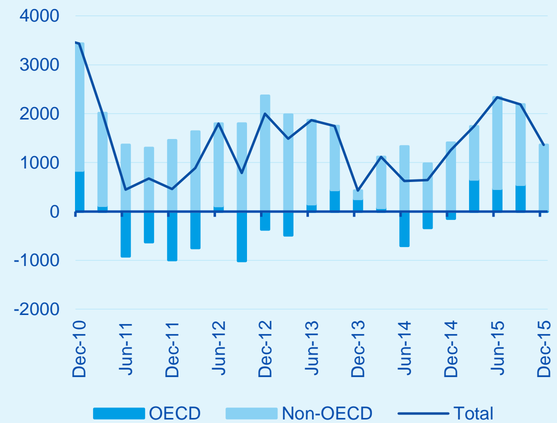
Between the early 2000's and the second half of 2014, oil prices exhibited a period of sustained gains interrupted momentarily by the Great Recession. In this commodity super-cycle, oil market conditions were characterized by robust growth in both non-OECD demand and non-OPEC supply of crude oil, supported by loose monetary policy, unprecedented technological advancements and search-for-yield investment strategies. As a result, a massive amount of resources were allocated throughout the oil and gas (O&G) value-chain.

Global demand was largely driven by the formidable economic expansion of emerging markets. Between 2000 and 2015, emerging markets contributed with 70 cents per each additional dollar –PPP adjusted- of world's GDP. In the same period, the increase of global demand for petroleum products was entirely driven by emerging markets. Moreover, China's staggering 9.5% average GDP growth in this period and its large spillover effects on other emerging markets, explain 62% of the net increase in petroleum products demand in the last 15 years.

Figure B.1.1
WTI Spot Price ($ per barrel)

Source: BBVA Research & Haver

Figure B.1.2
Oil Product Demand (yoy change, thous b/d)

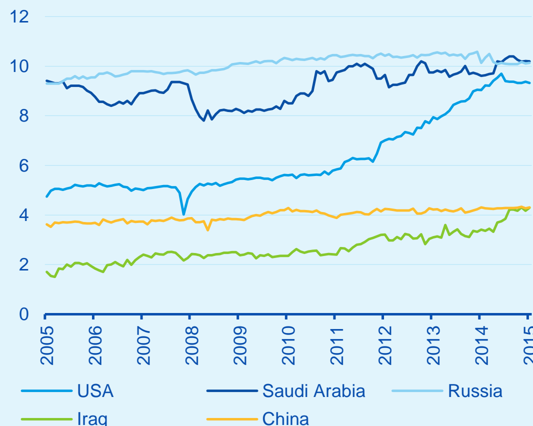


Source: BBVA Research & Haver

Non-OPEC supply's surge was driven by the U.S., where a combination of high oil prices, hydraulic fracturing, horizontal drilling, deep-water technologies and historically low interest rates encouraged a significant amount of investments in the O&G industry. In fact, the ratio of total capital expenditures in O&G to GDP increased from 0.4% in 2000 to 2.1% in 2014, accumulating $2.8tn in 15 years. As a result, U.S. crude oil production increased from 5.7 million b/d in 2011 to 9.7 million b/d in April 2015. In this period, the U.S. accounted for 83% of the cumulative net increase in global crude oil supply.

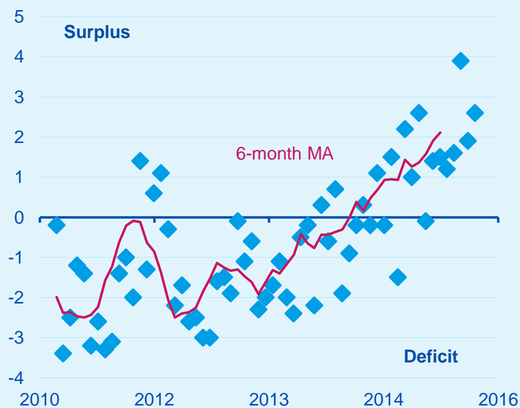
Throughout much of this period, crude oil prices increased consistently suggesting that demand-side factor dominated market expectations. However, beginning in 2011, when U.S. supply began to surge, oil prices stabilized as expectations discounted a more balanced market. However, by 2014, demand was unable to absorb supply, leading to a decline in prices that continues until today.

Figure B.1.3
Crude Oil Production (million barrels per day)



Source: BBVA Research & Haver

Figure B.1.4
Global Oil Supply and Demand Balance (million barrels per day)



Source: BBVA Research & Haver

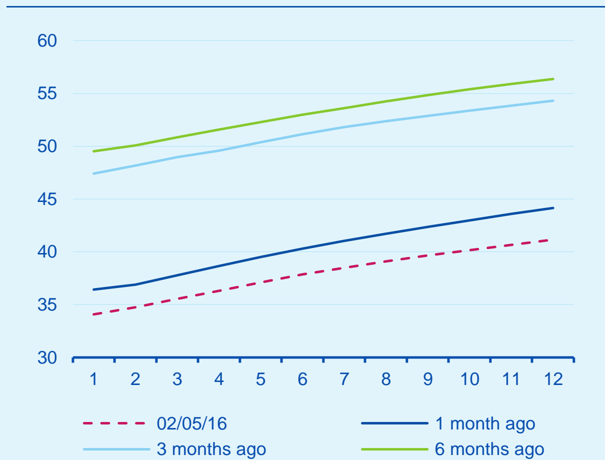
In previous episodes of price downturns, OPEC would have reacted by cutting production as it did during 2001 and 2008; however, in November 2014, the cartel surprised markets by deciding to keep its production quota unchanged which was interpreted as an attempt to protect market share. The reluctance to cut production and even revamp it in 2015, when prices continued declining, was seen by some experts as an attempt to force higher-cost producers to exit the market.

At the same time, in mid-2014, China's economic deceleration became more evident. This trend has persisted ever since. For example, the manufacturing PMI has decelerated consistently since July 2014, after it reached a peak of 51.7. The spillover effects into emerging markets have been significant. For instance, growth of industrial production in emerging markets and the volume of foreign trade from and to this region have slowed to their lowest levels in six years.

Our econometric analysis confirms that the drop in oil prices has been primarily driven by fundamentals: supply and demand, including expectations about both factors. In particular, resilience –and expectations about- the non-OPEC oil supply and the weakness –and expectations about- the non-OECD aggregate demand have had a relevant role in the oil prices level and volatility. In addition, the reassessment of global growth expectations in favor of developed economies relative to emerging markets along with monetary policy divergence in developed economies –both of which strengthened the relative value of the U.S. dollar-, have generated further downward price pressures. Price volatility has also reflected geopolitical developments such as the lifting of sanctions on Iran and military conflicts in the Middle East.

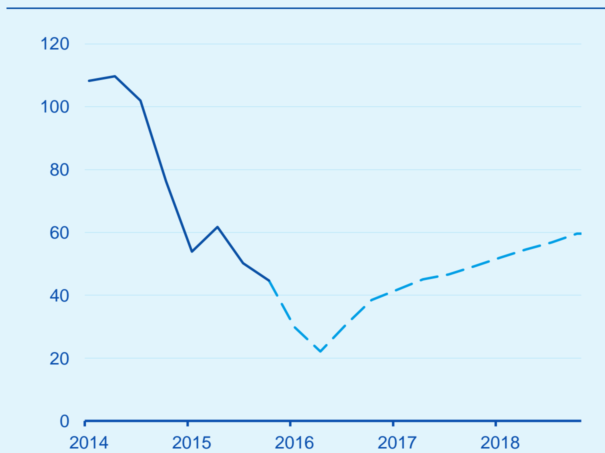
Our baseline scenario projects a downward adjustment in 1H16 followed by a mild recovery thereafter. By the end of 2018, prices are expected to stabilize around $60bbl, level around we estimate the long-term equilibrium level.

Figure B.1.5
Brent Crude Futures ($ per barrel)



Source: BBVA Research & Haver

Figure B.1.6
Crude Oil Price Forecast – Baseline (Brent, $ per barrel)

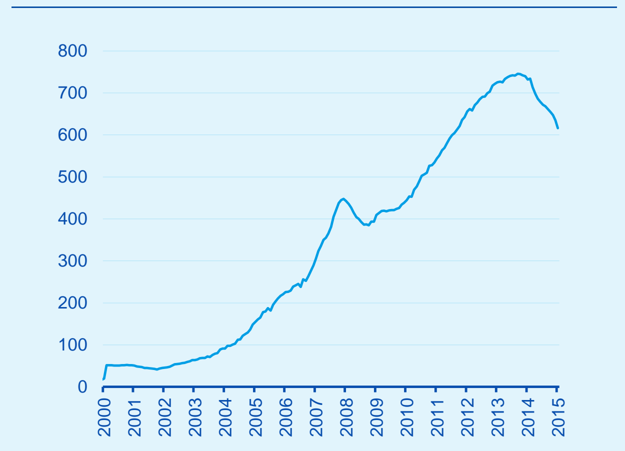


Source: BBVA Research & Haver

Further prices correction is possible in the next few months

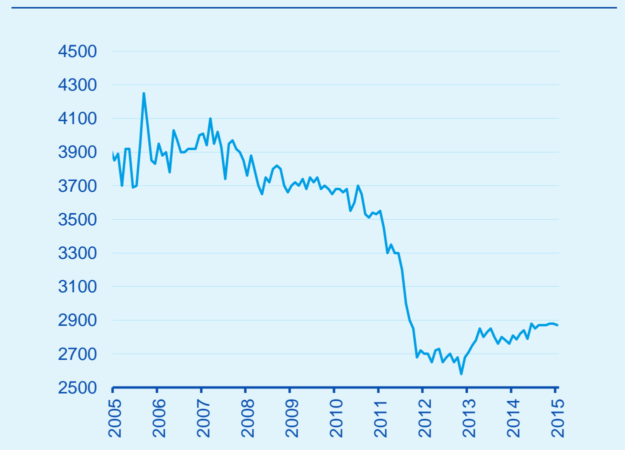
Since prices began to fall, futures contracts have persistently reassessed expectations to the downside, suggesting that it is still uncertain when prices could reach a bottom. Concerns on oversupply persist. OPEC has not shown any convincing signs of a potential cut in production. This could be explained by two factors. On the one hand, the marginal cost per barrel for Saudi Arabia and other OPEC members remains well below $20bbl. On the other hand, Saudi Arabia – the biggest producer and holder of the second largest proven reserves- has been able to absorb the impact of low prices on its economy through a combination of austerity measures and selling foreign reserves. Considering the foreign reserves level ($616bn, 100% of GDP) and that public debt is low (6.7% of GDP), the country has ample room to withstand a longer period of low oil prices.

Figure B.1.7
Saudi Arabia: foreign reserves (total minus gold, EOP, billion US$)



Source: BBVA Research & Haver

Figure B.1.8
Iran: crude Oil Production (million barrels per day)



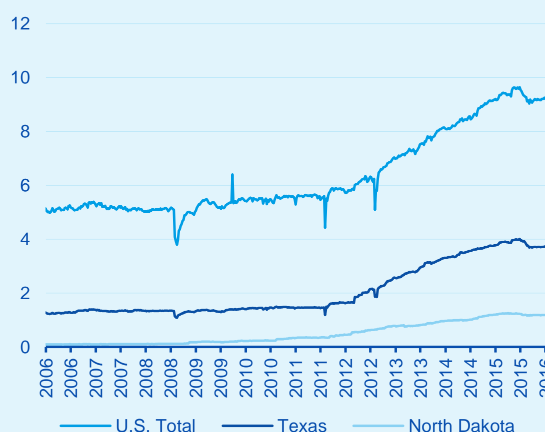
Source: BBVA Research & Haver

Divisions within OPEC obscure the possibility of agreement among members. The cartel is split in two groups. The first includes countries like Venezuela, Nigeria, Iran, Iraq and Libya whose troubled economies desperately need higher prices and would like to see production cuts coming from members with stronger economic conditions. The second group is comprised by Saudi Arabia and other Gulf states who believe that any cut in production should be shared not only by all OPEC members but by non-OPEC producers as well; a necessary condition to maintain market shares unchanged. However, non-OPEC countries like Russia –the second world's largest producer- and Brazil may find it difficult to cut production voluntarily as their economies are contracting and oil revenues are critical to support countercyclical fiscal policy. Not surprisingly, recent efforts to persuade Russia to join OPEC in cutting production have been unsuccessful.

Another source of downward price pressures has to do with Iran's ability to export crude after the lifting of sanctions resulting from the nuclear deal with the P5+1. The Iranian government aims to increase production by 1 million b/d in 2016, which would mean returning to full production capacity, estimated at nearly 4 million b/d. However, a more reasonable estimation suggests that the amount of additional oil that the country can inject into the global market in the short-term is between 300K b/d and 500K b/d. A larger expansion in production will take time as significant amounts of investments are needed to modernize a deteriorated infrastructure. These investments will not flow swiftly given tighter credit conditions and diminished risk appetite.

Given OPEC and Russia's impasse together with Iran's reintegration to the global market, the attention has turned to the U.S. where production has shown a significant degree of resiliency. Since its last peak of 9.7 million b/d in April 2015, U.S. crude oil field production went down gradually to 9.3 million in November 2015. Until now absence of an abrupt decline in U.S. production can be explained by a series of factors. First, highly- leveraged operators need to continue producing and selling crude in order to service debt. Second, variable costs have adjusted faster than expected providing a temporary relief to partially absorb the impact of declining prices. The third factor is the heterogeneity of the industry and its assets. For instance, break-evens vary across shale plays and so do operators' responses to declining prices. Some companies are more diversified than others or have assets of better quality. Adjustments in production have been heterogeneous across shale plays; for example, as of December 2015, production continued to expand in the Permian and Utica, but contracted in the Bakken and the Eagle Ford. However, those factors are not permanent. In the extent that the scenario of low prices remains, the decline of U.S. oil production would be more intense.

Figure B.1.9
U.S. Crude Oil Production (millions barrels per day)



Source: BBVA Research & Haver

Table R.1.1
Real GDP growth (% change y / y)

	Estimates	Projections	
	2015	2016	2017
Russia	-3.7	-1.0	1.0
China	6.9	6.2	5.8
India	7.3	7.5	7.5
Brazil	-3.8	-3.0	1.3
South Africa	1.3	0.7	1.8

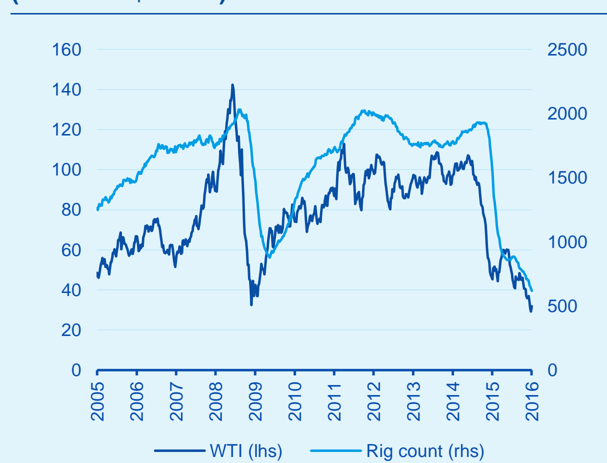
Source: BBVA Research, IMF & Haver

From the demand side, prospects for global growth have diminished due to weakness in emerging markets and modest growth in developed economies. In particular, China's economic growth is expected to go from 6.9% in 2015 to 6.2% in 2016 and 5.8% in 2017. Our baseline scenario assumes a "soft landing"; however, uncertainty about the magnitude of the slowdown and the government's ability to manage the cycle through fiscal and monetary policy is likely to exert downward pressures on crude prices in the short-run. Slower growth in China will have spillover effects on other emerging markets with negative implications for the demand of crude. Another factor preventing prices to go up anytime soon are persistently high levels of inventories, mainly in the U.S. where crude stocks excluding strategic reserves are the highest in eighty years, and where despite their exponential growth, pressures on working storage capacity are still contained.

Modest improvement in 2H16 and 2017

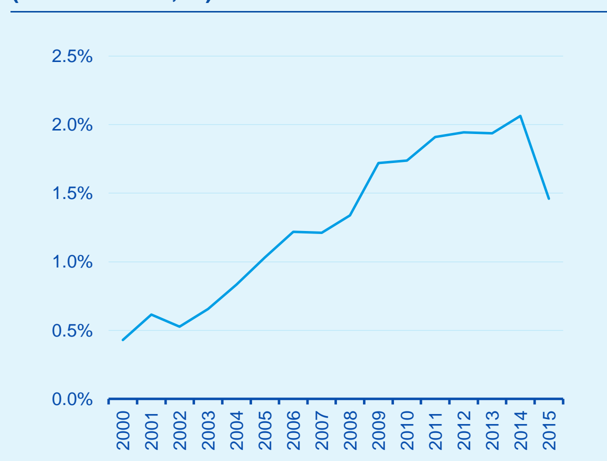
Although prices could decline further in 1H16, a stronger adjustment in U.S. production could bring them up in 2H16 and 2017, particularly if the drop in US production is larger than the potential increase in supply from other producers (e.g. Iran). The rapid reduction of active rigs suggests that U.S. crude oil production could decline by around $1 million b/d over the next twelve months. This would trim a substantial portion of excess supply in the market, currently estimated to be between 1.5 and 1.8 million b/d. In 2015, U.S. real private fixed investment in mining exploration, shafts and wells contracted 35%, $47.3 billion less than in 2014. This trend is likely to continue in 2016 as O&G make further CAPEX reductions in response to pressures on profitability. As a share of GDP, CAPEX in the U.S. O&G industry declined to 1.5%, the lowest since 2008. U.S. production will also be affected by an increasing number of bankruptcies and a more risk-averse environment reflected by tighter credit standards for O&G financing[1].

Figure B.1.10
U.S. Active Rig Count and WTI (units and $/barrel)



Source: BBVA Research & Haver

Figure B.1.11
U.S. Capital Expenditures in O&G (share of GDP, %)



Source: BBVA Research & Haver

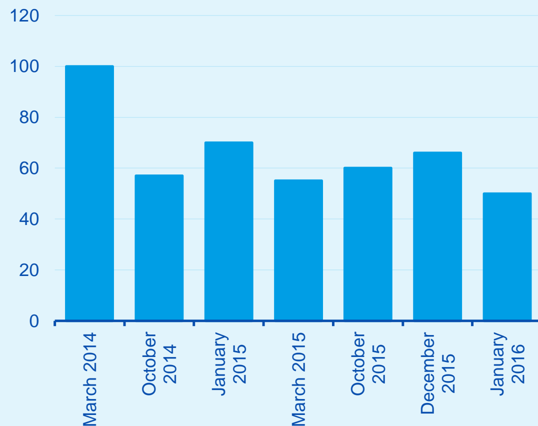
Global production could also decline if OPEC manages to convince Russia to reduce production; however, as we prepare this document, there is no solid evidence that this could happen soon.

Although a deeper adjustment of U.S. production or an OPEC agreement with Russia could bring prices up again, the upside will be limited by the

1: According to the Shared National Credit Program, approximately $34.2bn of outstanding syndicated debt in O&G may be at risk of default, that is one in seven loans of more than $20 million. In 2015, around 40 firms declared bankruptcy with an estimated total debt of $16.7bn

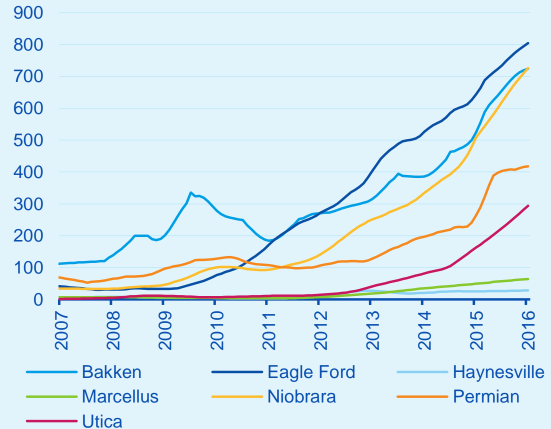
following factors: first, if Saudi Arabia and its partners want to maintain or gain market share, they need prices to be just below the breakeven prices of high-cost producers. This means that they cannot cut production to a point that high-cost producers become competitive again. Second, the flexibility and efficiency of the U.S. shale industry suggest that firms may revamp production relatively quickly once they perceive prices are increasing again. The short time between investment decisions and production will prevent the U.S. shale industry to be the key factor in sustaining a price upturn. Third, prospects for slower economic growth could counterbalance any upside coming from a supply adjustment. In other words, for Saudi strategy to work, the period of low oil prices needs to be somewhat prolonged in order to avoid a quick return of shale oil producers.

Figure B.1.12
North America Average Break-Even Prices (Tight oil, $ per barrel)



Source: BBVA Research, FT, HIS, Wood Mckenzie

Figure R.1.13
Rig Count Productivity (B/d per rig)

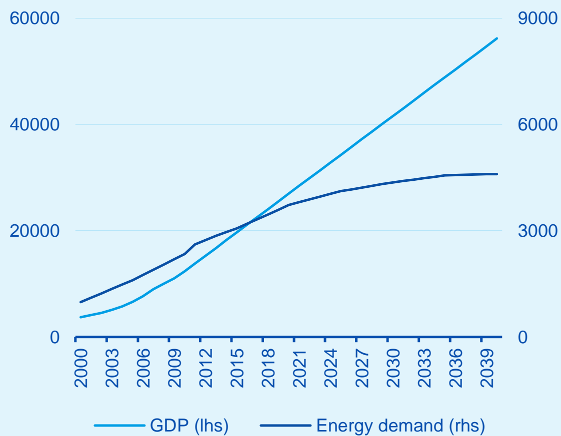


Source: BBVA Research, FT, HIS, Wood Mckenzie

Are oil prices heading to lower long term equilibrium? Yes, they probably are, but uncertainty is huge

Structural changes in the energy market will have a significant impact in the long-run. From the supply side, increasing competition from non-OPEC producers will continue to weaken the role of OPEC as a price stabilizer. More competition will foster innovation that could bring break-even prices down, making currently high-cost producers more competitive in the future. The U.S. shale revolution proved that a more competitive environment encourages innovation that boost productivity and grants access to once unavailable resources. Technological advancements have rendered the notion of "peak oil" –that is the hypothetical point in time when production reaches its maximum and declines thereafter to depletion– less relevant in a world where reserves continue to be discovered and extraction is increasingly feasible. One example of productivity enhancers is plasma-pulse, a technology that maximizes oil recovery by using a high-energy plasma arc rather than by injecting fluids at high pressure to stimulate the reservoir. Plasma-pulse is a more efficient and more environmentally friendly option than traditional techniques.

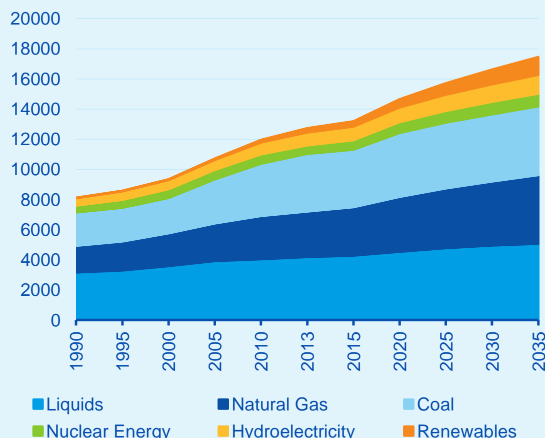
Figure B.1.14
China: GDP and Energy Demand ($tn PPP, and million tonnes of oil equivalent)



Source: BBVA Research & EIA

From the demand side, emerging markets will continue to drive growth while demand in developed countries will continue to lose relative importance; however, the rebalancing of the Chinese economy could have far reaching implications for oil. While China's GDP may well remain above 6%, a re-composition of growth sources could imply a much sharper adjustment in crude oil demand than if growth remains supported mainly by the industrial sector.

Figure B.1.15
World Energy Consumption by Fuel (million tons of oil equivalent)



Source: BBVA Research & EIA

As China transits from an investment-driven to a consumption-driven economy, energy use per GDP is likely to change as it has been the case for developed countries. In this regard, the International Energy Agency projects Chinese energy demand to start decoupling from GDP by the end of this decade and stabilize near 4000 million tons of oil equivalent by 2040[2]. This divergence will bring the energy to GDP ratio downward implying higher energy efficiency in transportation, commercial and industrial activity.

Finally, commitments to reduce CO2 emissions to the atmosphere –epitomized by the unprecedented success of the 2015 UN Climate Change Conference– are expected to encourage significant amounts of investments in order to increase the share of renewables in the global energy mix. These investments together with fiscal incentives across the globe promise to increase the cost-competitiveness of clean energy relative to fossil fuels. As technology adopters, emerging markets could make a relatively quick transition to energy efficiency and renewable sources even if oil prices remain low for a prolonged period of time. These trends would imply a new and certainly lower than previously expected equilibrium price for crude oil, although the uncertainty is huge about the intensity or even about the effective manifestation of those long term factors in the forecast horizon.

From a long term perspective, oil markets may be moving to a new paradigm. One in which hydrocarbons are abundant and accessible, but energy demand is shifting towards multiple sources. The world's energy needs are massive, but also complex. On the one hand, vast amounts of cheap energy are needed to support economic growth in developing countries where population is expected to grow the most. However, as the impact of climate change becomes more acute and governments and private agents around the world take it more seriously, the need for "clean and cheap" energy is no longer an option but an imperative. Hydrocarbons fit only in the "cheap" part of the equation. Renewables, on the other

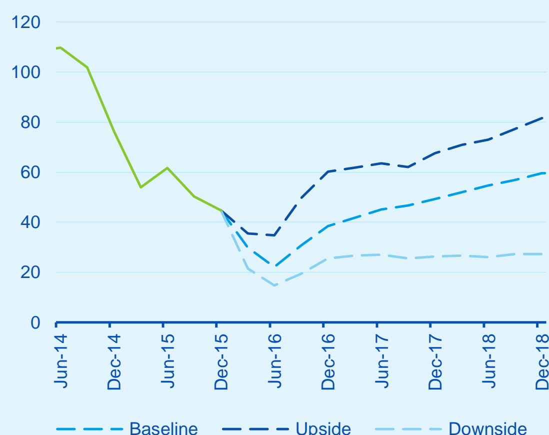
2: Source: EIA, World Energy Outlook 2015.

hand, are clean, but it will take some time before they become a cost-effective alternative for economic development, more so if prices remain low. In this new paradigm, oil will still be needed, but in less quantities, and companies will produce "energy" in the most holistic sense of the term.

Huge uncertainty around our baseline scenario, also in the short- and mid-run

The uncertainty doesn't vanish in the short and mid-term than in the long term. Prices could stop falling and resurge rapidly if 1) OPEC decides to cut production, 2) U.S. production shows a faster than expected adjustment with long-lasting impact on the industry, and/or 3) the deceleration of the global economy turns out to be milder than expected. Opposite events could outcome the opposite scenario of prices, i.e.: 1) a "hard-landing" of the Chinese economy materializes; 2) OPEC maintains its current production quotas and engages in a price war against other producers, and 3) U.S. production remains resilient while break-even prices decline due to innovation. The financial resilience of oil producers –OPEC and non-OPEC- to low oil prices scenario, the uncertainty about the soft landing of EM and the real impact of incoming innovation in oil industry will shape the final outcome of oil prices.

Figure B.1.16
Crude Oil Price Forecasts
Brent, $/b



Source: BBVA Reserarch

Table 3.2
Crude Oil Price Forecasts
(Brent, $/b, annual average)

	Baseline	Upside	Downside
2015	52.6	52.6	52.6
2016	**30.3**	**45**	**20.3**
2017	**45.7**	**63.7**	**26.4**
2018	**55.7**	**75.7**	**26.8**

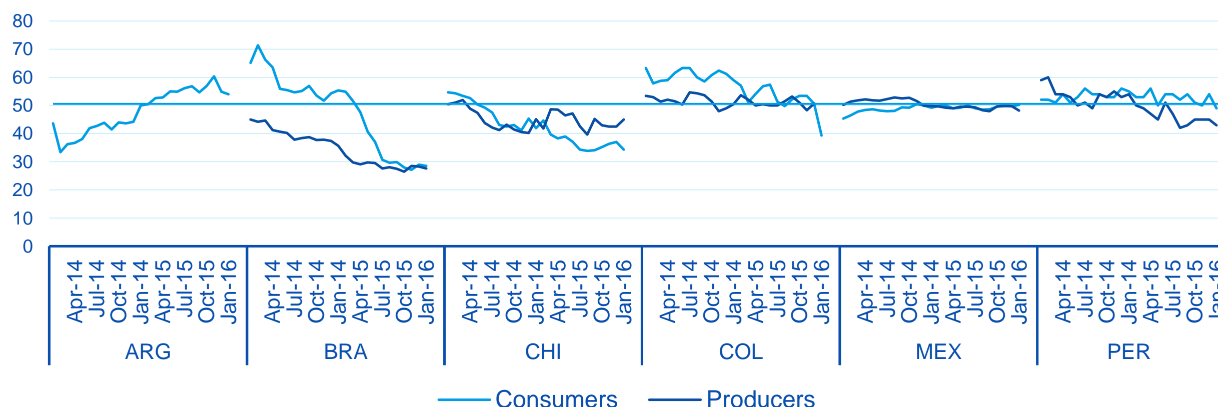
Source: BBVA Research

4 Latam growth hit by the impact of market volatility and weak domestic demand

Household and business confidence indicators remain weak, dampening domestic demand

There has been no further decline in confidence indicators in most geographical areas, but they still show a pessimistic trend (Brazil, Chile, Colombia) or are very weak (in Peru and Mexico) due to (i) political factors; (ii) question marks about economic policies (including reform processes in certain countries); (iii) cyclical deterioration, including less dynamic job markets; (iv) higher inflation, which affects disposable income; and (v) a gloomier international setting, including a fall in commodity prices. Argentina is the main exception to the rule: confidence indicators remain positive, although the data for January shows some degree of negative impact to consumer confidence caused by the new government's necessary adjustment measures (Chart 4.1).

Chart 4.1
Consumer and manufacturing confidence (values over 50pts indicate optimism)*



*For Colombia the latest data is from December-15. Chile business confidence only until January.
Source: BBVA Research

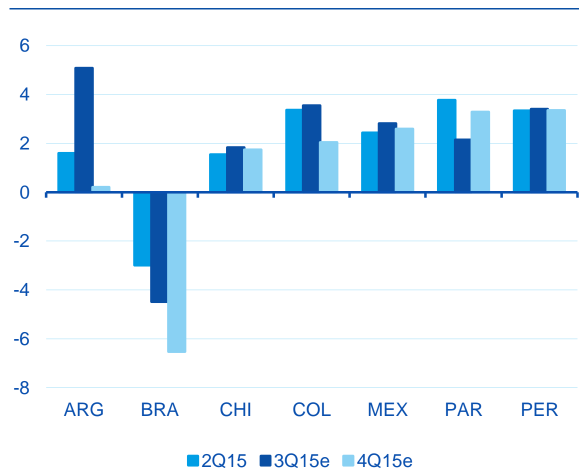
Little recovery is expected in domestic demand until late 2016.

In correlation with the lower confidence levels, private consumption fell further in most countries, strongly impacted by the inflationary spike in the latter part of the year (except in Mexico); its effects were partly offset by continued resilience in the labour market, although it was slightly worse than at the start of 2015. The slowdown in investment also continued, indeed investment dropped more sharply in year-on-year terms in Brazil and Chile, and remained lack-lustre in other countries (Chart 4.2 and 4.3). The recession in Brazil has had a negative impact on its Mercosur partners such as Argentina, Paraguay and Uruguay, mainly through the depreciation of the Brazilian real, but also through tourism and foreign direct investment. Importantly, exports to Brazil account for approximately 3%, 3.5% and 3.8% of the GDP of Argentina, Paraguay and Uruguay, respectively, and 21%, 22% and 12% of those countries' exports are to Brazil[3].

3: For a more in-depth analysis refer to: What impact does Brazil have on the Latin American economy? BBVA Research, June 2015

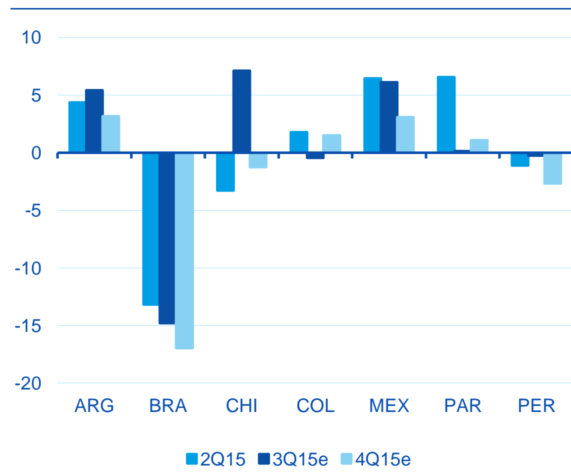
Recovery in domestic demand in the coming quarters would be expected to be slow due to the scenario of persistently low commodity prices, lower growth in foreign demand as well as political uncertainties and possible reforms.

Chart 4.2
Private consumption: Chg.% YoY



Source: BBVA Research and national statistics

Chart 4.3
Investment: Chg.% YoY



Source: BBVA Research and national statistics

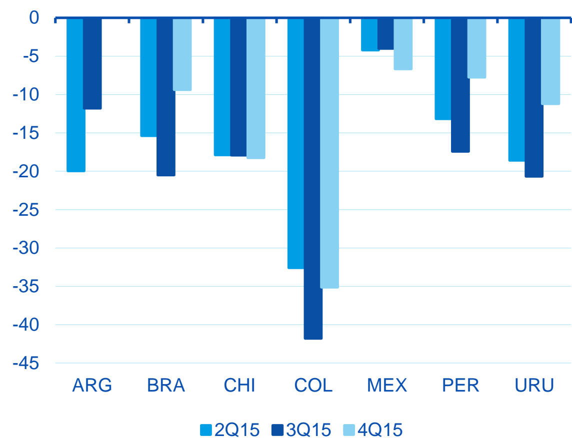
Lower commodity prices put further pressure on exports, albeit to a lesser extent in the last quarter than in the third quarter, and even though there was relatively little change in export volumes. Exports are hit not only by low commodity prices but also by lower foreign demand, and particularly from other Latin American markets. The fall in exports in Colombia, where lower oil prices have played a key role, is particularly significant (Chart 4.4). It is important to note that a fairly high proportion of exports to Latin American countries are of non-commodity goods: between 80% and 85% in Argentina, Brazil and Uruguay and approximately 75% in the three Andean states, so that slowing demand for manufactured goods (basic and non-basic manufacturing) has an impact on the rest of the region.

Growth in Latin America will hit bottom in 2016 and should recover in 2017 (-0.9% and 1.9%).

Growth estimates for Latin America in 2016 and 2017 are adjusted downwards, mainly due to a more adverse international setting, including lower commodity prices, particularly oil. The more adverse domestic environment in most countries, including somewhat more restrictive monetary and fiscal policies, is another reason for the downward revision.

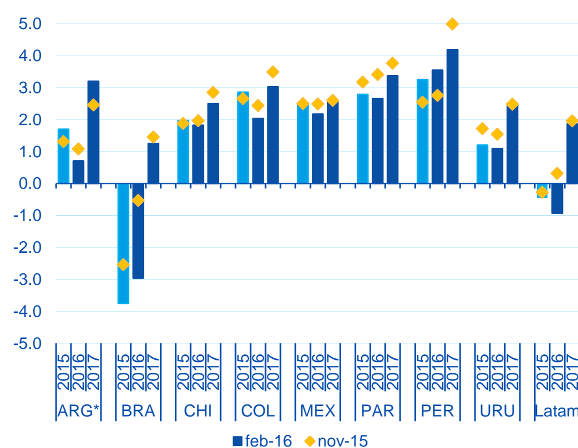
The magnitude of Brazil's estimated downturn in growth is particularly significant (Chart 4.5). The recession of 2015 will continue in Brazil, marked by inadequate resolve on various fronts. The fiscal situation is especially complicated due to the possible impeachment of President Rousseff, which hampers political agreements on fiscal matters.

Chart 4.4
Exports, chg.% YoY



Source: BBVA Research and national statistics

Chart 4.5
GDP, chg.% YoY



* A measure of private GDP is considered, given that Argentina's official statistics are being revised.
Source: BBVA Research and national statistics

In the other countries, the lower commodity prices are the other factor which has prompted the downward revision of growth in 2016, as they affect not only exports but also investments in commodity-related sectors. This slowdown in investment will be partially offset by higher public investment, particularly in Peru and Colombia. On the domestic front, the impact of household consumption will persist, driven by less dynamic labour markets, inflation at the upper end of central banks' target ranges, and less benign lending conditions (Brazil, Chile, Colombia, Peru), factors which will still weigh heavily on household consumption. As we have said above, in addition to these internal factors, we also have to consider the adverse effect of lower demand in the region.

The exception is in Peru, where we have revised our 2016 estimates upwards against our last quarterly estimates, due to the slighter expected impact of the El Niño weather pattern (a few months ago it was considered to be "extremely intense" and has now been changed to "moderate").   On top of this, a number of important mining projects are to be started up earlier than expected in Peru.

Looking towards 2017, we expect to see increased growth, albeit slow, in the region. The improved outlook for 2017 is based on (i) the driver of the external sector, fuelled by recovery in global growth, improvement in terms of trade and the depreciation of exchange rates; (ii) less political uncertainty in Brazil; (iii) a revival of private investment in Argentina, particularly if the debt holdouts question is resolved; and (iv) stronger investment in infrastructure in Andean states, above all Colombia and Peru.

A key factor for Brazil next year will be an increase in the terms of trade, implying growth in exports. The current political uncertainty will tend to ease off towards mid-2016, when a decision will be taken on whether or not to impeach President Dilma Rousseff. Once this happens, then the economy will cease contracting as it enters 4Q16. This improved outlook for the following year will spread to Brazil's major trading partners, allied with the potential resolution of imbalances in Argentina. Improvement in the external sector will be crucial for Andean countries in 2017, although grow will persistently be driven by commodity prices. In Colombia's case, tax reform will impact private consumption, having a one-off effect. In Peru's case, the brighter outlook for 2016 owing to a less intense El Niño phenomenon will also imply less of a rebound effect in 2017. Taking these factors into account, we have slightly reduced our growth outlook for the three Andean states.

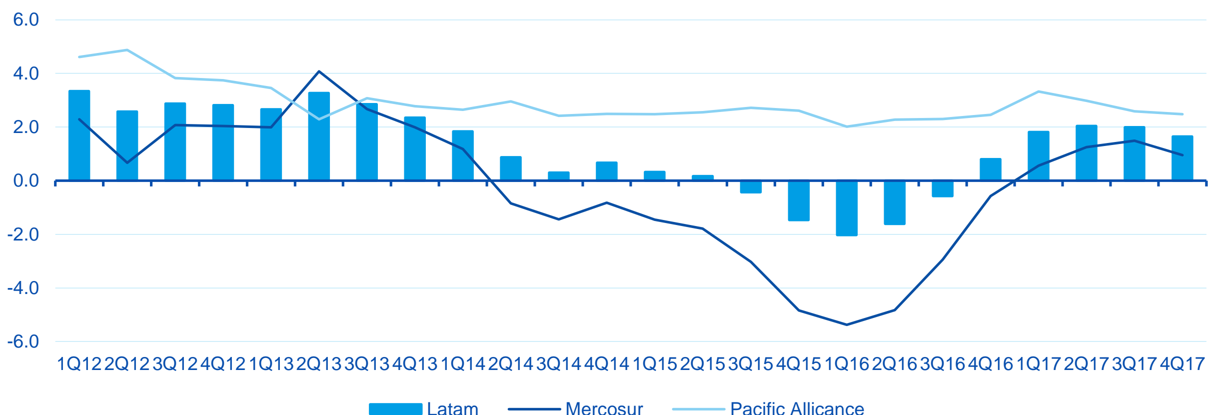
In Mexico, the expected slowdown this year (2.2% in 2016 vs. 2,5% in 2015), driven by oil and spending cuts, will tend to be offset by the improved demand in US manufacturing and some measure of improvement in oil prices.

Heterogeneity between Latin American countries will persist. Pacific Alliance countries will be the most dynamic in 2016, and will be joined by Argentina in 2017

In 2017, the region will recover in terms of growth, although it will still lag behind its estimated potential growth of around 2.7%. Pacific Alliance countries are expected to maintain growth in the region of 2.5%, albeit substantially lower than was estimated three years ago (circa 4%). Another important factor is that Brazil is now expected to come out of its recession much more slowly than was estimated a few months ago. The strongest growth in 2016 will be in Peru, Colombia, Mexico and Paraguay. Argentina will join this high-growth group in 2017, once its adjustment programme has ironed out the imbalances over the course of the year (Chart 4.6).

Over the two-year period between 2016 and 2017, a higher than expected downturn in China will be a persistent risk factor for the region as a whole, and it would also imply a negative impact on commodity prices. Furthermore, political risks and uncertainty will remain at least during the first half of 2016; as a result, an even more protracted or enduring fall in confidence levels could trigger a further decline in domestic demand.

Chart 4.6
Latam countries: growth in DGP (% YoY)



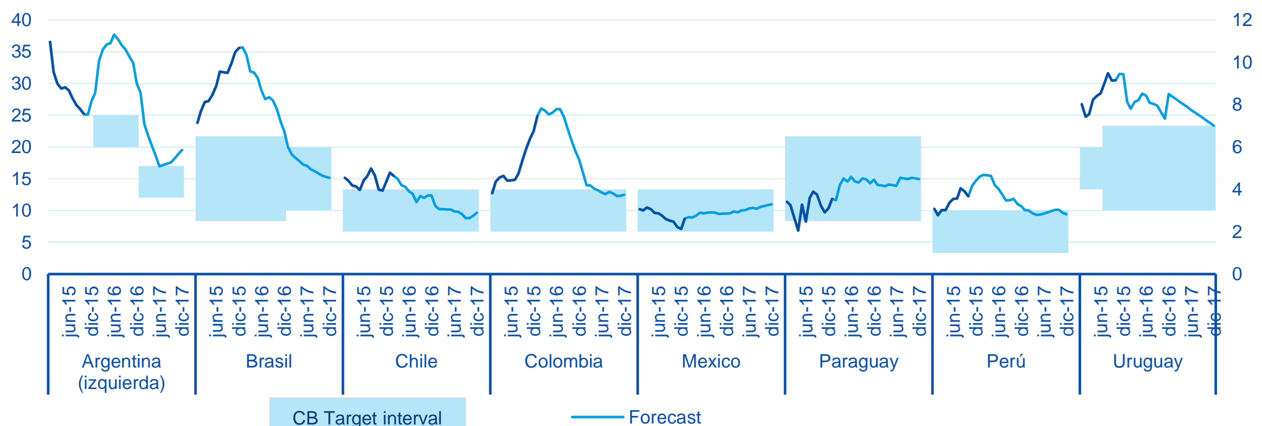
e= estimate.
Source: BBVA Research

5 Currency devaluation and food prices stoke high inflation levels in South America

Pressure on inflation remains high, despite cyclical weakness. Risk of inflationary expectations being unanchored in some countries

Inflationary pressures will remain high in most Latin American countries. In countries with inflation targets, the most recent indices show variations in prices above the target range for each economy, except for Mexico and Paraguay (Chart 5.1). Inflation levels recorded are particularly high in Brazil and Uruguay (10.7% YoY and 9.7% YoY respectively in January 2016). Inflation levels are lower in Chile, Colombia and Peru compared with the two Mercosur countries, although they are higher if compared with other quarters, especially taking into account the relative weakness of domestic demand. In January, inflation in Chile and Peru stood slightly below 5% YoY (4.8% YoY and 4.6% respectively). In Colombia, however, it was recorded at 7.5% YoY, the highest level for the last 8 years. In Paraguay, inflation leapt from 3.1% in December to 5.2% in January, but remained within the target range. In Mexico, inflation was also up in early 2016, from 2.1% in December to 2.6%, albeit still at extremely low levels, largely due to the effect of price reforms in sectors such as the telecommunications sector.

Chart 5.1
Inflation: observed and expected * (YoY %)



* Data for Argentina is on the left axis. The other countries are on the right axis.
Source: National statistics and BBVA Research

In general, currency depreciation (even though indicators show no evidence of increased currency pass-throughs to inflation) and higher food prices are the key factors behind persistently high inflation across most of the region, against a background of weak domestic demand. The latter factor is largely the result of supply problems due to changes in weather patterns, mainly concerning El Niño. In January, year-on-year inflation in food prices reached 14.6% in Brazil, 12.3% in Colombia, 8.3% in Uruguay, 6.4% in Paraguay and 5.4% in Peru. High inflation in food prices also pushed inflation records above January's estimates in practically the whole region.

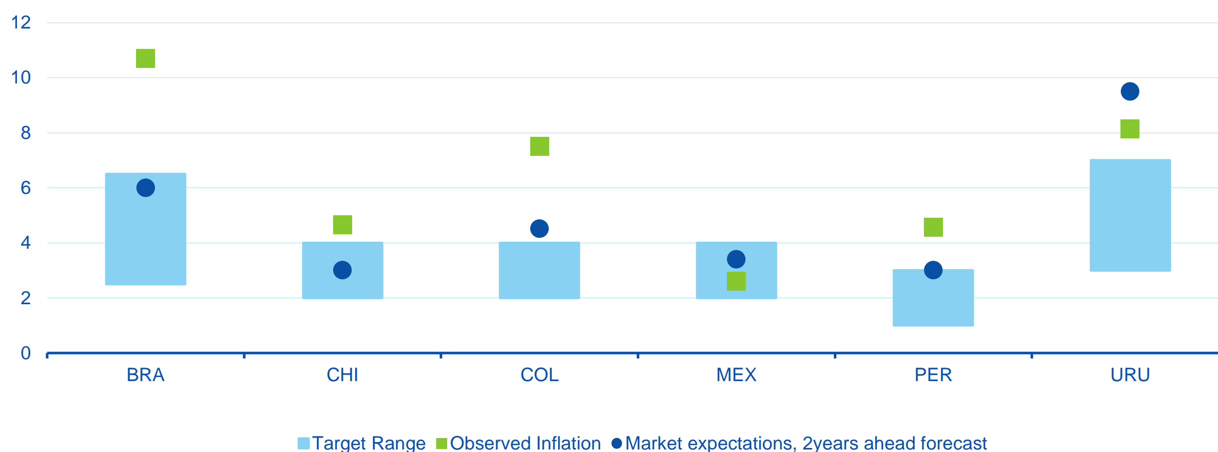
There are other factors in play as well as currency devaluation and higher food prices, which are more local in scope, and which have prompted recent price increases. Government price controls (in Brazil and Uruguay), inflation propagation indexation mechanisms (above all in Brazil and Uruguay, but also in Colombia and Chile) and fiscal adjustments (in Chile), play a particularly significant role.

Recent inflationary pressures have had an impact on future inflationary expectations, which, in certain cases, are not firmly anchored (Chart 5.2). Two-year inflationary expectations in Uruguay, once the direct impact of recent shocks has faded, lie above the target range, close to 10% YoY. In Brazil market inflation expectations have been revised upward and are near the ceiling of the 2017 target range, which was reduced to 6.0% last year. The monetary authorities of both Uruguay and Brazil face an uphill struggle in anchoring inflationary expectations.

In Peru and Colombia, 2-year inflationary expectations point towards inflation being close to or even above the target range ceiling. There is evidently a risk that inflation expectations could be unanchored in these two countries, and their central banks are already taking this factor into account in their decisions.

Lastly, the decisions taken by the monetary authorities in Mexico and Chile and the recent inflation pattern, especially in Mexico, have served to anchor expectations.

Chart 5.2
Inflation: current and market expectations (YoY %)



Source: National statistics and BBVA Research

Inflation will slowly converge towards central banks' targets

Despite the risk posed by higher pressures from food prices and currency devaluations, the most likely scenario is that inflation will ease off during the forecasts horizon, converging towards the targets set by local monetary authorities (Chart 5.1 and forecasts table in section 9).

Inflation figures would converge because of the overwhelming impact of relatively feeble domestic demand, tightening of local monetary conditions and the lack of momentum in global growth and commodities markets upon domestic prices. Domestic prices are also expected to moderate because the outlook is that the sharp depreciation in exchange rates will ease off in 2016 and 2017.

In any event, it will be a gradual process, slower than was previously expected, partly due to the greater resilience of inflation in 2015 and early 2016. Specifically, the convergence at target ranges would take place in 2016 in Chile, and only in 2017 in the case of Brazil, Colombia and Peru. In Brazil's case, lower increases in administered prices following the heavy adjustment in 2015 will help to curb inflation.

We also expect inflation in Chile to close 2016 at 3.7% YoY, and reach 2.9% YoY in December 2017, a few tenths above our former estimates. In Brazil, Colombia and Peru, inflation would stand at 6.8% YoY, 5.4% YoY and 3.2% YoY respectively at the close of 2016, and 4.5%, 3.7% and 2.8% at the end of 2017. Generally speaking, the estimates are higher than they were three months ago, except the Peru estimate for

2016, which was revised downwards due to the brighter outlook regarding the impact of El Niño on local prices.

However, we expect inflation in Uruguay to remain high, above target levels, until at least the end of 2017, while in Paraguay and Mexico it should keep within the ranges set by monetary authorities.

In Mexico, we expect inflation to remain below 3% YoY throughout 2016, benefiting from a relatively moderate pass-through of the exchange rate to prices, relatively sluggish demand, increased competition in telecommunications markets due to the application of the latest reform and lower adjustment in energy prices. Inflation would increase slightly in 2017, to 3.3% in December, in line with the more buoyant tone in domestic demand.

6 Further tightening of monetary policy in Latin America

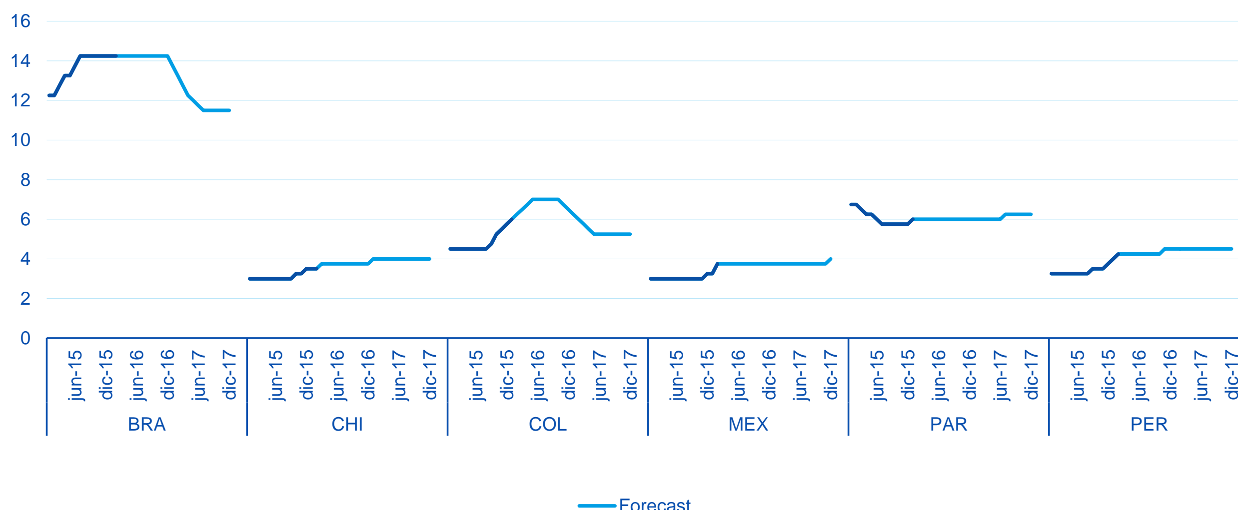
Pacific Alliance countries have been forced to tighten their monetary policy in the light of worse outlook for inflation and interest rate hikes by the Fed

The higher inflation and the risk of inflation expectations being unanchored prompted further tightening of monetary conditions in the three Andean countries in recent months (Chart 6.1). Specifically, reference interest rates for Chile, Colombia and Peru recently reached 3.50%, 6.0% and 4.25% respectively, levels which are 50, 150 and 100 basis points above the rates observed a year ago.

The direction of monetary policy has been swayed by the 25 basis point interest rate hike in the US and pressures on exchange rates in the three Andean states and in Paraguay, where, following months of stability, interest rates were raised 25 bp in January to 6.0%. Banxico also adjusted its overnight interest rate by 50 bp on 17 February, faced with pressure on the exchange rate and a possible pass-through to inflation; this came after it had reacted to the Fed's first interest rate hike with a 25 bp increase. This is the Mexican central bank's way of attempting to temper risks of greater financial volatility.

In the end, Brazil's central bank decided to keep interest rates stable at 14.25% (200 and 700 bp higher respectively than one year and three years ago) in its last meeting; this decision is in line with our forecast, but not with consensus, which expected a new upward cycle in the wake of further decline in inflation in recent months. Amidst political pressures, the ultimate fear was that fresh increases in the Selic interest rate might trigger an even deeper recession, mainly taking into account the growing doubts about global growth and recent financial turmoil.

Chart 6.1
Monetary policy rate in countries with inflation targets systems (%)



Source: BBVA Research

Also, despite the adjustments announced in recent months, interest rates in most Latin American countries are still below their long term equilibrium levels (in fact, in some cases interest rates are below current inflation or even expected inflation). This is the not the case, however, in Brazil, where the central bank is compelled to maintain a restrictive monetary policy despite the recession because of the inflationary pressures and fiscal decline.

Further interest rate hikes are expected in 2016 in Andean countries, along with stability in Mexico and Brazil

The tightening of monetary policies in the three Andean countries is not over yet. The tightening will almost certainly continue, offsetting the risks of inflationary drifting and decoupling with the US monetary cycle, reducing the expansionary tone of monetary policy in these three countries throughout the year. Specifically, we are expecting a further adjustment of 25 bp in the coming months in Chile and Peru and of four 25 bp hikes in upcoming monetary policy meetings in Colombia.

In Mexico, following the unexpected adjustment of 50 bp in February, the central bank will have to keep a stable overnight rate of 3.75% throughout the year.

Furthermore, after interest rates were increased at the close of 2015 and throughout 2016, we expect further adjustments in 2017 in Chile (+25 bp), and, towards the end of the year, in Mexico (+25 bp). In Peru, the most likely scenario is that reference interest rates will be unchanged at 4.50% in 2017.

In Colombia, the monetary tightening cycle would come to an end in the first half of 2016, with interest rates at 7.0%. The expected slowdown in inflation would create extra room for manoeuvre in order for the central bank to make interest rates converge at 6.5% in the last quarter of 2016 and towards 5.25% in 2017.

In Brazil, the central bank is not expected to implement further interest rate hikes because of its major concerns about the domestic recession and the international setting. Although inflation would be expected to ease off from February onwards, potential interest rate cuts would only be made from 2017 onwards because inflationary expectations are not firmly anchored.

It is also interesting to note that certain central banks in the region, such as Brazil's, interpret the international setting in a more dovish light, due to the supposed negative impact on activity, while others, such as Mexico's, have a more hawkish reading of the state of the world economy, mainly due to the possible impact of further exchange rate devaluation. This shows the complexity of the current setting, and suggests that changes in the global scenario could imply adjustments in monetary policy strategies across Latin America.

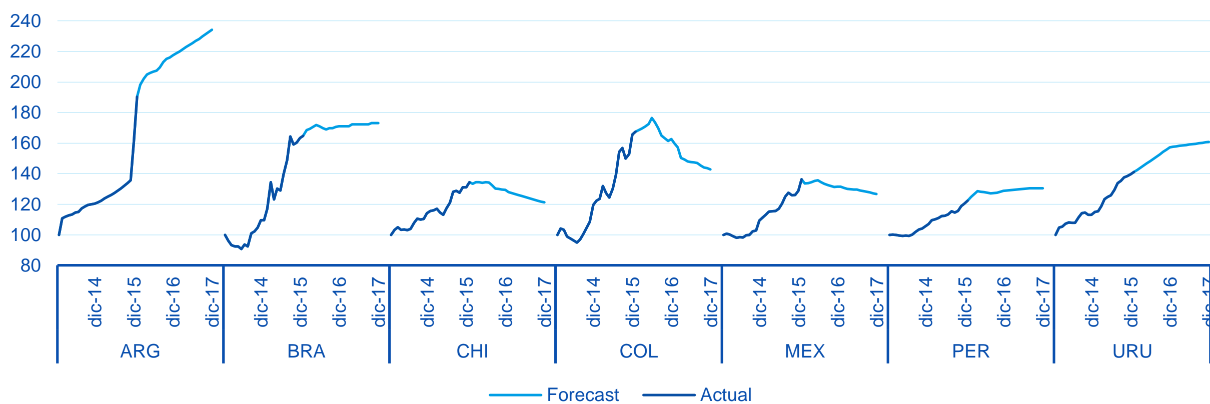
Exchange rates should remain at relatively low levels as a result of the Fed's increase in interest rates and a less favourable international setting

As we stated above, in section 3, the most likely scenario is that market volatility will persist due to uncertainty over China and about US monetary policy. Taking all these factors into account, if our base scenario occurs, including a “soft landing” in China, steady recovery in the US economy and moderate increases in commodity prices from the second half of 2016 onwards, then, looking ahead, further depreciations as strong as those recorded last year would be unlikely (Chart 6.2 and forecasts table in section 9).

That said, we expect further exchange rate devaluation, albeit to a lesser extent, in Brazil, Uruguay, Peru and Paraguay. In the first two countries, the high domestic inflation levels are a factor which would help depreciations further down the line.

We expect the currencies of Chile, Colombia and Mexico to appreciate to a certain degree from mid-2016 on, as these countries' fundamentals are bolstered and the decline in commodity prices is halted. The Chilean peso should be shored up to some degree by the copper price from the second half of 2016 onwards, while the relative rise in value of the Colombian and Mexican peso would be underpinned by recovery in oil prices (for further details on patterns in commodity prices, refer to Chart 3.8 and the forecasts table in section 9).

Chart 6.2
Exchange rate: observed and expected (local currency / US dollar) (January 2014 = 100) *



* Increases indicate depreciations.
Source: BBVA Research

7 High trade deficits in Latam, though they have begun to be corrected

Moderate staple commodity prices will continue to affect trade deficits in Latin America

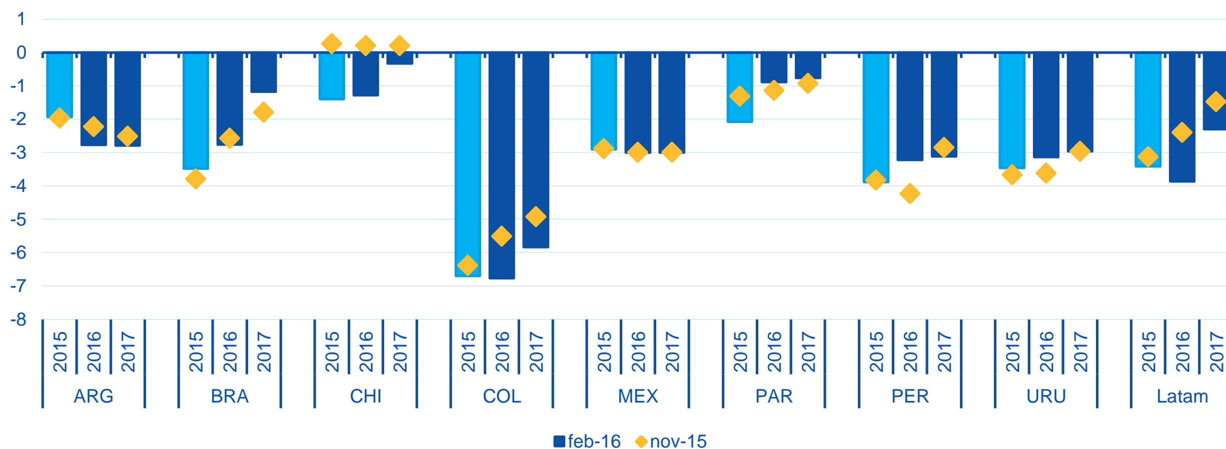
The slump in the main Latin American export commodity prices has caused a negative shock to most countries' current account balances. In many cases, their deficits have widened compared to our estimates three months ago. The fall in estimated oil prices has had a particularly negative impact in Colombia's case, while in Mexico, this lower value of oil exports has been offset by higher non-oil exports. In crude oil importing countries such as Argentina, Chile, Uruguay or Paraguay, however, the slump in oil prices has partly offset the prices of their exports (copper or soy, depending on each individual country).

Nevertheless, the downturn in domestic demand (which is stronger than expected) is prompting a reduction in imports and trade deficits which is starting to become apparent across many countries in the region. In Peru's case, this also comes with increased export volumes due to the start-up of major mining projects. Over the last few quarters, therefore, most Latin American countries continued to bring down their trade deficits, though they remain at high levels except for Chile and Paraguay. (Chart 7.1).

Latin America has limited external vulnerability, but there is a risk of increased dependency on short-term funding

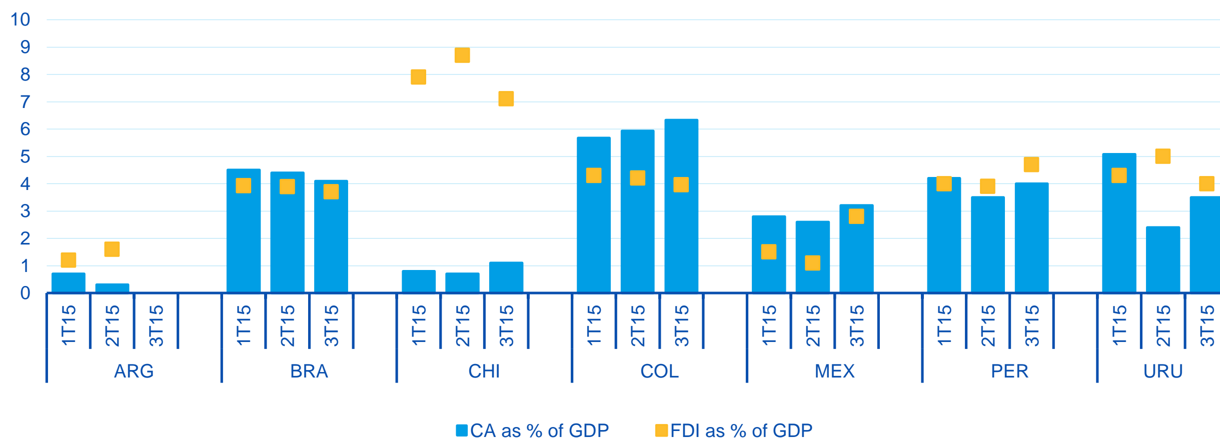
Although external deficits in the region are expected to steadily fall, it is also true that outlook for Foreign Direct Investment (FDI) is not overly optimistic looking ahead, insofar as the return in the primary sector has been hit but the slump in commodity prices. Hence, even if external funding needs are reduced, they will still be very significant in certain countries, against a background in which it is tougher to attract short-term capital. For the time being, FDI still covers most countries' external funding requirements (Chart 7.2), but the relative pace of the drop in FDI and the external deficit will determine whether Latin American countries do or do not have external vulnerability.

Chart 7.1
Current account as % of GDP



Source: BBVA Research

Chart 7.2
Current account deficit and FDI as % of GDP



Source: BBVA Research and national statistics

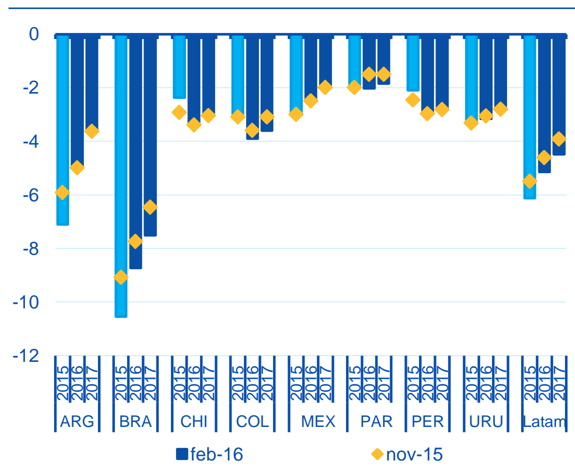
8 Fiscal outlook jeopardised by political processes, commodities and slowdown

Gloomier outlook for fiscal balances in Brazil and Colombia in 2016 and 2017

There has been a significant decline in Brazil's fiscal revenue. This has mainly been caused by the fact that, at the close of 2015, it had to pay off an accumulated debt of approximately 1% of GDP with public banks and funds, which had advanced payments for social projects (Chart 8.1). The government faces further obstacles in trying to reach an agreement to carry out fiscal reforms in order to increase revenue and bring down public spending. Furthermore, the lower tax revenue due to the profound recession sweeping the country is also having a negative impact on public balances.

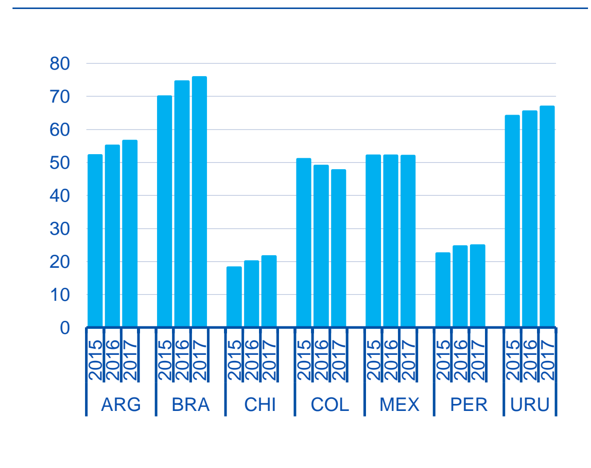
Adjustment will continue this year and the next in Argentina, through the reduction in subsidies initiative, although all the details regarding how this will be applied are not yet known. In the Andean states, Uruguay and Paraguay, reduced economic activity and lower commodity prices will mean lower tax revenues, partially offset by the effect of the recent tax reforms and greater fiscal efficiency (in Chile and Colombia, respectively) and lower growth in public spending. The situation will be similar in Mexico, apart from the fact that substantial cuts have been announced in public spending to try to staunch the dramatic fall in oil revenues. In Peru, Uruguay and Mexico, we expect the outlook for fiscal deficits against the previous quarter to remain unchanged. In terms of gross public debt, most countries will continue with the trend of slight increases in the coming years. As a rule, this increase will, however, be sustainable and should not jeopardise their solvency in terms of long-term financial requirements (Chart 8.2).

Chart 8.1
Tax Balances as % of GDP



Source: BBVA Research

Chart 8.2
Gross public debt (% of GDP)



Data on non-financial public debt.
Source: BBVA Research, WEO of IMF, Oct 2015

9 Tables

Table 9.1
GDP (% YoY)

	2012	2013	2014	2015e	2016f	2017f
Argentina	-0.9	1.7	-1.1	1.7	0.7	3.2
Brazil	1.9	3.0	0.1	-3.8	-3.0	1.3
Chile	5.5	4.2	1.9	2.0	1.8	2.5
Colombia	4.0	4.9	4.6	2.9	2.0	3.0
Mexico	3.8	1.6	2.3	2.5	2.2	2.6
Paraguay	-1.2	14.0	4.7	2.8	2.7	3.4
Peru	6.0	5.8	2.3	3.3	3.6	4.2
Uruguay	3.3	5.1	3.5	1.2	1.1	2.5
Mercosur	1.7	2.7	-0.4	-2.8	-3.4	1.1
Pacific Alliance	4.3	2.9	2.6	2.6	2.3	2.8
Latin America	2.8	2.8	0.9	-0.5	-0.9	1.9

e = estimated f = forecast
FuSourceente: BBVA Research

Table 9.2
Inflation (average % YoY)

	2012	2013	2014	2015	2016f	2017f
Argentina	22.5	23.8	39.4	28.6	34.4	19.7
Brazil	5.4	6.2	6.3	9.0	8.7	5.1
Chile	3.0	1.8	4.4	4.3	4.0	2.9
Colombia	3.2	2.0	2.9	5.0	7.1	4.0
Mexico	4.1	3.8	4.0	2.7	2.8	3.1
Paraguay	3.7	2.7	5.0	3.1	4.3	4.4
Peru	3.7	2.8	3.2	3.5	4.0	2.9
Uruguay	8.1	8.6	8.9	8.7	8.8	6.9

f = forecast
Source: BBVA Research

Table 9.3
Exchange rate (vs. USD, average)

	2012	2013	2014	2015	2016f	2017f
Argentina	4.6	5.5	8.1	9.3	14.7	16.1
Brazil	1.96	2.18	2.36	3.40	4.12	4.18
Chile	486	495	570	654	712	669
Colombia	1.798	1.869	2.001	2.742	3.301	2.911
Mexico	13.2	12.8	13.3	15.8	17.6	17.0
Paraguay	4.415	4.333	4.514	5.226	5.967	6.217
Peru	2.64	2.70	2.84	3.19	3.57	3.65
Uruguay	20.2	20.4	23.2	27.3	32.3	33.9

f = forecast
Source: BBVA Research

Table 9.4
Interest rate (%, average)

	2012	2013	2014	2015	2016f	2017f
Argentina	13.8	16.9	22.5	21.5	27.5	19.2
Brazil	8.5	8.4	11.0	13.6	14.3	12.1
Chile	5.0	4.9	3.7	3.1	3.7	4.0
Colombia	4.9	3.4	4.0	4.8	6.7	5.5
Mexico	4.5	3.9	3.2	3.0	3.7	3.8
Paraguay	6.0	5.5	6.7	6.1	6.0	6.1
Peru	4.3	4.2	3.8	3.4	4.3	4.5
Uruguay	18.6	17.7	21.5	21.9	23.0	22.8

f = forecast
Source: BBVA Research

Table 9.5
Current account (% GDP at end of period)

	2012	2013	2014	2015	2016f	2017f
Argentina	-0.2	-0.8	-1.1	-1.9	-2.8	-2.8
Brazil	-3.1	-3.2	-4.5	-3.5	-2.8	-1.2
Chile	-3.6	-3.7	-1.2	-1.4	-1.3	-0.3
Colombia	-3.1	-3.3	-5.2	-6.7	-6.8	-5.8
Mexico	-1.4	-2.4	-2.0	-2.9	-3.0	-3.0
Paraguay	-2.0	1.7	-0.4	-2.1	-0.9	-0.8
Peru	-2.7	-4.2	-4.0	-3.9	-3.2	-3.1
Uruguay	-5.3	-4.9	-4.4	-3.5	-3.1	-3.0
Mercosur	2.9	1.5	1.4	-5.2	-16.4	-1.8
Pacific Alliance	-1.2	-1.8	-2.0	-3.7	-5.8	-3.0
Latin America	-2.2	-2.5	-3.3	-3.6	-4.2	-2.0

f = forecast
Source: BBVA Research

Table 9.6
Fiscal balance (% GDP at end of period)

	2012	2013	2014	2015	2016f	2017f
Argentina	-2.2	-2.0	-2.6	-7.1	-5.0	-3.7
Brazil	-2.5	-3.1	-6.7	-10.5	-8.7	-7.5
Chile	0.6	-0.6	-1.6	-2.4	-3.3	-3.0
Colombia	-2.3	-2.4	-2.4	-3.0	-3.9	-3.6
Mexico	-2.6	-2.3	-3.5	-3.0	-2.5	-2.0
Paraguay	-1.8	-2.0	-2.3	-2.0	-2.0	-1.8
Peru	2.3	0.9	-0.3	-2.1	-3.0	-2.7
Uruguay	-2.7	-2.4	-3.5	-3.5	-3.2	-2.9
Mercosur	-5.7	-2.3	-1.9	-0.9	0.4	-2.1
Pacific Alliance	-1.8	-1.6	-2.0	-3.8	-3.3	-3.2
Latin America	-2.2	-2.3	-4.5	-7.3	-6.2	-5.4

f = forecast
Source: BBVA Research

Table 9.7
Commodities forecast

	2012	2013	2014	2015	2016f	2017f
Oil (Brent, USD/barrel) (average)	112	109	99	53	30	46
Soya (USD/ton) (av.)	538	517	458	350	330	338
Copper (USD/pound) (av)	3.61	3.32	3.11	2.51	2.02	2.29

f = forecast
Source: BBVA Research

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