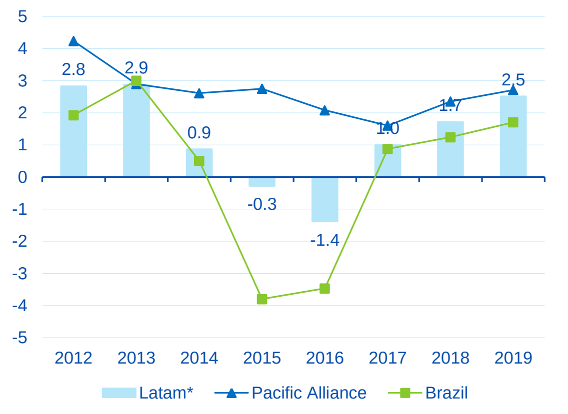
1. Summary

Financial markets in South America recovered the losses suffered after the elections in the US. The recovery was undoubtedly supported by higher commodity prices, which offset the increase in long-term US interest rates. In contrast, in Mexico, the exchange rate and asset prices continued to be pressured by uncertainty about US economic policies.

South America will recover in 2017 after a 4-year slowdown, but in Mexico, the shock of US policy uncertainty is being received in full. Confidence indicators plummeted in Mexico on the outcome of the US elections, while in South America they began to recover, especially for households, although in general they remain at pessimistic levels. The different response to uncertainty about US policies marks the divergence in the dynamics of growth in the two areas of Latin America. Both South America and Mexico will grow 1% in 2017, but in South America this represents a turning point after 4 years of slowdown and a negative growth of -1.4% in 2016. In Mexico, on the other hand, uncertainty about US policies will affect investment, which together with a more restrictive monetary policy and a deceleration in consumption because of the higher inflation brought on by the peso's depreciation, will generate a deceleration in economic activity in 2017 compared to a growth rate of about 2.3% in previous years. We anticipate that both regions will grow by about 1.7% in 2018.

Figure 1.1

Latam: GDP growth (%)



* Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Mexico, Uruguay and Venezuela.
Source: BBVA Research

Inflation will increase strongly in Mexico, but will continue to decline in South America. Inflation in Mexico will be driven by the strong exchange-rate depreciation, which will take it well above Banxico's target range in 2017. In turn, the differential behaviour of the exchange rate in South America (where it will remain stable or with limited depreciations) will allow inflation rates to continue to decline and converge to central bank targets. In turn, the divergent trajectory of inflation between Mexico and South America will also be reflected in the tone of monetary policy, more accommodating in South America (where interest rate cuts will continue in 2017), while it will tighten in Mexico, where we anticipate Banxico will continue to raise interest rates in 2017.

The risks around this growth forecast are still biased downwards. On the domestic side, the main risks are related to political noise (increased by ongoing corruption investigations in several countries), which interact with a very dense electoral cycle in the region, with important elections in 2017 or 2018 in almost all countries. Likewise, the delay in key infrastructure works in some countries may affect not only growth (due to the lower contribution to demand), but also the confidence of companies and families. On the external side, the risks focus on the uncertainty about the economic policies that the new US administration will eventually implement (especially but not exclusively, the risk of increased protectionism), as well as the process of reducing macroeconomic imbalances in China, which could severely affect growth in that country.

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This report has been produced by the South America Unit:

Chief Economist for South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Enestor Dos Santos
enestor.dossantos@bbva.com

Cecilia Posadas
c.posadas@bbva.com

Lorena Lechuga
lorena.lechuga.cuesta@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
luana.tellez@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

With the contribution of Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research: Azul Street, 4. La Vela Building - 4 and 5 floor. 28050 Madrid (Spain). Tel.:+34 91 374 60 00 y +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com