# 2. Latin America: divergence between north and south

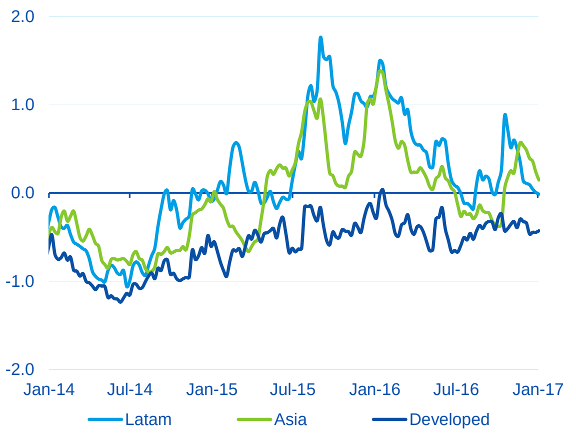
## Global context: more growth, greater uncertainty and long-term risks

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Global growth accelerated in the last quarter of 2016, there has been a notable increase in confidence in all areas, and the indicators for the industrial sector are growing alongside a budding improvement in world trade.

Despite this acceleration, the outlook for 2017 and 2018 is plagued with uncertainty. This is principally related with the economic policy of the new US administration, the shape of which remains largely to be seen. Fiscal stimulus and deregulation measures have been announced in various sectors, which was positively received by the markets in developed economies. However, this was not the case in the emerging economies, which registered capital outflows and depreciation in their currencies, being reflected in an increase in financial tensions at the end of 2016 (Figure 2.1). However, announcements of protectionist measures could seriously damage international trade in the medium and long term and affect confidence in the near future, especially outside the US. Likewise, the uncertainties still pending on US economic policies appear to have been moderating market optimism since the beginning of the year.

Figure 2.1

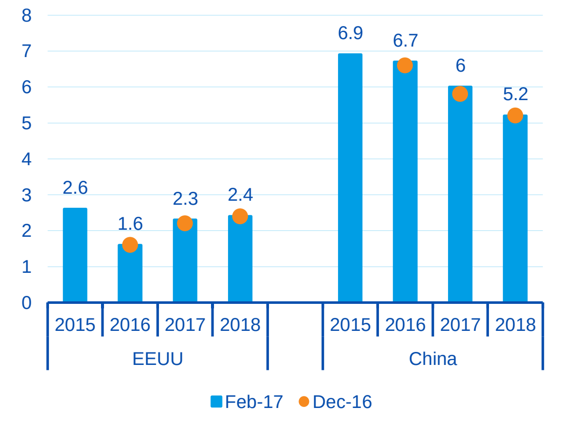
**BBVA financial stress index**




Source: BBVA Research

Figure 2.2

**GDP growth in the US and China (%)**




Source: BBVA Research

Global growth will increase from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018

The magnitude of inflationary pressures is another unknown factor opening out at a global level. Commodity prices (and in particular oil) have picked up somewhat more than expected in recent months, following the OPEC agreement and the improvement in activity. If to this we add the size of the balances accumulated in recent years by central banks in developed countries, due to quantitative easing programmes and the prospects of fiscal stimulus, the result is that the deflationary risks of a few quarters ago have been replaced by inflationary pressures in developed economies, generating a number of questions about the reaction of its monetary policies.

In principle, the Federal Reserve remains cautious and continues to aim for a relatively slow rate normalisation. Our forecast is for two interest rate increases to take place this year, with another two in 2018. For its part, we expect the ECB to begin the process of withdrawal from QE in early 2018 and decide on the first interest rate increase at the end of that year.

All in all, our growth projections for 2017 in the major economies have undergone no substantial revision, although they are subject to a higher degree of uncertainty than normal. The base effect of increased growth in late 2016 and its inertial effect, together with the fiscal stimulus packages expected in the US, have encouraged us to revise the forecasts moderately upward for the US and Europe, and slightly more for China, while the forecasts for Latin-American countries are being revised downward, principally due to idiosyncratic factors. In particular, in the US we anticipate growth of 2.3% and 2.4% in 2017 and 2018 (Figure 2.2). In China we expect growth of 6% in 2017, which would be reduced to 5.2% in 2018, given the vulnerabilities with which the economy is faced and an economic policy geared more towards ensuring financial stability than maintaining growth. Thus, overall growth should increase slightly from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

The risks are largely biased downwards and are governed by the previously mentioned uncertainty linked with protectionism in the US, a less friendly attitude towards immigration and the danger that the fiscal stimulus policies will not have any impact on growth and will increase inflation, or that the deregulation announced in various sectors will not be properly managed. In addition, there is the potential reaction of other countries or regions to these protectionist impulses. An unexpected rise in inflation could lead to the tightening of monetary policy by the main central banks, with global consequences. In the long term, the risks of the accumulation of imbalances in China, together with the lack of structural reforms in public companies, could have an impact on its capital flows and currency and lead to a sudden slow-down in growth. In Europe, the political risk is high, in a year filled with election dates. And, generally speaking, geopolitical risks continue to run high.

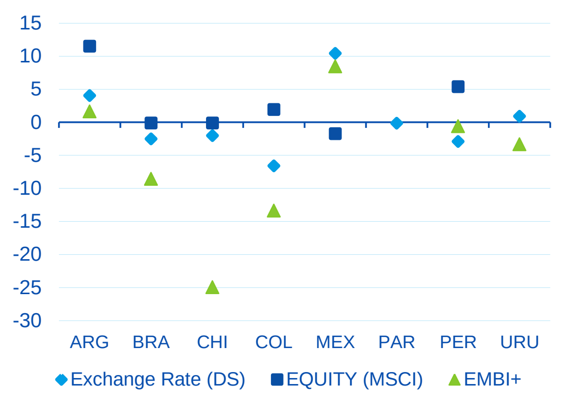
# Recovery in financial markets in South America, but pressure continues on Mexico

As we pointed out in the previous issue of our Latin America Economic Outlook, from the beginning of November to mid-December, Latin American financial assets, and especially the Mexican ones, registered losses due to the increased uncertainty about US economic policy following the November 8 presidential election and, to a lesser extent, the Fed's interest rate hike on December 14.

However, after the initial shock the markets of the region recovered some calm since the end of last year. In fact, this recovery has allowed financial assets of the Latin American countries to recover the levels seen before the US presidential election in the great majority of cases (Figure 2.3).

Figure 2.3

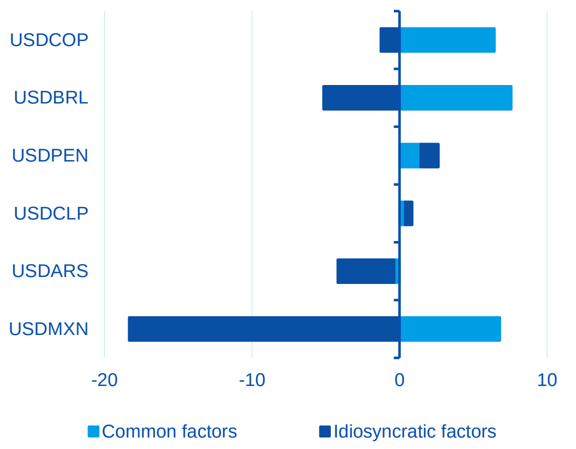
**Financial markets: percentage change since US elections***




* Variations between November 7 and February 6. Exchange rate: domestic currency / dollar. In this case, an increase indicates depreciation. Country risk premium: EMBI.
Source: Haver Analytics, Datastream and BBVA Research

Figure 2.4

**Determinants of exchange rate variation: contribution of common and idiosyncratic factors* (%)**




* Reference period: between November 7 and February 8. The common factors are based on the co-movements between the currencies (extracted from the main factors that have directed the co-movements, using factorial analysis). The part not explained by these common factors is the idiosyncratic part (the residue), which describes the differential or concrete dynamics of the exchange variation.
Source: BBVA Research

The notable exception is Mexican assets, which are still under pressure at levels lower than those observed at the beginning of November. Specifically, in the early days of February the Mexican peso was trading at around 20.5 per dollar, 11% more depreciated than the day before the American elections, while its stock market was about 2% below on that date and its country risk premium had risen to 220 points, compared with 202 points on November 8. In any case, in these three markets the current levels are better than those registered a few weeks ago: the exchange rate reached 21.95 in the first days of January, the Mexican Stock Exchange touched minimum values, 6% less than the current values, in mid-November and the Mexican risk premium reached 272 points also in mid-November.

Looking at the exchange market, in Figure 2.4 we see that idiosyncratic factors, such as exposure to US policies, were much more relevant in explaining recent movements than in other countries in the region.

With respect to the most recent market recovery in South America, it was partly supported by higher commodity prices in recent months. Oil, copper and soybeans, for example, rose 21%, 16% and 7% respectively since the American elections, accumulating gains of 84%, 31% and 22% over the past 12 months. Recent increases in commodity prices are related to stronger demand and in some cases like to oil, also due to supply constraints, mainly after the agreement reached by OPEC.

Going forward, commodity markets are likely to continue to provide some market support, though not necessarily more than lately. We expect the price of a barrel of oil, currently around 56 dollars, to converge on about 60 dollars over 2017 and 2018. Both the greater strength of the dollar and the effect that higher prices will have on supply tend to reduce the probability of more significant increases in the price of crude oil. In the case of soybeans and copper, we expect moderate price declines following increases in recent months, either due to financial issues (mainly in the case of copper, where part of the recent rise is related to the increase in long speculative positions), or because of fundamental factors, like the moderation of growth in China.

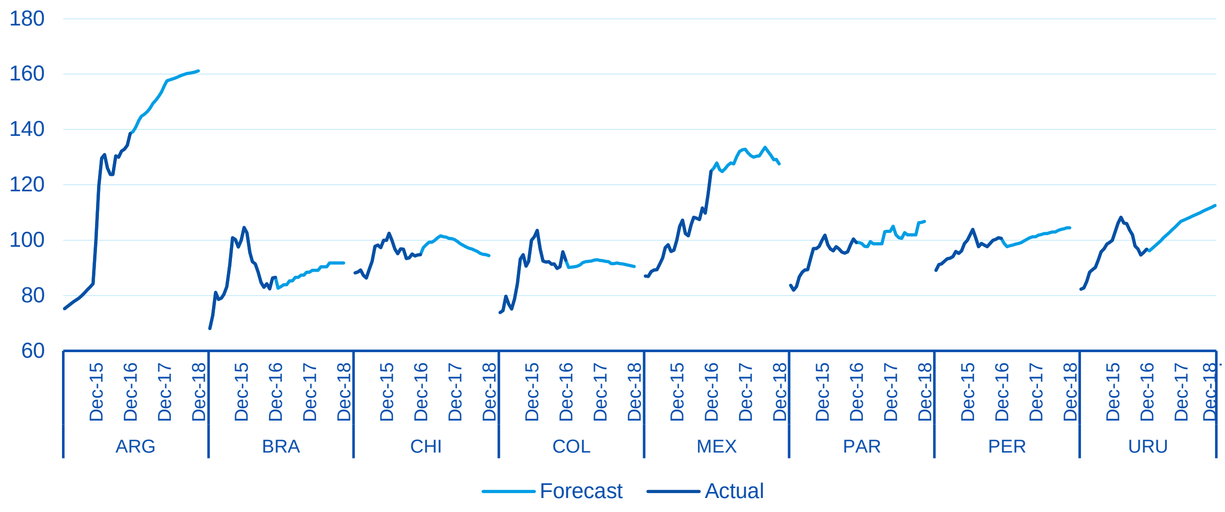
Volatility could return to the region's markets depending on the policies that the US finally adopts

In this environment, and taking into account that the interest rate differential of the countries of the region with respect to the global rates is likely to decline over the next few years, we expect currency depreciations throughout 2017 in all the countries of the region, especially in Argentina and Uruguay due to higher inflation in these two economies. Depreciation may continue in 2018 in most countries, but not in Colombia, Chile or Mexico. In the first two, we see some scope for currencies to converge on their level of equilibrium as the economic recovery materializes, while in Mexico the reduction of uncertainty about US policies would reduce pressure on the exchange rate.

In any case, it is necessary to emphasize that the markets will be very dependent on the policies that are finally adopted in the US, and also on the evolution of the Chinese economy. Both factors may determine new episodes of volatility in the financial markets of the region.

Figure 2.5

**Nominal exchange rate: observed and expected (local currency/US dollar) (January 2015 = 100)***




* Increases indicate depreciation.
Source: BBVA Research

# South America leaves the slowdown behind. Mexico receives the full *shock* of uncertainty from the US

The divergence in financial markets in Latin America, between Mexico on the one hand, and South America on the other, was also partly a reflection of a divergence in the sentiment indicators of families and businesses in the two areas. Specifically, confidence indicators in Mexico fell sharply in December and January. In the case of businesses, the fall in confidence was fundamentally associated with uncertainty about the future measures to be taken by the new US administration, especially those with greater potential to negatively impact the Mexican economy, such as those related to the possible renegotiation of the North American Free Trade Agreement (NAFTA), possible restrictions on migratory flows and remittances, or plans to modify the tax system, with a negative impact on imports. In the case of households, the increase in the price of gasoline and the upward impact it is already having on inflation (the inflation section below) was undoubtedly influenced by confidence.

In contrast, in South America, confidence indicators in most countries did not worsen with the first measures and announcements of the new US administration. Some countries, such as Chile, Brazil and Peru experienced improvements with respect to levels in November, especially with regard to households, aided by the moderation in inflation, although the labour market remains weak. However, with the exception of Peru, confidence remains at pessimistic levels (Figure 2.6).

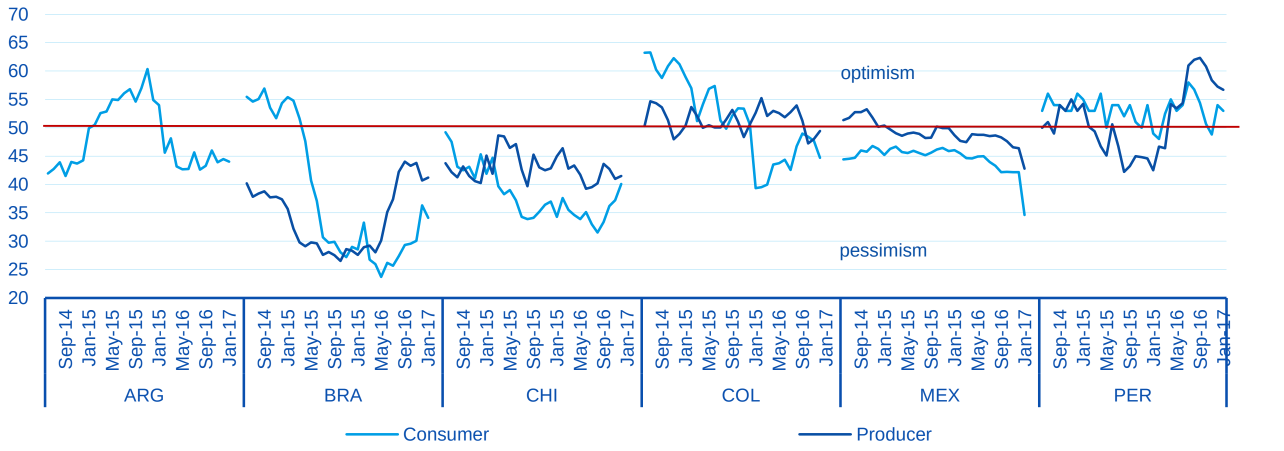
This differential behaviour in markets and trusts also moved to activity and our forecasts for this year and next. We therefore anticipate that most countries in South America should show higher growth in 2017 than in 2016, with the exception of Peru and Paraguay. This will lead the South American average to grow 1% in 2017 and 1.7% in 2018. A trend towards a slowdown in growth in the last 4 years, between 2013 and 2016, has therefore ended. Going forward, we continue to predict that the main boost to growth in South America will come from the external sector (with better commodities export prices and the positive effect of the depreciation of the last two years), as well as from the momentum of public and private investment in countries such as Argentina, Colombia and Peru. In contrast, although we expect Mexico to grow 1% in 2017, this will represent a slowdown in relation to the growth rate of recent years, which was around 2.3% per year. Thus, we anticipate growth for the region as a whole of 1% in 2017 and 1.7% in 2018 (compared to -1.4% in 2016), a growth rate that is still very moderate compared to the potential of the region, which is closer to 3% (Graph 1.1).

South America and Mexico will both grow 1% in 2017, but in the first case this represents the end of a 4 year slowdown

These regional growth rates for 2017 and 2018 are 0.5pp and 0.3pp lower than we anticipated in December. Within this downward revision in 2017, the negative surprises regarding activity in recent quarters in Argentina and Chile have also been especially influential, as well as the already mentioned impact of the uncertainty of the new US administration's policies on Mexico and the delay of investments in a key infrastructure project in Peru (the Southern Gas Pipeline). In 2017 and 2018, a monetary policy that should support growth a little more in most South American countries is expected (see the section on central banks below), although without completely counteracting the negative impact of the above factors.

Figure 2.6

**Consumer and producer confidence (values over 50 points indicate optimism)**



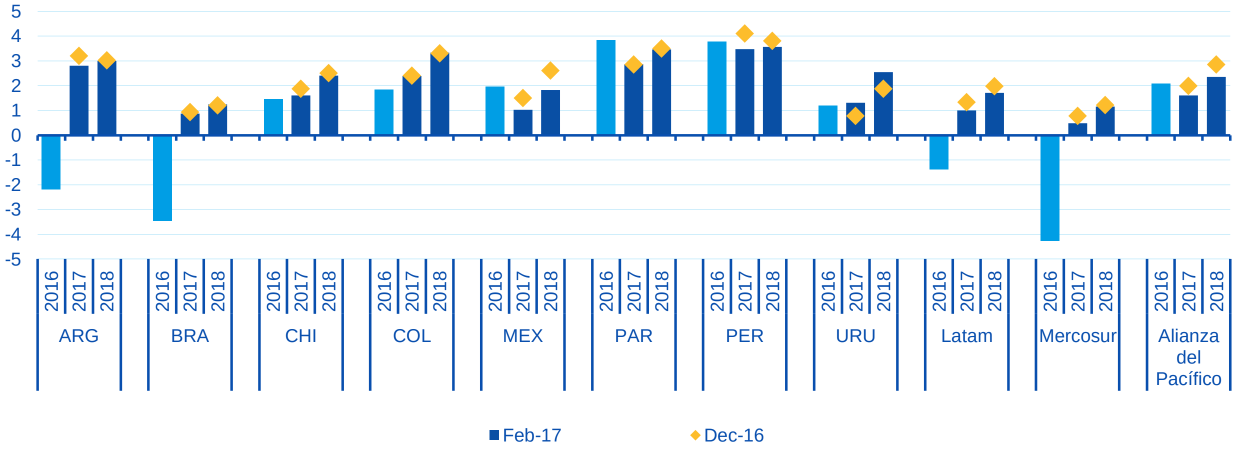

Source: BBVA Research

As usual, the region continues to show very heterogeneous behaviour (Graph 2.7), beyond the divergence between Mexico and South America.

- In **Brazil**, we expect the recovery in growth to continue and we maintain our growth forecasts of 0.9% in 2017 and 1.2% in 2018. The recovery will be supported by the approval of the tax reform and the reduction of interest rates, although the risks of an outpouring of political tensions put a downward bias on these forecasts.
- In **Mexico**, uncertainty over US economic policies will affect investment, while depreciation of the peso and the consequent increase in inflation will force a more restrictive monetary policy with a negative impact on growth. This leads to a downward revision of growth to 1% in 2017 and 1.8% in 2018. However, risks are biased downwards if the US implements some of the measures that, for the moment, are still under discussion.
- In **Argentina**, weak activity in the second half of 2016 has led us to downgrade our forecast for growth in 2017 to 2.8%, but we are keeping the forecasts for 2018 at 3%. We begin to see the first signs of reactivation of the activity in 2017, which will rely especially on the rebound in investment.
- In **Colombia**, we maintain our growth forecasts for 2017 and 2018 at 2.4% and 3.3%. Growth will be supported particularly by investment in infrastructure, exports and industrial production.
- In **Peru**, growth forecasts are set to decline in 2017 and 2018, to 3.5% and 3.6% due to the delay in the construction of the southern gas pipeline. We continue to anticipate that investment in infrastructure will be the main driver of growth this year and next.
- In **Chile**, weak activity in the last quarter of last year causes us to revise our 2017 growth forecast down to 1.6%, but we maintain that of 2018 at 2.4%. Growth will remain below the potential for those two years, due to weak investment (although recovering) and the labour market.
- In **Uruguay**, prospects are improving after a prolonged period of stagnation, which makes us revise growth forecasts upward to 1.3% in 2017 and 2.6% in 2017. The rebound will be based on a recovery in consumption, given the moderation in inflation, as well as the positive impact of investment in a third pulp mill in the country.
- In **Paraguay**, we maintain our forecast for growth in 2017 and 2018 (2.9% and 3.5%, respectively), supported by the dynamism of domestic demand and investment in infrastructure through PPPs.

Figure 2.7

**Latin America countries: GDP growth (%)**




Source: BBVA Research

# Inflation will increase strongly in Mexico, while the downward trend in South America will continue

Inflation has moderated in all South American countries in recent months. In most cases, inflation reached higher levels during the first half of 2016 and has begun to moderate since then, while in Argentina moderation only began to be more clearly seen at the end of last year (Graph 2.8). Inflation remains relatively high, above the target range, not only in Argentina (38% in January), but also in Uruguay (8.3%), Colombia (5.5%) and, to a lesser extent, in Peru (3.1%). On the other hand, after the recent deceleration, inflation records are already within the range established by the monetary authorities in both Chile (2.8%) and Brazil (5.4%). In Paraguay, the strong – and to some extent temporary – moderation in domestic prices brought inflation to 1.9% in January, below the target range.

Inflationary trends in South America contrast with Mexico's one, where inflation has increased consecutively over the past seven months, reaching 4.7% in January, for the first time above the central bank's tolerance interval since 2014.

Figure 2.8

**Inflation: observed and forecast * (YoY %)**


Source: BBVA Research

An important part of the divergence between the inflation trends in Mexico and South America is due to the divergence, discussed above, between the behaviour of their currencies in recent months. In addition, recent adjustments in the price of fuel have contributed to the rise in inflation in Mexico. On the other hand, in South America in general, the effects of the sharp slowdown in demand, as well as the lower pressures of food prices in some countries, such as Colombia and Brazil, have been more significant.

Going forward, it is likely that this divergence between inflationary trends in Mexico and South America will continue to manifest itself. Thus, in Mexico we predict that the depreciation in the peso will continue to fuel inflationary pressures, while the exchange rate and weak demand will continue to pave the way for inflation to continue to weaken and converge on the respective objectives in the countries of South America.

Inflation in Mexico will continue to increase during 2017, reaching 6% at the end of the year

We expect that inflation in Mexico will gradually increase during the year to reach 6.0% at the end, and will only moderate again and converge again towards the target range in 2018. These forecasts are significantly higher than those we had previously predicted. This is basically due to the greater depreciation in its currency and the process of liberalization of energy prices. With respect to South America, we maintain our forecasts that in Brazil inflation will converge on the central objective of 4.5% in 2017 and will remain at this level in 2018, while we are slightly adjusting our forecasts for Argentina, Colombia, Chile and Peru. In the case of Argentina, the moderation in inflation will be somewhat slower than we expected due to greater inflationary inertia and higher increases in utility rates. In Colombia, the upward adjustment (+0.2pp in the forecasts for 2017 and 2018) is largely explained by the impact of the VAT increase, while in Peru, where the upward revision is 0.4 p.p. and is concentrated in 2017, it has to do with the lower probability of a VAT cut, as expected three months ago. Finally, in Chile the adjustment of our forecasts (+0.4pp in 2017) is due to a somewhat more depreciated change and a more stimulating monetary policy. Also, as mentioned above, we expect inflation to gradually converge to inflation targets (see Chart 2.8 and the forecast tables in section 3).

## South American interest rates will continue to fall, but Mexico will tighten monetary conditions

As inflation is on a downward trajectory and expectations that convergence on targets will continue are higher, South American central banks are beginning to announce cuts in their respective monetary policy rates. In Brazil and Chile, where inflation is already within the target range, monetary policy rates were cut in January by 75bp and 25bp, respectively. In the first case the fall was greater than expected and occurred after two previous cuts of 25 bp at the end of 2016, while in Chile the cut was the first after the stability of the rates observed throughout 2016. In Colombia and Argentina the bearish cycle of interest rates began last year, but more recently it was stopped because of some concern with inflation expectations in the first case, while in Argentina they still do not converge on central bank's target range. In Peru and Paraguay, the monetary authorities have continued to maintain benchmark rates in recent months (Chart 2.9).

As the challenges in terms of inflation are greater at the moment in Mexico, the tone of its monetary policy is obviously different. In effect, Banxico has raised monetary policy rates by 150 bps since the elections in the United States, 50 bp at the November meeting, 50 bp in January and 50 bp in February. The funding rate is currently 6.25%, 300 bp more than at the beginning of 2016 and already on restrictive terrain since we consider that the neutral rate is around 5.5%.

Argentina, Brazil, Chile, and Colombia have already started to lower interest rates, something that should not take long to occur in Peru

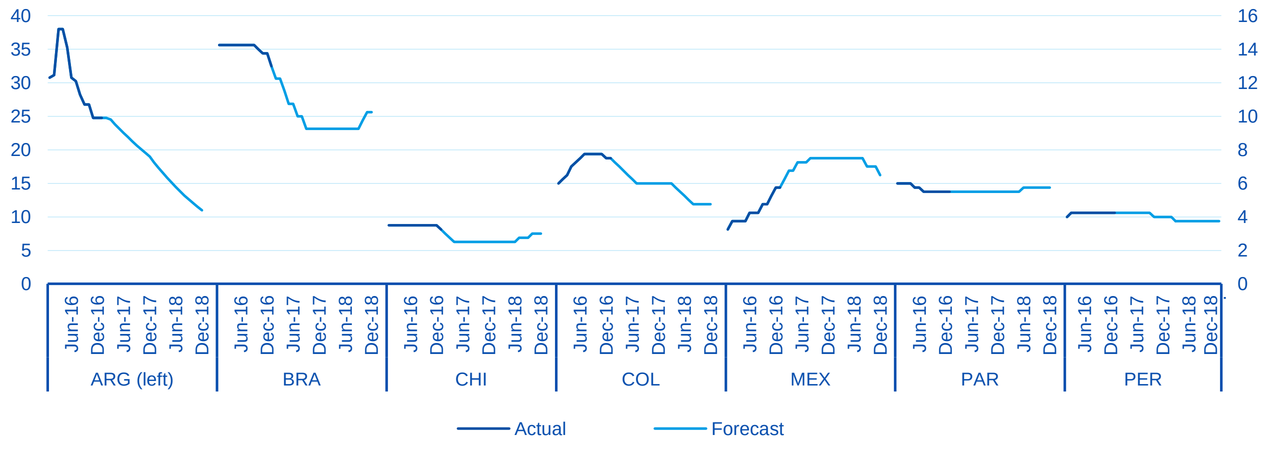
Banxico is likely to continue to raise interest rates in the coming months, with the aim of containing second-round effects on prices and anchoring inflation expectations in an uncertain environment, where inflation will increase despite the fact that domestic demand will continue to grow a little. Our forecast is that monetary policy rates will reach 7.5% by the middle of this year and that only from the second half of 2018 will there be scope to start cutting them.

In South America, in contrast, we anticipate further cuts in interest rates in countries that have already begun the process of easing monetary conditions, including in Colombia and Argentina where monetary authority prudence has involved a recent pause in the process. Thus, we expect monetary policy rates to fall throughout 2017 in Brazil to 9.25%, 2.5% in Chile, 6% in Colombia and 19% in Argentina. With respect to 2018, we expect further cuts in Colombia and Argentina and upward pressures in Brazil and Chile.

In Peru, where interest rates are still stable at 4.25% as inflation remains above the target range and expectations are not too far from it, we expect the central bank to cut the policy rate only as inflation decelerates more strongly, which we estimate more likely in the second half of this year. Finally, in Paraguay, we expect that the reference rates will remain stable at 5.5% throughout 2017 and a good part of 2018.

Figure 2.9

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




Source: BBVA Research

# Internal risks focus on political noise, the electoral cycle and delays in investment

The risks in our forecasts for Latin America remain biased downwards, both because of external factors and domestic elements.

Among the domestic factors, the political noise that continues to be heard in most countries in the region continues to be particularly prominent, which has recently been accentuated by the possible corruption of members of the political class in many countries (especially important in those affecting the current administration). An increase in political noise in a number of Latin American countries may not only undermine governance and delay a number of ongoing reform processes in the region. It may also continue to undermine public confidence in the political class, with the risk that the emergence of populist movements that channel this citizen disapproval will not have an economic program of reforms that is coherent and promote growth in the long term. It is good to remember that in 2017 and 2018 a cycle of presidential elections (or others of great political importance) opens in most countries of the region, with the main exception of Peru, and this increases this risk.

In addition, the possible delay of public works projects in countries like Argentina, Peru or Colombia also represents a significant risk to growth in 2017, which has the development of infrastructure as one of the engines of growth in those countries. Recent cases of corporate corruption, which tarnished many countries in the region, can generate not only delays in the execution and tendering of infrastructures, but also have the potential to hamper and increase the cost of private funding on which these projects are based.

In addition, political noise (and a possible governance crisis) as well as the backlog of infrastructure works also have the potential to affect the evolution of confidence, especially business confidence. As we have seen throughout this report, confidence is gradually beginning to improve in many countries but in most of them it still remains at levels of pessimism. In order to achieve a sustained recovery, especially in investment, it is necessary to clearly recover that business confidence, and a political crisis or the maintenance of depressed levels of growth can mean that such a recovery leads to a vicious circle of low growth and low confidence.

On the external side, the risks are concentrated on the uncertainty about US policies and growth in China

Among the external factors, the main uncertainty at this time is associated with the economic policy of the new US administration, the shape of which remains largely to be seen. As we said at the beginning of this report, within these policies to be defined is the one related to foreign trade and the advance of protectionist tendencies, as well as a less friendly attitude toward immigration. In addition, it is not clear how other countries will react to these protectionist pressures, precisely at a juncture in which Latin America must overcome the slowdown of recent years, partly supported by the external sector.

On the other hand, there is a danger that fiscal stimulus policies will not have an effect on growth and, above all, generate more inflation. An unexpected increase in inflation may lead to a rapid tightening of central bank monetary policy in developed economies, increasing the costs of external financing in Latin America, with effects not only for the sovereign market but also for a significant part of the corporate sector.

More in the medium and long term, the biggest risk to Latin America in particular is still linked to imbalances in the Chinese economy, which show no signs of abating and could perhaps lead to abrupt adjustments later. The main medium and long-term risk is the result of the over-indebtedness of private companies and the lack of reforms in the public sector, recently added to by US trade policy and the response that this may produce from China, should they materialize. A sharp adjustment in the Chinese economy would especially affect the economies of South America through the fall in exports to that country, and in the prices of raw materials, as well as in the volatility of international markets.

## DISCLAIMER

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