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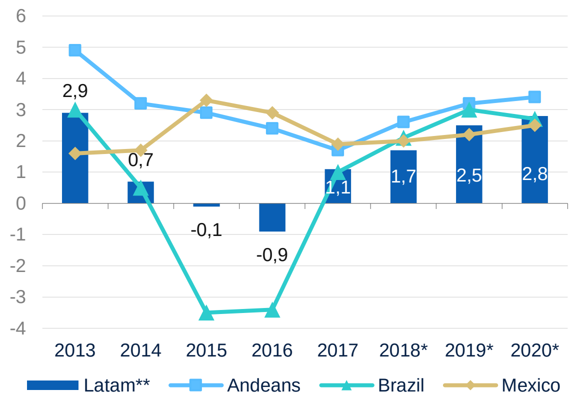
1. Summary

Financial markets in Latin America have continued to show a positive tone. Volatility remained low and capital inflows persisted, although these did ease up gradually. This positive trend was underpinned by improved world growth and the rise in commodity prices. Going forward, we anticipate modest depreciations of exchange rates in the region on the back of the divergence between monetary policy paths in the US, where the Fed will continue to adjust interest rates up, and Latin America, where easing cycles are coming to an end. Taking the latter into account, there exists a risk of increased bouts of volatility along the way.

Figure 1.1 Latam: GDP growth (%)



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

Latin America will grow 1.7% in 2018 and 2.5% in 2019, after having expanded 1.1% in 2017. The about-turn in the trend in the region is thus taking hold, following a five-year slowdown up to 2016. (Figure 1.1). The forecast for 2018 is 0.1pp higher than it was three months ago after we revised growth upwards for many countries in the region on better-than-expected activity figures, higher world growth and firmer commodity prices. The main exceptions are Mexico and Colombia (for which forecasts remain unchanged) and Peru (where we have lowered our forecast amidst an upturn in political unrest). Regional growth in the next two years will be driven by the external sector and investment. Growth in 2019 will be approaching the region's potential level, yet this is below the potential rate exhibited in the decade of surging commodity prices up to 2013, which points to a new normal for Latin America.

Inflation pressure remains relatively limited, except in Argentina and Mexico. Inflation ended 2017 at low levels, apart from in Argentina (although this showed a clearly downward trend) and Mexico. Instrumental here were frail domestic demand and currency strength. With inflation now almost in line with central bank targets, there is still room for some additional interest rate cuts in certain South American countries going into 2018, following which rates should remain stable up until early 2019. In Mexico's case, Banxico should hold rates steady over the rest of 2018 after a possible additional upside correction in February.

Risks surrounding forecast growth have downside bias, but they have abated relative to three months ago. On the external front, short term risks linked to China have diminished after a local authorities' sharper focus on reducing imbalances. The risks associated with monetary normalisation in the United States and US trade policy remain however. Within the region, political risks have died down in Argentina and Chile after elections, but upheaval and political uncertainty remain in Peru, Brazil, Colombia and Mexico. There is also still the persistent risk of delays to infrastructure projects underway in several countries.

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