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Economic Outlook

Latam

Third Quarter 2012
Economic Analysis

- **Global economic growth should recover gradually in 2013** as European and US authorities clear up uncertainties.
- **Latin America looks set to grow 3.2% in 2012 and 3.6% in 2013,** driven by domestic demand and still high commodity prices. The downward revision to forecasts reflects both internal and external factors.
- **Latin America is mainly exposed to external risks** deriving from the crisis in Europe and fiscal contraction in the US.
- **Monetary policy is shifting cautiously towards providing greater support to activity,** given the uncertainty abroad and more benign inflation.
- **The region is prepared to weather a new global crisis,** although there is less scope for countercyclical policies. Potential complacency on the part of authorities poses the biggest threat.

Índice

Closing date: August 7, 2012

1. Summary

We have trimmed our global GDP growth forecasts slightly, to 3.4% in 2012 and 3.7% in 2013. The downgrade derives from financial stress in Europe and the slowdown –slightly greater than expected three months ago- above all in the main emerging economies, e.g. China, India and Brazil. Our global scenario is predicated on the assumption that authorities will adopt the necessary policies to progress in the institutional development of the European Monetary Union (EMU) and to prevent automatic fiscal contraction in the US.

Growth in Latin America, except Mexico and Chile, continued to flag in the first half of 2012. GDP growth was below our forecasts of three months ago, especially in Brazil, where activity was slow to recover. More than the situation abroad, internal factors were at the root of the scant growth, especially in the cases of Brazil, Argentina, Paraguay and Colombia. Overall, buoyant domestic demand is still supporting growth.

Business and consumer confidence remain positive, indicating continued, albeit slower, growth in domestic demand. Confidence indicators have declined over the past three months, mostly because of internal (social and political) factors. That said, the deepening of the crisis in Europe is also starting to undermine confidence in Latam and explains why indicators have declined simultaneously. At any rate, the impact of the European crisis has so far been limited.

Our updated forecasts for Latam point to a GDP growth of 3.2% in 2012 and 3.6% in 2013, slightly below our scenario of three months ago. This slowdown compared to 2011 is the result of more modest forecasts for global growth (from 3.9% in 2011 to 3.4% in 2012). In the medium term, the region should continue to converge towards its potential growth of just below 4%.

Inflationary pressures and forecasts have eased in most countries on the back of lower oil prices and more moderate growth prospects. However, a number of countries are still highly exposed to the recent increase in food prices caused by the drought in the US. In any case, we expect year-on-year changes in prices to stay within central bank target ranges.

Monetary policy should become more biased towards supporting activity in Latin America in the wake of lower growth in domestic demand, more benign inflation and greater uncertainty abroad. Central banks that use inflation targeting, e.g. Brazil, Colombia and Uruguay, are likely to lean more towards cutting interest rates further or keeping them unchanged longer, with other, e.g. Chile and Peru, likely delaying their rate-tightening campaigns until early 2014. In Mexico, forecasts for official rates are unchanged and call for the first increases around the middle of 2013 amid greater inflationary pressures than in South America.

Exchange rates should resume their upward trend as financial stress in Europe and, in turn, global risk aversion eases in line with the trend seen in the first quarter this year.

Fiscal and current account balances should remain in manageable ranges. Fiscal deficit forecasts are slightly higher due to the outlook for lower growth and lower export commodity prices, although in some Latam countries better budget out-turns in the year's first half and, in Brazil's case, a lower debt service burden offset these factors. Foreign deficits are suffering from the negative impact of lower export prices, which is only partially counterbalanced by lower imports.

The main global threat is the potential for a sudden and deep worsening of the crisis in Europe. Latam is prepared to weather such a shock, but the impact would be considerable. Countries in the region boast stronger financial positions, with higher international reserves, better fiscal balances and a shock absorber through flexible exchange rates. What's more, monetary authorities have gained credibility over the last two decades, while local banks remain solid. However, there is less scope for countercyclical (monetary and fiscal) policies now than in 2008 and activity and confidence data have declined more than expected. The main risk is the potential complacency of authorities, which should keep the more advanced economies growing at a prudent pace.

Within the region, doubts surrounding the sustainability of Brazil's growth model stand in contrast to the relatively more upbeat stemming from competitive gains in Mexico. This is feeding through to a reversal of market expectations regarding the two countries and a growing risk about that part of South America being dragged down if the Brazilian economy does not take off as expected.

2. External environment: a slowdown that may deepen unless decisive economic policy action is taken

Global growth will improve only if economic policy measures are fully implemented in time

After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13 (Chart 1), but relies on the assumption that necessary policy measures are implemented in time to avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident." This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

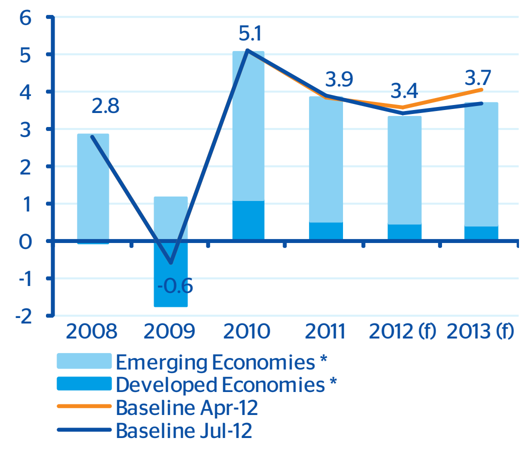
Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice, but that requires that the measures approved at the end of June are implemented quickly, and also the effective use of the European stabilization mechanisms (first the EFSF and later the ESM) for intervening the markets.

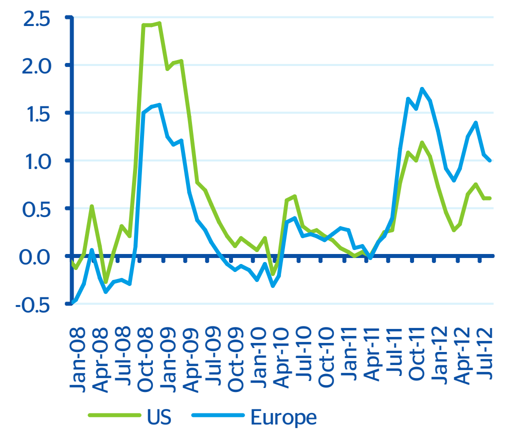
All in all we have revised downwards our forecast for the eurozone due to continued financial stress (Chart 2) and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012- 13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Chart 1
Global GDP growth (%yoy)



* Growth contributions
Source: BBVA Research, Haver and Bloomberg

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually increase during 2H12.

In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area.

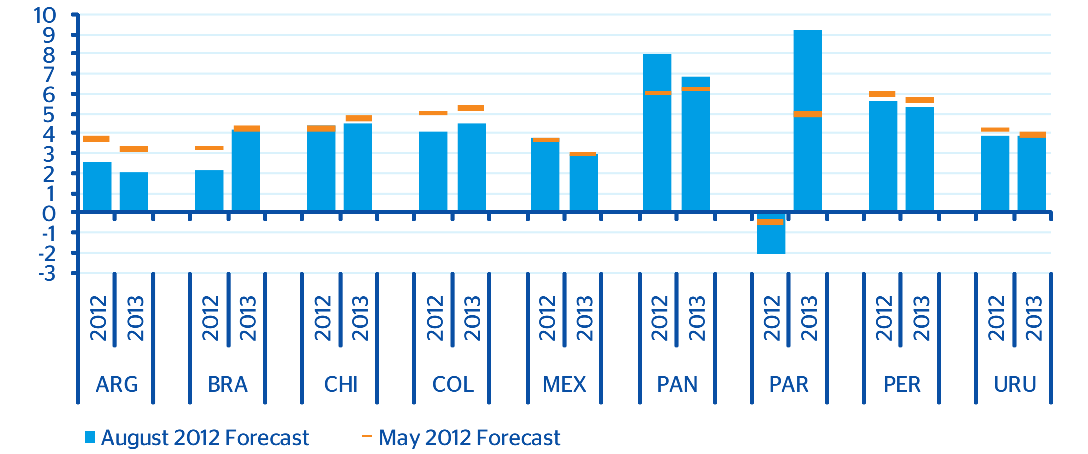
As for Asia, growth in the first half of the year slowed in China more than expected. In line with the weaker global outlook, we have accordingly revised our projections for 2012-13 down. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

3. Resilience of Latam growth amid widespread global uncertainty

Economic activity should remain strong, but growth forecasts have been trimmed in the wake of the negative surprises of the first half 2012 and uncertainty abroad

We have cut our growth forecasts for Latin America to 3.2% in 2012 and 3.6% in 2013 from 3.7% and 3.8%, respectively, in May. The downward revision for 2012 stems mainly from lower-than-expected growth in the first half of 2012, above all in Brazil and Argentina. Combined, these two countries represent 48% of Latam GDP. Therefore, the downgrades to the forecast for Brazil from 3.3% to 2.2% and for Argentina from 3.7% to 2.5% (Chart 3) Argentina (Chart 3) significantly lowers expected growth for the region as a whole this year.

Chart 3
Latam countries: GDP growth forecasts, 2012-2013 (%)



Source: BBVA Research

Looking ahead to 2013, the slight decrease is mainly due to lower global growth forecasts (see previous section). This has led us to cut our forecasts for most countries, but we have kept them unchanged in Mexico and Uruguay and raised our forecasts for Paraguay and Panama due to idiosyncratic factors.

These growth forecasts, as well as the rest of the macroeconomic forecasts discussed later that form our baseline scenario for Latam, are predicated on the assumption that the right political decisions will be taken in both Europe (i.e. institutional reform to complete the monetary union) and the US (i.e. political agreement to prevent automatic fiscal contraction in early 2013), which would help the global recovery expected for next year.

Lower-than-expected growth in the first half of 2012 was due more to local than external factors

The negative surprises seen so far this year – the main reason behind the downgrades to our growth forecasts for Latam in 2012 – are due more to internal than external factors. In Brazil, for instance, economic activity has recovered only marginally so far this year, lower than expected. Although global turbulences have had a negative and appreciable impact, Brazil's late economic performance is the result of fatigue in credit markets and the loss of competitiveness of the Brazilian industry. There are also signals that Brazil's current growth model, too centred on credit expansion and private consumption, is running its course.

As with Brazil, the idiosyncratic factors weighed more heavily than external factors on the negative surprises seen -and in growth forecast cuts for this year- in Argentina (loss of confidence among agents), Paraguay (weather conditions) and Colombia (delays in the execution of public expenditure and temporary negative shocks in the production of coffee and oil).

In Peru, where GDP grew slightly less than expected in the first half of the year, the cut to our 2012 growth forecast is due more to expectations of a larger impact from the global environment on net trade and domestic demand.

In contrast, growth in the first half of the year topped expectations in Mexico, Chile, and Panama, prompting us to leave our GDP forecasts for this year unchanged for the first, and raise them for the latter three countries.

In Mexico, both the job and credit market have performed well, providing stronger support to domestic demand than anticipated. The positive surprise in the first half of the year, coupled with greater penetration of Mexican exports in the US market, should outweigh the impact of lower growth in the US economy. In addition, relatively positive data from Mexico contrasts with disappointing readings in Brazil, causing market expectations regarding the two countries to reverse (see box at the end of this section for more details on comparisons between Brazil and Mexico).

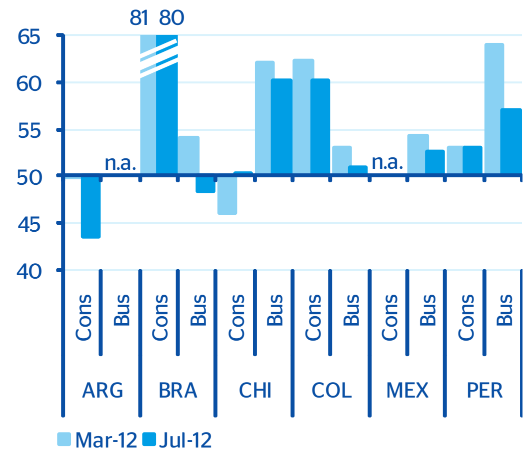
Although local factors overweigh global factors, the turbulences in Europe and lower global growth are affecting all Latam countries in varying degrees

Looking at local confidence indicators, we see that business and consumer confidence have fallen in virtually all Latam countries over the past months (Chart 4), with the recent drops in consumer confidence in Argentina and of business confidence in Brazil and Peru worth noting. We should also point out that in most cases confidence is at levels indicating growth (above 50 in the Chart), which is hardly a surprise, given the resilience shown by most countries in Latam, except Argentina and Brazil.

Although there are important internal factors behind these declines, the virtually across-the-board fall in confidence in the region suggests there is a common denominator: the international environment. That said, the impact of the crisis in Europe through sentiment has been limited so far.

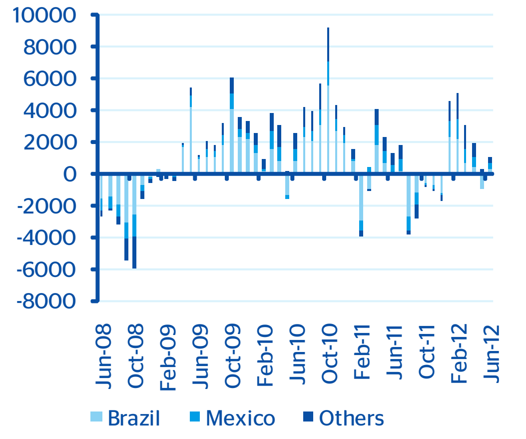
Capital flows into the region have also been somewhat sluggish in the last couple of months (Chart 5), but nothing like the strong outflows seen during the Lehman Brothers crisis or even in the second half of last year when the crisis in Europe heightened. What's more, the breakdown of data shows that capital outflows are concentrated in Brazil, owing to the country's weak economic growth and rapid pace of interest-rate cuts. In Mexico and the rest of the region (mostly Peru, Colombia and Chile), flows are still positive.

Chart 4
Consumer (cons) and business (bus) confidence on march and july 2012



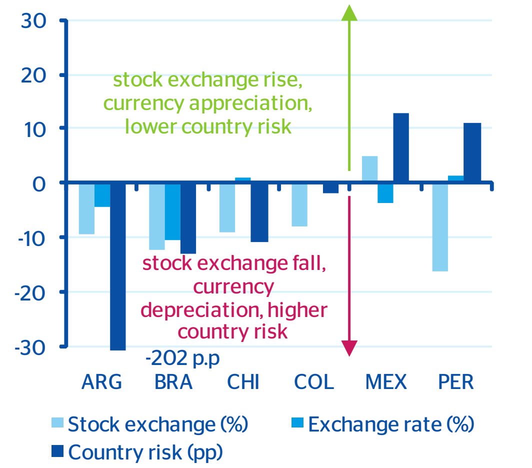
* Levels greater than 50 indicate expansion/optimism and lower than 50 indicate contraction/pessimism. Last data available: july (ARG-cons; BRA-bus), may (CHI-bus; COL-bus), june (others). Data for ARG-bus and MEX-bus: not available.
Source: National statistics and BBVA Research

Chart 5
Capital entry flows (fixed rate and variable rate). Millions of USD



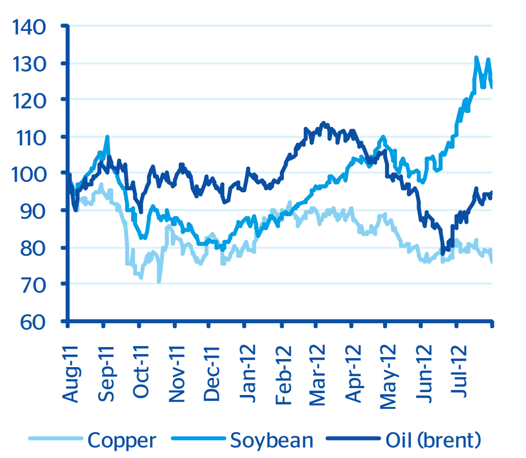
Source: EPFR and BBVA Research

Chart 6
Stock market, exchange rate and country risk. Variation, march-july 2012



Source: BBVA Research and Haver Analytics

Chart 7
Commodity Prices for the main exports (100=one year ago)



Source: BBVA Research and Haver Analytics

Elsewhere, since the end of March, the external environment has dragged down local stock markets and currencies. All countries have seen their exchange rates slip, stock markets slide and sovereign spreads widen (see Chart 6), but not all to the same extent.

The European crisis is not only eroding confidence and having a financial impact on Latam, but it has begun having a commercial effect as well, causing net trade to slump and terms of trade to fall, both heavily correlated to commodity prices in Latin America. To illustrate, oil prices have plummeted 14% and copper prices 10% since March (Chart 7). Soy prices have bucked the trend, surging 47% in the period thanks to a temporary supply shock caused by the US drought.

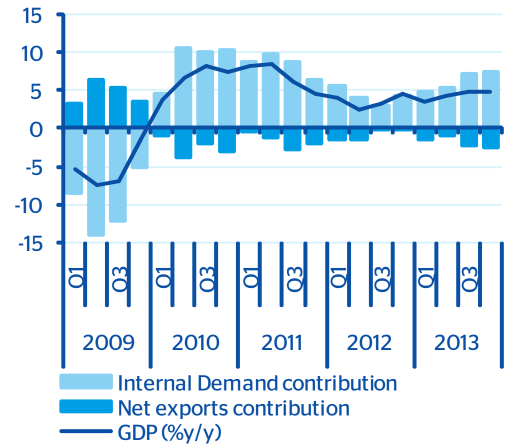
Robust domestic demand and still high commodity prices should continue to underpin growth

Growth in Latam in general tapered off in the early months of this year, yet despite the impact from abroad it remains rather robust, running at around 3% year-on-year in the second quarter (Chart 8) even with Brazil growing below 1% in the same period. GDP growth for mostly every other Latam country is nearly 4% or higher.

Behind the booming economy is the robust domestic demand, which is backed by strong labor and credit markets, not to mention other structural factors (e.g. better handling of social policies). Even in countries where growth has eased over the past few months, domestic demand components continue to provide firm support to growth in activity (e.g. private consumption in Brazil).

Chart 8

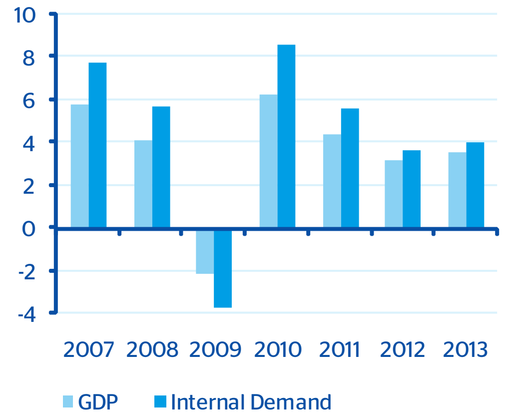
Latam*: contribution of internal and external demand to yoy growth rates (pp)



* Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research and Haver Analytics

Chart 9

Latam*: GDP and internal demand growth (%)



* Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research and Haver Analytics

Our baseline scenario shows domestic demand supporting growth in Latam in both the second half of this year and in 2013 (Charts 8 and 9). Also contributing should be economic policies that for the most part will maintain an expansive bias, especially in countries that can and need to adopt them, e.g. Brazil. In any case, in this scenario not all Latam needs to adopt countercyclical policies.

In aggregate, we expect activity to slow gradually over the coming quarters (see Chart 8). This trend is heavily influenced by the outlook for recovery in Brazil after virtually a year with economic activity at a standstill. In other countries, we expect some moderation in line with the global economic slowdown. This would not necessarily be bad since growth is still above potential in some cases (e.g. Peru and Panama).

Finally, we would also highlight that despite recent downs, commodity prices look set to remain relatively high, continuing to buttress growth in Latam. Our forecasts for 2012 and 2013 show oil and soy prices up 6% and 10%, respectively, on their 2-year averages. For copper, we expect prices to be 9% below 2010 and 2011 levels, but still well above their long-run average.

Inflationary pressures have eased in line with economic activity. Prices should remain in line with central bank targets.

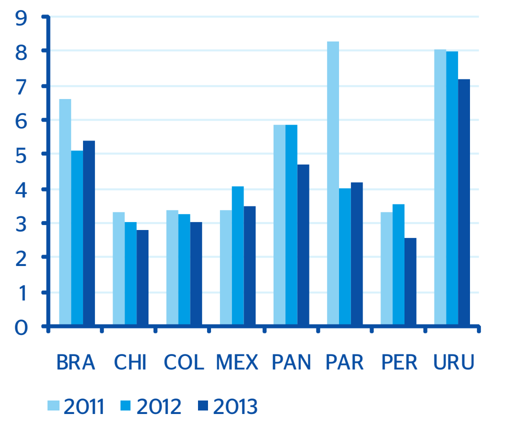
Inflation has eased in Latam in line with the moderation of economic activity and the recent drop in oil prices (mainly in Chile, where fuel prices are more volatile) and the fall in food prices in the first few months of the year (mainly in Chile, but also in Peru, Colombia and Brazil), not to mention certain one-off factors (e.g. tax cuts in Brazil).

In fact, inflation has fallen more than we had anticipated three months ago, leading to downward revisions to forecasts for most of the countries in the region. Exceptions include Mexico (increase in forecast inflation from 3.5% to 3.8% due to food supply shocks), Panama and Uruguay.

However, with our new forecasts, we still see a scenario in which the inflation in countries that use inflation targeting remains in a range above central bank targets (Chart 11). For Chile, Colombia and Paraguay, we expect inflation to be in line or below target in both 2012 and 2013.

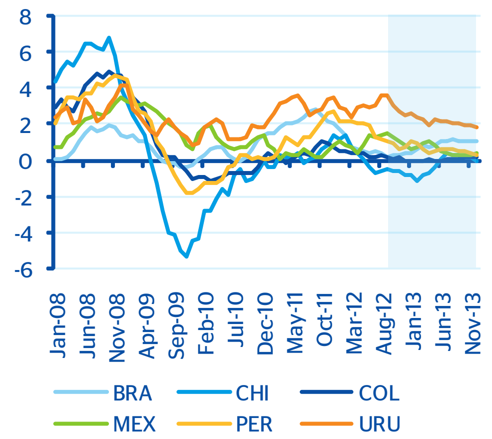
Although the risks related to developments in Europe leave our forecasts tilted to the downside, the recent uptick in food prices in world markets poses upside risk to inflation in Latam countries.

Chart 10
Latam countries: Average yearly inflation (%)



Source: BBVA Research

Chart 11
Countries with inflation targets: difference between inflation and central bank's targets (pp)



Source: BBVA Research and Haver Analytics

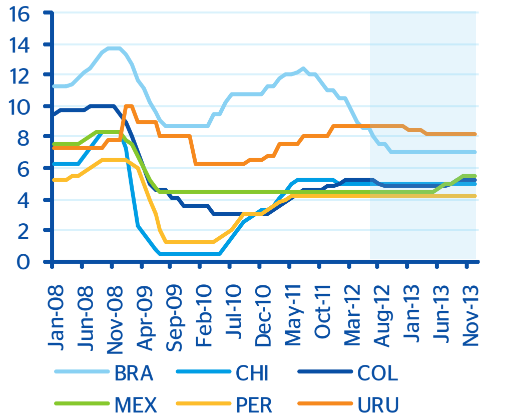
Monetary policy is shifting cautiously towards providing greater support to activity given more benign inflation and greater uncertainty surrounding the international environment

Central Banks of countries using inflation targeting remain cautious against a backdrop in which external risks are offsetting the still robust domestic demand and inflation rates that, for the most part, remain in the upper part of target ranges. In recent months, however, external risks have heightened, while concerns of domestic demand overheating and price pressures have eased.

Most Latin American central banks are taking a “wait-and-see” approach, avoiding adopting monetary tightening policies until there is clear evidence that global and domestic signals are actually affecting domestic prices. Nonetheless, in line with recent changes in the macroeconomic environment, the bias of monetary policy has begun turning less restrictive and, in some countries, is clearly shifting towards supporting growth. For instance, expectations of interest-rate increases in Chile and Peru have been pushed back to the end of 2013 or the beginning of 2014. Even in countries where inflation has not performed as well, central banks are in a holding pattern. Interest-rate expectations still call for rises in Mexico starting around mid 2013 despite the uptick in inflation caused by supply shocks, and for cuts in Uruguay at the beginning of next year.

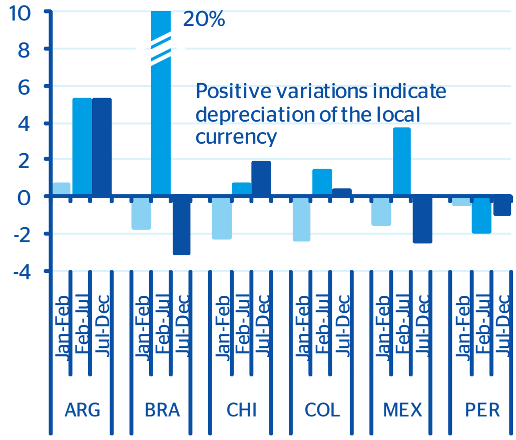
In Colombia and Brazil, (observed and expected) monetary policy trends are in line with the moderation of inflation, lower domestic growth and increasing uncertainty regarding the external environment. Specifically, in a surprise move, Colombia's central bank cut interest rates by a quarter-point to 5% at the end of July, with further cuts being now expected by the end of the year. In Brazil, the SELIC rate is down 450 basis points since August 2011. A further 100-point reduction is expected over the next few months, after which interest rates are expected to remain at 7% over an extended period of time.

Chart 12
Official interest rates
for countries with inflation targets (%)



Source: BBVA Research and Bloomberg

Chart 13
Variation of the exchange rate against the USD (%)



Source: BBVA Research

Lower exchange rates amid increased risk aversion and lower commodity prices

Exchange rates of most Latam currencies except the Peruvian new sol (Chart 13) have fallen over the last few months. Behind this trend are both increasing global risk aversion and declining commodity prices, with the currencies of Brazil, Argentina and Uruguay showing the greater falls. In Brazil and Argentina, also affecting exchange rates is the sharp slowdown in economic activity, whereas in Uruguay, this is also a reaction to the depreciation of the exchange rates of its main Mercosur partners.

Looking forward, Latam exchange rates should remain broadly stable, with a certain trend towards appreciation as the pace of growth recovers (especially in Brazil) and, more importantly, financial tensions in Europe ease, reducing global risk aversion. Meanwhile, the strong increases expected in grain (e.g. soy and corn) prices to all-time highs should lend further support to the exchange rates of Mercosur countries.

Fiscal and current account balances in manageable ranges

In our baseline scenario for Latam, foreign trade and budget balances should remain in manageable ranges.

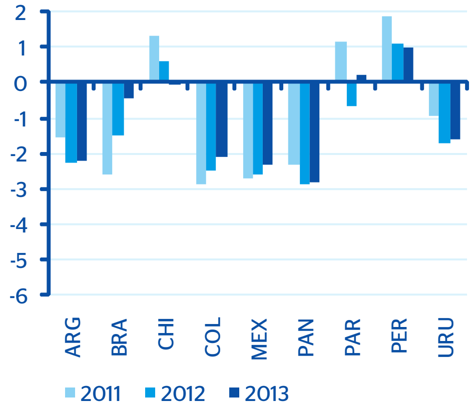
An environment of lower growth and commodity prices has eroded expectations regarding fiscal balances in most countries due to smaller public revenue. At the same time, in some countries (e.g. Argentina, and Peru), a stronger-than-expected fiscal stimulus is also involved. Meanwhile, better performances than anticipated in the first half of 2012 have prompted upward revisions to forecasts for Chile's and Colombia's fiscal balances (higher surplus and lower deficit, respectively). For Brazil, the upward revision relates to lower debt interest payments –this factor also has a certain impact on Colombia's accounts-.

Against this backdrop, Chile and Peru should continue to show fiscal surpluses both this year and next, building up resources for a likely worsening in their terms of trade. We expect public deficits below 3% of GDP in 2012 (Chart 14).

As for external accounts, the impact of recent changes in the macroeconomic environment on current accounts has been marginal in most countries, as the effect of lower commodity prices has, largely, been offset by slightly weaker domestic demand and lower exchange rates, especially in Brazil. In contrast, the fall in oil prices, coupled with a 1% contraction in domestic demand and extremely high soy prices, should bring down Paraguay's foreign deficit sharply compared to our previous forecast.

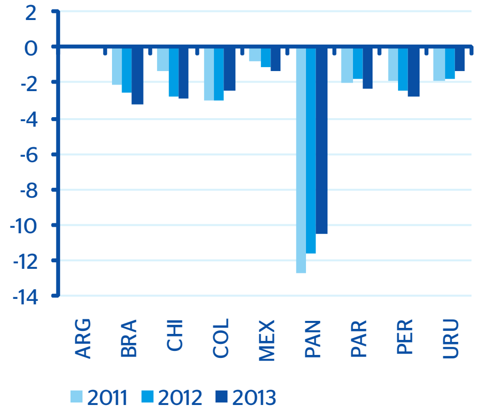
In short, we do not expect current account deficits to be much higher than 3% of GDP in Latam (Chart 15) except in Panama, where the deficit should continue to adjust, but remain above 10% of GDP in 2012 due to the temporary boost deriving from investment in infrastructure and robust domestic demand. We also expect Argentina to continue showing foreign trade surpluses.

Chart 14
Latam countries: fiscal balance (% of GDP)



Source: BBVA Research

Chart 15
Latam countries: current account balance (% of GDP)



Source: BBVA Research

Box 1. Brazil and Mexico: changing perspectives and remaining challenges

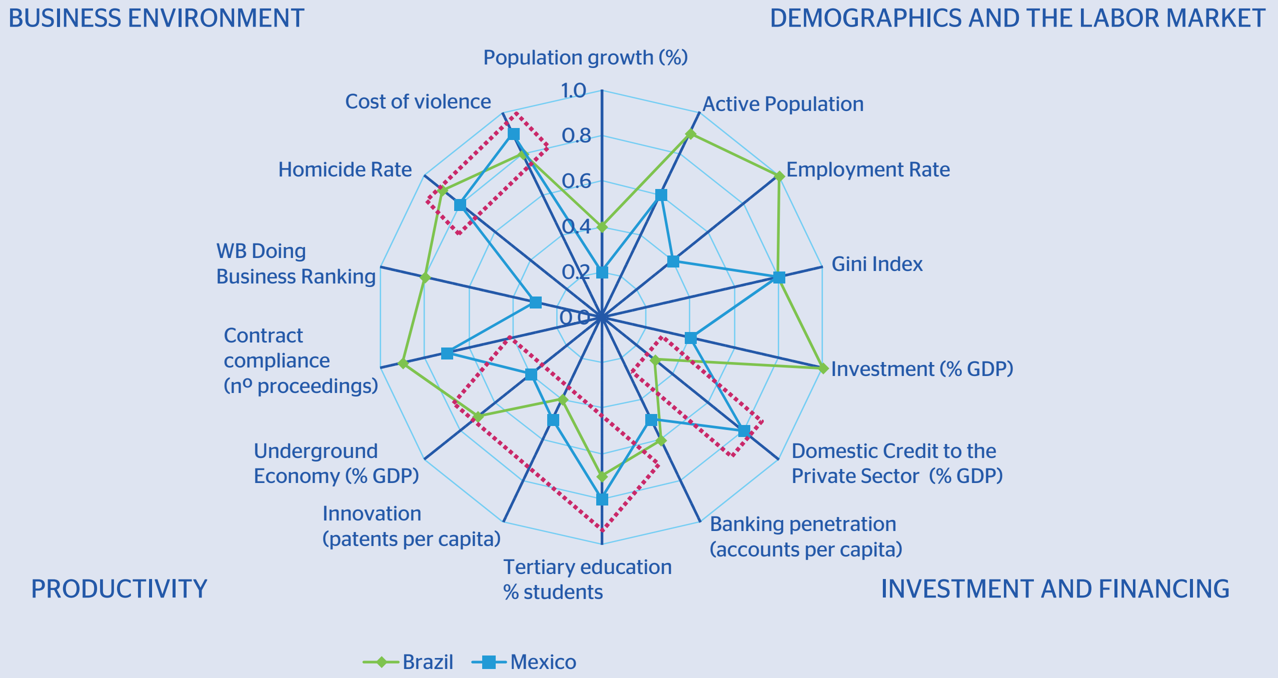
There has been an outlook change in recent quarters regarding the Brazilian and Mexican economies seen, for example, in consensus growth of 3.8% for Mexico in 2012, nearly two points above that for Brazil. If this turns out true, 2012 would be the second year in a run where Mexico grew more than Brazil, after four years where the average growth gap in Brazil's favor was 3.5pp.

Both Mexico and Brazil belong to the "EAGLES[1]" group, comprising countries which, in the next decade, will contribute more to global GDP than the average of developed economies. Mexico belongs to this group more for initial size than for growth which, in recent years, has been lower than other emerging economies and, specifically, than Brazil - the other Latin American "eagle". Brazil's GDP is almost 50% larger than Mexico's and has seen average growth of 3.8% in the last 10 years, around one and half points more than Mexico.

This performance coincided with a global shift in growth sources, with an increasing contribution from emerging Asian and Latin American economies and the standstill and decline of developed economies. This has had important effects on foreign demand from Brazil and Mexico, given their very different exposure to the aforementioned areas. In this sense, the main export destinations for Mexico are developed nations, with a total predominance by the US where around 83% of overseas sales of goods go. On the other hand, Brazil's exports to the US account for 12% of sales, while 68% go the high performance areas such as China, Asia and the rest of Latin America (in Mexico the figure is 12%). In this way, the GDP of destination economies for Brazilian exports grew 50% from 2003 while for the destinations for Mexican products, growth was only 20%.

In the medium term, the balance between both economies does not show a clear dominance for either, with advantages for each country in some of the more important factors. If we take an economy from a supply perspective, the capacity to expand by the appropriate interaction of production and efficiency factors, there are four major elements to consider: demography and the job market, investment and savings, productivity and, finally, the business environment (Chart 16).

Chart 16
Brazil and Mexico: vulnerability radar for emerging economies



Note: the lower the value, the better the relative position
Source: BBVA Research, with IMF, World Bank and UN data

1: Emerging and Growth-Leading Economies.

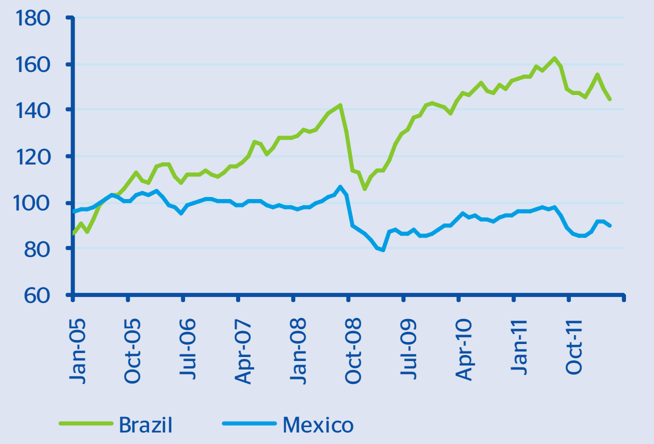
As for population and the job market, it would seem that the demographic boon is higher in Mexico than Brazil, with higher population growth and a higher share of the population in the job market. The low employment rate in Brazil stands out, measured as a percentage of those in work out of the working age population. According to available figures, this sits at 40%, around 20 points below the average for the group of countries looked at.

Both economies contrast in investment and bank financing with a better position for Mexico in the former and for Brazil in the latter. On average for the last decade, Mexico saw an investment ratio of GDP over five points higher than Brazil (24.6% vs. 18%), although without hitting levels in countries which, at times, are seen as reference points such as South Korea (29.4% over the same period). In short, the investment level in Mexico is rightly substantial for a country which does not have the domestic savings rate of an Asian emerging economy or that has not obtained savings from the overseas sector at an important level. The domestic savings rate in Mexico is 23.6% of GDP versus 17.3% in Brazil on average between 2001 and 2011. This is a clear limitation without help from overseas for increased investment. Both public and private consumption have a greater weight in Brazil, further boosted by greater access to bank credit.., Domestic banking sector credit is over 50% of GDP in Brazil, almost 30pp higher than in Mexico, with a higher gap in loans granted by public banking than in private banking.

Improving the business environment still requires work in both Brazil and Mexico. Although Mexico has a clear advantage over Brazil in terms of ease of doing business according to the World Bank's Doing Business. Increased violence, however, creates uncertainty for the Mexican economy.

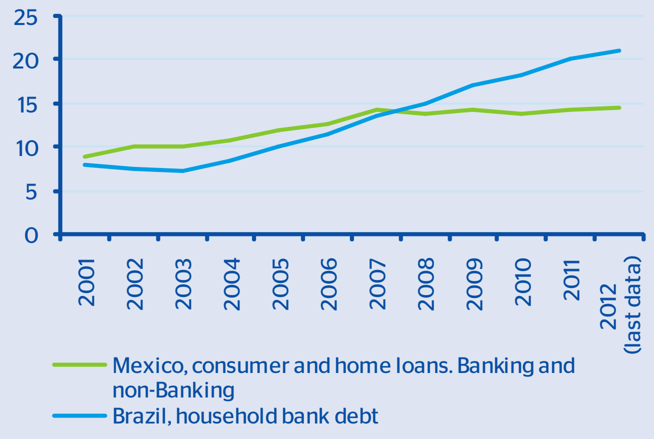
The key to growth lies in efficiency using available productive factors. In the radar chart, as part of the selected variables as representative of productivity, figures do not favor Brazil. Quite the opposite, in fact: among other things, the weight of the black market as part of GDP is much higher in Brazil than in Mexico. Informality is a good sign of productivity since if the activity functions outside current regulations, mainly in fiscal matters, then economic agents cannot take advantage of economies of scale or adequately access the financial market to improve efficiency and increase its value in physical and human capital. In this sense, according to ILO data Mexico has a higher level of informality in the job market. In any event, it would seem that the challenge for both economies is to reduce the black market so that the main source of long-term economic growth (productivity) improves.

Chart 17
Price competitiveness, real effective exchange rate (2005=100)



Note: Increases in the index point to strengthening
Source: BBVA Research and Haver Analytics

Chart 18
Household debt (% of GDP)



Source: BBVA Research with CNBV data for Mexico and BCB data for Brazil

Brazil's strength of demand (not necessarily its supply capacity) and higher performance from its trading partners have created better perspectives in recent years. Nevertheless, the signs of exhaustion in the Brazilian model (too centered on higher demand) and the gains made in competitiveness in Mexico with regard to Brazil are contributing to a shifting relative vision of the two economies, in favor of the Mexican economy. In line with this analysis, it would appear that greater growth capacity in the medium term for Brazil cannot be justified by demography, labor participation or investment rates. In this way, the better GDP record must be linked from the supply side to efficiency or productivity where there seems to be no major differences in either economy in terms of the variables able to estimate it. On the demand side, the more favorable external environment and higher access to bank finance support higher growth in Brazil with regard to Mexico. However, both factors are not necessarily permanent: the performance of emerging Asian economies could slow and/or Brazil could lose competitive advantages in terms of prices. Borrowing ability could be less important for growth from a certain debt level for economic agents.

Indeed, there has been a recent change in market perceptions of both countries, in Mexico's favor, in line with the slowdown in China, fatigue on Brazilian credit markets and the negative impact that labor costs and the higher exchange rate had on Brazilian industry. The last two factors contrast with the recent dynamism on credit markets and signs of increased competitiveness in Mexico. In any event, they are two large economies with good growth potential over coming years. In addition, respective outlooks will continue to be determined by their different exposure to the global environment and by their ability to adopt reforms reducing their weaknesses.

4. Latam could withstand a global shock, but the impact would be considerable

The region has taken important steps towards reducing its exposure and shoring up the reputation of its economic policies

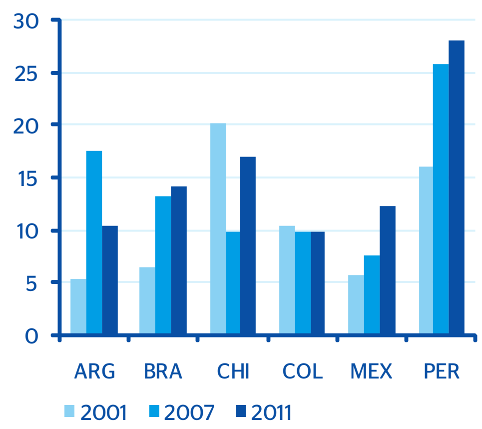
Latin American policy hardly resembles the unorthodox policies of the 1970s and 80s, making it less vulnerable now than it was 30-40 years ago. One example is the region's superior growth during the 2008-09 global recession. Unlike during other global crises (e.g. 1981, 1998 or 2001), Latam managed to bridge the gap in per capita income with developed countries in 2008 –the process began strongly a decade ago- and expectations suggest the gap will continue to decrease over the coming years. This has been a major change for the region.

Overall, the region continues to show improvements in its vulnerability indicators. Most Latam countries continue to build up international reserves (Chart 19), while fiscal and external vulnerability indicators remain relatively low.

On the fiscal front, deficits are still within manageable levels and government debt as a percentage of GDP has decreased in the majority of countries (Chart 20), although in some countries the spreads between interest rates and GDP growth could pose a major challenge in terms of future debt trends

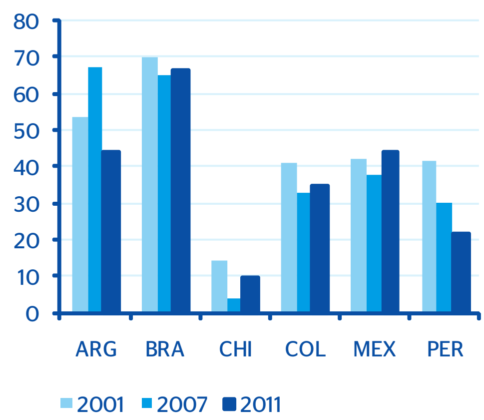
External vulnerability is also relatively limited, as although current account balances are above the average for the main emerging regions, the low levels of external debt (both debt to GDP and debt to exports ratios) leave some scope to deal with a sudden halt to capital inflows.

Chart 19
Latam countries: international reserves (% of GDP)



Source: BBVA Research

Chart 20
Latam countries: government gross debt (% of GDP)



Source: BBVA Research and IMF

That said, the healthy fiscal and external indicators are underpinned largely by high export commodity prices and come amid a context of relatively favorable external financing indicators due to accommodative policies by central banks in developed economics. This further underscores the importance of the prudent macroeconomic policies adopted by most Latam governments over the last two decades, which have reduced cyclical volatility and improved their ability to provide countercyclical responses in monetary and fiscal policy, as show in the global crisis of 2008-09. The good reputation of the economic authorities in most countries of the region could also help them deal with external shocks.

In the current context, the region could suffer the effects of an external shock from developed countries

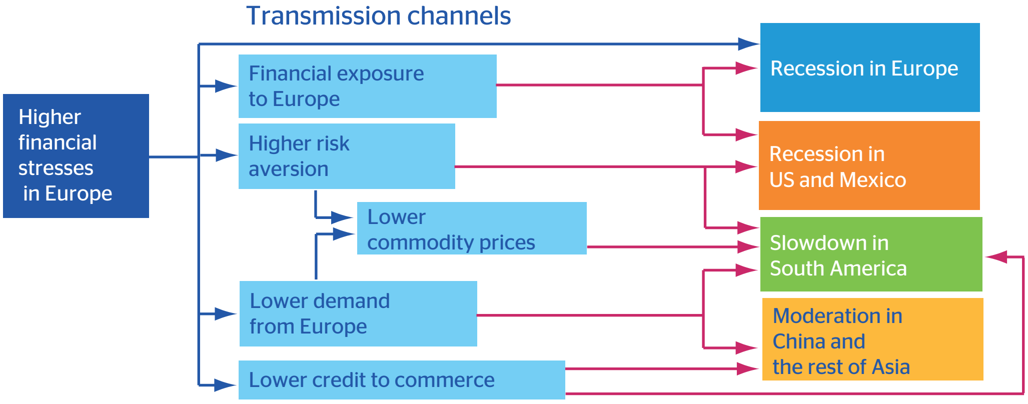
Internationally, there is a chance of a relapse in the main developed economies if there is no agreement in Europe to redesign the economic institutions in the monetary union.

Meanwhile, the US is a major commercial partner for Latam, especially for Mexico. The main risks in the US lie in the inherently fragile state of the recovery and the possibility of a rapid fiscal contraction in 2013 unless a political deal is cut to soften that adjustment. However, this may be difficult with presidential elections slated for November.

In both cases, our baseline scenario is predicated on the assumption that the necessary political agreements will be reached to gradually reduce tensions in Europe and to avoid a rapid fiscal contraction in the US in the early part of next year. Nonetheless, the two factors, especially the situation in Europe, represent the main global risk factor and the main risk for the region.

How would an abrupt worsening of stresses in Europe and a strong automatic fiscal contraction in the US affect Latam? A worsening in Europe could come, for instance, from a messy exit of a country from the monetary union or a failed intervention by the European Stability Mechanism (ESM) in the Spanish or Italian bond markets. This could cause sovereign spreads in the European periphery to widen sharply and make it impossible for these countries to tap the markets for finance. Consequently, some countries that are vulnerable to contagion could face a liquidity crisis from a run on bank deposits and a credit crunch in the European periphery. This could have knock-on effects for core European countries through bank exposure and counterparty risk. This scenario would have a severe negative impact on activity, pushing the eurozone as a whole back into a deep recession like after Lehman Brothers went bust.

Chart 21
Transmission channels and impact of a worsening in the Euro crisis



Source: BBVA Research

Such a scenario would likely cause a chain reaction in the rest of the world. Contagion beyond the eurozone would come through five main channels (Chart 21). First, external demand would decrease sharply for eurozone neighboring countries (Eastern Europe, North Africa and the Middle East). Second, the increase in risk aversion would dampen appetite for risk assets, with negative implications for assets held by US households, and undermine household and business confidence, in turn causing private sector demand to fall. At the same time, the increase of risk aversion and flight to quality would reduce capital flows into emerging economies, severely affecting those that are more vulnerable to reversals of capital flows or with burgeoning current account deficits. Third, lower demand in Europe and higher risk aversion would push commodity prices down because of both fundamentals and the reduction in the demand for commodities as risk assets. Fourth, the exposure of Europe's financial sector (especially the large banks in European core countries) would reduce the supply of liquidity of mutual funds in the money market, in turn hurting US institutions that raise fundings in this market segment. Fifth, a context of strong international financial restrictions would end up having a major impact on international trade financing, having a multiplier effect on the fall of the demand for exports.

Emerging Asia as a whole would resist, given its sound underlying fundamentals and political room to maneuver to counteract losses in external demand and a decline in private investment caused by uncertainty. However, some of the smaller and more export-centric economies could see growth rates taper off sharply. Nevertheless, developed economies have less room to adopt policies to compensate for the negative effects of this type of scenario.

The US would see GDP growth slow sharply and run the risk of facing the automatic fiscal contraction approved for early 2013, which would further undermine the country's growth and cause it to dip back into recession, taking along the countries with the greatest exposure to the US economy, such as Mexico.

South America would be hit mainly through three of these five channels. First, the substantial increase in global risk aversion would cause local risk premiums to rise, pushing up funding costs, lowering capital inflows and generating downward pressure on local currencies. Second, commodity prices would tumble and foreign demand would fall, even from the region's main trading partners, e.g. the US, and to a lesser extent, China. Third, there would be a bigger fall in business and consumer confidence that seen until now. This would have a strong impact on private investment, which was the component that suffered most during the crisis of 2008-2009.

Some elements could cushion the effects of a foreign shock...

An external shock of this magnitude would have negative implications for the local economies, yet some elements indicate the region could hold up relatively well.

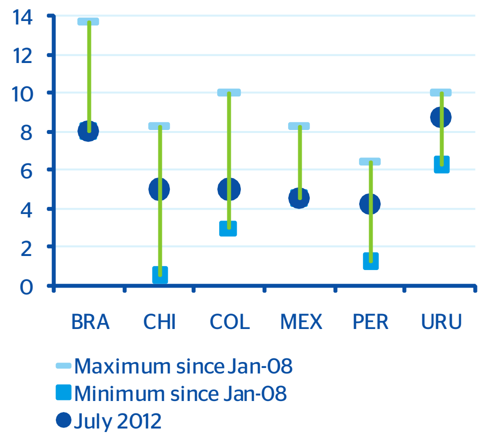
On the plus side, most Latam countries enjoy sound financial positions. As indicated previously, international reserves have been rising since 2008 and fiscal balances of most countries have improved after the stimuli put in place in 2008-09, while the maintenance of flexible exchange rates in the majority of the countries represents a first absorber of external shocks. Moreover, economic authorities (central banks and governments) have the experience of the 2008 crisis to adopt better aimed countercyclical policies and the credibility built up in the last few years after maintaining prudent policies. Most of the countries' credit ratings have been upheld or upgraded and most are at investment grade.

Meanwhile, an important differentiating factor from the past in most Latam countries is the solidity of the local banks in terms of both their exposure to short-term external finance and the oversight of their general risks. The banking sector magnified the external shock in the 1998 crisis, but not in 2008-9 and probably won't if another crisis arises if external conditions deteriorate further. Particularly, most banks with foreign capital in Latin America follow decentralized capital and liquidity management models, self-financing by tapping the local market, which has nothing to do with the parent. The advantage of this financing autonomy is that it provides a natural firewall and reduces the probability of contagion during bouts of turbulence.

...but there are also signs that demand is losing steam, while there is less scope to adopt countercyclical policies post-Lehman Brothers' bankruptcy

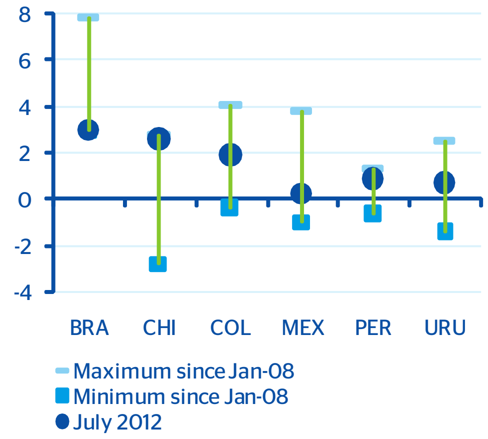
Many countries in the region have less room to implement countercyclical policies than in 2008. In virtually all of them, the scope to lower official interest rates (nominal and real) is less than in the months prior to the collapse of Lehman Brothers and, in some cases (e.g. Brazil), interest rates are now already lower than then (Charts 23 and 24). Perhaps where the least improvement has been made in recovering the ability to cushion external shocks is on the fiscal front, where even though deficits and public expenditure should remain in manageable levels this year, they are still higher than immediately before the 2008 crisis.

Chart 22
Current official interest rates compared to the historic range since january 2008 (pp)



Source: BBVA Research

Chart 23
Real interest rates* compared to the historic range since january 2008 (pp)



* Current interest rates minus inflation
Source: BBVA Research

In addition, as we mentioned previously, the latest activity data showed a sharper-than-expected slowdown in the first half this year in most countries, while confidence indicators have declined considerably in the last three months. This has been the result of greater uncertainty in the external environment caused by increasing tensions in Europe, but it is also true that the decline in confidence indicators, in many cases attributable to internal factors, bode for a slowdown in domestic demand, the main driver of growth in the region in the last few years.

Overall, Latin America is prepared to weather a new global crisis, although it would have a considerable impact on growth

In conclusion, although a worsening of external conditions will have –potentially major- implications for the Latam economy, the crisis would not be as greater as during previous episodes of contagion from developed economics.

The impact on the region as a whole would be manageable. There would be a sharp deceleration in growth in 2013, with a prompt return to potential in a relatively short period. Peru and Chile would be the best prepared as they have greater fiscal flexibility and monetary maneuverability, and the least, those with less access to international markets to absorb the fall in commodity prices and less room to maneuver to implement countercyclical policies.

In addition, since a shock now would be less of a surprise than the one caused by the Lehman Brothers bankruptcy, a new crisis in Europe would have a smaller impact than in 2008-2009. The slowdown would certainly be intense, but the region's economy as a whole should be able to keep from contracting.

In any case, the main risk is the potential complacency of authorities in the face of favorable external financing conditions and the currently high terms of trade. The external risks are substantial so the authorities need to keep the region growing at a prudent pace.

Other external risks can derive from an abrupt downturn in growth in China, but this is rather unlikely

There are other external risks apart from an intensification of the crisis in Europe and sharp fiscal contraction in the US, although the chances of them occurring are more remote.

The first is a steeper rise in food prices. This is mostly a weather-related shock (drought in the US) and, as such, one that should be temporary. However, in some of the more vulnerable economies, the increase in food prices from this shock could prevent central banks from adopting a more expansionary bias for fears that these price increases could trigger second-round effects on other prices and wages. At the same time, we must not forget that a sharp jump in food prices reduces disposable income levels considerably in many Latin American economies.

Finally, South America's strong reliance on high commodity prices makes it extremely vulnerable to a sudden slowdown in growth in China. In our baseline scenario, growth in China should not slow down any more than in the first quarter of this year. To wrap up, risks for Latam are tilted to the downside due to uncertainty deriving from Europe, although the room to implement stimulus measures should enable annual growth rates to remain above 7%, even in the scenarios of greater tensions.

5. Tables

Table 1
GDP (% yoy)

	2010	2011	2012*	2013*
Argentina	8.2	8.9	2.5	2.0
Brazil	7.6	2.7	2.2	4.2
Chile	6.1	6.0	4.4	4.5
Colombia	4.0	5.9	4.1	4.4
Mexico	5.6	3.9	3.7	3.0
Panama	7.6	10.6	8.0	6.8
Paraguay	13.1	4.4	-2.1	9.2
Peru	8.8	6.9	5.6	5.3
Uruguay	8.9	5.7	3.8	3.9
Latin America	**6.3**	**4.4**	**3.2**	**3.6**

*Forecasts. Closing date: May 3. 2012
Source: BBVA Research

Table 2
Inflation (% yoy. average)

	2010	2011	2012*	2013*
Brazil	5.0	6.6	5.1	5.4
Chile	1.4	3.3	3.0	2.8
Colombia	2.3	3.4	3.3	3.0
Mexico	4.2	3.4	4.1	3.5
Panama	3.5	5.9	5.9	4.7
Paraguay	4.6	8.3	4.0	4.2
Peru	1.5	3.4	3.6	2.6
Uruguay	6.7	8.1	8.0	7.2
Latin America	**6.4**	**6.9**	**6.1**	**6.6**

*Forecasts. Closing date: August 3. 2012
Source: BBVA Research

Table 3
Exchange Rates (vs. USD. average)

	2010	2011	2012*	2013*
Argentina	3.91	4.13	4.54	5.27
Brazil	1.75	1.68	1.94	1.97
Chile	510	484	493	502
Colombia	1.899	1.848	1.782	1.760
Mexico	12.67	12.48	13.30	12.62
Panama	1.00	1.00	1.00	1.00
Paraguay	4.734	4.188	4.411	4.590
Peru	2.83	2.75	2.65	2.57
Uruguay	20.0	19.3	20.6	21.4

*Forecasts. Closing date: August 3. 2012
Source: BBVA Research

Table 4

Interest Rates (%. average)

	2010	2011	2012*	2013*
Argentina	10.11	13.34	13.34	13.54
Brazil	10.00	11.71	8.40	7.00
Chile	1.54	4.75	5.00	5.00
Colombia	3.13	4.10	5.00	4.94
Mexico	4.50	4.50	4.50	4.92
Panama	2.69	1.86	1.53	1.94
Paraguay	1.46	8.49	6.33	7.13
Peru	2.06	4.04	4.25	4.25
Uruguay	6.31	7.69	8.75	8.31

*Forecasts. Closing date: August 3. 2012
Source: BBVA Research

Table 5

Current Acount (% GDP)

	2010	2011	2012*	2013*
Argentina	0.8	0.0	0.1	0.0
Brazil	-2.2	-2.1	-2.6	-3.2
Chile	1.5	-1.3	-2.8	-2.9
Colombia	-3.1	-3.0	-3.0	-2.4
Mexico	-0.3	-0.8	-1.1	-1.4
Panama	-10.8	-12.7	-11.6	-10.5
Paraguay	-3.7	-2.0	-1.8	-2.4
Peru	-2.5	-1.9	-2.5	-2.8
Uruguay	-1.1	-1.9	-1.8	-1.3
Latin America	**-0.7**	**-0.8**	**-1.4**	**-1.8**

*Forecasts. Closing date: August 3. 2012
Source: BBVA Research

Table 6

Fiscal Balance (% GDP)

	2010	2011	2012*	2013*
Argentina	0.2	-1.5	-2.3	-1.8
Brazil	-2.5	-2.6	-1.5	-0.5
Chile	-0.4	1.3	0.6	-0.1
Colombia	-3.9	-2.9	-2.5	-2.1
Mexico	-3.5	-2.7	-2.6	-2.3
Panama	-1.9	-2.3	-2.9	-2.8
Paraguay	1.4	1.2	-0.6	0.2
Peru	-0.3	1.9	1.1	1.0
Uruguay	-1.1	-0.9	-1.7	-1.6
Latin America	**-2.4**	**-2.3**	**-2.1**	**-1.4**

*Forecasts. Closing date: August 3. 2012
Source: BBVA Research

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