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Economic Outlook

Latam

Fourth Quarter 2012

Economic Analysis

- **World economic growth will pick up steadily to 3.5% in 2013,** supported by lower risk aversion in response to the measures taken by central banks, in particular the ECB.
- **Latin America will grow by 3% in 2012 and 3.7% in 2013,** boosted by domestic demand and commodity prices. Brazil should finally have taken off in the third quarter.
- **Monetary policy is being maintained on hold,** although it will face growing dilemmas caused by increased pressure on inflation.
- **The challenges for the region are concentrated in the external environment:** they arise from how a possible crisis in Europe or the fiscal adjustment measures in the U.S. are handled, and also from the increasing use of macroprudential measures to control global liquidity.

Index

Closing date: November 6, 2012

1. Summary

Decisive intervention by central banks in developed countries has limited the possibility of a systemic risk scenario arising. The ECB has dissipated fears regarding the irreversibility of the common currency and forged a path for continued progress toward a new institutional framework. The Federal Reserve's injection of liquidity has anticipated the potential impact of a major fiscal adjustment in the U.S. at the start of next year. To sum up, global uncertainty has receded. In this context, we expect the world economy to continue to recover steadily, with rates of growth of between 3% and 3.5% in 2012 and 2013.

Growth in Latin America recovered in the third quarter, boosted mainly by faster growth in Brazil. In most countries the figures for growth in the second quarter were better than expected in August. This has led to an upward revision of growth estimates for 2012. The major exception is Brazil, whose take-off was delayed until the third quarter.

Thus we expect growth of 3% for the region overall in 2012 and 3.7% in 2013. The 2012 figure is slightly below the forecast three months ago, while growth in 2013 will be slightly above that forecast in August. This slowdown on 2011 will be consistent with the moderation in global growth (from 3.9% in 2011 to 3% in 2012). In the medium term, we expect the region to continue convergence towards growth rates close to its potential of slightly under 4%.

Inflationary pressure and inflation forecasts have increased slightly in most countries, due to the strength of economic activity and increased food prices. Inflation rates in most countries will continue at above central bank targets, but still within the permitted range.

The precarious balance between uncertainty regarding the external situation and pressure from domestic demand will make most central banks remain on hold. Except for Colombia, Uruguay and Paraguay, interest rates are expected to remain stable at current levels for at least one more year.

Exchange rates will tend to appreciate again as global risk aversion is reduced in a context of lower financial tension in Europe.

The fiscal and foreign balances will remain within manageable levels. The fiscal deficit is expected to remain in check, allowing an additional reduction of the public debt. On the foreign front, the external balance is strongly conditioned by the rate of economic growth: countries with higher growth rates will also currently have bigger foreign deficits.

The main global risk is a possible resurgence of the European crisis. Overall, Latin America is prepared to support this shock, though it would have a significant impact. The effect on the region would be manageable, although there would be clear differences between countries. Those best prepared are Peru and Chile, with greater room for fiscal and monetary maneuver; those in the worst position are countries with less capacity to access international markets to cushion the fall in commodity prices and with less room to use countercyclical policies.

The major monetary expansion in developed countries is pushing an increasing number of countries to use macroprudential measures, with the risk that countries could begin on an escalating series of policies that are not properly calibrated.

2. External environment marked by the decisive measures taken by the ECB and the Fed

Bold actions by central banks have clarified the global economic outlook but challenges remain for policy-makers to avoid setbacks

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012, 4.1% on average in 2010-12). It is supported by lower risk aversion, following the influential decisions taken by central banks, especially the ECB. However, three factors stand out among those that could make this outlook deteriorate significantly: first and most worrying, troubles in Europe, if euro break-up fears that loomed during the first half of the year resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect at the beginning of 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

Central bankers to the rescue; other policy makers should follow suit

Against a backdrop of high uncertainty and threats to the world economy recovery, over the past months authorities across the world – in particular central bankers in the eurozone and the US – have taken significant steps forward. Those bold measures have spared the world economy from a systemic event that would have been comparable with the financial developments of late 2008. Both central banks have built a bridge to a new institutional environment in the case of Europe, and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room for manoeuvre. However, the FED's actions are more open-ended than the ECB's due to different conditionality: strict fiscal fulfillment is compulsory in Europe, whereas labour market improvement is the objective in the US.

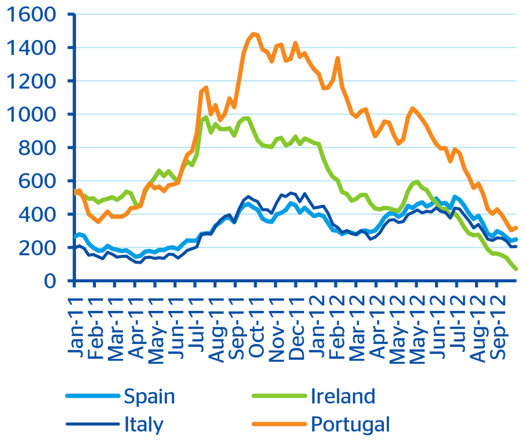
"… whatever it takes…"

In our view, when the European Central Bank (ECB) President Mario Draghi announced the implementation of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July, the institution took a decisive step to put an end to the debt crisis in Europe. Under certain conditions, the ECB could intervene in the secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind the Draghi announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears, compromising the ECB's mandate amid a severe financial fragmentation.

The ECB move was more decisive than anticipated. We consider that break-up fears are not justified now as long as this process continues. Tensions in financial markets have eased significantly since June (see Chart 1) and, in our view, the maintenance of this situation in spite of recent adverse market events is proof of its capacity to dispel doubts.

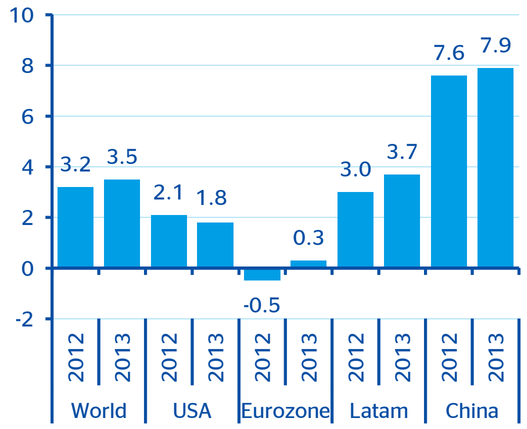
At the end of the process, we think the eurozone may eventually come up with a full package that will reinforce its governance. As we have long argued, it should comprise a banking union, a fiscal union and a lender of last resort to prevent fragmentation. Progress has been made on all of these fronts. Probably that progress has not been ambitious enough to revert the current dynamic quickly. Yet, policy makers seem committed enough to the process and we think the worst of the crisis may, at last, be over. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, the proper implementation of the banking-union plans and further definition of the fiscal-union design will be a key factor to the long-term sustainability of the eurozone.

Chart 1
Financial Stress Index for eurozone countries



Source: BBVA Research

Chart 2
GDP growth rate (%)



Source: Bloomberg and BBVA Research

"... as long as needed..."

The US economy is still growing, but at historically low rates and the unemployment rate remaining persistently high. This is the result of a still high indebtment that should keep on reducing, but also of the uncertain external environment regarding the final resolution of the euro crisis and, from a domestic perspective, of the lack of agreements about how to reduce the high public debt while avoiding the automatic income and expense adjustment that is coming closer by the day (fiscal cliff).

Against this backdrop, the Fed additionally eased the monetary policy in its September meeting. It announced that it intends to keep rates at its current low levels at least until mid-2015, a year over what was previously declared. But to support the improvement of the job market's expectation, it also announced a new round of quantitative easing (QE) through the purchase of mortgage backed securities (MBS) in an attempt to improve financial conditions for households. With this, the Fed is buying insurance against the "fiscal cliff," that in our baseline scenario we expect not to fully happen.

The potential effects of QE3 are not restricted to the US economy. As previous programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs in those countries, boosting the availability of credit, their growth rates and also their inflation.

Central bankers' responses are not enough to bring the global economy back to a firm expansion

The world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 great recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too, though in some important cases, as Brazil and China, recent data shows that activity is stabilizing.

However, the actions that have been taken by central banks in the US and in the eurozone are partly dispelling some doubts and improving the outlook. Under our baseline scenario, growth in the eurozone is likely to gain momentum entering 2013. Although the eurozone's GDP will decrease in 2012 (-0.5%), it will rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to compensate partially the slowdown it is experiencing (see Chart 2).

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. First, this scenario assumes that the recent wrangling over financial supervision does not substantially affect June's agreements, so the vicious link between sovereign and bank risk is broken and the monetary policy transmission, which in the eurozone is conducted mainly by banks, works again. Second, we assume that the mechanism in place to eliminate the "convertibility risks" is activated in full if needed. This will keep yields in peripheral economies contained, but substantial reductions will happen at the same time as Europe progresses in its new institutional arrangement and the commitments are fulfilled Finally, in this scenario, Greece will continue being part of the euro, which will, in turn, require further support from Europe by additional funding and/or a longer period to fulfill fiscal conditionality. Based on past experience, too many things could still go wrong, but policy makers tend to find solutions to Europe's problems when crunch time approaches.

3. Latin America: growth converges to its potential

So far in 2012, growth has been higher than expected in most of the economies in the region, with the significant exception of Brazil

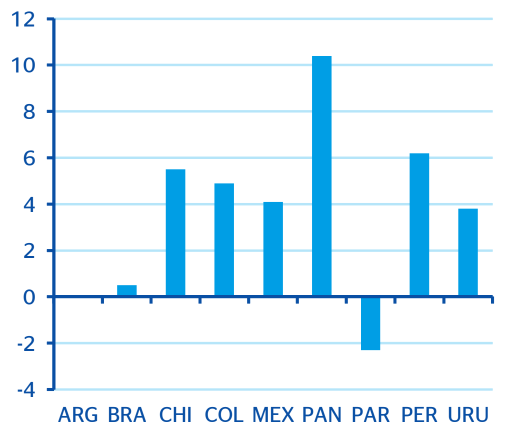
In most countries in the region growth in the first half of the year was higher than we had estimated. This is the case with Chile, Colombia, Panama, Peru and Mexico. Despite the fact that commodity prices remained relatively high and financial stress moderated in recent months, the key determinant of the positive performance of these countries in an environment marked by lower global growth has been the strength of their domestic demand. Both consumption and investment continue to be supported by robust labor and credit markets.

From a different perspective, domestic demand in much of Latin America continues to be backed by what are still expansive monetary and fiscal policies. In other words, interest rates in most of the economies in the region are still at lower levels than what could be considered neutral, and public expenditure continues to support economic activity. The aim is to counter the negative impact of more moderate growth in developed countries, and even (though to a much lesser extent) in Asia.

Thus growth in most of the region continues within a very positive range, from levels of close to 4.0% in the case of Mexico, to around 10% in Panama (see Chart 3 below).

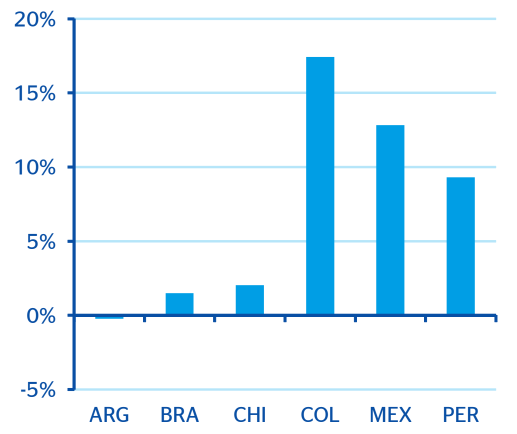
Financial markets have moved in line with the strength of economic activity: stock markets have gained (Chart 4), while in general upward pressure on currencies has been maintained, and the risk premiums of countries where growth continues high have narrowed, despite the instability of external markets.

Chart 3
GDP growth, second quarter of 2012 (year-on-year %)



Source: National statistics and BBVA Research

Chart 4
Cumulative stock market performance, % YTD



Source: Bloomberg and BBVA Research

However, the positive growth enjoyed by economies such as Chile, Colombia, Panama, Peru and Mexico cannot be generalized to the rest of the region. In the two biggest Mercosur countries, Argentina and Brazil, recent data were a negative surprise and the size of their growth contrasts with those of the countries mentioned earlier.

Specifically, in Brazil growth remained at under 1% in the first half of the year, in line with the negative global environment, the moderation of the domestic credit markets and the loss of domestic industrial competitiveness.

Low growth in Brazil was an external shock for the Mercosur countries (and in turn negative feedback for the Brazilian economy). In Argentina, this shock was accompanied by a deterioration of the confidence of the agents (related to bigger foreign-exchange restrictions); and in Paraguay, by a major drought and sanitation problems that led to a significant fall in meat and soy exports. In the case of Argentina growth closed the first half slightly above 1.0%, and in Paraguay the importance of the agricultural sector in the GDP led to a recession.

Uruguay stood up better than the other founding Mercosur countries to the impact of the shock from Brazil and the turbulence in the global environment. Thus Uruguay's GDP increased at a rate of around 4% in the first half of the year, far above that of its neighbors and within a similar range to the Andean countries and Mexico.

Despite the large differences, average growth in the region remained within a relatively high range of slightly under 3.0% overall, but over 4.5% excluding Brazil and Argentina.

Growth should have grown in the region in the second half of 2012, boosted particularly by the recovery in Brazil

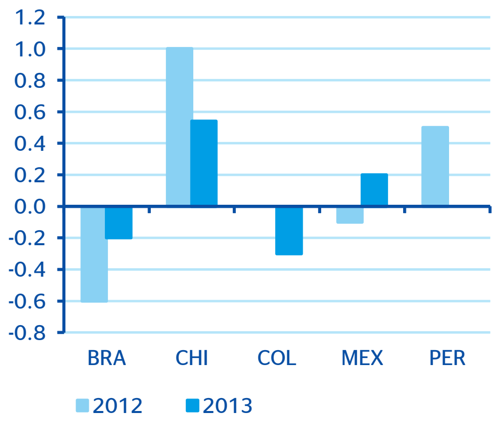
We expect growth to moderate in general in the second half of the year in those countries where it was strongest in the first half, and a significant recovery in Brazil, Argentina and Paraguay. This kind of convergence is in line with our estimates of the output gap for countries in the region. In other words, in countries where growth is above potential moderation will already have begun, while in countries where it is below potential we expect growth to pick up pace (see Chart 5). As shown in Chart 6, average growth in the region will increase in the second half of the year, largely due to the recovery in Brazil and Argentina.

The recovery in Mercosur countries will be headed by stronger output in Brazil, where the high-frequency indicators of economic activity show that the worst of the cyclical sluggishness has already passed and that the combination of unprecedented monetary expansion together with a series of fiscal incentives is beginning to have its effect. Both Brazil and the founding Mercosur partners will also benefit from high international prices of their main agricultural exports, due to severe drought in the U.S. Paraguay will also benefit from the gradual opening up of export markets for meat and the boost from a countercyclical fiscal policy.

The slight moderation expected in other countries in the region is in line with the desire of governments to control the upturn in domestic demand, with lower prices for the metals exported by countries such as Chile and Peru (in part due to the slowdown in China). It is also the result of more moderate growth in developed countries; the impact here is particularly strong in Mexico due to its close relations with the U.S. In any event, the slowdown is in general smooth and not a sudden loss of strength.

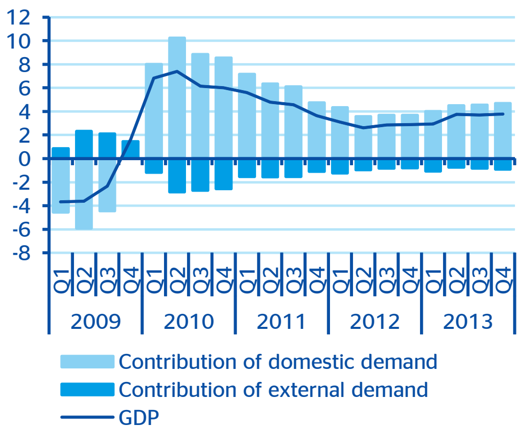
As is the case with other high-frequency indicators, the most recent indicators of confidence enhance the prospects for a strong recovery in Brazil and robust growth in the Andean countries and Mexico (among others) throughout the second half of the year. These prospects are bolstered by the reduction of global financial stress following the decisions taken recently by the ECB on outright monetary transactions (OMT) and the adoption of a new round of monetary stimuli (QE3) by the Federal Reserve. The relative recent strength of the indicators of confidence contrasts with their weakness only a few months ago, when the global environment and some idiosyncratic factors gave a negative bias to economies in the region (see the previous issue of our Latin America Economic Outlook).

Chart 5
Latam: Output gap* (%)



* Output gap: (observed GDP - potential GDP) / (potential GDP)
Source: BBVA Research and Haver Analytics

Chart 6
Latam*: contribution of domestic and external demand to year-on-year growth (pp)



* IIncludes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research

Latin America set to grow 3.0% in 2012 and 3.7% in 2013, converging toward its potential

Given the positive surprises in economic activity in the second and third quarters, we have revised upwards our growth forecasts for 2012 in most countries (see Chart 7). This is the case with Chile, Colombia and Peru, where forecasts for 2012 were adjusted to 5.0%, 4.3% and 6.0%, respectively.

We only maintain the forecasts we made three months ago in two countries: Mexico, where we still expect the economy to grow by 3.7%; and Uruguay, where GDP should grow by 3.8% in 2012. However, the dependence of the Mexican economy on the U.S., and of the Uruguayan economy on its neighbors Argentina and Brazil, naturally makes the figures depend on the growth we expect for these other economies.

In the case of Brazil and Argentina, the recovery that already started in the second half of the year will not offset the negative surprises of the first half of the year. As a result, we have revised down growth figures for the whole of the year. In the case of Brazil, we expect the year to close with a growth of 1.6% (0.6 points less than in our August forecast), while in Argentina we have revised our growth forecast down to 2.1% from 2.5% in August.

The downward revisions of Brazil and Argentina are the only ones in the group of ten countries we analyze, but the weight of the two economies (48% of regional GDP) justifies a slight downward revision of the GDP of Latin America as a whole from 3.2% to 3.0%.

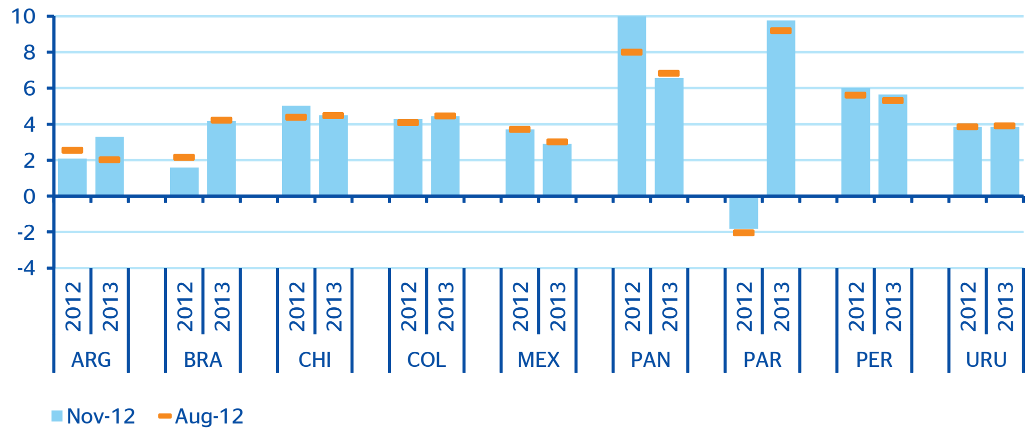
GDP convergence to its potential will continue not only in the second half of this year, but also throughout 2013 (see Chart 7). The higher growth expected in 2013 in Brazil is related to a bounceback effect, given that the GDP will this year be significantly below its potential. GDP will also benefit from a statistical effect of around 2 percentage points next year. In Argentina, the bigger agricultural harvest will have a significant impact on economic activity.

The situation in Paraguay is not very different. After a recession in 2012, growth should reach nearly 10% in 2013. This to some extent will reproduce what happened in the country during the previous agricultural crisis, when its GDP fell by 4.0% in 2009 before growing by more than 13.0% in 2010.

In Colombia, growth will continue to be robust in 2013, at close to 4.4%, but slightly below the country's potential GDP. In Peru the slight moderation expected for 2013 will guarantee convergence of output to its potential level. Growth in Chile and Mexico will moderate with respect to this year, from 5.0% to 4.5% in the case of Chile and from 3.7% to 3.0% in Mexico. In both Chile and Mexico, however, GDP will be above potential next year.

In aggregate terms, GDP growth in the region will accelerate from 3.0% in 2012 to 3.7% in 2013. This increased pace reveals the region's strength, in particular the soundness of its fundamentals and its capacity to adopt measures to mitigate the impact of a global environment characterized by low growth in developed economies and high risks.

Chart 7
Latam countries: GDP growth estimates, 2012-2013 (%)



Source: BBVA Research

The strength of economic activity and food prices are putting pressure on inflation and in general keeping it slightly above the targets set by central banks

According to the most recent data, inflation is above the targets set by practically all the central banks in the region with a target system. The exceptions are Chile, where inflation is at 2.8%, slightly below the 3.0% target, and Paraguay, where the major recession faced by the country has pushed inflation down to levels far below the target of 5.0%.

Rising food prices, largely related to the major drought experienced in the U.S., are a source of pressure common to the countries in the region, particularly those where their weight in the consumer basket is more significant. It is certainly one of the factors that explain the deviation of inflation from the countries' respective targets.

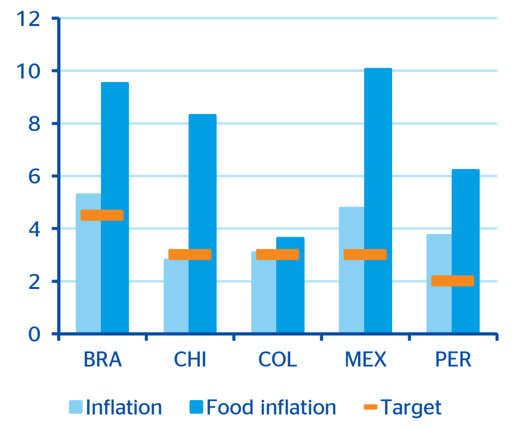
Chart 8 shows that food inflation in a selected group of countries in the region is currently significantly above the average inflation rate. The difference is particularly significant in the case of Brazil, Mexico and Chile. In Chile, however, the weight of the food item in headline inflation is relatively small (19%), which makes it easier to comply with the target in the current circumstances. In Brazil and Mexico, the weight of food in the reference basket is 24% and 23% respectively. Although the gap between food inflation and headline inflation is not as big in Peru as in other countries, the weight of this item is particularly high there (38%), which helps explain the gap between observed inflation and the target. Finally, in Colombia, the weight of food products is in an intermediate range (28%), but the pressure is much less strong than in other countries in the region.

However, food prices are not the only factor responsible for inflationary pressures. Another source is economic activity. As can be seen in Chart 9, inflation of non-tradable goods, which better reflects demand pressures, is above 4% in all the countries except for Colombia, where it is slightly below this figure (3.8%). It is highest in Brazil (6.4%), where the weight of this group of products is also relatively high (64%), even though the country's GDP is below potential (which should imply lower demand pressures).

Another element of pressure is the expected upturn in oil prices, with a very significant impact in countries such as Chile, Colombia and Peru, although the recent changes in oil prices should have a positive impact in the short term.

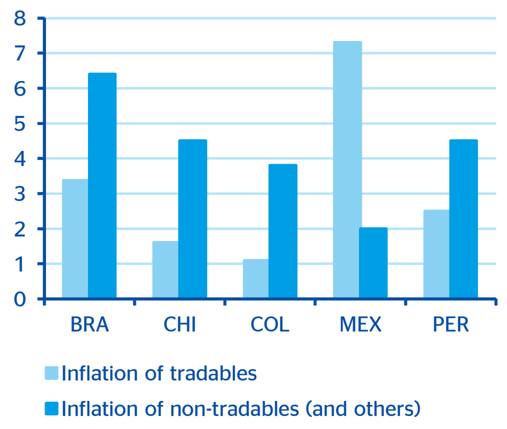
Inflation in tradable goods, in contrast, is in general a source of easing pressure, particularly in countries where its weight is relatively high and/or the foreign-exchange policy does not allow more appreciation of the currency (such as Chile, and in clear contrast with countries such as Brazil where the weight of tradable goods is low and an appreciation of the exchange rate has been avoided).

Chart 8
Latam countries: headline and food inflation and the inflation target (September 2012, y/y %)



Source: National statistics and BBVA Research

Chart 9
Latam countries: inflation of tradable and non-tradable goods (September 2012, y/y %)



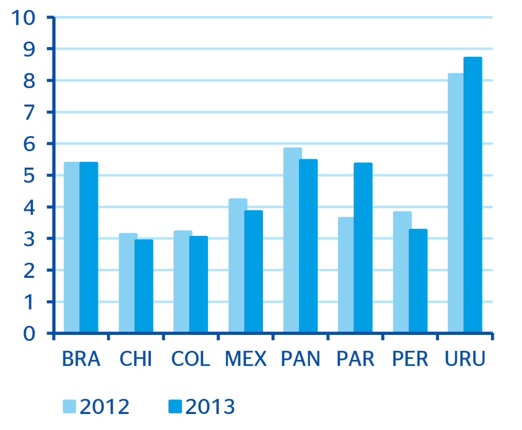
Source: National statistics and BBVA Research

Both economic growth and food prices are putting more pressure on inflation than we expected three months ago, with more or less intensity depending on local characteristics. We have therefore revised upwards the inflation forecasts for Brazil, Chile, Peru and Mexico and maintained relatively unchanged those for Colombia, Paraguay and Uruguay.

As can be seen in Charts 10 and 11, we expect inflation to converge until the end of the year to (or even below) its respective targets in Chile, Colombia and Paraguay. In Peru and Mexico, inflation will be within the upper target range, but expectations will continue to be well anchored. In Brazil, we also expect inflation to remain within the upper target range, but in this case we do not expect it to converge to the target during our forecasting horizon, in part due to the expansive bias of the Brazilian central bank's monetary policy. Finally, in Uruguay inflation should continue at above the target range, despite the recent change in stance (less expansive) by the central bank.

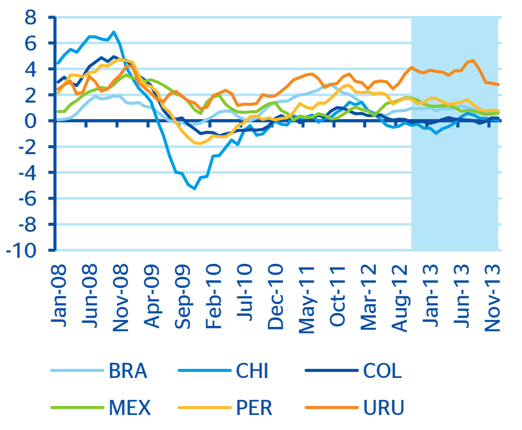
In 2013 inflation should continue close to the core target in Chile, Colombia, Peru and Paraguay. In Mexico, prices are expected to moderate slightly in 2013 as the impact of the supply shocks that led to an increase in inflation this year dissipate, and as a result of the stronger peso. In Brazil inflation will continue significantly above target and will only not get close to the target ceiling (6.5%) due to the positive impact of the aggressive tax cuts, if they are adopted next year.

Chart 10
Latam countries: Average annual inflation (%)



Source: BBVA Research

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



Source: BBVA Research and Haver Analytics

Stable expansionary monetary policy for a sustained period

Following the historic reduction of interest rates in Brazil, the adjustments made by the Bank of the Republic of Colombia throughout the year, the cut in Paraguay to combat the recession and the surprising increase in reference rates in Uruguay in October, the outlook is for stable interest rates at the current levels for a prolonged period of time in the countries that have a system of inflation targets.

The forecast of stable interest rates for a prolonged period of time (at least a further year, with the exception of Colombia, Uruguay and Paraguay) is supported by a balance of risks that is in relative equilibrium: risks related to continued strong domestic demand are offset by risks about the global economy slowing down even more and financial stress remaining at very high levels. An adjustment of interest rates may also be postponed to prevent additional pressure on local currencies, at least in countries such as Colombia, Peru and Brazil.

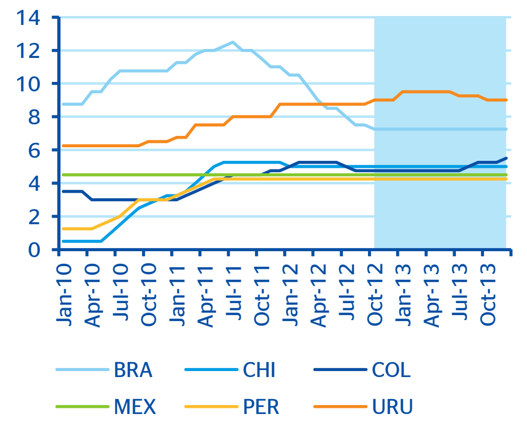
Concerns regarding excessive strengthening of currencies suggest that although we do not expect an increase in interest rates within the next 12 months, monetary policy may become less expansive through the adoption of macroprudential measures. This is a tool that has been used a great deal recently, above all in Brazil and Peru. In any event, we expect that the discussion on whether or not to increase interest rates will become more intense next year.

Thus monetary policy in much of the region will remain expansive at least until the end of next year (Chart 12).

In Colombia and Paraguay we expect interest rates to adjust upward next year, in line with faster economic growth, particularly in the case of Paraguay. The adjustment in Colombia will be adopted in the second half of the year and increase the monetary policy rate from its current expansive position of 4.75% to 5.5%, more in line with the neutral.

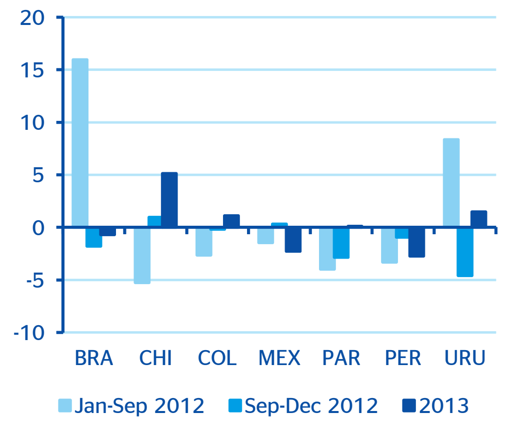
In Uruguay, we expect an upward adjustment of interest rates at the start of next year from the current 9.0% to 9.5%, to prevent inflation from hitting 10%, which would trigger increments in indexed minimum wages and retirement pensions. However, this toughening of monetary conditions will be temporary. We believe that the monetary authorities will lower the reference rates in the second half of 2013 to 9.0%, in line with the moderation in inflationary pressures.

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



Source: BBVA Research and Bloomberg

Chart 13
Exchange rate variations* against the dollar in countries with inflation targets (%)



* A positive variation indicates a strengthening of the currency against the dollar
Source: Bloomberg and BBVA Research

The reduction in global risk aversion, monetary expansion in developed countries and domestic strength, all support the strength of currencies in Latin America

The exchange rates of most Latin American countries appreciated following a period of some weakness in the currencies of the region in the second quarter of the year. They were reacting to the reduction of global financial stress in the wake of announcements issued by the ECB since the end of July supporting the euro and European sovereign debt and the adoption of a new round of stimuli (QE3) by the US Federal Reserve.

In some countries such as Brazil, Peru and Colombia, pressure on currencies was countered by renewed intervention by the authorities in foreign-exchange markets.

Another factor supporting regional currencies was the upturn in the price of some commodities, including agricultural products and oil, related to supply and financial factors. The trend in metal prices was different. The price of copper, for example, was negatively impacted by the slowdown in China. This was an element of weakness for the Chilean peso. At the same time, the Brazilian real was also affected by the moderation in the price of iron ore, but this downward pressure on the Brazilian currency was offset by the positive impact of increased prices of agricultural commodities. In fact, commodity prices continue to be a source of strength rather than weakness for the currencies in the region.

In the future we expect the general trend to be for a slight appreciation (Chart 13), given the growth (and interest-rate) difference between the Latin American and developed countries, particularly in an environment of high global liquidity. We also expect Colombia, Peru and Brazil to continue defending their currencies. In Brazil, however, we consider that the currency controls will be somewhat less effective as economic recovery is consolidated and inflationary pressures increase.

In Mexico, where the attitude of the economic authorities with respect to the strengthening of the currency differs with respect to other currencies in the region (at least in part because the Mexican peso is relatively undervalued with respect to its fundamentals), the reduction in risk aversion and greater global liquidity should allow the peso to begin to appreciate again.

Economic growth determines changes in the external accounts

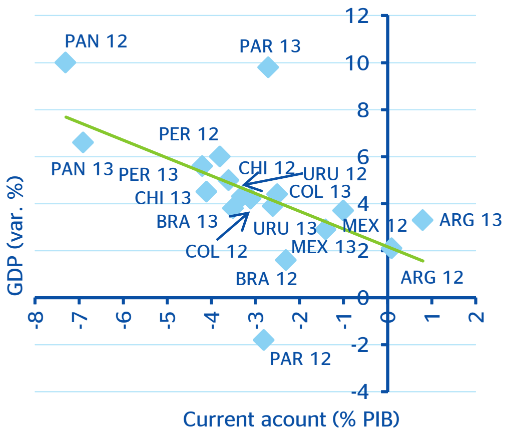
The strength in economic activity of the countries in the region, compared with the low growth in developed countries, will mean that practically all the Latin American countries will post a deficit in their current accounts at the close of 2012 and the following years (Chart 14), despite the fact that the terms of trade (which are closely linked to commodity prices) continue at historically positive levels.

The changes in our forecasts for the external accounts also reflect the tone of economic activity. Brazil's current account deficit for the end of 2012 has been revised down from 2.6% to 2.3%, in line with growth being slower than we had expected. We have also revised the current-account deficits of countries such as Colombia and Peru for the end of 2012 significantly upward, due to their increased pace of economic activity. In Argentina and Mexico we have maintained our predictions for the current account practically unaltered. In the case of Argentina, the impact of import controls and slower growth offset the negative impact of the drought on agricultural exports; while in Mexico, we have retained our growth estimates unchanged.

In 2013 the strength of economic activity should lead to an increase in current-account deficits in Brazil, Chile (where lower copper prices will underpin the upward trend in the deficit), Mexico and Peru. In Argentina, Uruguay and Colombia the current accounts will improve next year due to higher agricultural prices, the better harvest in countries in the Southern Cone of the region, and higher oil prices in Colombia.

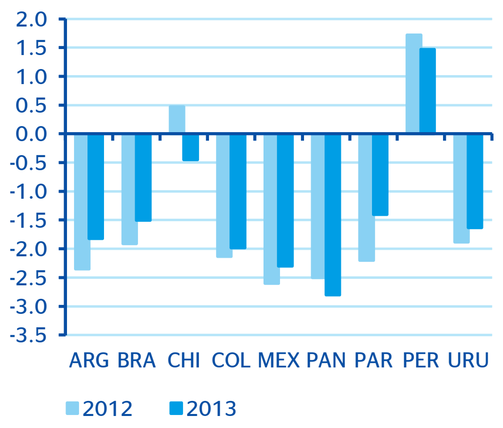
The additional deterioration in the external accounts caused by higher economic growth is particularly important given the continued growth prospects for Latin America in the upcoming years. However, the external accounts remain at manageable levels and countries continue to have very positive FDI flows and substantial international reserves.

Chart 14
Latam countries: Current account (% GDP) and GDP (2012/2013 %)



Source: BBVA Research

Chart 15
Latam countries: Fiscal balance (% GDP)



Source: BBVA Research

Fiscal policy: support for economic activity without jeopardizing the solvency of the public balances

Growth of public revenues in line with the increase in domestic demand and relatively high commodity prices, have turned fiscal and monetary policy into an element supporting economic activity in an environment characterized by unusually high uncertainty and low growth in the developed economies.

In some countries in the region, as is clearly the case in Colombia, public expenditure has been compensating for lower exports and domestic demand. The examples of Brazil and Peru demonstrate that wage policies, social expenditure and transfers to the private sector are also supporting economic activity, whether for structural (reduction of poverty and inequality) or cyclical reasons.

Similarly, the tax reforms recently approved in Paraguay and Chile, as well as the discussions about the subject in Mexico, will increase the capacity to adopt anticyclical measures and give greater support for income transfer policies. This will not compromise fiscal solvency, as the public debt is relatively low in these three countries.

Support from fiscal policy to the Brazilian economy has also increased. The fiscal deficit has been revised upward from 1.5% to 1.9% in an environment of lower than potential growth and significantly lower debt servicing expenditure (due to a significant fall in the SELIC rates).

The support for economic activity will not in general threaten the soundness of the public balances in countries in the region (for more details about the positive trend in public debt in Latin America over recent years, see the previous issue of our Latin America Economic Outlook). The fiscal figures remain at manageable levels (Chart 15). Only in a few cases (basically Brazil and Paraguay) have we revised upward our fiscal deficit estimates for the close of 2012.

In practically all the countries in the region the size of the public deficit in both 2012 and 2013 is restricted to levels that will allow the public debt as a percentage of GDP to be reduced. In Chile, and particularly Peru, we expect a fiscal surplus for at least part of the forecast horizon. This will allow a greater reduction in the public debt in these countries, and as a result, give more room to adopt policies supporting growth in the future.

Box 1. The new Pacific Alliance bloc: Mexico and the Andean countries look to Asia

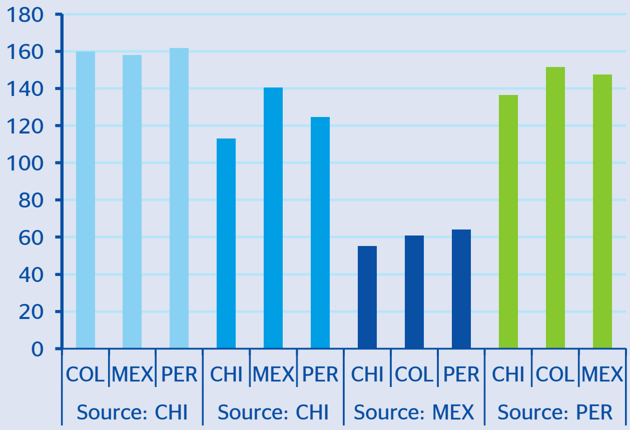
The Pacific Alliance is a new regional bloc whose aim is to promote international cooperation and relations with Asian economies. Chile, Colombia, Mexico and Peru created the economic bloc in June 2012 with the aim of promoting cooperation and also as a strategy for creating closer ties with Asian economies. Costa Rica and Panama are associate members. As a bloc, the Alliance is the ninth biggest economy in the world, with more than 200 million consumers and a per capita GDP of around USD 10,000.

The opportunities for increasing trade between members are asymmetrical, and will potentially benefit Mexico more than the other three countries, given their economic structure. At present, the Mexican economy exports most of the goods (manufactured products of high-added value) imported by the Andean countries, but the reverse is not the case, particularly for Chile and Peru. In other words, Mexico does not focus its imports on natural resources such as copper and minerals, which are the main exports of Chile and Peru.

However, there are other sectors with high potential gains derived from cooperation, such as infrastructures and capital markets. In the case of infrastructures, the quality available in Mexico, Colombia and Peru is much lower than in Chile, which can supply its know-how and expertise in structuring these kinds of projects for its member partners. In the case of capital markets, a possible joint venture between the Integrated Latin American Market (MILA, made up of the securities markets of Chile, Colombia and Peru) and the Mexican Stock Exchange would create the biggest stock exchange in the region.

The Alliance creates an attractive economic bloc for promoting ties with the Asian economies in general, not only with China. Although China is the Alliance's biggest Asian trading partner, Japan and South Korea are also notable investors in the region. They are interested in other kinds of projects, such as the automobile and electronics industries. The Alliance also creates an attractive economic bloc that could become part of the global value chain, due to its free trade area with the United States, the European Union and other developed economies.

Chart 16
The Pacific Alliance: Production structure and potential for intra-regional exports (0=high export potential; 200=low export potential)



* The higher the value, the more similar productive structure, therefore the lesser exporting potential (from source country to destination country).
Source: BBVA Research with Comtrade data

4. External risks moderate, but are still significant

The region continues to watch closely for the effects of a possible shock from the developed countries

Despite the measures introduced by the main central banks in developed countries (analyzed in section 2), there is still a chance of a double-dip in the main developed economies, although this is less likely than three months ago. In the case of Europe, it could be the result of an accident on the way to fiscal and banking union, which would substantially increase global financial tensions. A possible scenario for such an "accident" could be if the core countries reached a point of bailout exhaustion or those on the periphery exhausted their reforms and did not comply with the targets they had undertaken to meet.

The implications would be significant for the rest of the world. In the specific case of Latin America, they would arise through the channels of contagion we discussed in our previous issue of Latin America Economic Outlook. First, there would be a substantial increase in global risk aversion; the local risk premiums would make financing difficult and reverse capital inflows, thus weakening the currencies. Second, through lower commodity prices and external demand, also in the region's major trading partners such as the U.S., and to a lesser extent, China. Finally, there would be a major reduction of business and consumer confidence with a major impact on private investment and demand for durable goods.

In addition, risks in the U.S. are focused on the possibility of a sudden fiscal contraction at the start of next year if there is no political agreement to ease the adjustment. In this case the effect on Mexico would be a major contraction.

What would be the impact on the region of a sharp increase in tension in Europe and a major automatic fiscal adjustment in the U.S.? Overall, emerging Asia, particularly China, would resist, given its strong fundamentals and political room for maneuver to offset falls in external demand and the reduction in private investment due to the uncertainty. This would help Latin America ride the external adjustment better, as would its room to introduce countercyclical policies (monetary and fiscal) and a flexible exchange rate in many countries in the region.

Latin America is prepared to resist a new global crisis. Overall, the impact on growth would be significant

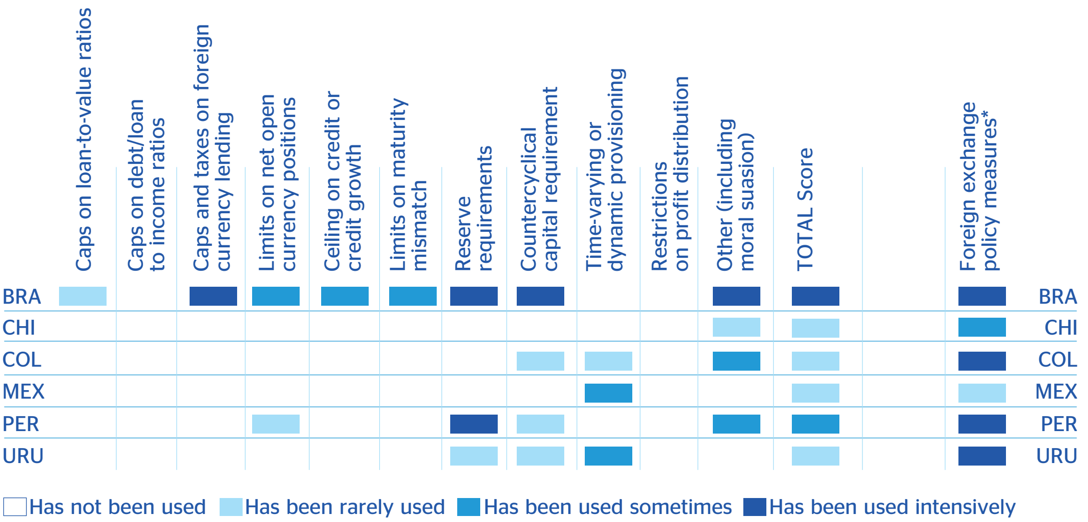
Although worsening external conditions would have an impact that could be significant for the region's economy, they would not lead to a crisis as in previous cases of contagion from the developed economies.

The effect on the region as a whole would be manageable, although there would be clear differences between countries. There would be a major slowdown in 2013 and 2014, with a swift recovery back to potential in a relatively short period of time. Those best prepared are Peru and Chile, with greater room for fiscal and monetary maneuver; in the worst position are countries with less capacity to access international markets and cushion the fall in commodity prices, and with less room to use countercyclical policies.

Given that the shock would be less of a surprise than that arising from the bankruptcy of Lehman Brothers, the effects of a new crisis in Europe were more limited on the region than those in 2008-2009. It is true that the slowdown would be intense, but the region as a whole should be able to escape negative rates of growth.

In any event, the authorities have to remain alert to a possible sudden worsening of the external financing conditions and of the generous current terms of trade. The external risks are considerable, and the authorities therefore have to make sure the region is prepared.

Chart 17
Use of macroprudential policies in Latin America between January 2010 and October 2012



* Includes, for example, FX intervention, limits to foreign investment by pension funds, limits to foreign currency purchase by pension funds, etc.
Source: BBVA Research

In the context of a major monetary expansion in developed countries, there is also a risk of an escalation of macroprudential measures that are not fully calibrated

As we mentioned at the start of this report, measures taken by central banks in the developed countries have reduced the possibility of a very unfavorable scenario for the global economy in the short term. However, the monetary expansion in developed countries generates significant challenges for the central banks of emerging countries, particularly those with robust growth prospects, very strong domestic demand and flexible interest rates. In response to external monetary expansion and the resulting increase in capital flows, many central banks have opted to apply macroprudential measures to limit or discourage these flows. They have avoided increasing interest rates (to tackle the increased pressures on domestic demand) and thus reduced the upward pressure on exchange rates.

Among those countries with inflation targets, Brazil has been the most active in the use of macroprudential measures to reduce incentives for the entry of capital flows and rein in the increase in domestic credit (see Chart 17). In second place is Peru, which has operated with care in a context of a financial system that is still strongly dollarized, although with a clear trend towards de-dollarization. Thus the macroprudential policies in most countries have been used to replace traditional monetary instruments as a tool for tougher monetary policy.

However, there are three risks in this trend that have to be taken into account by the authorities. First, if the macroprudential policies shift capital flows to other emerging countries, boosted by the expansive monetary policies in developed economies, there is an overall risk of an excess of the use of these macroprudential measures. This kind of escalating series of macroprudential measures ends up having an effect beyond its usefulness for each emerging economy taken individually. Second, the economic authorities do not yet have sufficient experience (their own or others') in the use of most of the macroprudential measures. This increases the chance of faults in their use, either by excess or default. Finally, it should be recalled that macroprudential measures end up being a drag on progress in the financial penetration needed in the region, given that most of the countries still have, for example, credit/GPD ratios that are far below those expected of economies of their characteristics.

In short, it is important for the economic authorities to be aware not only of the advantages of using macroprudential measures, but also of their disadvantages and possible collateral effects. In any event, progress in coordinating macroprudential policies is essential in order to avoid an escalating upward spiral of such policies in the region.

5. Tables

Table 1
GDP (% yoy)

	2010	2011	2012*	2013*
Argentina	8.2	8.9	2.1	3.3
Brazil	7.6	2.7	1.6	4.2
Chile	6.1	6.0	5.0	4.5
Colombia	4.0	5.9	4.3	4.4
Mexico	5.6	3.9	3.7	3.0
Panama	7.6	10.6	10.0	6.6
Paraguay	13.1	4.3	-1.8	9.8
Peru	8.8	6.9	6.0	5.6
Uruguay	8.9	5.7	3.8	3.9
Latin America	6.3	4.4	3.0	3.7

* Forecasts. Closing date: November 2, 2012
Source: BBVA Research

Table 2
Inflation (% yoy. average)

	2010	2011	2012*	2013*
Brazil	5.0	6.6	5.4	5.4
Chile	1.4	3.3	3.1	2.9
Colombia	2.3	3.4	3.2	3.0
Mexico	4.2	3.4	4.2	3.8
Panama	3.5	5.9	5.8	5.5
Paraguay	4.6	8.3	3.6	5.4
Peru	1.5	3.4	3.8	3.3
Uruguay	6.7	8.1	8.2	8.7
Latin America	6.4	6.9	6.2	6.4

* Forecasts. Closing date: November 2, 2012
Source: BBVA Research

Table 3
Exchange rate (against USD, average)

	2010	2011	2012*	2013*
Argentina	3.91	4.13	4.55	5.30
Brazil	1.75	1.68	1.95	1.96
Chile	510	484	485	488
Colombia	1.899	1.848	1.795	1.775
Mexico	12.67	12.48	13.11	12.56
Panama	1.00	1.00	1.00	1.00
Paraguay	4.734	4.188	4.411	4.167
Peru	2.83	2.75	2.64	2.54
Uruguay	20.0	19.3	20.5	20.4

* Forecasts. Closing date: November 2, 2012
Source: BBVA Research

Table 4
Interest Rate (%, average)

	2010	2011	2012*	2013*
Argentina	10.11	13.34	13.72	15.06
Brazil	10.00	11.71	8.46	7.25
Chile	1.54	4.75	5.00	5.00
Colombia	3.13	4.10	5.00	4.96
Mexico	4.50	4.50	4.50	4.50
Panama	2.69	1.86	1.44	1.60
Paraguay	1.46	8.49	6.00	7.38
Peru	2.06	4.04	4.25	4.25
Uruguay	6.31	7.69	8.81	9.31

* Forecasts. Closing date: November 2, 2012
Source: BBVA Researchs

Table 5
Current Account (% GDP)

	2010	2011	2012*	2013*
Argentina	0.8	0.0	0.1	0.8
Brazil	-2.2	-2.1	-2.3	-3.1
Chile	1.5	-1.3	-3.6	-4.1
Colombia	-3.1	-3.0	-3.3	-2.5
Mexico	-0.4	-1.0	-1.0	-1.4
Panama	-10.8	-12.6	-7.3	-6.9
Paraguay	-3.7	-2.0	-2.8	-2.2
Peru	-2.5	-1.9	-3.8	-4.2
Uruguay	-1.9	-2.8	-3.3	-2.0
Latin America	-0.8	-0.9	-1.6	-1.8

* Forecasts. Closing date: November 2, 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	-1.9	-1.5
Chile	-0.4	1.3	0.5	-0.4
Colombia	-3.9	-2.9	-2.1	-2.0
Mexico	-3.4	-2.7	-2.6	-2.3
Panamá	-1.9	-2.3	-2.5	-2.8
Paraguay	1.4	1.2	-2.2	-1.4
Peru	-0.3	1.9	1.7	1.5
Uruguay	-1.1	-0.9	-1.9	-1.9
Latin America	-2.4	-2.3	-2.3	-1.9

* Forecasts. Closing date: November 2, 2012
Source: BBVA Research

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