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Economic Outlook

Latam

First Quarter 2013
Economic Analysis

- **The global situation continued to improve during the last quarter** as global tensions eased further.
- **Growth in Latin America will jump from 2.8% in 2012 to 3.6% in 2013 and 3.7% in 2014.** This growth will be underpinned by domestic demand and will gradually reach the region's potential.
- **Monetary policy will remain on hold in 2013, except in Mexico, Colombia and Paraguay.** Monetary policy will be less expansive from 2014 onwards, with the exception of Brazil and Mexico where interest rates will remain steady.
- **The region must manage its success.** It must find ways to moderate pressure on exchange rates, while keeping an eye on possible domestic distortions arising from capital inflows.

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Closing date: February 15, 2013

1. Summary

The outlook for the world economic scenario has improved in the last quarter as global financial tensions eased further –particularly in Europe, and an agreement was reached that managed to avoid the "fiscal cliff" in the US for now. Global growth will climb from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014. However, for the recovery to continue the US and the euro zone need to implement the appropriate policies. This will make further shocks from outside less likely, and limit their impact if they do ultimately arise.

Growth in Latin America was already slightly up in the fourth quarter. The solid data observed in the final quarter –which were better than expected– in countries such as Peru, Chile and Mexico were partly countered by disappointing growth in Brazil in the third quarter of the year and the moderate indicators in the last quarter. The slowdown was also more severe than expected in Argentina and Colombia. That said, in Colombia the slowdown was temporary and the economy was already on the road to recovery in the first quarter of this year.

As a result, estimated growth in 2012 for the region as a whole is down from 3% three months ago to 2.8%. We expect growth of 3.6% for 2013, which is very similar to the estimate in November and of 3.7% in 2014. We expect growth will pick up steadily from the first quarter of this year onwards, particularly as a result of the improvement of growth in Brazil, where there has been a significant injection of monetary and fiscal stimuli, as well as Argentina and Colombia. In 2013 there will be considerable growth in the three Andean countries, a recovery in Paraguay and ongoing dynamic activity in Panama. Growth is set to reach its peak for the region (around 4%) in 2014.

Inflation will remain stable in the Andean countries and in Mexico, whereas pressure on prices will increase in Brazil. At the close of 2012, inflation stood within the target range in most of these countries due in part to the reduced pressure on food and energy prices. The exception was Chile, where inflation remained below the target range, and Uruguay, where it was above the official range in spite of a recent downward turn. We expect inflation to stay within the target ranges of the respective central banks in 2013 and 2014, with the exception of Uruguay. Brazil is expected to keep inflation within target thanks to tax reductions and the management of administered prices.

In most countries the balance between the precarious and uncertain international situation and the pressures of domestic demand will remain somewhat the same, leaving the majority of central banks in limbo. With the exception of Mexico, Colombia and Paraguay, interest rates are expected to remain stable at current levels in 2013. From 2014 onwards, monetary policy will be less expansive, in line with the global recovery, with the significant exception of Brazil and Mexico, where interest rates will remain unchanged, and Uruguay, where falling inflation will make it possible to reduce interest rates again.

Exchange rates will start to appreciate again slightly to the extent that financial tensions continue to ease and global liquidity continues to increase. Certain central banks, particularly in Peru, will face growing dilemmas between robust domestic demand and sustained pressure on the appreciating exchange rate.

Fiscal and international balances will remain within manageable ranges due to strong domestic demand, despite a slightly worse forecast for external balances. With respect to fiscal balances, the general tendency in the region will be for one of improvement, underpinned by solid domestic demand and high prices of commodity exports.

The region's new normal is characterized by high growth and reduced vulnerability, which will raise the problem for many economies of how to manage success. The region must find ways to moderate pressure on appreciating exchange rates while keeping an eye on possible domestic distortions arising from capital inflows. One possible answer is to try to resist the impact of the inflows through an increasing use of macroprudential measures. Another answer, which does not exclude the first, is to make use of the surge in these inflows and channel them into direct investment in key sectors such as infrastructure. It would also be wise to take advantage the good times in order to further develop the supply side of the reform process.

2. Global economic outlook improves

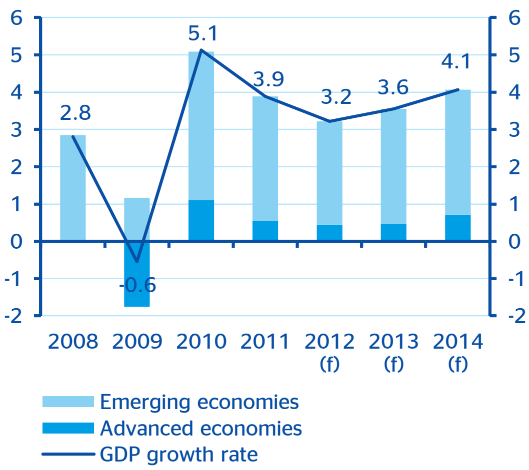
The global economic outlook improved in the last quarter thanks to the continual decline in global financial tensions, especially in Europe, and the agreement avoiding the so-called “fiscal cliff” in the US

Confidence indicators have picked up across all major economic areas and data for output and spending continue to point to limited global growth. Europe has seen financial tensions ease for six months now, with markets gradually, albeit not fully, offering funding to financial and non-financial businesses in certain peripheral economies in the euro area.

The mood in financial markets improved steadily in recent months thanks to three factors: (i) data show that China is not heading for a hard landing, as some analysts had expected; (ii) the US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well; and (iii) Europe continued to progress towards a the banking union, reinforcing the commitment to preserve the euro.

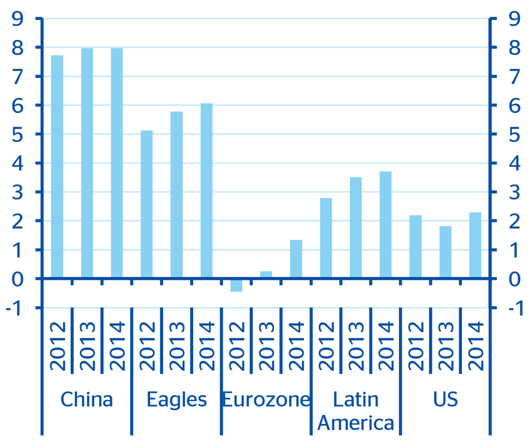
Nonetheless, improvement in market perception does not make up for lack of improvement in fundamentals, and growth will remain weak in developed countries. Therefore, global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 - almost the same forecast as three months ago (Chart 1). In 2013, the downward revision of Brazilian growth and the unchanged scenario in the eurozone and the US should be offset by better forecasts for China, Mexico and some Latin American economies (Chart 2).

Chart 1
World GDP growth rate



Source: BBVA Research

Chart 2
GDP growth rate



Source: BBVA Research

The recovery will only continue if the appropriate policies are implemented in the US and the eurozone. The US needs to do more than just soften the impact of imminent tax rises and should dispel any uncertainty surrounding debt repayment and how the burden of fiscal consolidation is to be shared. With respect to the eurozone, progress in governance, especially with respect to the banking union, must continue, both through additional agreements and the effective implementation of the agreements reached on banking supervision and resolution procedures.

Although positive surprises are not out of the question, the uncertainty surrounding the global economic outlook looks set to remain high. Reduced global growth would be the consequence of increased financial tensions and a drop in confidence if doubts reappeared as to the European authorities’ commitment to shore up the euro, which have been contained for now both thanks to the ECB's statement last July and the agreements reached between the countries in the eurozone in support of the single currency. If these tensions did emerge, new agreements on financial safeguards would be necessary and the recession in the eurozone would continue throughout 2013. The risk in the US would arise if the contagion arising from the European risk was added to the disagreements regarding fiscal consolidation or the debt ceiling. In that case, and with the support of emerging markets, the global GDP would range from 2.5% to 3% in 2013 and 2014. This risk scenario is less likely and the impact is lower than estimated three months ago. This is thanks to the progress that has been made in implementing policies in the most developed regions, and the resilience demonstrated by the emerging economies.

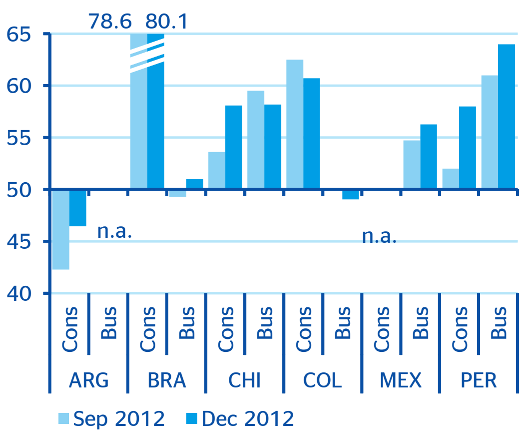
3. Latin America: a recovery from 2013 onwards

The slowdown in growth at the end of 2012 in Brazil, Argentina and, to a lesser extent, Colombia was in contrast with the solid performance of countries such as Peru, Chile and Mexico

The easing of global tensions in the past few months has meant that country-risk levels have been adjusted downwards and that the prices of a number of assets in most Latin American countries have picked up in recent months. Despite the fact that increasing stability in developed nations also poses a challenge to economic policy, it generally has a positive impact on the countries within the region (see the box on the effect of QE3 in Latin America).

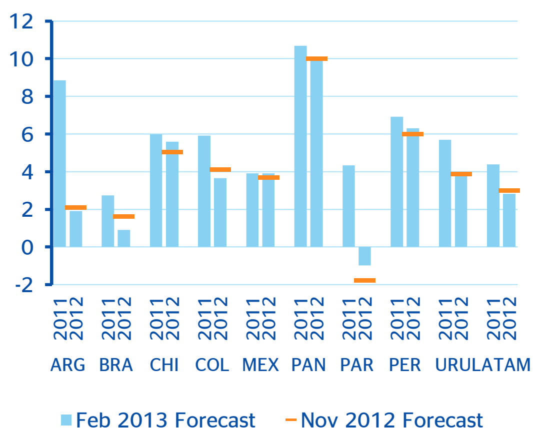
Recent changes in the international arena supported increased confidence in the growth of some of the more open economies in the region (see Figure 3). This is the case for countries such as Peru, Chile, Panama and Uruguay, where we have revised our estimates for economic growth in 2012 upwards (see Chart 4).

Chart 3
Consumer confidence (Cons) and business confidence (Bus) in September and December, 2012



* Over 50 indicates expansion/optimism; under 50 indicates contraction/pessimism. Last available data: December, 2012 (ARG-Cons; BRA-Cons; BRA-Bus COL-Bus; PER-Cons; PER-Bus), January, 2013 (all others) Data for ARG-Bus and MEX-Cons: not available.
Source: National statistics and BBVA Research

Chart 4
GDP Growth, 2011-2012 (%)



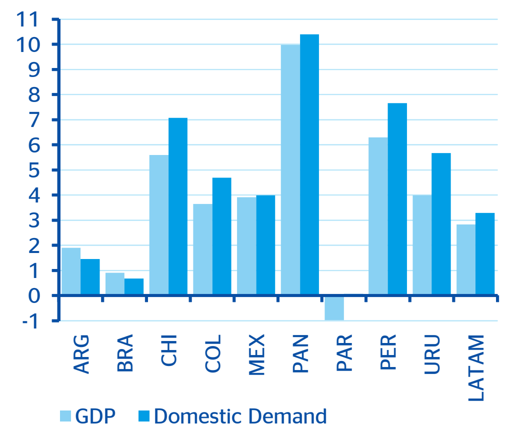
Source: National statistics and BBVA Research

Another common trait among this group of countries, also supported by an overall increase in consumer and corporate confidence in the economy, is that growth in domestic demand overtook GDP in 2012 (see Figures 3 and 5). Robust growth in these countries is generally related not only to lower global tensions but to the existing environment, which has enabled economic policies to remain expansionist. Also important are more long-term factors that continue to support the economic activity in these areas (development of the credit markets, institutional stability, progress within labor markets and high commodity prices). In the case of Mexico, growth has been underpinned by a recent surge in competitiveness against countries such as Brazil and even China, and the expected economic reforms that will increase the potential for growth in the country.

The strength of these economies contrasts with the considerable moderation in activity in countries such as Brazil and Argentina, where in addition to our forecast that GDP in 2012 was much lower than in prior years, we also had to revise downwards our estimates for 2013, as data observed in the last quarter were worse than we expected only three months ago. In both countries, the source of the surprise has been more to do with internal factors (lower soybean prices and lower than expected production in the case of Argentina, and some exhaustion of the growth model based on consumption and credit in Brazil) rather than external factors. Likewise, in view of the strong economic ties between the two main members of Mercosur, it is fair to say that some of the weaknesses in Brazil are related to the weaknesses observed in Argentina and vice versa.

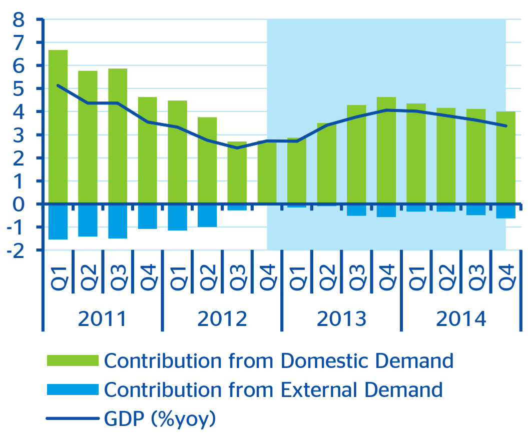
Surprisingly, GDP in Colombia fell recently, which has also sparked a revision of the growth expected for 2012 from 4.1% to 3.7%, down on the growth of 5.9% observed in 2011. Despite this drop, growth in Colombia has remained relatively high since it also benefits from the same long-term factors that favor other countries in the region, as well as from an environment in which growth-based policies can be adopted.

Chart 5
GDP and domestic demand in 2012 (%)



Source: National statistics and BBVA Research

Chart 6
Contribution from domestic and external demand to y/y* growth (pp)



Included Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: National statistics and BBVA Research

In aggregate terms, the weight of Brazil and Argentina means that growth in Latin America in 2012 will be revised downwards from 3.0% to 2.8% as a result of the negative surprises in these countries. There has been a considerable slowdown in the region's aggregate growth in comparison with the growth of 4.4% in 2011, though this figure does not show the huge variety of growth in different countries in response to the more challenging global environment.

Sustained and relatively high dynamism in Andean countries and Mexico, together with the recovery in Brazil and Argentina, will raise growth in the region to 3.6% in 2013

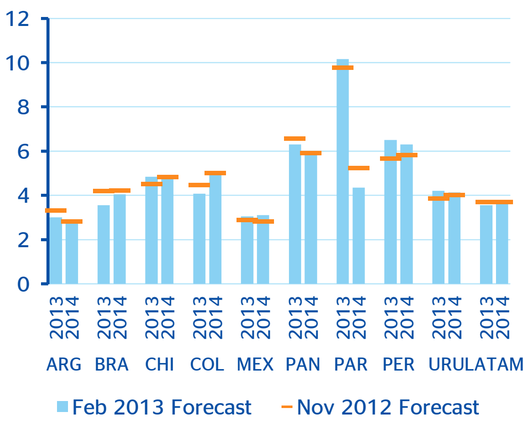
Based on our estimates, the fall in economic activity in Latin America should have ended in the second half of 2012. As shown in Figure 6, the slowdown in GDP should have bottomed out and we will see a gradual recovery from the first quarter of this year onwards. At the forefront of this recovery will be stronger growth in Brazil, Argentina and, to a lesser extent, Colombia, as well as the sustained momentum from countries such as Chile and Peru. The gradual recovery of activity in Brazil will be determined by the impact of increased stimulus measures introduced by the country's financial authorities, the reduction of industrial inventories and the easing of global tensions. In Argentina, recovery will go hand in hand with an improved soybean harvest and increased dynamism in Brazil (the data on confidence given above support an expected recovery in Brazil and Argentina). Lastly, in Colombia, where the slowdown has been slightly less acute than in the other two Mercosur members, the performance of private consumption will guarantee an increase in GDP during the year.

In 2013, economic recovery in countries that slowed down in 2012 will be countered by a slight reduction in the dynamism of countries such as Chile and Mexico. The slowdown in Chile is in line with convergence to its potential GDP; in Mexico, it can to a great extent be explained by some reduction in momentum in the US in 2013. Lastly, the slowdown that we previously expected in Peru should not actually materialize since the rate of growth in consumption and investment has, surprisingly, taken an upward turn, thereby increasing expectations for growth. As a result, we expect that in the case of Peru growth will remain virtually stable in 2013, in line with the high levels recorded in 2012.

On the basis of our estimated performance of the main economies in the region for the year, and bearing in mind the expected -albeit gradual- global improvement, we estimate an increase of 3.6% in GDP in the region in 2013 (see Figure 7). This growth will continue to be underpinned by dynamic domestic demand in most countries (Figure 6), and at the same time fostered by high commodities prices (Figure 8). Growth in the three Andean countries (Chile, 4.8%; Colombia 4.1%; and particularly Peru, 6.5%) will be particularly significant as will the recovery in Paraguay (10.2%) once it has overcome the effects of the drought, and Panama (6.3%), boosted by heavy investment in infrastructure projects.

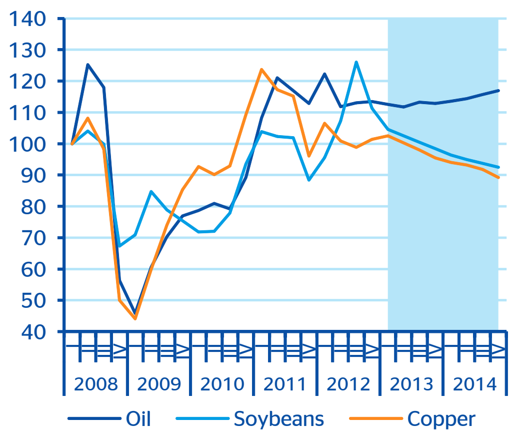
Our overall growth forecasts for 2013 remain unchanged with respect to three months ago since the downwards revision of the figures for Brazil, Argentina, Colombia and Panama were offset by the upwards revision of their peers, specifically, Peru (from 5.6% to 6.5%).

Chart 7
GDP growth forecast in 2013-2014 (%)



Source: BBVA Research

Chart 8
Commodity prices (Q1 2008=100)



Source: BBVA Research and Haver Analytics

Growth will continue to move up towards the region's potential of around 4% in 2014

The countries in the region will continue to approach their potential GDP in 2014, when GDP in Latin America is expected to rise at a rate of 3.7%, a slight increase on the estimated rate for 2013. As in 2013, this dynamism will continue to be underpinned by domestic demand in most countries.

Activity in Brazil is set to surge and will reach 4% in 2014, supported by the recovery in private investment in a domestic environment marked by the positive (albeit temporary) impact in domestic demand due to the organization of the Soccer World Cup and to the presidential elections.

Growth in Mexico will be pegged just above 3% in 2014. In addition, the active political schedule in 2013 could result in the adoption of important reforms (energy, competition, fiscal, inter alia) that could result in an increase in potential growth and, therefore, observed growth. In other words, our medium and long-term forecasts for Mexico have a positive bias as a result of the possible reforms to aggregate supply. This positive trend is in stark comparison to the more pessimistic forecasts for Brazil, where a number of internal risks (steep inflation, uncertainty relating to the country's growth model and excessive government intervention in the economy) could put paid to the country's recovery.

In other countries in the region, the rate of GDP growth should remain over 4.0%, with the exception of Argentina where we expect a GDP growth under 3.0% in 2014. The recovery of the Colombian economy is especially relevant, at an estimated 5.0% for 2014, while Peru will maintain its strong momentum with an increase of 6.3%.

Inflation will remain pegged in Andean countries and Mexico while tensions will rise in Brazil

Although activity in Brazil will continue to be significantly less dynamic than in Mexico and the Andean countries Peru, Chile and, to a lesser extent in Colombia, it is in Brazil where inflationary tendencies are set to stay very high.

At the end of 2012 inflation was within the target range in both Mexico and the Andean countries (except Chile, which ended the year under the target range) and Brazil (where target inflation is 4.5%, higher than in other countries). However, the trend observed in prices in Brazil was very different to that of other countries (see Figure 9). While prices were surprisingly high in Brazil during the second half of last year, in the other countries analyzed inflation was down at the end of 2012.

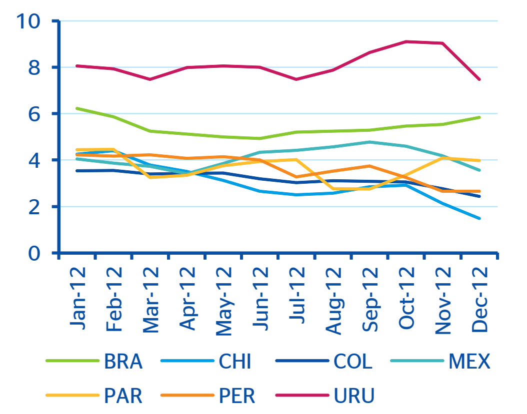
In our opinion, the difference in price dynamics was not a result of these economies' external factors such as the increase in the price of food recorded in the second half of 2012. As analyzed in the last edition of Latin America Watch, the weight of the food group on the official inflation indicator is not higher in Brazil than in other countries. In fact, it only exceeds the weight of this group in Chile, but is practically identical to its weight in Mexico and lower than the weight in Colombia and Peru.

The difference in Brazil can be explained by country-specific factors: in particular, the higher depreciation of the Brazilian currency throughout the year in comparison to other countries; the perceived increased tolerance of its central bank with respect to inflation; and the high level of indexation in its economy. It must also be noted that the Brazilian labor market is still very tight, which goes some way to explaining the changes in prices at the end of 2012.

Elsewhere, in addition to the positive effect of exchange rates on domestic prices and stronger commitment to inflation targets, inflation in Mexico and the Andean countries benefited from factors such as a reversion of increases in food and fuel prices (Chile, Colombia and Peru) and regulated prices (Colombia and Mexico), as well as positive shocks in domestic supply (Colombia and Mexico) and the slowdown in domestic demand (Colombia).

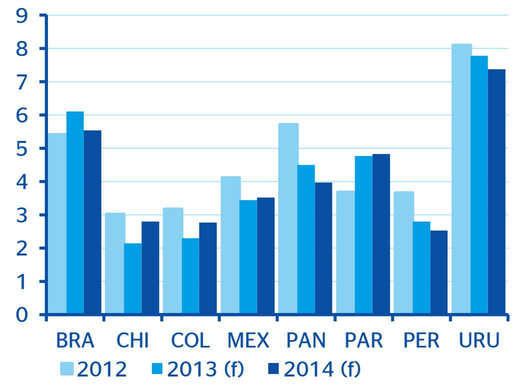
Inflation in Paraguay also ended 2012 within the target range, which did not happen in Uruguay despite the downward trend observed at the end of the year and a more stringent monetary policy.

Chart 9
Monthly inflation in 2012 in countries with inflation targets (% y/y)



Source: National statistics

Chart 10
Annual average inflation (%)



Source: BBVA Research

In 2013 we expect inflation to be contained in most of the countries in the region, in many cases below the levels recorded in 2012 (see Figure 10 for average inflation in the countries in the region that have a system of target inflation).

In general, we expect that inflation will remain between 2.0% to 3.0% in Chile, Peru and Colombia, and we expect it to remain between 3.0% and 4.0% in Mexico. In all four countries, forecasts for 2013 are beneath the estimates made three months ago, which is to a great extent a result of the surprises that have emerged over the last few months. Such low inflation will help to keep prices stable and to prevent a decline in consumer purchasing power and a reduction in competitiveness in these economies.

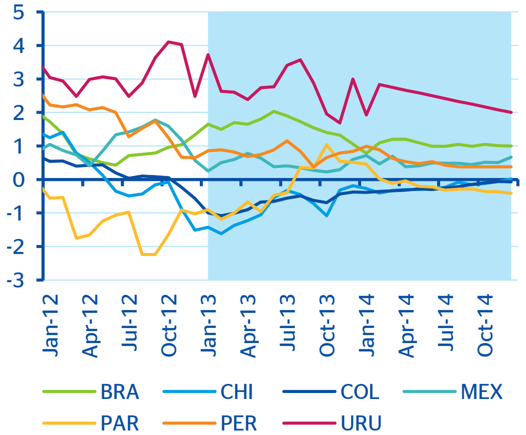
Inflationary pressures in Brazil will continue to accumulate in 2013 (at a higher rate than previously expected), particularly in the first half of the year, when inflation could reach the target ceiling (6.5%) despite the strategic approach to administered prices, tax cuts and increased tolerance with respect to the appreciation of the exchange rate.

In our opinion, in Paraguay the increase in inflation will go hand-in-hand with a significant surge in domestic demand. We forecast that the rise in domestic prices will stand at 5.5% at the end of 2013, i.e. within the Paraguayan monetary authorities' benchmark range. In Uruguay inflation may slow down, although it is set to remain above the target range despite a possible renewed toughening of the monetary policy.

Nonetheless, work to keep prices under control in the countries in the region will benefit throughout 2013 from the expected appreciation in local currencies and lower commodity prices than those estimated three months ago.

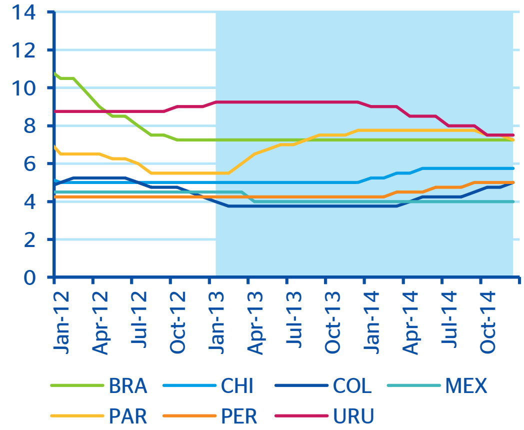
In 2014, we expect inflation to continue its slow and steady path toward the target range in Uruguay. We also expect that it will stay within the limits established in other countries in the region that run a target system. Mexico, Peru and Brazil will remain at the higher end of their targets and, in the specific case of Brazil, we maintain an upwards bias to our inflation forecast.

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



Source: BBVA Research and Haver

Chart 12
Official interest rate for countries with inflation targeting (%)



Source: BBVA Research and Bloomberg

Monetary policy will stay on hold in 2013, except in Colombia, Mexico and Paraguay

Official interest rates, which have remained stable for more than one year now in Peru and Chile, and for some months in Brazil, will stay unchanged in these three countries in 2013. The same will be true in Uruguay following the last rise in interest rates at the end of 2012.

Although monetary conditions in these four countries are expected to remain stable throughout this year, the current stance of their monetary authorities is quite different in an environment where the central banks of the region acknowledge the recent easing of global tensions.

In Peru, the neutral stance of its central bank remains virtually unchanged. Although growth is still high and inflation is also at the upper end of the target, a hike in monetary policy rates is unlikely given the additional pressure that this could bring for the Peruvian nuevo sol. Faced with this monetary policy dilemma, the most likely scenario is that the monetary authorities will continue to increase reserve requirements to keep the economy from overheating. From 2014 onwards, monetary conditions will be normalized by increasing interest rates until they reach a neutral position, at a time when less monetary slack is also expected at the global level.

Chile has recently adopted a slightly tougher stance with respect to inflationary risks due to strong domestic demand, despite the low levels of inflation recorded. Consequently, the pace of this more restrictive momentum must steadily rise during the year and an adjustment of interest rates to levels that are more neutral would begin to be adopted starting early in 2014.

The central bank in Brazil recently acknowledged the reduction in the number of inflation-related risks and adopted a tougher stance, which was still in line with an extended maintenance of the SELIC rates, (2013 and 2014). Increased inflationary pressures in the next few months should give rise to a stricter approach from the monetary authorities without increasing reference interest rates, given the concerns regarding the country's low growth.

Lastly, in Uruguay the monetary policy rate will remain unchanged until the end of 2013 -keeping the real interest rate in positive territory and pushing inflation towards its target range.

Unlike these four countries, in Mexico, after more than a year of stable official interest rates, Banxico shifted its neutral position some months ago in response to downward surprises in inflation, core inflation under 3% and the expected potential increase in GDP if the reforms currently under discussion are adopted. This has virtually wiped out any expectations of a hike in benchmark interest rates and ups the likelihood of a cut during this year (which we expect will take place in the second quarter). From then on, we expect that official interest rates will stay pegged at 4% in 2013 and 2014.

In Colombia, the central bank still has room to make a final cut of 25 bps in interest rates against a backdrop of unexpected decreases in inflation in recent months. This reduction will be expedited as a result of the appointment of two new members to its board, who we expect to have a more dovish stance. The additional cut will push official rates down to 3.75%, 150 points lower than midway through last year when downside surprises to economic activity began to make room for a more lax monetary policy.

Unlike the other countries that run a target system in the region, we expect that the monetary authorities in Paraguay will announce increases in the reference interest rate during the year to ensure that inflation does not exceed the target range despite the strong recovery expected in economic activity.

Reduced global tensions, copious external liquidity and solid expectations for the region will continue to keep currencies strong in Latin America

The currencies of the main Latin American economies appreciated between 3.0% and 8.0% last year, with the obvious exception of the Brazilian real (Figure 13). This appreciation was the result of the increased dynamism of the economies in the region in an environment characterized by weak developed economies and copious global liquidity. Another major influence was the recent reduction in global tensions and the sustained historically high level of commodity prices (see Box 1 on the effect of QE3 on Latin America).

In Peru and Colombia, their currencies appreciated despite the ongoing macroprudential measures taken to reduce pressure. Brazil also turned to these types of measures in the first part of the year, which meant that the real depreciated instead of appreciating as in other countries in the region. The depreciation of the Brazilian currency was also related to the significant moderation in domestic growth and increasing general uncertainty. However, mounting concerns over inflation and the magnitude of the depreciation of the real (which was over 12.0% on the value recorded at the end of 2011) led to an easing of the measures to control capital adopted by the Brazilian authorities at the end of the year.

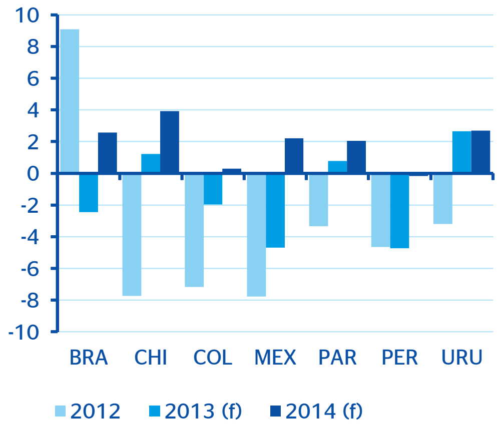
In 2013, we expect easing global tensions and sustained domestic strength (even acceleration in the case of Colombia and Brazil) will maintain upward pressure on currencies. At least in certain countries such as Peru and Colombia, these pressures will determine whether further measures are adopted to control the excessive appreciation of their currencies, which includes the deferral of a hike in their interest rates.

In line with our forecasts, most currencies in the region will appreciate this year (see Figure 13) although the scale of this appreciation (around 2% in Colombia and Brazil and 5% in Peru and Mexico) will be lower than the level observed in 2012.

Although the slight appreciation in Brazil must be tolerated because of the growing concern regarding inflation, the authorities will probably continue to fear that further appreciation will make their exports less competitive. This in practice will limit the efforts to strengthen the real. The same concern, combined with a fall in soybean prices (around 8%), should give rise to a slight nominal (but not real) depreciation of the Paraguayan guarani and the Uruguayan peso. Lastly, in Chile the peso is expected to depreciate slightly, in line with the estimated fall in copper prices (around 3%).

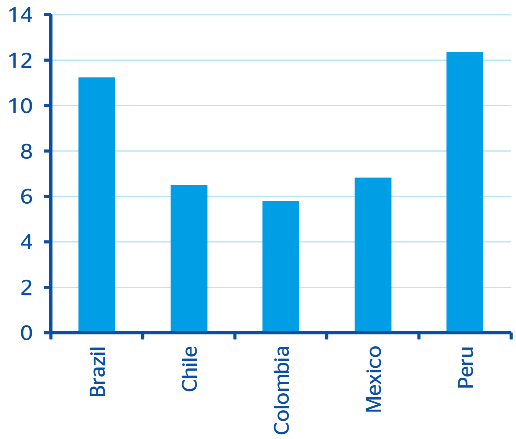
In 2014, the slight depreciation expected in virtually all countries can be explained by the ongoing recovery in developed economies and the associated gradual reduction in global liquidity (i.e. the changes mean stronger currencies in developed countries rather than weaker local currencies) due to a natural adjustment, given that inflation in Latin American countries is set to remain above the rate in developed economies, and soybean and copper prices are set to fall (by 7% in both cases).

Chart 13
Changes* in the nominal exchange rate vs. dollar in countries with inflation targeting (%)



*A positive change indicates currency depreciation vs. the dollar
Source: BBVA Research

Chart 14
Changes* in the real effective exchange rate (% January 2010-January 2013)



*A positive change indicates currency depreciation vs. the dollar
Source: BBVA Research

Foreign balances will deteriorate slightly in certain countries, while fiscal balances will improve somewhat over the next two years

Robust economic activity should continue to foster a deterioration of the current account (due to increased imports) and improved fiscal results (due to the impact on tax revenues).

Our forecasts point towards a clear deterioration in the current account balance in Mexico, Brazil and Chile although it will remain manageable (see Figure 15). However, in all three cases the increase in the deficit will be less than estimated three months ago due to the reduction in estimated growth (Brazil) and the improvement in the terms of trade (Mexico, Chile).

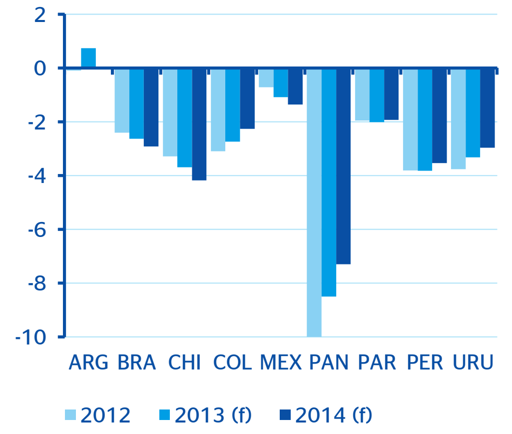
In Peru, where the current account deficit will be pegged at 3.0% to 4.0% over the next few years, expected improvements in the terms of trade and a rise in the volumes exported will lead to a gradual adjustment. The increased soybean harvest should raise the current account surplus in Argentina (at least in 2013) and reduce pressure on the current account in Paraguay. In Uruguay, reduced dependency on energy imports as a result of the more normal climate situation and the expected increase in demand from Brazil and Argentina will help to reduce its deficit. Lastly, particularly noteworthy is the healthy reduction in the deficit of Panama's current-account balance in the next few years as a result of the slowdown in domestic demand.

In general, the increasing current-account deficits, determined by dynamic domestic demand and the adverse impact on competitiveness due to the appreciation of real effective exchange rates (6% in Colombia to 12% in Peru in the last three years, based on the data presented in Figure 14) should continue in the coming years. However, they will remain manageable, given the strong FDI inflows in the region and the current levels of international reserves.

There will be a general improvement in public-sector balances over the next two years (see Figure 16). Relatively high commodity prices, increased harvests (Argentina and Paraguay) and lower expenditure (Uruguay), including debt interest payments (Brazil), combined with the generally robust economic activity in the countries in the region, support this downward trend.

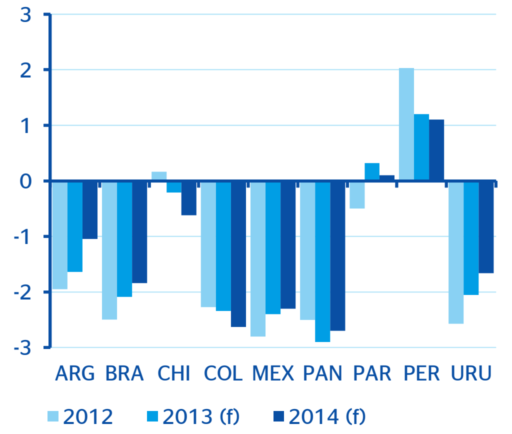
Unlike the overall trend in the region, fiscal balances are expected to worsen slightly in Chile and Peru. In Chile this is due to the expected fall in copper prices, while in Peru it is due to the decision to provide bigger support for economic activity. However, these are precisely the two countries that produce (and will continue to do so) the best fiscal results in the whole region.

Chart 15
Current-account balance (% of GDP)



Source: BBVA Research

Chart 16
Fiscal balance (% GDP)



Source: BBVA Research

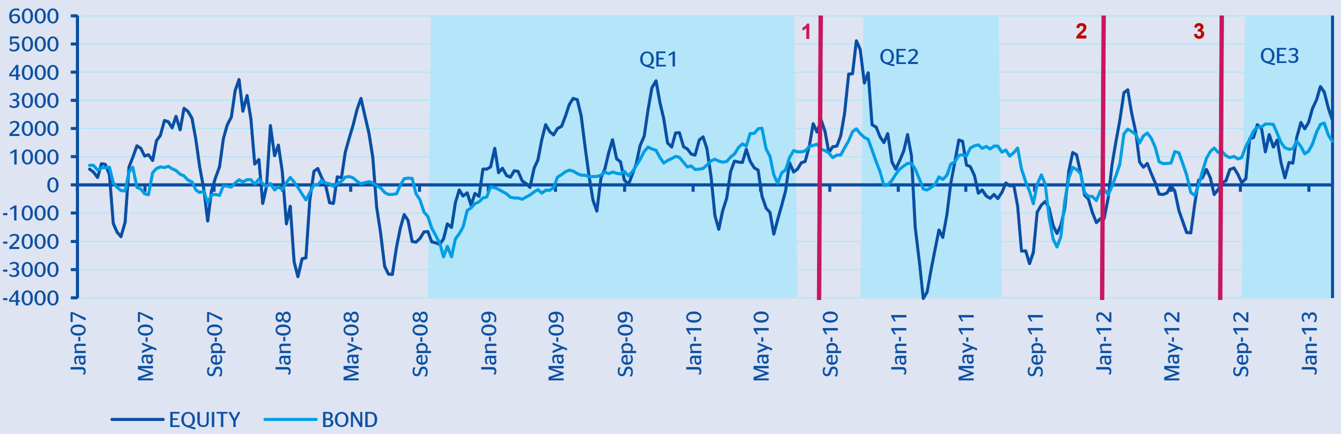
Box 1. Effects on Latin America of QE3 and the ECB measures

The announcement of a new round of quantitative easing (QE3) by the US Federal Reserve meant a significant injection of liquidity into the global financial markets. While growth in the US remains weak and the recession in Europe continues, a considerable amount of this liquidity will eventually end up in emerging countries with open high-yield economies.

As we analyzed in our report in September, Latin America will be one of the regions that most benefits from this measure. Its effects will not only be seen through an increase in the inflows of capital, but in commodity prices and exchange-rate fluctuations.

In Figure 17 we can see that, unlike in the case of QE1 and QE2, capital inflows into Latin America have increased since QE3 and since the action taken by the ECB in the second half of 2012. This is because the region is now in a much better position than previously, with growth almost at its potential and enough room for countercyclical measures to be taken, should the global situation get worse.

Chart 17
Inflows of capital into Latin America* (millions of USD)



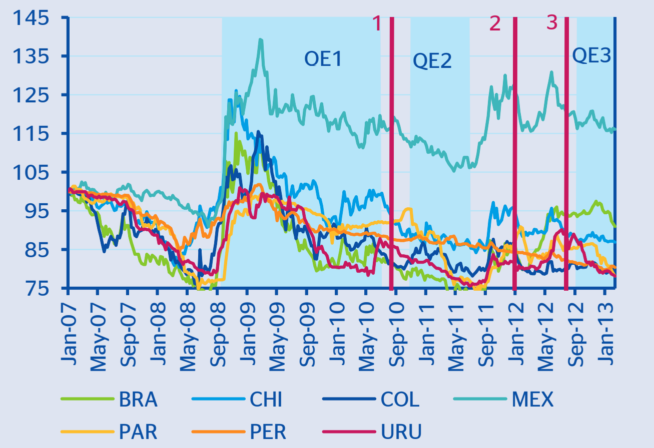
* Highlighted areas represent periods of quantitative easing
1: QE2 announced.
2: ECB LTROs.
3: Draghi hints at saving the euro.
Source: BBVA Research and EPFR

As shown in Figure 18, the last two rounds of quantitative easing, introduced in periods of lower financial tensions than the first, have caused currencies to appreciate in Latin America. The effect is much more significant when assessing the period from QE2 to QE3, when the dollar appreciated substantially in the region. From the announcement of QE3 up until today, most countries have basically maintained a non-interventionist policy in the foreign-exchange market, except for Brazil, Colombia and Peru.

The analysis of commodity prices is more complex. If we adjust our time scale, we can see an increase in prices, particularly copper prices and, to a lesser extent, oil prices, since the Jackson Hole meeting (where discussions on a Fed intervention began). However, since mid-October there has been a downward trend, while fears of the fiscal cliff started to become more visible. In the case of soybeans, there has not been any upward pressure on prices as a result of QE3; in fact, prices have actually dropped due to factors relating to the increase in worldwide supply expected for the coming harvest period.

Chart 18

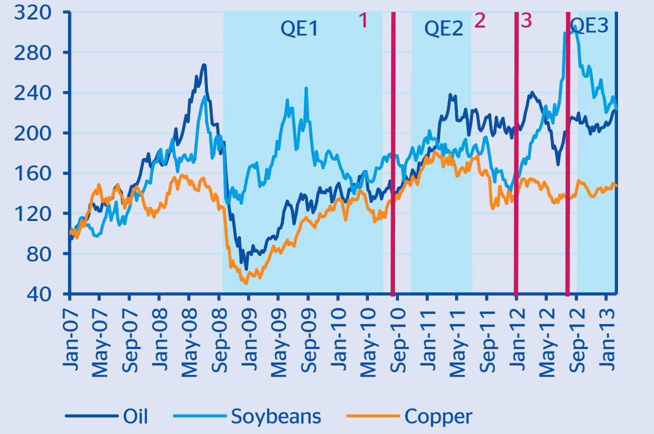
Exchange rate vs. USD* (January, 2008=100)



* Highlighted areas represent periods of quantitative easing.
1: QE2 announced.
2: ECB LTROs.
3: Draghi hints at saving the euro.
Source: Haver and BBVA Research

Chart 19

Commodity prices* (January, 2008=100)



* Highlighted areas represent periods of quantitative easing
1: QE2 announced.
2: ECB LTROs.
3: Draghi hints at saving the euro.
Source: Haver and BBVA Research

Another positive result can be seen in the issuance of sovereign bonds, where several countries have benefited as a result of increased demand and lower interest rates, including countries that do not usually trade on the international markets. Bolivia and Paraguay are particularly relevant here. In the case of Bolivia, the bond issue in October, 2012 (the first in 90 years) took the market by surprise with demand eight times greater than supply and an interest rate of 4.875%, extremely low for a country with its characteristics. In the case of Paraguay, the issuance in January, 2013 (the first of this kind) displayed the same trend, with demand ten times higher than supply and an even lower interest rate of 4.625%: very surprising for a country that is just emerging from a recession.

The same pattern was also observed in the case of countries with more experience in issuing bonds, with interest rates reaching historical lows and demand also considerably outstripping supply. Issuers took advantage of a period when the ratings for these countries remained stable, or even improved in the case of Chile, despite the global crisis.

4. Challenges to managing success in Latin America

The "new normal" for the region is characterized by higher growth than in developed countries and less vulnerability

Latin America is currently a region that has shown itself to be overwhelmingly resilient during the crisis. It has enormous potential for medium and long-term growth. Average growth before the crisis (2003-2008) was 4.7%, while we estimate growth for the next five years (2013-17) at 3.5%, not far off our considered potential for Latin America (4%).

However, the new normal in Latin America is not just higher growth than in developed nations or the fact that it has overcome the global crisis of 2008 without any major problems. The new normal in Latin America is something else: it consists of two basic principles: convergence towards the developed world and less vulnerability.

With respect to the first point, Latin America has been consistently narrowing the gap in living standards with respect to developed economies for some time now. For example, based on our estimates, we expect Latin America to up its per capita income with respect to the US from 23% in 2003 to 31% in 2016. However, the most important aspect of this convergence process is that, unlike in previous global crisis, it has managed to stay on course, despite the momentous global crisis of 2008: the gap in per capita income has continued to narrow even during the worst years of the crisis.

The second important point to make on the "new normal" in the region is that this increased dynamism has gone hand in hand with reduced vulnerability supported by economic, political and social factors.

From an economic viewpoint, foreign and fiscal deficits have been reduced to manageable levels, in general, under 3% of GDP. Moreover, foreign and public debt have continued to decrease in tandem, in the case of public debt with an increase in the proportion of public debt denominated in local currency. At the same time, financial development has increased (for example, in Peru and Chile the credit to GDP ratio has increased by more than 10 percentage points in the last 10 years), but it has not compromised the soundness and health of the financial system, with a NPL ratio under control and very high levels of capitalization. During the crisis, the banking system has acted as a source of strength rather than a mechanism for extending the international crisis, as occurred in the crisis of 1998. Lastly, most countries in the region have consolidated prudent economic policies, that have made room for countercyclical fiscal and monetary. Together with the commitment to flexible interest rates, these amount to a much-needed cushion against foreign crises.

On the political front, most countries in the region have upped their institutional stability through a process of "democratization" lasting for two decades, in response to the spectacular failure of the "import substitution" approach and the inability of the military dictatorships to tackle the imbalances that were left in its wake.

From a social viewpoint, we must not underestimate the positive impact of growth and institutional stability on the considerable growth of the middle classes, whose numbers soared from approximately 100 million people in 2000 to 150 million in 2010. This means that there are now as many middle-class individuals in Latin America as there are low- income individuals in the region, when ten years ago the low-income population outnumbered the middle classes by 2.5 times. At the same time, the increase in the middle classes has undoubtedly propped up the reform process and the move towards market economies as a source of opportunities. The rise in the middle classes has therefore served to cement the reforms and to keep at bay populist and unorthodox policies, speeding up the increase in per capita income while increasing the number of middle classes, in what is a virtuous circle in many countries in the region.

Although there is now less vulnerability, there are two types of risks that the authorities must not overlook: on the one hand, the external cyclical risks, such as a shock from abroad…

Faster growth in China, the partial agreement over the fiscal cliff in the US and the effects of the ECB's outright monetary transaction (OMT) program, are all good reasons to believe that the global economy has managed to avoid a situation of systemic risk, and we can assume that this has at least partially been assumed by the markets. However, these three regions (Asia, the US and Europe) constitute the sources of risk of a shock from abroad that may affect Latin America, although the chances of it happening clearly vary enormously in each case.

Even though the US has avoided the fiscal cliff, US politicians still have to reach an agreement on certain key issues such as the automatic expenditure cuts and the debt ceiling. Any one of these things could throw the process off course. And even if they do reach an agreement, fiscal policy is set to become even more constrictive in 2013. But if these agreements are not reached, a tougher fiscal policy could be all that it takes to plunge US rates of growth back into negative figures. Although the housing sector is recovering, the deleveraging process is still playing an important role and the foreign sector is far from dynamic.

In the euro zone, the improvements in the financial markets have still not been backed up by data on economic activity, although there are signs that the confidence of economic agents is growing and that the tail risks (highly unlikely but with a huge negative impact) have dropped. Nonetheless, the peripheral economies are still in recession, crippled by fiscal consolidation and financing conditions. If the foreign sector and exports push GDP up, some economies will still have to face a process of deleveraging and fiscal austerity. Although the new institutional framework limits the probability and impact of potential risks, financial tensions may re-emerge for different reasons: such as, for example, not fulfilling the fiscal objectives on the EU periphery, which will lead to an even greater fiscal adjustment. Conversely, even though the ECB seems prepared to intervene should it have to, any potential disagreement with the central and peripheral countries on the conditions of intervention is a source of possible instability. Other factors may also play an important role, such as the details of the bailout plan in Cyprus (which have still not been finalized) or political events such as the elections in several European countries. If financial tensions increase as a result of one or more of these factors, the euro zone could remain in recession in 2013.

Finally, in China the short-term outlook for the economy has probably become clearer. The new authorities are committed to sustainable growth, which means a clear intention to use a sufficiently expansive economic policy, while growth seems to be picking up.

Although the probability of these risk scenarios arising is much less likely than three to six months ago (as the impact of a crisis in Europe would be more contained due to the ECB's readiness to intervene), if both risks materialize our estimates suggest that the world economy would grow almost one percentage point less than in the base scenario – considerably less than its historical average.

Despite the above, Latin America has enough shock absorbers to reduce the impact of an eventual shock from abroad, through flexible exchange rates, ample international reserves, reduced public and foreign debt and the creditability of its macroeconomic policies. Furthermore, most of the countries in the region have room for countercyclical economic policies (albeit less so than in 2008), both on the monetary and fiscal side; there is also room for ongoing credit flows since a process of deleveraging the financial system is not necessary. Accordingly, the effect of an external shock from developed nations cannot be ruled out, but it would not spell a recession for most countries in the region.

...or the effect of low-risk high growth: how to manage success

Another cyclical risk in the region consists of the high growth and low vulnerability that we alluded to previously. The region has grown since 2007 at a rate four times higher than the rate of developed nations. Looking forward, when the current crisis is over it is set to continue to grow at least twice the rate of industrialized economies. This means that Latin America is now very attractive to international investors, particularly if we add the considerable expansionist monetary policies in developed nations to this favorable growth differential, which will lead increased global liquidity to look for returns in alternative destinations such as the emerging economies.

Faced with less flexible foreign exchange and fewer financial openings in Asia, particularly China, there has been a disproportionate surge in capital inflows into Latin America (see Box 1), where exchange rates are more flexible and the financial account is also more open. It is partly a question of managing success; of how to find ways to mitigate the pressure on appreciating exchange rates while looking out for possible domestic excesses arising from short-term speculative capital inflows. In short, about consolidating the new normal so that the region continues to have low-risk high growth.

There are two possible answers to this challenge: resist the impact of the inflows or, as in judo, use its momentum to channel it to your advantage.

Accordingly, one possible way of becoming more resilient to the impact of capital inflows has been to increase the use of macroprudential measures, which have been adopted by several countries in the region. Although in theory they are valid, we must remember that they are still at the experimental stage and there is still little evidence to support their effects. They are therefore a risky and unsuitable replacement for monetary policy. It is only natural that a country should want to halt part of this impact by using such measures, but perhaps the most important thing to bear in mind is that certain macroprudential measures inherently freeze the process of financial development, and this may be counterproductive in the long term in a region such as Latin America where the penetration of the financial sector is still very low, given the characteristics of the countries.

The alternative response to global monetary expansion is to take advantage of its momentum and see it as an opportunity for the region; in other words, leverage the crisis in Europe (and in general in developed nations) to the advantage of the region: firstly, make the most of the good international financing conditions to shore up direct investment in the region. in sectors that are vital to long-term growth such as infrastructure; secondly, ride the wave of the lower resilience offered by the “good times” to develop the reform process further, thereby enabling the rise in productivity and supply to make the increase in domestic demand sustainable. Of course, unlike the first method the second method for managing success in the region requires the development of a banking system and financial markets that act as a natural intermediary and a pillar for long-term growth.

But we must also be prepared to tackle structural risks

Finally, we must not only be prepared for cyclical risks; we must think about the structural risks that loom over the region. In particular, Mexico and the countries in Central America must face up to the risk of an exhausted growth model in the US based on consumption and leverage of the private sector. In South America, there is a risk of exhaustion in the growth model, based on domestic demand and high commodity prices. The result could be a reduction of potential growth to well below the current rate of 4%. At the moment, these concerns are focused particularly on Brazil, where there has probably been too much emphasis on implementing demand-oriented policies in order to boost growth. However, the situation is similar in other countries in the region.

What needs to be done to tackle this structural risk? Latin America must look inward to develop increased reserves of productivity and, therefore, potential growth. Thus it is essential to carry out supply-side reforms on five possible fronts: (i) fiscal reforms to extend the tax base, reduce distortionary taxes, foster the feeling that the tax system is fair, and improve the quality of expenditure; (ii) labor market reforms, increasing formality and mobility; (iii) regulatory reforms and a real increase in competition in the product, services and factor markets; (iv) more equal opportunities and social mobility to create incentives for private investment in physical and human capital and to strengthen the development of the domestic market; and (v) investment in physical and human capital, with a special focus on infrastructure and public investment in education and healthcare.

However, the region must also look beyond its own borders and become more integrated with the rest of the world, beyond the relationship it now has through commodity exports. In this respect, Mexico has made the biggest progress towards realizing its potential by extending its presence in global chains of production. The region as a whole must take advantage of its close proximity to key markets, particularly given rising shipping costs. It is therefore crucial to develop a tight-knit network of free trade agreements, the Pacific Alliance being an important example. As a bonus, opening up more commercially to the main developed markets may counteract the dangerous effects of the foreign-currency war caused by the lax monetary policies of developed countries.

5. Tables

Table 1
GDP (% yoy)

	2011	2012*	2013*	2014*
Argentina	8.9	1.9	3.0	2.8
Brazil	2.7	0.9	3.6	4.0
Chile	6.0	5.6	4.8	4.8
Colombia	5.9	3.7	4.1	5.0
Mexico	3.9	3.9	3.1	3.1
Panama	10.7	10.0	6.3	5.9
Paraguay	4.3	-1.0	10.2	4.4
Peru	6.9	6.3	6.5	6.3
Uruguay	5.7	4.0	4.2	4.1
Latin America	4.4	2.8	3.6	3.7

* Forecasts
Source: BBVA Research

Table 2
Inflation (% yoy. average)

	2011	2012	2013*	2014*
Brazil	6.6	5.4	6.1	5.5
Chile	3.3	3.0	2.1	2.8
Colombia	3.4	3.2	2.3	2.8
Mexico	3.4	4.1	3.4	3.5
Panama	5.9	5.7	4.5	4.0
Paraguay	8.3	3.7	4.8	4.8
Peru	3.4	3.7	2.8	2.5
Uruguay	8.1	8.1	7.8	7.4
Latin America	6.8	6.2	6.7	6.4

* Forecasts
Source: BBVA Research

Table 3

Exchange rate (against USD, average)

	2011	2012	2013*	2014*
Argentina	4.13	4.55	5.42	6.56
Brazil	1.68	1.96	1.97	2.01
Chile	484	486	473	496
Colombia	1.848	1.798	1.758	1.749
Mexico	12.48	13.15	12.56	12.37
Panama	1.00	1.00	1.00	1.00
Paraguay	4.188	4.417	4.196	4.373
Peru	2.75	2.64	2.51	2.42
Uruguay	19.26	20.25	19.56	20.09

* Forecasts
Source: BBVA Research

Table 4

Interest Rate (%, average)

	2011	2012*	2013*	2014*
Argentina	13.34	13.85	15.39	16.85
Brazil	11.71	8.46	7.25	7.25
Chile	4.75	5.00	5.00	5.63
Colombia	4.10	4.94	3.77	4.27
Mexico	4.50	4.50	4.13	4.00
Panama	1.86	1.52	1.77	2.33
Paraguay	8.49	6.00	6.81	7.67
Peru	4.04	4.25	4.25	4.69
Uruguay	7.69	8.81	9.25	8.25

* Forecasts
Source: BBVA Researchs

Table 5

Current Account (% GDP)

	2011	2012*	2013*	2014*
Argentina	-0.1	-0.1	0.7	0.0
Brazil	-2.1	-2.4	-2.6	-2.9
Chile	-1.3	-3.3	-3.7	-4.2
Colombia	-3.0	-3.1	-2.7	-2.3
Mexico	-0.8	-0.7	-1.1	-1.4
Panama	-12.6	-10.0	-8.5	-7.3
Paraguay	-1.0	-2.0	-2.0	-1.9
Peru	-1.9	-3.8	-3.8	-3.5
Uruguay	-2.9	-3.8	-3.3	-3.0
Latin America	-1.0	-1.4	-1.7	-1.8

* Forecasts
Source: BBVA Research

Table 6
Fiscal balance (% GDP)

	2011	2012	2013*	2014*
Argentina	-1.6	-1.9	-1.6	-1.0
Brazil	-2.6	-2.5	-2.1	-1.8
Chile	1.3	0.2	-0.2	-0.6
Colombia	-2.9	-2.3	-2.3	-2.6
Mexico	-2.6	-2.8	-2.4	-2.3
Panamá	-2.3	-2.5	-2.9	-2.7
Paraguay	0.7	-0.5	0.3	0.1
Peru	1.9	2.0	1.2	1.1
Uruguay	-0.9	-2.6	-2.1	-1.7
Latin America	-2.3	-2.6	-2.1	-1.9

* Forecasts
Source: BBVA Research

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