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Economic Outlook

Latam

Second Quarter 2013
Economic Analysis

- **Global growth remains strong, although there is significant disparity among geographical areas,** particularly in developed economies.

- **Latin America will increase its GDP growth from 2.9% in 2012 to 3.5% in 2013 and 3.7% in 2014,** in line with its potential. The three Andean countries, Panama and Paraguay will particularly stand out, while doubts continue regarding the recovery of Brazil.

- **Monetary policy will remain on hold in 2013,** except in Brazil, where the adjustment has already begun, and in Mexico, where it will ease in the third quarter. Upward pressure on exchange rates in the region will continue.

- **The region has to undertake reforms to increase productivity and thus consolidate its long-term growth.** The region has to recognize that sustainable per capita income growth cannot be based solely on capital accumulation and increasing employment.

Index

Closing date: May 13, 2013

1. Summary

Global growth remains strong, although the prospects are more uneven for the main economies. This greater disparity in growth rates will also extend to the developed economies, where recovery in Europe is lagging behind a U.S. that has proved resilient to the fiscal adjustment underway. In turn, emerging economies will continue to underpin global growth. We estimate that the global economy will grow 3.3% in 2013, only 0.1 point above the figure estimated for 2012. The rate in 2014 should be around 4%, although the risks remain tilted to the downside.

The international backdrop continues to present major challenges for the region, including moments of extreme market volatility, a downward trend in commodity prices and increased capital inflows. Capital inflows continue boosted by the quantitative easing policies of various central banks in the main developed economies. The challenge for most Latin American countries is still to manage these flows, since the latest available data show that they continue at relatively high levels.

Domestic demand will underpin sustainable growth in the region. Latin American GDP will grow at 3.5% in 2013 and 3.7% in 2014, if Brazil finally recovers. Despite some moderation at the start of the year, the confidence indicators continue at high levels in most countries in the region. The aggregate growth rates in the region will continue to increase over the coming quarters, as Brazil joins the buoyant economies in the rest of the region, although in this case the risks on growth have a strong downward bias. The three Andean countries will grow particularly strong, Paraguay will recover and Panama's economy will keep a strong dynamism. Growth will continue to converge at the region's potential (around 4%) in 2014.

Inflation will in general remain within the target ranges of the central banks over the next two years. It is currently outside the target range in most countries, except for Peru and Colombia. In Chile and Paraguay, inflation has been under the target, while at the other end, in Uruguay, Mexico and Brazil it is above the range, although in the case of Mexico core inflation continues to be clearly anchored to the target. We expect inflation to return to within the target ranges of the respective central banks in 2013 and 2014, with the exception of Uruguay. In the case of Brazil, this will be achieved above all thanks to tax cuts and the handling of administered prices, as well as a tighter monetary policy.

The central banks will maintain a wait-and-see stance in 2013, and begin to raise interest rates early in 2014. In Brazil, however, the high rate of inflation forced an immediate toughening of the policy, which will continue. For the rest of 2013 there will be a balance between the weakness of the external scenario and domestic demand pressures in many countries. This will lead to stable interest rates in 2013, with the exception of Mexico and Brazil. In the case of Mexico, we expect a reduction of interest rates, given the easing in many of its neighboring economies. In contrast, in Brazil the high rate of inflation will lead to the continuing toughening of the monetary policy for a few more months. Starting in 2014 the tone of monetary policy will be less lax in the Andean countries and Paraguay, in line with the global recovery. At the other extreme, Uruguay will begin to reduce its official interest rates if the expected downturn in inflation is confirmed.

The domestic and international macroeconomic environment will continue to generate upward pressures on exchange rates in most countries. These pressures will be conditioned by the monetary expansion programs in some of the main developed economies, which will continue to generate pressures for capital inflows to the region. In some countries such as Peru, Brazil, Colombia and Uruguay, these pressures will still be countered actively by the economic authorities.

The strength of economic activity will put even more pressure on the external accounts, due to the robust domestic demand. Brazil's worsening external accounts are particularly notable, pointing to a considerable loss of competitiveness of the country's manufacturing sector. There will also be a significant deterioration in other countries in the region, such as Chile and Peru, as a result of the strong boost provided by domestic demand and the appreciation of exchange rates. With respect to fiscal balances, the general trend in the region will be to an improvement boosted on the revenue side, except for the Andean countries, where the weakness of demand in Colombia, the expected slowdown in Chile and the boost provided by expenditure in Peru will lead to a deterioration in the fiscal balances. It is important to keep track of the fiscal and external balances, as they may increase the vulnerability of the region if the benign external financing conditions are reversed or if there is a strong correction of commodity prices.

The region should promote reforms to increase productivity, consolidate long-term growth and thus reduce vulnerability to external shocks. Latin America has achieved high growth rates in recent years, combined with a substantial reduction in poverty and a major increase in the middle classes. However, around 85% of this high growth rate has been driven by factor accumulation, above all of the labor force. If the region wants to consolidate its high rates of growth, it has to recognize that sustainable per capita income growth cannot be based solely on capital accumulation and increasing employment; productivity also has to improve. It is therefore essential to generate a consensus on the importance of structural reforms, including an improvement of the business climate, more competition in product and factor markets and increased savings to sustain investment on physical capital, above all on infrastructure, but also on human capital.

2. A more uneven global scenario

The world economy continues to grow, but there is an increasing uneveness between the different areas, especially within developed countries

Global growth continues its steady recovery, but the very different prospects for the developed economies are halting the strength of improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated at 0.7% by BBVA Research at the start of 2013, will have been slightly over 0.6% in the last quarter of 2012, but available indicators point to a growing dispersion of activity, particularly between the most developed economies, where the euro zone is once more lagging behind the U.S. and even Japan. Emerging economies will continue to underpin global growth. Overall, the rate of global growth in 2013 is expected to be at 3.3%, only 0.1 points above the figure estimated for 2012 (Chart 1). In 2014, the rate will be close to 4%, although the risks continue to be downside.

Europe has withstood recent shocks, although recovery is being delayed to 2014 despite the role of the ECB as a firewall against financial tensions

In the Euro Zone, the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show a general cyclical weakness beyond the European periphery, which justifies the ECB's recent interest-rate cut.

This is a positive measure, although it is unlikely in itself to reduce the financial fragmentation that is already having less impact on sovereign issuers and even large corporations, but is continuing to affect households and companies due to the uneven operation of the banking channel. The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. More is needed than the extension in the liquidity line for banks at least until 2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

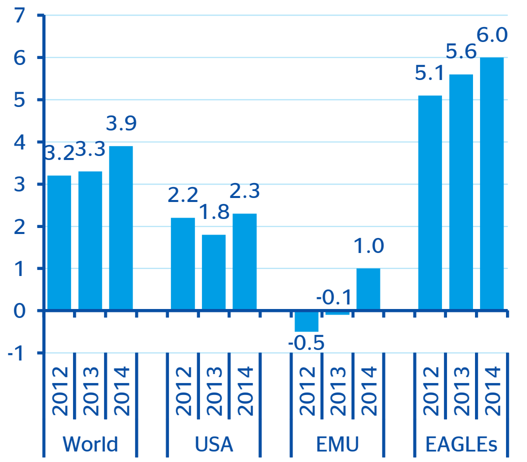
In this context, our scenario includes a downward revision of growth for the euro zone. We estimate GDP will fall by 0.1% in 2013 and rise 1% in 2014, 0.4 and 0.3 points, respectively, below the figure forecast in our January publication. In any event, the risks continue to have a downside bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

An additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation. A path that achieves a credible timetable for cutting the deficit without leading to a short-term growth deterioration that makes useless the adjustment effort. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. What is Europe missing? More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to the reforms in the peripheral countries.

In the US the strength of private demand against a backdrop of fiscal adjustment, is sustaining growth prospects

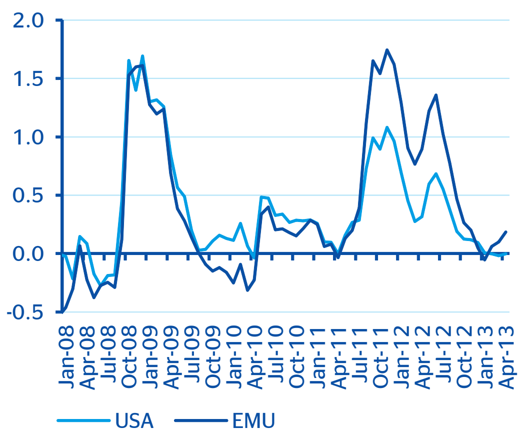
In the U.S., the strength of private demand is sustaining growth prospects despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short term has receded in terms of scenarios that included the closure of government offices (although without undertaking credible long-term fiscal consolidation measures). The elimination of some tax breaks and the entry into force of expenditure cuts have not triggered alarms in the financial markets (Chart 2), nor do they appear finally to have provided a substantial brake on private expenditure, thanks to monetary expansion that is maintaining very favorable financing conditions and is contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public demand in the GDP figures for the last two quarters.

Chart 1
GDP growth



The EAGLEs are the emerging countries that will contribute most to growth over the next 10 years. They are: China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
BBVA Financial Stress Indicator



Source: BBVA Research

In Asia, doubts linger about the strength of the Chinese growth; optimism in Japan on the back of its massive quantitative expansion

The Chinese economy has lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure for making monetary conditions tougher, so authorities have room for maneuver given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

The path of sustained monetary expansion, which the Central Bank of Japan has now joined, involves challenging problems. The idea that investors looking for returns should move to more risky assets may favor valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between the central banks with quantitative expansion policies, each of them looking to its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are supporting the major capital inflows well, it is essential to maintain vigilance over the domestic excesses this could generate.

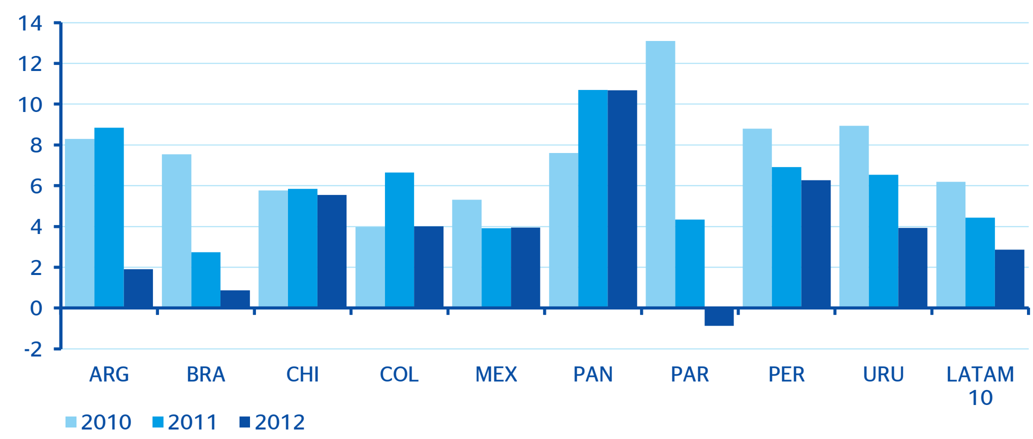
3. Latin America remains strong

Growth in the region was 2.9% in 2012, below the figure for the two previous years, dragged down above all by the performance of Brazil

After growing 6.2% in 2010 and 4.4% in 2011, Latin America's GDP grew at a rate of 2.9% last year. This moderation was at least partly not only predictable but also desirable, as following the 2009 crisis when the region entered recession and its GDP slumped by 2.2%, growth remained above potential levels, which are only sustainable for a limited period.

In some countries moderation of economic activity was fairly gentle and growth remained robust in 2012. This is the case of Peru and Chile, where GDP grew by 6.3% and 5.6% respectively (Chart 3).

Chart 3
GDP growth, 2010-2012 (%)



Source: National statistics and BBVA Research

In Mexico, growth of 3.9% in 2012 suggests some moderation on the rate with respect to 2010, but not to 2011, when GDP grew by a similar amount. This trend reflects a slower and therefore more extended recovery from the 2009 crisis than in most other countries in the region, where the impact of the Lehman Brothers crisis was less strong and the recovery faster. At the same time, the relative robustness of the Mexican economy in 2012 is related to the recovery of the United States. In addition, the gains in competitiveness of its economy in recent years and the prospects of adopting a series of reforms that over the upcoming years could have a positive impact on growth in the country.

In Colombia, GDP growth slowed from 6.6% in 2011 to 4.0% in 2012. This is still a relatively high level, but below the economy's potential. In any event, in Colombia the slowdown is considerably more marked than in Peru, Chile and Mexico. The reason for this difference in Colombia is mainly the result of two temporary factors: logistical bottlenecks in the mining sector and a lower level of execution of public infrastructure investment.

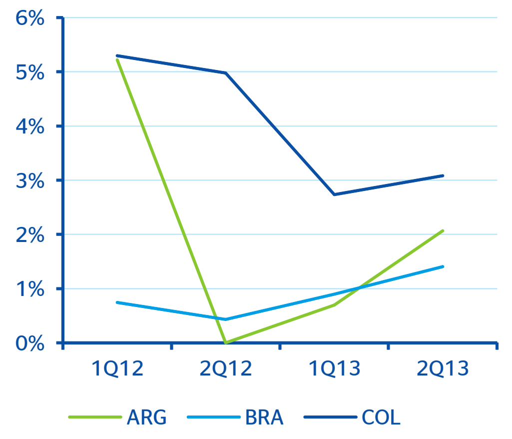
Among other countries in the region there has also been a notable slowdown in Brazil, particularly last year, when GDP growth was barely 0.9%. The country's sluggish growth is related to loss of competitiveness in the manufacturing sector, moderation in credit growth (in part due to increased household debt) and uncertainty with respect to the economic policies adopted in the country. The weak Brazilian economy in part explains the slowdown in Argentina (from GDP growth of more than 8% in 2010-2011 to 1.9% in 2012). This impact was amplified by idiosyncratic factors such as the impact of the unfavorable weather conditions on the agricultural harvest.

Finally, there is also a wide variety among the smallest economies in Latin America. Panama grew at a rate of 10.7%, the same as in 2011, and it still has to converge to a more sustainable rate, with major investment projects continuing for the next two years. In Uruguay, the process of moderation towards its potential level occurred last year, when GDP grew by 3.9%. Despite the sluggish growth of its two neighbors, expansive economic policies avoided a steeper slowdown. However, in Paraguay, the impact of livestock health problems on meat exports, as well as the bad agricultural harvest, led to a contraction of 0.9% last year.

In general, therefore, the process of growth moderation that begun in 2010, following the recession of 2009, continued into 2012. Despite idiosyncratic conditions playing a clear role in determining the steepness of the slowdown in each country, the continuous, though steady, loss of strength in the global economy is a factor that has to be taken into account among the reasons explaining the performance of the countries in the region in recent years (after contracting by 0.6% in 2009, global GDP grew at 5.0% in 2010, 3.9% in 2011 and around 3.2% in 2012).

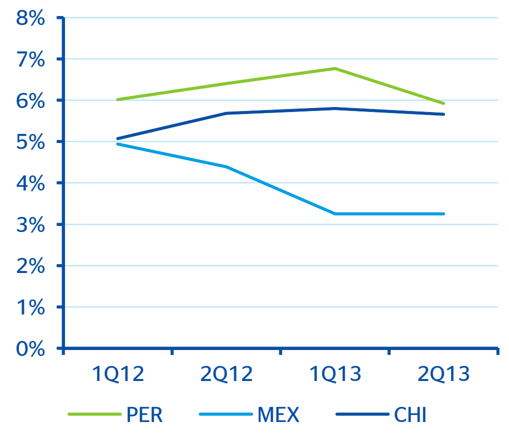
At the same time, the quarterly data suggest that recovery of economic activity is already underway in the countries where the process of slowdown has been most abrupt (Chart 4) and that the slowdown continues in all the countries where it has been gentlest (Chart 5).

Chart 4
GDP growth in quarterly terms (y/y %)



Source: National statistics and BBVA Research

Chart 5
GDP growth in quarterly terms (y/y %)



Source: National statistics and BBVA Research

The international backdrop continues to present major challenges for the region, including high market volatility, a downward trend in commodity prices and increased capital inflows

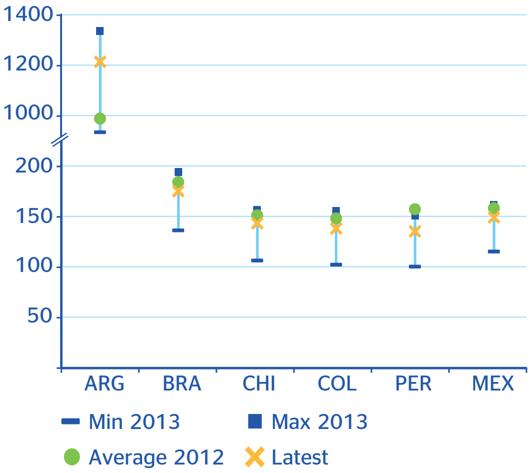
As mentioned in the first section of this report, the international backdrop has evolved and risks of a major disruption of global markets have receded in recent months. This should mean global GDP growth will no longer diminish this year, with a rise of around 3.3% (compared with 3.2% in 2012). However, turbulence and uncertainty persist with respect to the developed economies, and also with respect to the continuing growth of some emerging economies, such as China.

Among other consequences, this turbulence generates fluctuations in global risk aversion, which in turn impact the countries of Latin America through changes in its risk premiums. In this sense, the wide fluctuations of these risk premiums are a measure of the impact of the volatility of global financial markets on the region (Chart 6).

In this environment, despite the fact that international trade should be more buoyant than in 2012, commodity prices should on average remain under the prices registered last year (Chart 7). We expect China's GDP to achieve a growth of 8.0% this year[1], but if this does not happen, as some of the market has been speculating, it would lead to a greater downward adjustment on commodity prices, which will be an additional challenge for countries in the Latin America region.

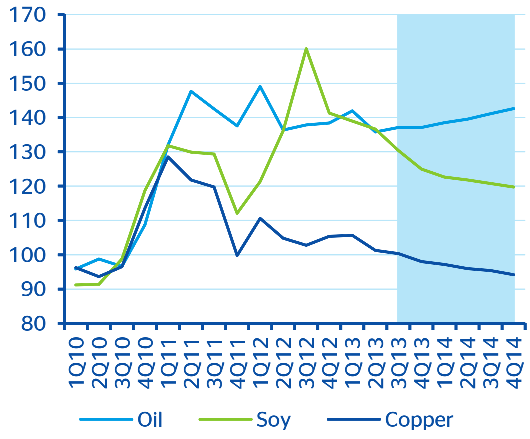
1: For more details, see our China Economic Outlook for the second quarter of 2013.

Chart 6
Risk premiums - EMBI (bps)



Source: Haver Analytics

Chart 7
Commodity prices (2010 average = 100)



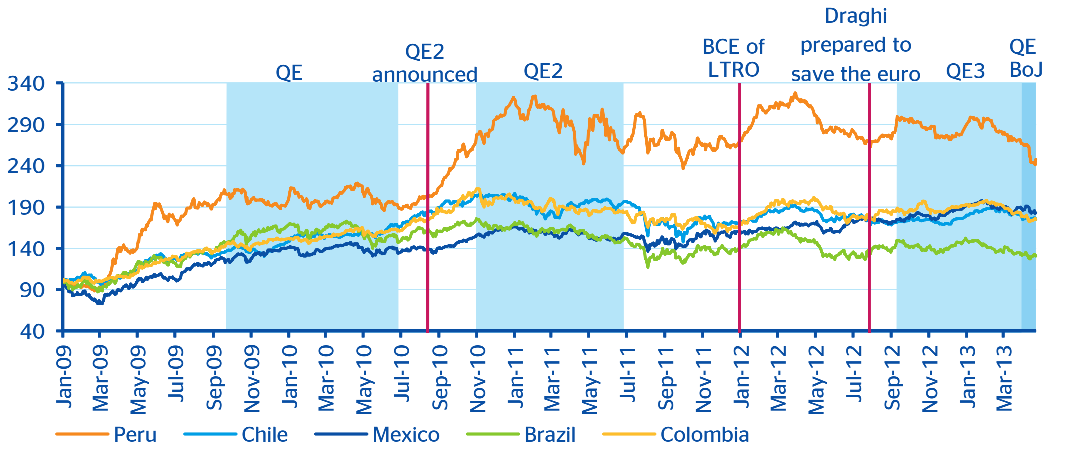
Source: Bloomberg and BBVA Research

Another challenge for Latin American countries is to continue managing foreign capital inflows, whose pressure will increase as a result of the monetary expansion program recently announced in Japan. As we have highlighted in previous publications (see, for example, our Latin America Economic Outlook for the first quarter), these flows have the potential to distort the price of domestic assets and increase doubts regarding the appropriateness of a possible increase of interest rates in the current circumstances[2]. In particular, as discussed below, capital flows could contribute to an excessive exchange-rate appreciation in the countries of the region. This appreciation is therefore one of the main challenges that have to be faced by the authorities in most Latin American countries.

Available data show that capital flows to Latin America continue at relatively high levels, at least since the second half of last year, when the ECB strengthened its commitment to the defense of the euro and the US Federal Reserve announced a new round of monetary stimuli, between them contributing significantly to reducing global risk aversion. At the same time, the flows to the region continue, despite the lack of confidence in the markets with respect to Brazil (for local reasons, such as moderation in growth, combined with growing inflation, as well as fears of what could be excessive intervention by the government in various economic areas). The most recent data on flows suggest that foreign capital inflows have already increased following the announcement of monetary expansion in Japan.

2: For a more detailed discussion of the potential impact that monetary expansion in developed economies can have on emerging economies, and the different response of economic policy, see for example the economic report "The Impact of the QE in Emerging Markets: Managing Success Problems", of November 2012.

Chart 8
Stock markets (January 2007 = 2007)



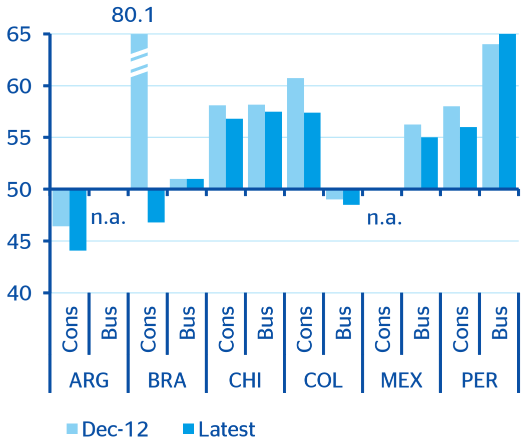
Source: Haver Analytics

Domestic demand will underpin sustained growth over the next two years. Latin American GDP will grow at 3.5% in 2013 and 3.7% in 2014, if Brazil finally recovers

Despite some moderation at the start of the year, confidence indicators continue at a high level in most countries in the region (Chart 9). This moderation strengthens the prospects of a slight slowdown in activity in countries such as Chile, Mexico and Colombia (although in the case of Mexico and Colombia the slowdown is expected to be reversed over the year). However, in other countries in the region the data on economic activity suggest that despite the moderation of confidence indicators, the rate of economic expansion will either be maintained, as in the case of Peru, or even speed up, as in Brazil in Argentina.

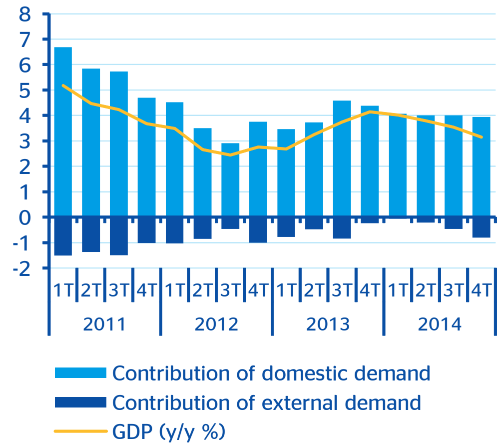
As an aggregate, growth in the region bottomed out in the third quarter of last year, and we consider that the recovery that began in the fourth quarter of 2012 will continue this year (Chart 10). Given that the flagging growth in the region last year was basically the result of lower activity in Brazil and Argentina, the two countries that between them account for nearly 50% of the region's GDP, the recovery that we expect to materialize there will be fundamental for speeding up aggregate GDP in the region.

Chart 9
Confidence indicators of consumers (Cons) and businesses (Bus): December 2012 and latest available data*



* Values over 50 indicate confidence. Latest data: February 2013 (COL Bus), April 2013 (ARG Cons, BRA Bus), March 2013 rest.
Source: National statistics and BBVA Research

Chart 10
GDP growth (y/y %) and contribution of domestic and external demand (pp)



Source: National statistics and BBVA Research

In the case of Brazil, the acceleration observed at the end of last year, and above all at the start of this year, is the result of the expansive tone of both fiscal and monetary policy (despite the cycle of monetary tightening that the Central Bank of Brazil will be carrying out in the coming months). The low level of inventories and the prospects for a better agricultural harvest are also behind the recovery. A better harvest, as well as the resurgence of activity in Brazil, should boost recovery in Argentina, where the most recent economic data already point to a more buoyant economy this year.

Thus we forecast that in 2013 Brazil's GDP will grow by 3.4% and Argentina's by 3.0%. In both cases these values are substantially higher than those recorded in 2012 (0.9% and 1.9% respectively). However, the risks with respect to this growth forecast in Brazil are strongly biased downward, as there is a significant probability that the surge in growth based on the boost from domestic demand is only temporary, and will be dragged down by household indebtedness, inflationary pressure and the tightness already observed in the labor market[3].

In Colombia, the acceleration in economic activity that we expect will take place starting midway through this year will also contribute to increase average growth in Latin America. This acceleration will be determined by the recent monetary stimulus and by a series of other measures taken by the government, many of them included in a stimulus package announced recently. In any event, the relative weakness of the economy in the first half of the year should prevent the Colombian GDP from growing much more this year than in 2012. Specifically, we expect a growth of 4.1% this year, compared with 4.0% in 2012.

In Peru, increased public expenditure will prevent slower exports (in part due to lower production of metals such as gold and copper than expected three months ago) from dragging growth this year below the 2012 level. Our estimates suggest that Peru's GDP should grow by 6.5% in 2013, slightly above its potential, and also above the figure of 6.3% last year.

In Chile and Mexico we expect the GDP to slow down with respect to the 2012 figure. In the case of Chile, this is due to a slower rate of investment in machinery and equipment, and despite the continued strength of private consumption. In the case of Mexico, it will be because of the expected slower growth in the United States. We expect growth in Chile at 5.0% and in Mexico at 3.1% in 2013.

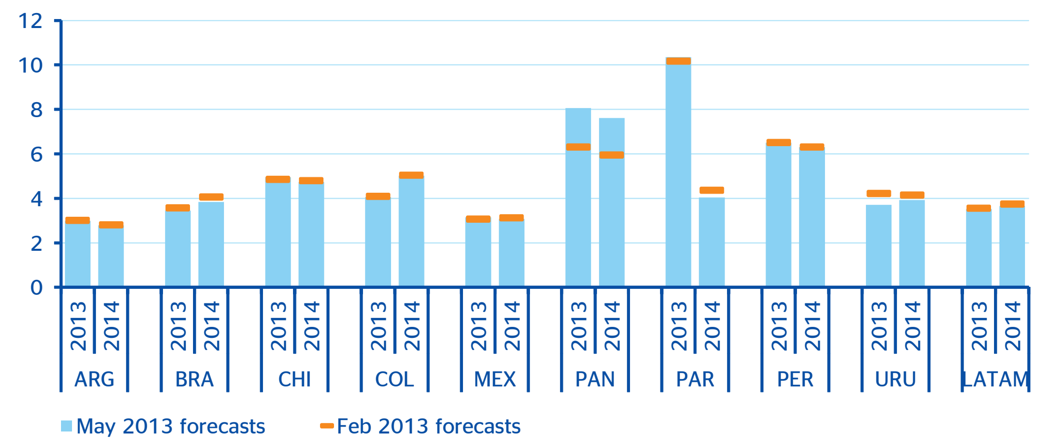
3: For a discussion of the main idiosyncratic risks for the Brazilian economy, see for example, the Brazil Economic Outlook for the first quarter of 2013.

Finally, our forecast is for GDP to upturn strongly in Paraguay, due to the recovery of agricultural production and the boost from Brazil and Argentina, and for it to moderate slightly in Uruguay and Panama.

Overall, taking into account these forecasts for each of the main countries in the region, we project a GDP growth of 3.5% in Latin America in 2013. This figure is practically the same as what we forecasted three months ago (3.6%), as the upward adjustments we made in our forecasts for Chile, Panama and Paraguay have almost entirely offset the slight downward adjustment in our forecasts for Brazil (due to the impact of an unexpected monetary toughening) and Uruguay (Chart 11). As mentioned earlier, the performance of the three Andean countries (Chile, Colombia and in particular Peru, at 5%, 4.1% and 6.5% respectively) is worth highlighting, as is the upturn in Paraguay (10.4%) after overcoming the effects of the drought, and the continued strength of Panama (8.1%), boosted by strong public infrastructure investment.

GDP growth estimates, 2013-2014 (%)

Chart 11
GDP growth estimates, 2013-2014 (%)



Source: BBVA Research

In 2014 we expect robust growth in the region to continue. More specifically, we project a slight acceleration toward 3.7% (without changes with respect to what we expected three months ago). This faster pace is largely due to i) the greater than expected strength of Brazil, in a context of presidential elections and the hosting of the soccer World Cup, factors that should support a growth of 3.8%; ii) continued recovery in Colombia; iii) the maintenance of growth in Mexico at 3.1%; and iv) expected moderation toward potential levels, which will be very gentle in Argentina, Chile and Peru (in Chile and Peru, partially conditioned by the increase in official interest rates).

Domestic demand will be the main determinant of growth in the region. In aggregate terms, growth should increase from 3.5% in 2012 to 3.9% in 2013 and 2014. Buoyant domestic demand will continue to be supported by the strength of labor and credit markets, as well as a series of positive structural changes implemented over recent years. In the case of the labor market, domestic demand will benefit from higher wages and lower unemployment and informality. In the case of credit markets, the process of credit penetration will continue, without an increase in default rates.

The strength of domestic demand will offset foreign demand, which in net terms will contribute negatively to growth. This is because the strength of domestic investment and consumption will put pressure on imports, while the relatively weak growth in developed countries will limit exports, despite favorable terms of trade.

Inflation will in general remain within the target ranges of the central banks in both 2013 and 2014

Inflation surprised downwards in Peru, Chile and Colombia at the start of the year, was slightly above the 2% target in Peru (2.6% in March) and slightly under the target in Chile, Paraguay and Colombia.

These surprises were determined by a scenario marked by moderation in commodity prices and a slowdown in growth, in the case of Colombia. In Chile, as well as moderation in commodity prices, prices benefited from a reduction in electricity tariffs.

Inflation below expectations in the first quarter of the year, and the prospects for tax cuts in Chile and Colombia have led us to reduce our inflation forecasts for this year. Specifically, we forecast that average inflation in Peru, Chile and Colombia will be 2.6%, 1.8% and 2.0% respectively, compared with our forecasts of 2.8%, 2.1% and 2.3% three months earlier.

Toward the end of the year, inflation in Chile will converge at 2.5%, a level that is slightly under the 3% target of its Central Bank; in Colombia it will continue just under 3%, which is the center of the target range; and in Peru it will remain at levels close to the present.

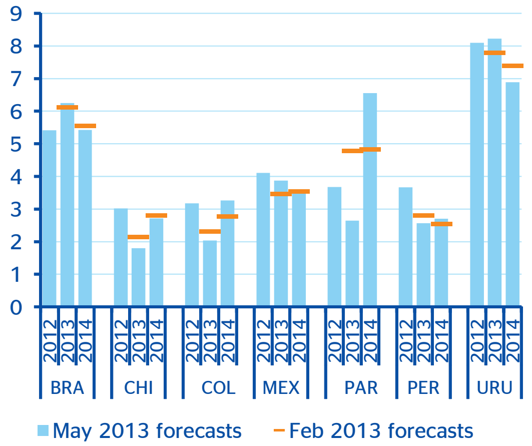
In 2014 inflation will remain within the target ranges of these three countries, at levels slightly higher than those in 2013 (Chart 12).

In Mexico and in Brazil, inflation recently exceeded the upper limit of their respective target ranges. In the case of Mexico, prices rose 4.25% in year-on-year terms in April. Inflation has therefore broken through the 4.0% ceiling after surprising downwards and remaining under this level since the end of last year, due to the reduction in some commodity prices, the positive impact of a stronger peso and falls in telecommunications prices. Despite it being above the upper limit of its target range and with the risk of some supply shocks not receding in line with expectations, we forecast that inflation will fall to 3.8% at the end of the year and that core inflation will continue anchored at around 3.0%. Inflation should therefore return to within the upper Banxico target range, where it will also remain in 2014.

Despite the fact that inflation in Brazil is also now above the upper limit of the Central Bank target range (inflation is currently 6.6% and the upper ceiling of the target range is 6.5%), the situation is very different from Mexico. In Brazil inflation has consistently surprised upwards since the end of last year, despite the impact of a series of extraordinary measures taken by the government to reduce domestic prices (among other things). These measures included the early implementation of the reduction in electricity tariffs, which also ended being bigger than expected, the reduction of taxes on a number of products with a significant weight in the consumer basket, including staple foods, and the postponement in the adjustment of public transport prices. In addition, medium-term inflation expectations are still not well anchored.

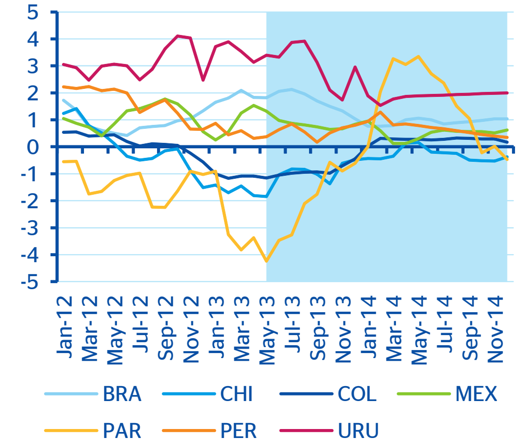
Pressure on domestic prices in Brazil comes from multiple sources, including: the expansive tone of monetary and fiscal policy; the robustness of the labor market; increased import tariffs; depreciation of the exchange rate in the second quarter of last year; and market perception that the central bank is not fully committed to inflationary convergence at the target of 4.5%. In any event, despite the expected recovery of domestic economy, we expect that inflation will continue to be consistently within the target range starting in the second half of the year. More specifically, we forecast that inflation will close the year at 5.5% and remain at similar levels in 2014. This reduction in inflation will be aided by positive base effects, as well as the monetary adjustment that is currently being adopted by the monetary authority, and lower pressure from the exchange rate.

Chart 12
Inflation, annual average (y/y, %)



Source: National statistics and BBVA Research

Chart 13
Countries with inflation targets: difference between inflation and central bank target (pp)



Source: BBVA Research and Haver Analytics

In Paraguay, the reaction of the economic authorities to greater demand pressures should mean that inflation will continue at around 4.5% at the end of 2013 and also in 2014, close to the country's inflation target.

Finally, Uruguay will continue to be an exception within the group of countries in the region that have a system of targets. Inflation there will remain higher (8.0% and 7.0% at the end of 2013 and 2014, respectively) and outside the target range of the Central Bank of Uruguay.

The central banks will remain in a wait-and-see mode in 2013, then move to a tougher stance at the start of 2014. The exceptions are Mexico, with a reduction of the rates in the third quarter, and Brazil, where the upward adjustment will continue

At the start of the year, the central banks of Mexico and Colombia announced reductions in their reference interest rates. In the case of Mexico, the lending rate was cut by 50 basis points to 4.0% in March, because i) inflation is expected to fall towards the target in the second half of the year; ii) there has been structural progress in the fight against inflation (such as the reduction of its level, volatility and persistence, and the lack of second-round effects); and iii) the weakness of global economic growth, and in particular the downward risk for growth in the United States.

In the case of Colombia, the adjustment that begun in June last year, when the monetary policy rate was at 5.25%, has continued this year. After three cuts of 25 basis points since January, the reference interest rate stood at 3.25% in March, very close to the all-time low of 3.0% observed for much of 2010. This monetary adjustment was determined by a domestic environment marked by the economy running out of steam since the middle of last year, as well as the moderation in inflation, the anchoring of expectations and an international environment of low growth, where excess global liquidity represents a risk in terms of appreciation of the currency (and other assets) for emerging economies.

Although the global environment could favor a cut in interest rates in other countries in the region, this has not happened, as domestic demand either continues very robust (as in Chile and Peru), or is already showing signs of recovery after low growth in 2012 (as in Paraguay). In other cases, such as Brazil and Uruguay, inflation continues to be an important source of concern.

In the specific case of Brazil, despite the external environment, at its most recent meeting the Central Bank was forced to increase the SELIC rate by 25 points to 7.50%, due to a growing risk that inflation could spiral out of control.

After the adjustments announced early in the year, we expect that interest rates will remain stable at current levels throughout the year in Colombia. The most recent monetary policy meetings of the Bank of the Republic in Colombia have reinforced this vision, although they also suggest that the risks are downside. In other words, an additional easing of monetary conditions could take place if the downward risks to the economy materialized; for example, if the economy did not react as expected to the monetary and fiscal stimuli adopted recently.

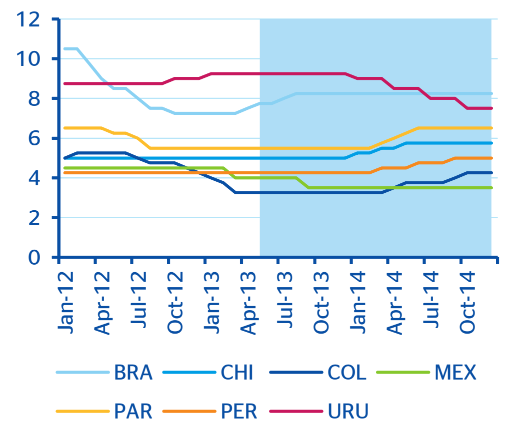
However, in the case of Mexico, the combination of three factors suggests an additional fall of 50 bps in September: first, core inflation has remained at around 3%, despite supply shocks; second, there is a certain pessimistic tone in Banxico with respect to the outlook for growth; and finally, a reduction in interest rates would partly correct the increasingly tight monetary policy in Mexico, given the monetary easing observed in various neighboring countries.

In Brazil, tougher monetary conditions should continue over the coming months. More specifically, we expect that additional adjustments of 25 basis points in the upcoming monetary policy meetings will result in a SELIC rate of 8.25%, a relatively low level by the country's standards. In our opinion, the main objective of increasing official interest rates has been to control inflation expectations in the medium term (basically 2014) and not necessarily to guarantee that inflation should converge to the target of 4.5%.

As in Colombia, and unlike Brazil and Mexico, the stability of official interest rates is likely to be maintained in the long term by all the other countries in the region with inflation target systems. In Chile and Peru external risks will continue to be reflected by domestic risks and prevent an increase in interest rates in 2013. It is however probable that the focus of the central bank of these two countries should be increasingly concerned with internal factors (the robustness of growth and the possible impact on inflation), as external risks lose their leading role. We also expect that interest rates will remain unaltered in Paraguay and Uruguay this year.

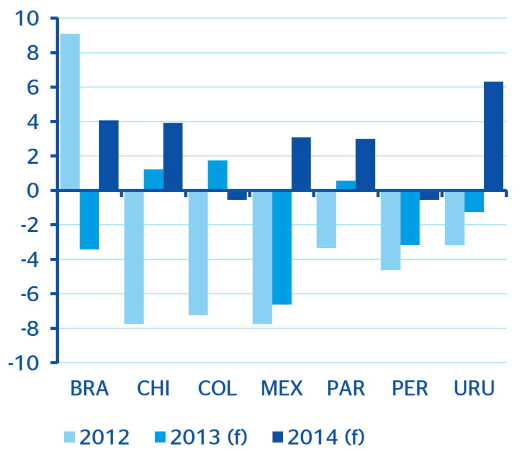
In 2014 we do not expect monetary adjustments either in Brazil or Mexico, where interest rates will therefore continue stable at 8.25% and 3.5% respectively; but we do expect them in the other countries of the region, where monetary policy will converge to less expansive levels. These adjustments will take place in the first quarter of 2014 in Chile, Peru and Paraguay and mid-way through the year in Colombia. In contrast, interest rates in Uruguay will be cut from 9.25% to 7.50% over 2014 due to the more moderate inflation we expect for next year (Chart 14).

Chart 14
Monetary policy interest rates (y/y %)



Source: National statistics and BBVA Research

Chart 15
Exchange rates



Source: National statistics and BBVA Research

The macroeconomic environment will continue to generate upward pressures on exchange rates in most countries

The monetary expansion programs and low interest rates adopted in some developed regions, as well as historically high commodity prices and the strength of economic activity in Latin America, all continue to put pressure on the currencies of most countries in the region.

In some countries such as Peru, Colombia, Uruguay and Brazil these upward pressures are being offset by intervention by the economic authorities, whether directly through dollar purchases by their central banks[4], or by the measures creating disincentives for foreign capital inflows, including the delay in the normalization of the monetary conditions or a greater reduction of interest rates than would be advisable in accordance with the other macroeconomic variables.

In Peru, these measures, as well as the frequent episodes of increased risk aversion, have prevented the Peruvian nuevo sol from appreciating so far this year (the currency has accumulated a slight depreciation of 2.7%), and it has appreciated only 0.8% in the last 12 months. In Colombia the measures adopted by the authorities, as well as the recent deterioration in the terms of trade and slowdown of economic activity, have generated a depreciation of around 4%, both YTD and in the last 12 months. In Brazil, intervention on the foreign-exchange markets helps explain the cumulative depreciation of 6% over the last 12 months, despite the marginal tolerance with respect to the appreciation of the Brazilian real due to concerns over inflation (which helps explain the appreciation of nearly 3% since the start of this year).

In the countries where there have been no recent interventions, such as Mexico and Chile, the appreciation of exchange rates has been more marked: 5% YTD and 8% compared with 12 months earlier in Mexico and 1% and 3% in the same periods in Chile.

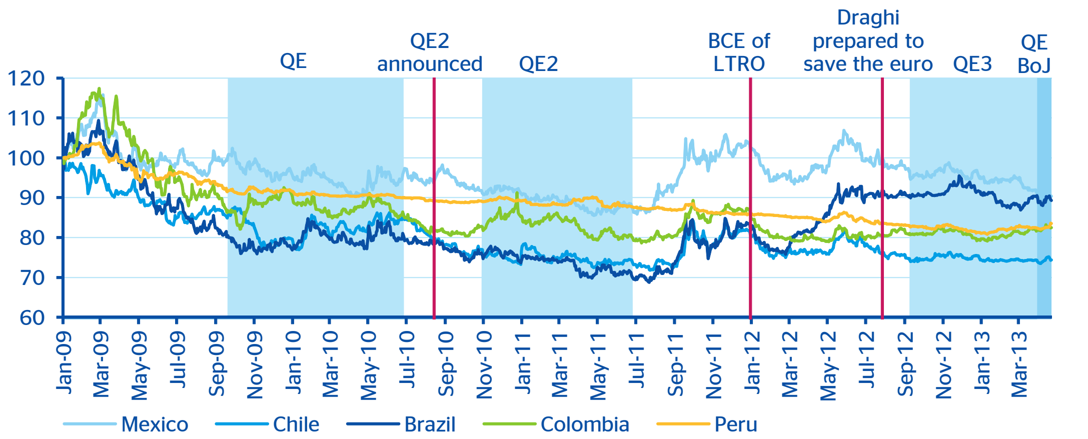
We forecast that in the short and medium term the strength of the economies in the region (which in many cases will involve an upward adjustment of interest rates), the level of global liquidity, and the weakness of the developed economies will all continue to have an impact on currencies in the region. However, the foreign-exchange interventions must continue in order to prevent a further appreciation of exchange rates and other assets.

More specifically, we expect a relatively stable exchange rate in Brazil, Colombia and Peru for the rest of the year and also in 2014. In Chile the expected reduction in copper prices (Chart 7) should lead to a slight depreciation of the Chilean peso. In Mexico, the optimism of global markets with respect to the country, largely due to prospects of the new government adopting pro-growth reforms, should generate an additional exchange-rate appreciation in 2013 (but not in 2014), so the Mexican peso will converge to its long-term equilibrium value. In accordance with the recent statement by the Mexican authorities, the peso will continue relatively depreciated for now, in both nominal and real terms, compared with the rate before the Lehman Brothers crisis (for our forecasts, see Chart 15 and the tables at the end of this report).

In any event, both the domestic and external environment, in general, favors the continued appreciation of real exchange rates in the medium term, whether by appreciation of the nominal exchange rates, or the positive inflation differential between the countries in the region and their main trading partners.

4: For a more detailed analysis of the foreign-exchange intervention strategies in the region by the central banks of Peru, Colombia, Uruguay and Brazil as the most active in resisting pressures toward appreciation, see the economic outlook "Foreign Exchange interventions in Latam: effective and sustainable?", to be published soon on www.bbvaresearch.com.

Chart 16
Exchange rates (January 2007 = 100)



Source: Haver Analytics

The strength of economic activity will deteriorate the external accounts in most countries in the region

The current-account balances continue to deteriorate in most of the region. Last year the deficits increased significantly in Chile, Peru and Uruguay, and somewhat less so in Colombia and Brazil. In these countries the deficit stood within a range of 2% to 5% of GDP in 2012 (Chart 17).

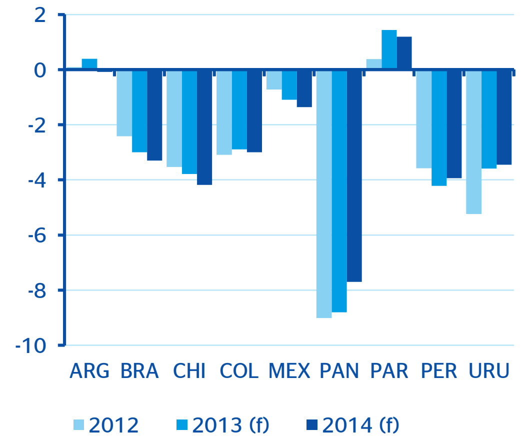
This deterioration is, in general, a direct result of the strength of domestic demand in these countries, in a global environment marked by the weakness of the developed economies. This is, for example, the case of Chile and Peru, although in Peru the maturity of various major mining investment projects should substantially improve the external balance starting in 2014. Some idiosyncratic problems have also contributed to the high current-account deficit in the region, such as export bottlenecks in Colombia and Peru, loss of competitiveness of the manufacturing sector and trading problems with Argentina in the case of Brazil.

However, this deterioration was not general in 2012. In Mexico, the gains in economic competitiveness and the relative recovery of the manufacturing sector in the United States prevented its strong domestic demand from generating an larger external deficit, which continues low (0.7% of GDP in 2012). In Argentina and Paraguay the external accounts also deteriorated last year, as in these countries domestic demand slowed notably. Finally, in Panama the current-account deficit fell, but remained at a very high level (9.0%), as domestic demand grew above 12.0% for yet another year.

The deterioration in the external deficits of countries in the region is likely to continue over the next few years, given the combination of an expansive domestic cycle and the weakness of many developed economies. Although the improved agricultural harvests could benefit countries in the south cone of the region and the moderate domestic demand may reduce Panama's external imbalance, the region as a whole will continue to increase its external deficits.

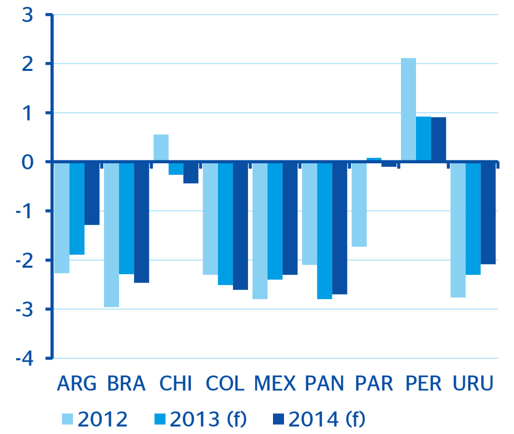
In any event, these deficits will continue at very manageable levels, above all considering that international reserves are very high and that external finance is mainly through FDI inflows (which are more stable than short-term flows and also help increase production and export capacity). Overall, this trend in the external deficits is an important element to keep an eye on, as it may significantly increase the vulnerability of the region if the benign external financing conditions are reversed, or if there is a strong correction of commodity prices. However, both scenarios currently have a very limited possibility of materializing.

Chart 17
Current account balance (% GDP)



Source: National statistics and BBVA Research

Chart 18
Fiscal balance (% GDP)



Source: National statistics and BBVA Research

Despite the fact that strong economic activity will benefit tax revenues and that commodity prices will remain high, the fiscal balances will worsen in the Andean countries

Although the impact of the strength of domestic demand on the external accounts is negative, its effect on tax revenues is in general positive. The increase of these revenues has allowed many countries in the region to adopt a fiscal policy of greater support to domestic growth without this necessarily implying a significant deterioration of the public balances. Also contributing in this direction are: the maintenance of commodity prices at historically high levels; the adoption of fiscal reforms and rules to guarantee the solvency of the public balances (notable in this respect are the measures announced last year in Colombia); and lower financing costs (particularly in Brazil, after the structural cut in the SELIC rates implemented since 2012, and despite the recent rise).

The deficit remains under the level of 3.0% of GDP in practically all the countries in the region, and it is also expected to continue to fall in the upcoming years (Chart 18). The main exception will be the Andean countries, where the weakness of demand in Colombia, the expected slowdown in Chile and the expenditure stimulus in Peru will lead to a worsening of the fiscal balance.

At the same time, a reduction of fiscal support to economic activity should be welcomed (except probably in the case of Colombia, given the recent slowdown). It could reduce pressure on domestic demand, moderate upward pressures on exchange rates, and as a result ease the monetary policy dilemma currently faced by many central banks in the region. In addition, it will allow a reduction of the size of the fiscal deficit in the countries in the region. Although these deficits are at manageable levels, in general they depend closely on commodity prices and thus are relatively vulnerable to a negative external shock.

4. Latin America must not lose sight of the long-term picture

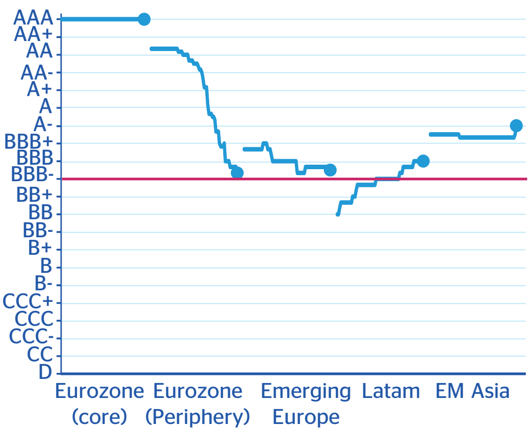
The region has achieved high growth rates with low levels of vulnerability in recent years

For a long time, Latin America was a region marked by macroeconomic instability, high inflation, poverty and excessive inequality. However, as we have highlighted in other issues of this Latin America Economic Outlook, the region has experienced a major transformation in the last 20 years.

Latin America is now a region that has proved to be tremendously resilient to this crisis and has a huge growth potential in the medium and long term. But the “new normal” in Latin America is not only higher growth than in developed countries, nor the fact that it has overcame the global crisis of 2008 without major problems; it is above all progress in convergence with the developed world and less vulnerability. This progress has been manifested in high growth rates and low inflation, also accompanied by more reduced and manageable fiscal and external deficits and, as a result, a sustained reduction in public and foreign debt. Finally, prudent economic policies have been consolidated in most of the countries in the region, and this process has made room for countercyclical monetary and fiscal policies. Together with the commitment to flexible exchange rates, these represent an essential buffer against external crises. This has allowed Latin America to make decisive progress toward middle-income levels. Credit risk ratings have also reflected this progress, with most of the countries being awarded middling ratings above investment grade (Charts 19 and 20).

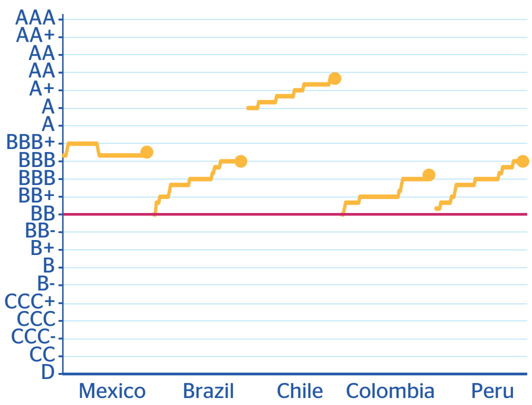
But the region’s achievements go beyond improving macroeconomic management. The last decade has witnessed a substantial and sustained reduction of poverty and inequality, without doubt boosted by greater growth and institutional stability. Poverty has fallen in nearly all the countries. In Latin America as a whole, 55 million fewer people were living under the poverty line in the region in 2011, compared with 2000 (IDB, 2013). At the same time, there has been a major increase in the middle classes, which have increased from around 100 million people in 2000 to 150 million in 2010, as we mentioned in our Latin America Economic Outlook last quarter. Although the figure remains high, there has also been a substantial reduction in inequality. Between 2000 and 2011, the Gini inequality coefficient fell by 6 percentage points or more in Argentina, Brazil, Peru and Venezuela, more than 3 percentage points in Chile and Mexico, and 2 points in Colombia (IDB, 2013).

Chart 19
Sovereign rating by regions 2007-2012



The horizontal line indicates investment grade
Source: BBVA Research

Chart 20
Sovereign rating index in Latin America 2007-2012



The horizontal line indicates investment grade
Source: BBVA Research

However, in order to avoid falling into the middle-income trap a high potential growth rate has to be consolidated through progress in productivity

Despite the good progress made in the region over recent years, it is important to compare its performance with that of other emerging economies. The growth rates in Latin America continue to be lower than in the east of Asia. In addition, it is also true that at least some of the good growth results over the last decade have been the result of high commodity prices for exports associated with Asian growth and the good financing conditions on international markets (recently boosted by quantitative easing programs by central banks in many developed countries). Finally, and perhaps most importantly, since 2000 productivity growth has been similar in Latin America and in the United States, but the region has continued to lose ground against Asia.

At the same time, savings and investment rates in the region continue to be very low compared with those in Asia. The rates of savings in Latin America range from 18% of GDP in Brazil to 24% in Mexico and Chile, which contrasts with 31% in India, 34% in Malaysia, and 51% China. And despite the recent progress, Latin America continues to be the region with the highest inequality rates, and poverty rates that are far higher than those to be expected given the region's income per capita.

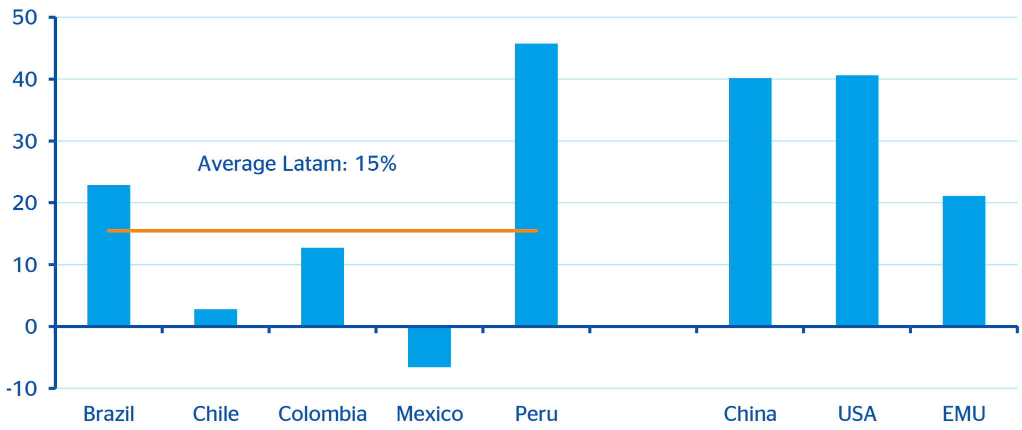
The strong growth of Latin America during the last decade has been mainly boosted by factor accumulation (above all, of the labor force, taking advantage of the demographic boom in many countries). This explains around 85% of the growth over the last 10 years (the rest is explained by the total factor productivity (TFP). More important still, most of the difference in growth between Asia and Latin America can be attributed to the difference in productivity growth between the two regions.

As we have explained in previous issues of Latin America Economic Outlook, this process of factor accumulation has benefited from institutional changes and more prudent handling of macroeconomic policy in the last 20 years, but it is a process that naturally tends to become exhausted once the benefits of eliminating these initial barriers to development disappear. In fact, most of the contribution of the labor factor to growth in the region is due to the reduction of unemployment, which has its natural limits, while the increase in the population of working age and in the participation rate will be lower in the future. In addition, in many countries investment is closely focused on the mining and extractive sectors, in many cases with falling productivity.

The region has to recognize that sustainable growth requires an improvement in productivity. It cannot depend only on continued factor accumulation and favorable international conditions, including high export commodity prices. Two decades ago, a consensus arose about the need for prudent monetary and fiscal policies to achieve macroeconomic stability, which in turn was a necessary condition for a return to growth. However, there does not now appear to be consensus in the region that productivity growth is essential for maintaining this rapid growth; and even less consensus on the policies needed to achieve such a productivity growth.

The elements needed to increase productivity are as follows: structural reforms, including an improvement of the business climate; more competition in product and factor markets; and an increased savings rate that can fuel greater investment in physical (above all infrastructures) and human capital.

Chart 21
Contribution of total factor production (TFP) to GDP growth, average between 2003 and 2012 (% total growth)



Source: BBVA Research

5. Tables

Table 1
GDP (% yoy)

	2011	2012*	2013*	2014*
Argentina	8,8	1,9	3,0	2,8
Brazil	2,7	0,9	3,4	3,8
Chile	5,9	5,6	5,0	4,7
Colombia	6,6	4,0	4,1	5,0
Mexico	3,9	3,9	3,1	3,1
Panama	10,7	10,7	8,1	7,6
Paraguay	4,3	-0,9	10,4	4,0
Peru	6,9	6,3	6,5	6,3
Uruguay	6,5	3,9	3,7	3,9
Latin America	4,4	2,9	3,5	3,7

* Forecasts
Source: BBVA Research

Table 2

Inflation (% yoy. average)

	2011	2012	2013*	2014*
Brazil	6.6	5.4	6.2	5.4
Chile	3.3	3.0	1.8	2.7
Colombia	3.4	3.2	2.0	3.3
Mexico	3.4	4.1	3.9	3.5
Panama	5.9	5.7	4.6	4.0
Paraguay	8.3	3.7	2.6	6.6
Peru	3.4	3.7	2.6	2.7
Uruguay	8.1	8.1	8.2	6.9
Latin America	6.8	6.2	6.9	6.7

* Forecasts
Source: BBVA Research

Table 3

Exchange rate (against USD, average)

	2011	2012	2013*	2014*
Argentina	4.13	4.55	5.41	6.56
Brazil	1.68	1.96	1.96	2.00
Chile	484	486	473	496
Colombia	1,848	1,798	1,812	1,810
Mexico	12.48	13.15	12.18	12.25
Panama	1.00	1.00	1.00	1.00
Paraguay	4,188	4,417	4,162	4,380
Peru	2.75	2.64	2.54	2.45
Uruguay	19.26	20.25	19.07	19.69

* Forecasts
Source: BBVA Research

Table 4

Interest Rate (%, average)

	2011	2012*	2013*	2014*
Argentina	13.34	13.85	16.13	18.03
Brazil	11.71	8.46	7.83	8.25
Chile	4.75	5.00	5.00	5.63
Colombia	4.10	4.94	3.35	3.75
Mexico	4.50	4.50	3.92	3.50
Panama	1.86	1.51	1.62	2.25
Paraguay	8.49	6.00	5.50	6.21
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	-0.3	0.1	0.4	-0.1
Brazil	-2.1	-2.4	-3.0	-3.3
Chile	-1.3	-3.5	-3.8	-4.2
Colombia	-2.8	-3.1	-2.9	-3.0
Mexico	-0.8	-0.7	-1.1	-1.4
Panama	-12.2	-9.0	-8.8	-7.7
Paraguay	1.1	0.4	1.4	1.2
Peru	-1.9	-3.6	-4.2	-3.9
Uruguay	-2.9	-5.2	-3.6	-3.4
Latin America	-1.5	-1.6	-1.8	-1.9

* Forecasts
Source: BBVA Research

Table 6

Fiscal balance (% GDP)

	2011	2012	2013*	2014*
Argentina	-1.6	-2.3	-1.9	-1.3
Brazil	-2.6	-3.0	-2.3	-2.5
Chile	1.3	0.6	-0.3	-0.4
Colombia	-2.9	-2.3	-2.5	-2.6
Mexico	-2.6	-2.8	-2.4	-2.3
Panamá	-2.2	-2.1	-2.8	-2.7
Paraguay	0.7	-1.7	0.1	-0.1
Peru	1.9	2.1	0.9	0.9
Uruguay	-0.9	-2.8	-2.3	-2.1
Latin America	-2.2	-2.5	-2.2	-2.2

* Forecasts
Source: BBVA Research

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This report has been produced by the Latam Coordination Unit:

Chief Economist
Juan Ruiz
juan.ruiz@bbva.com

Enestor Dos Santos
enestor.dossantos@bbva.com

Miguel Poblete
miguel.poblete.contractor@bbva.com

Jaime Costero
jaime.costero@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo.lopez@bbva.com

With Contribution:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

BBVA Research

Contacts details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com