

Latin America: Is it for real this time?

Joaquin Vial. Chief Economist South America, BBVA Research

Sao Paulo, April 2011.

Main messages

- Latin America has changed, both politically and economically
- A great deal of macroeconomic stability has been achieved: inflation has been conquered in most countries and fiscal discipline is now widespread
- These changes, together with external factors such as growing ties with Asia and benign terms of trade, have contributed to sustained growth in the region
- The region has passed major economic and political tests, and is emerging stronger from the financial crisis: higher credit ratings and lower risk premiums are evidence of this
- Major challenges remain, but growing middle classes with an stake in the good performance of the economic system is a major source of stability
- In the short-term several countries face severe risks of overheating. Central banks are reacting but they need support from fiscal policies to avoid excessive appreciation of the their currencies.
- We are convinced that this time is for real: Brazil and Latin America are in a path of sustained progress and convergence.

Contents

- ⑩ Section I: Latin America breaks with the past
- ⑩ Section II: Latin America's stress test
- ⑩ Section III: A bright future
- ⑩ Section IV: Short-term challenges

1

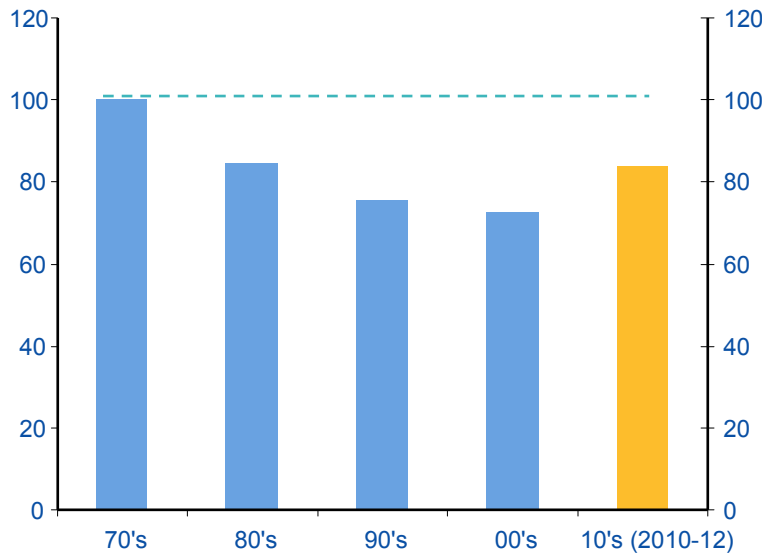
Latin
America
breaks with
the past

Breaking with the past

- Latam is beginning to close the Income Gap after decades of disappointment
- The financial crisis has not stopped the convergence process. In the past, recessions meant long periods of divergence

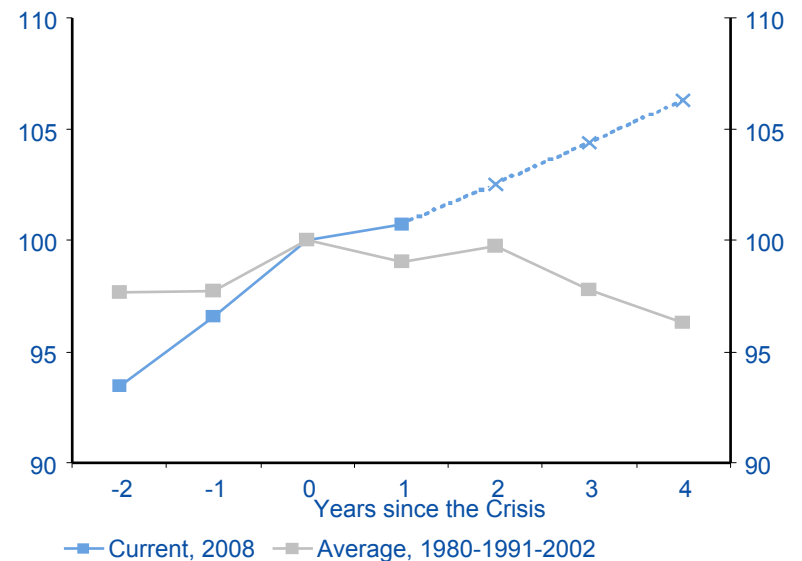
LatAm, GDP per capita, relative performance to US, decade average. 70's=100

Source: BBVA Research



LatAm, GDP per capita, relative performance to US, crisis(*) comparison. (*) US recession in terms of GDP pc.

Source: BBVA Research



Breaking with the past

- Economic reforms that began in the 80s are transforming Latin America.

Macroeconomic Reforms

- Fiscal consolidation with higher and better taxes → Fairness and stability.
- Independent Central Banks → Better monetary policies
- Financial reform → Corrected previous mistakes, sound banking systems.
- Opening of the Economy → Reduced distortions, created new sources of growth and more competition.

Microeconomic Reforms

- From labor protection to targeted transfers to the poor → big gains in efficiency and fairness of social expenditure
- Liberalization of internal markets and privatizations → attraction of private investment
- Receptiveness of FDI → More private investment, integration into the Global Economy
- Pensions system reforms → Better, fairer and fiscally sound

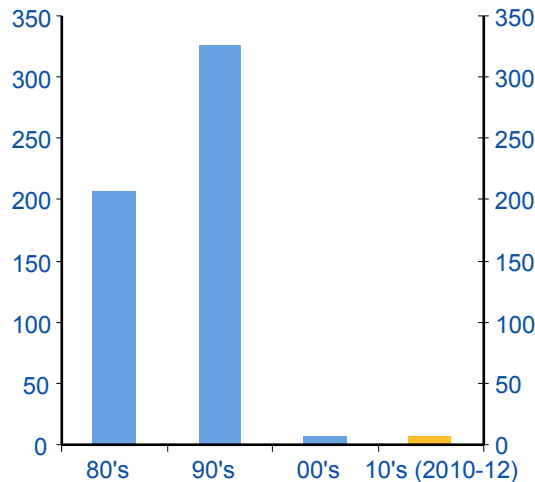
Better Business Climate for investment
and more equitable societies

Breaking with the past

- While taming inflation in the late 90s, the region made sustained progress in external and public solvency over the years

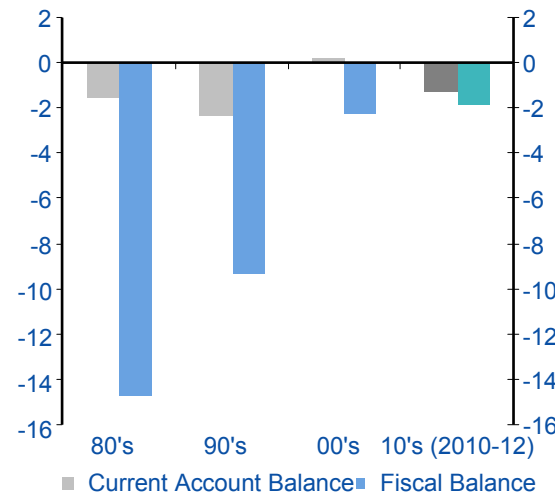
LatAm, Inflation
(CPI, % yearly average)

Source: BBVA Research



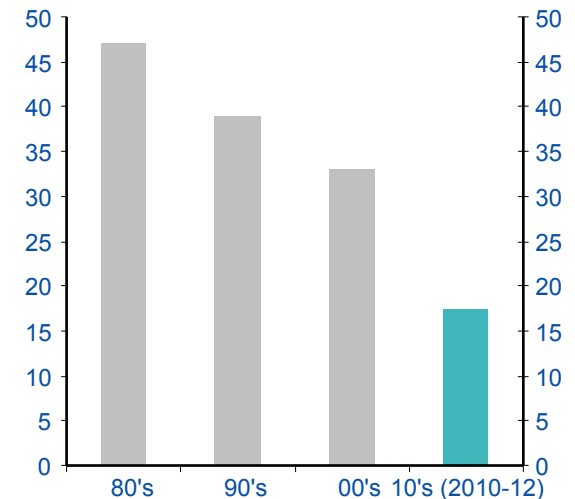
LatAm, External and Fiscal Balance.
(As % of the GDP)

Source: BBVA Research



LatAm, External Debt
(As % of the GDP)

Source: BBVA Research

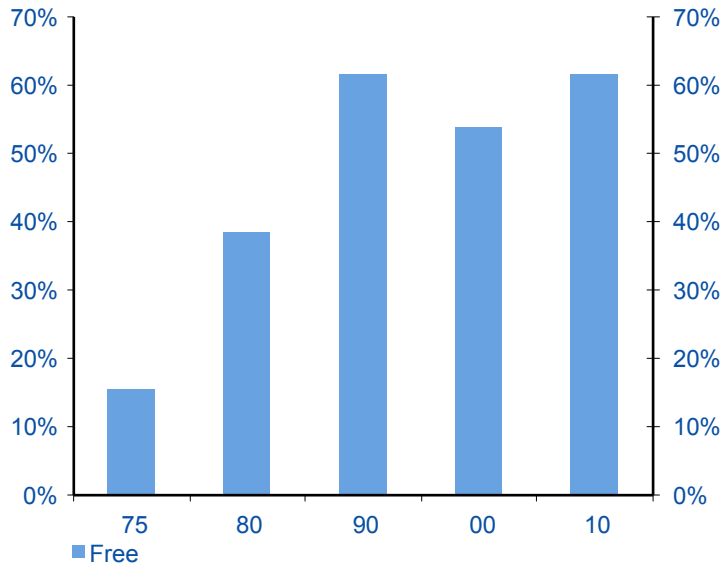


Breaking with the past

- Economic change has come along with institutional progress

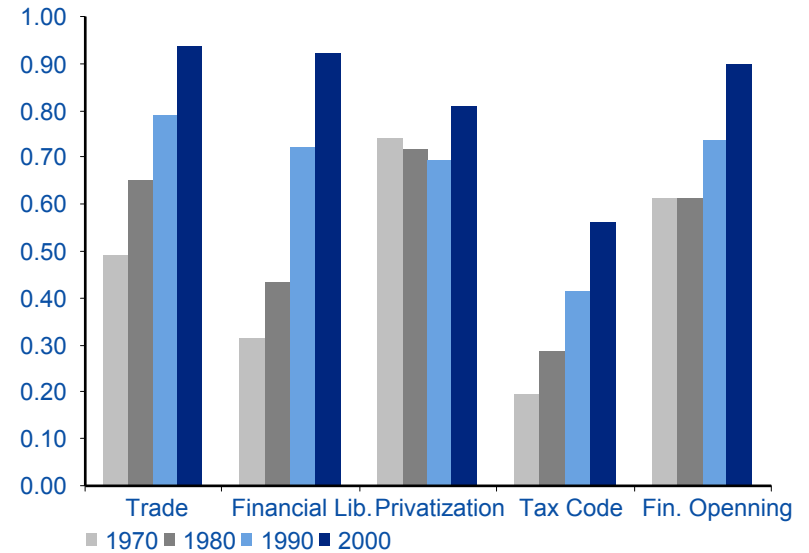
LatAm, Political Freedom
Freedom House Index, % of free countries

Source: BBVA Research with Freedom House data



LatAm, Economic reforms

Source: BBVA Research based on IADB and ECLAC data

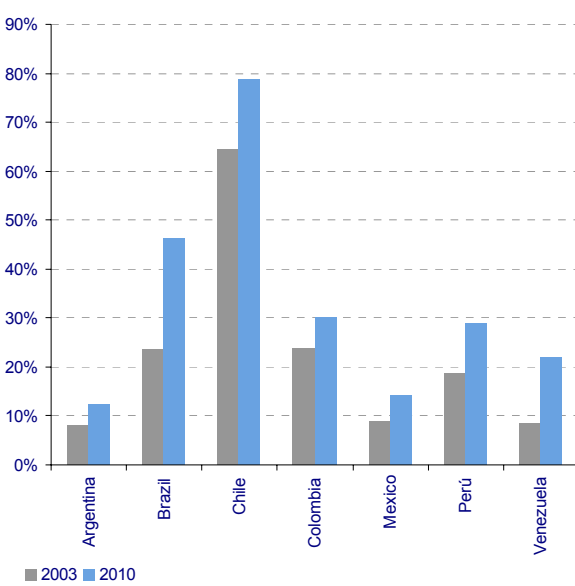


Breaking with the past

- The banking systems have been able to speed up credit supply, to cut NPL losses and to preserve high capital to assets levels

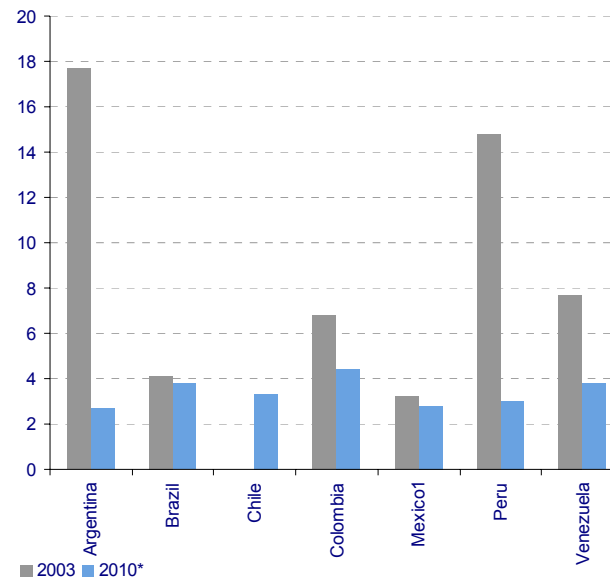
LatAm, Credit (As % of the GDP)

Source: BBVA Research, GSFR. 2010 Forecast



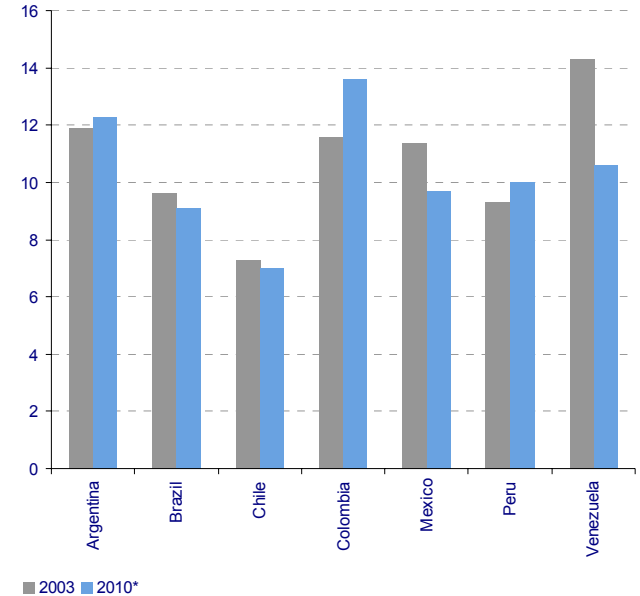
LatAm, NPL %

Source: BBVA Research, GSFR. *Last available information



LatAm, Bank Capital to Assets %

Source: BBVA Research, GSFR. *Last available information



2

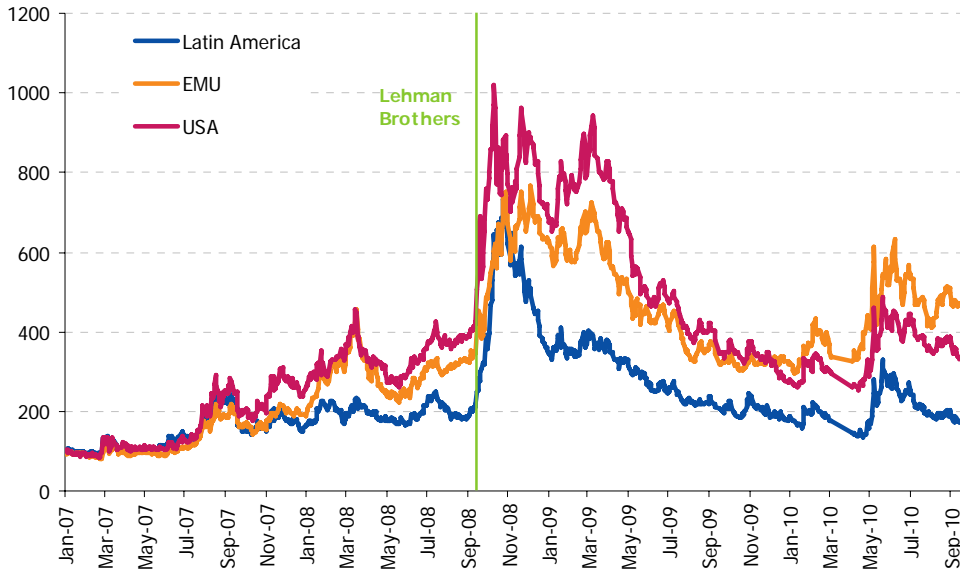
Latin America's stress test

Latin America's stress test

- The region resisted the global financial crisis, and has come financially stronger: lower spreads and less volatility without net foreign outflows

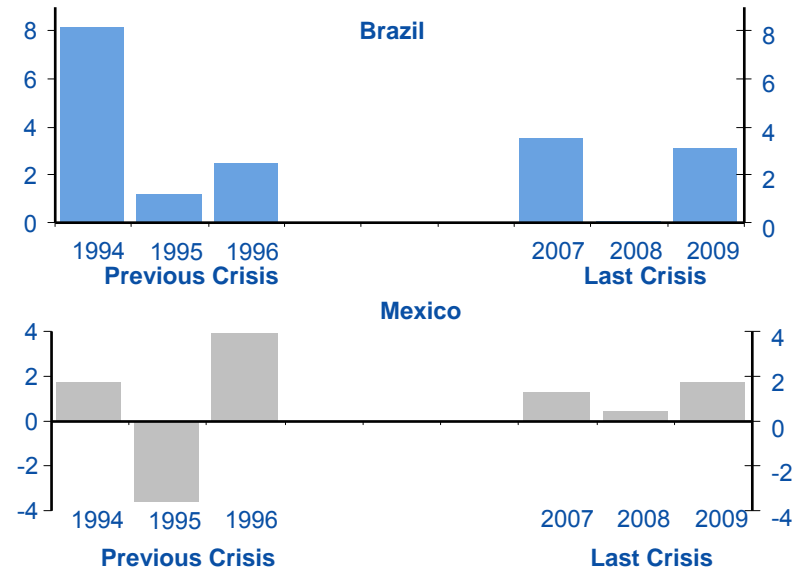
BBVA Research Financial Stress Indicator
Jan07=100

Source: BBVA Research



Portfolio Foreign Investment
Net Inflow, as % of GDP

Source: BBVA Research



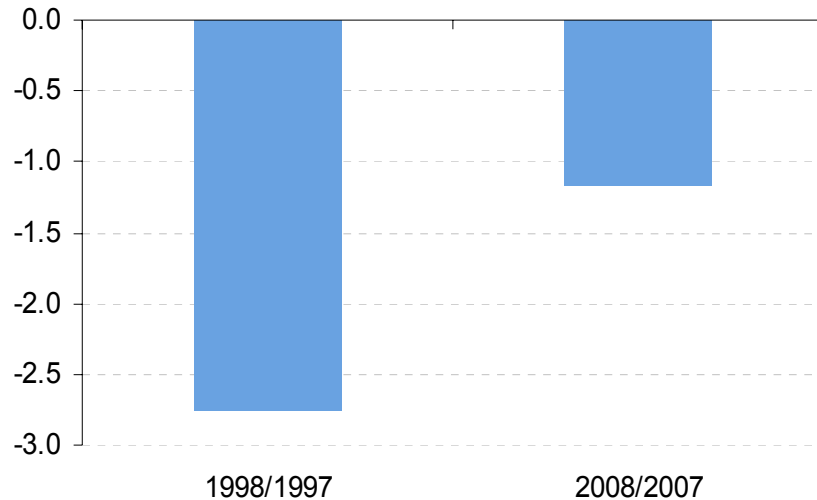
Latin America's stress test

- The deterioration of the Current Account was milder than in the Asian Crisis in spite of a larger negative commodity prices shock

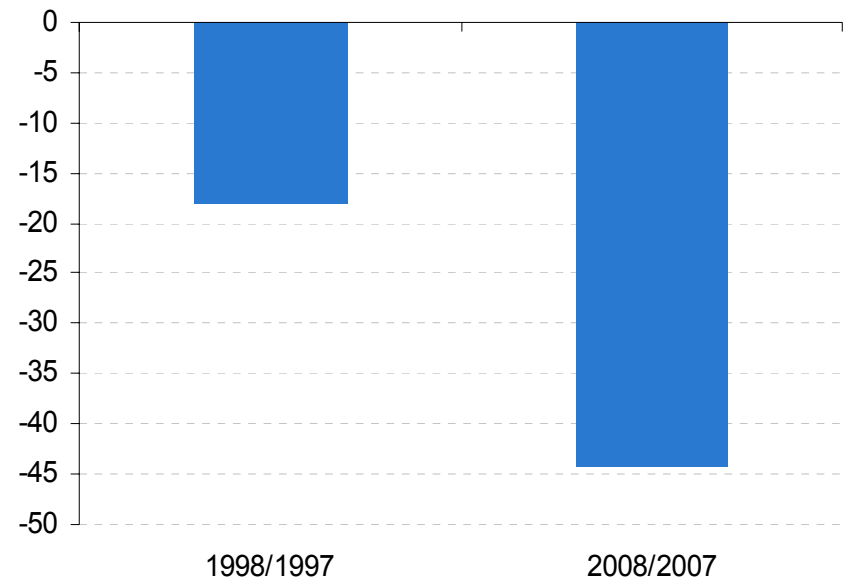
Deteriorations in crisis periods

Source: BBVA Research. *Latin

Latin America Current Account % GDP (% change in period)



Commodity Prices* (% change in period)

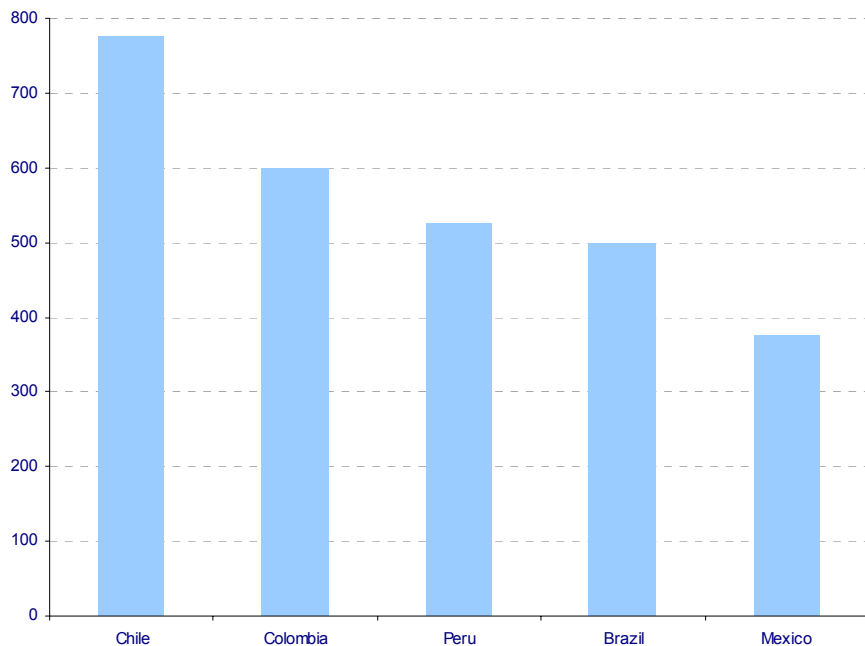


Latin America's stress test

- In this cycle fiscal and monetary policies were expansionary, marking a major break with previous cycles when financial constraints did not allowed them

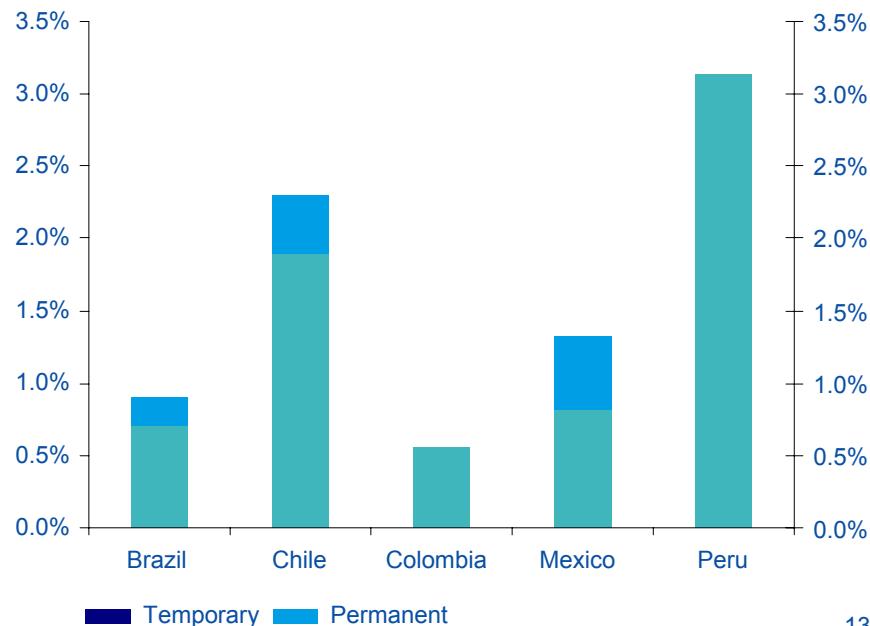
Interest Rate cuts during crises (Dec09- vs. Jan09, bps)

Source: BBVA Research



LatAm, Fiscal Stimulus as % of the GDP

Source: BBVA Research



3

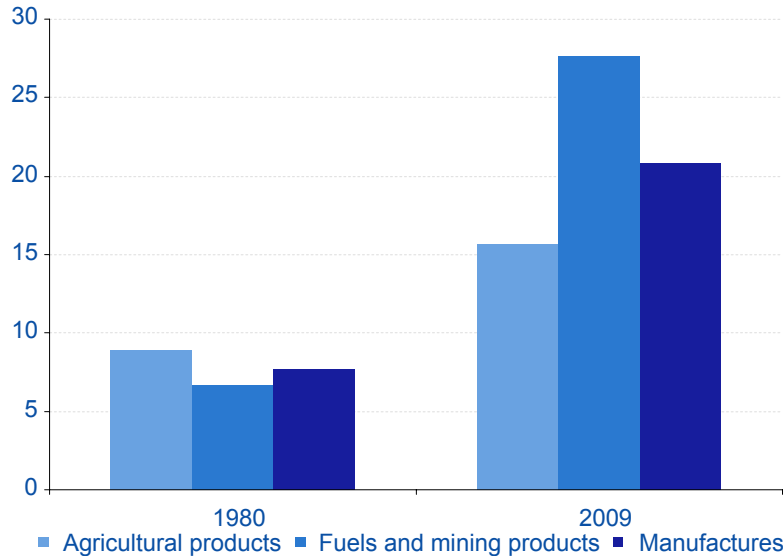
A bright
future

A bright future

- A more open region, both to trade and investment, is benefiting from Asian dynamism

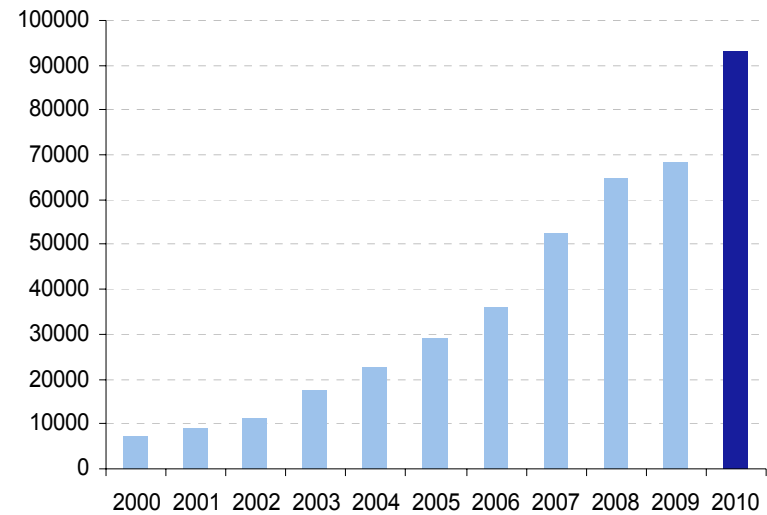
Emerging Asia: share in world imports (%)

Source: World Trade Organization.



Latin America Exports to Asia (US\$ M)

Source: BBVA Research.

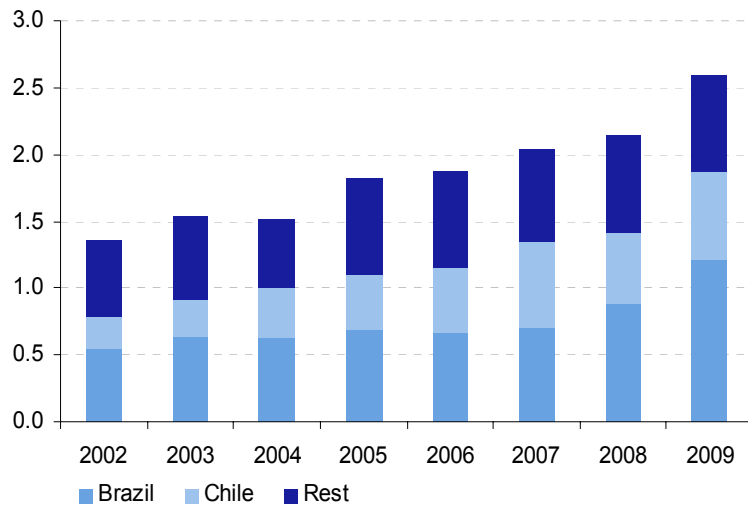


A bright future

- China is becoming the main trade partner for South America
- While importing food, metals and energy, it is also gaining importance as supplier of consumer goods

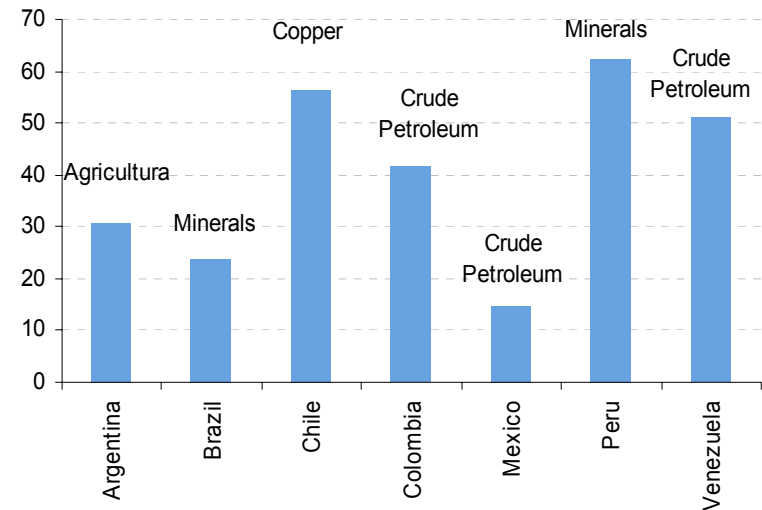
Asian imports from Latin America (% over total Asian imports)

Source: UN and BBVA Research



Concentration of the main product's exports to Asia from Latin America (% over total exports in each country).

Source: BBVA Research

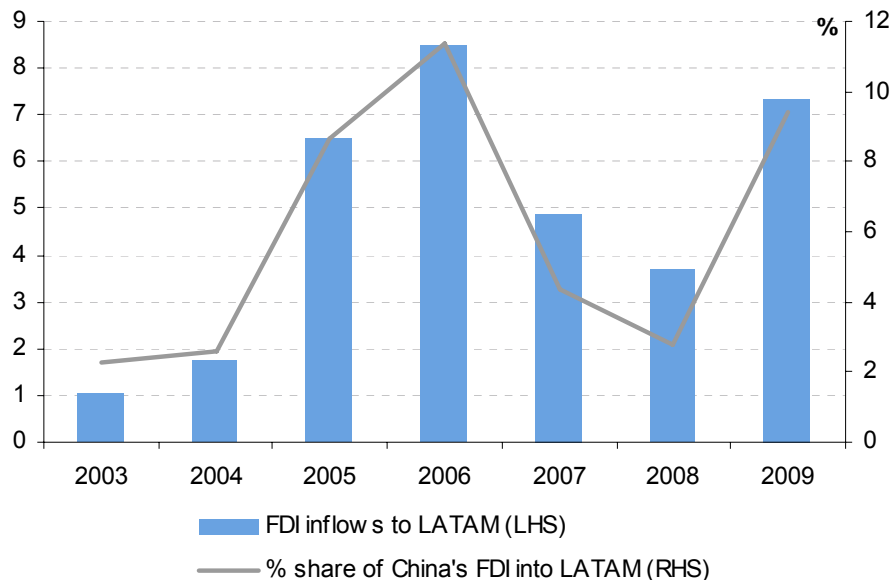


A bright future

- China's FDI flows on LATAM have gained importance in recent years mainly oriented towards oil and other commodity projects.

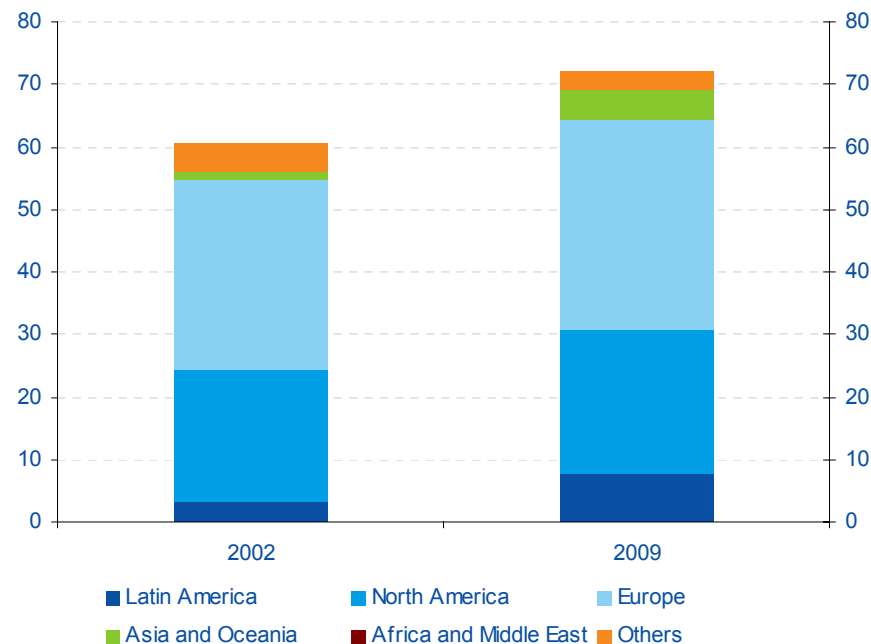
China FDI inflows to Latam (US\$ bn) Total Latin America and Caribbean

Source: China Ministry of Commerce and BBVA Research



Total FDI inflows to Latam 2002 and 2009 (US\$ bn) Bra, Ch, Col, Mex and Per

Source: BBVA Research,

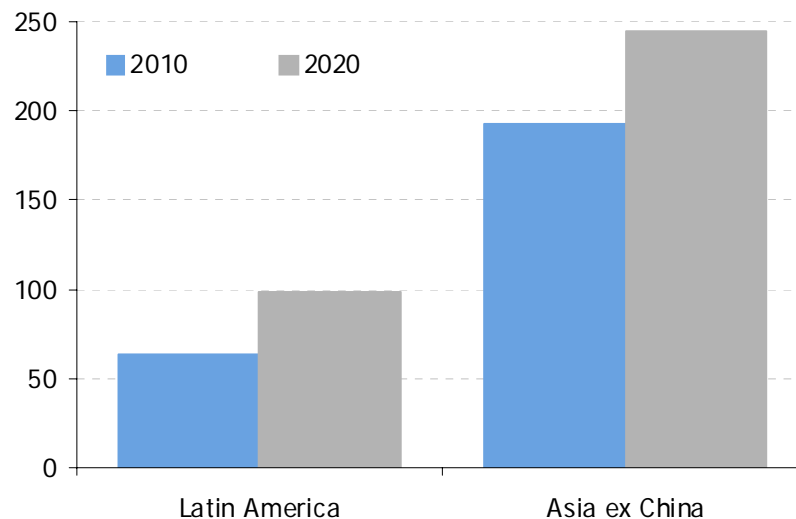
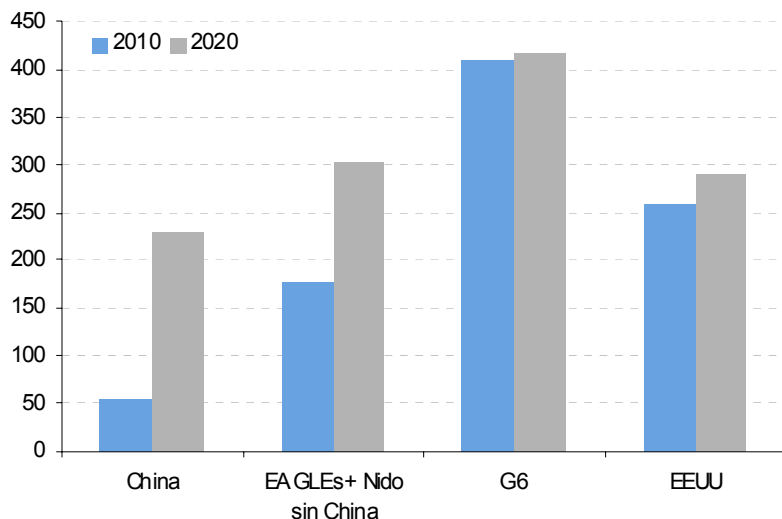


A bright future

- Emerging Middle Classes are reshaping world markets
- China and the EAGLES will be the fastest growing markets in this decade
- LATAM, and especially Brazil, will benefit from expanding domestic markets and significant ties with China and other places where Middle Classes will grow fast.

Size of population with middle-income higher or equal than middle-income threshold (millions)

Source: BBVA Research,

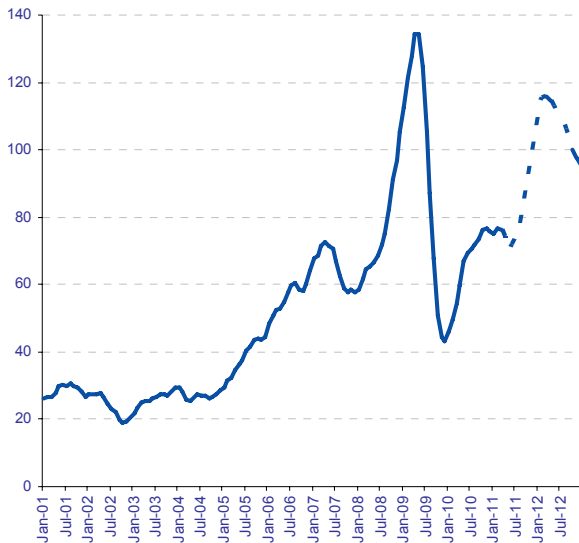


A bright future

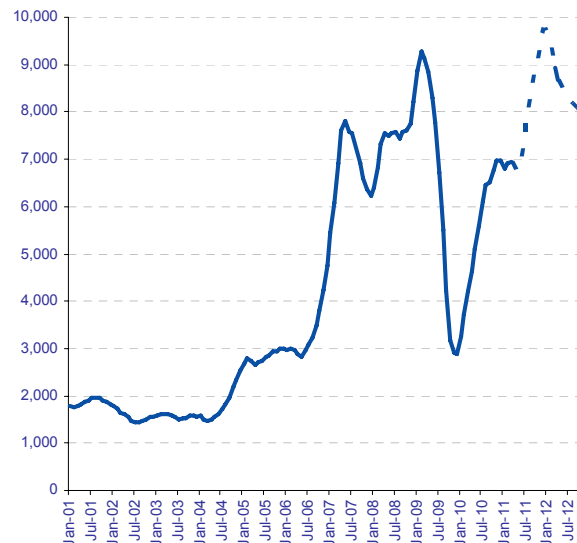
- Rising incomes, urbanization and fast industrialization in China put a lot of pressure on all kind of commodity markets. India is just at the beginning of a similar process.
- Commodity prices have been resilient to the financial crisis. A new cycle of high prices seem to be starting, fueled by fast Asian development. There is a similarity with the post WWII reconstruction in Europe and Japan.

Commodity prices (trend series)
Source: BBVA Research

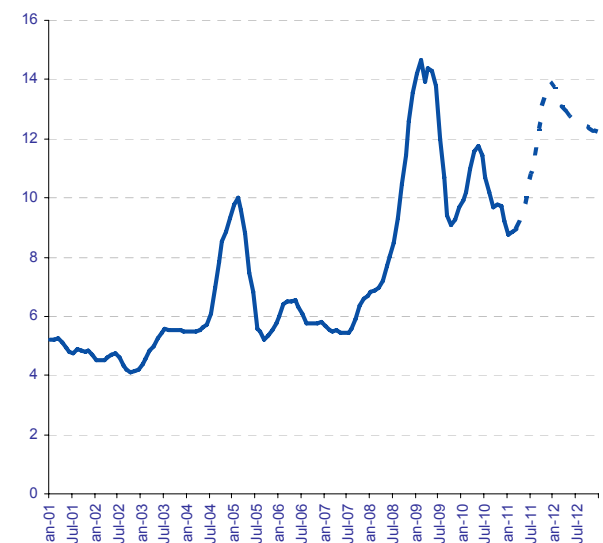
Oil (Brent), USD/b



Metals (Copper), USD/t



Agricultural (Soybean), USD/bsl



4

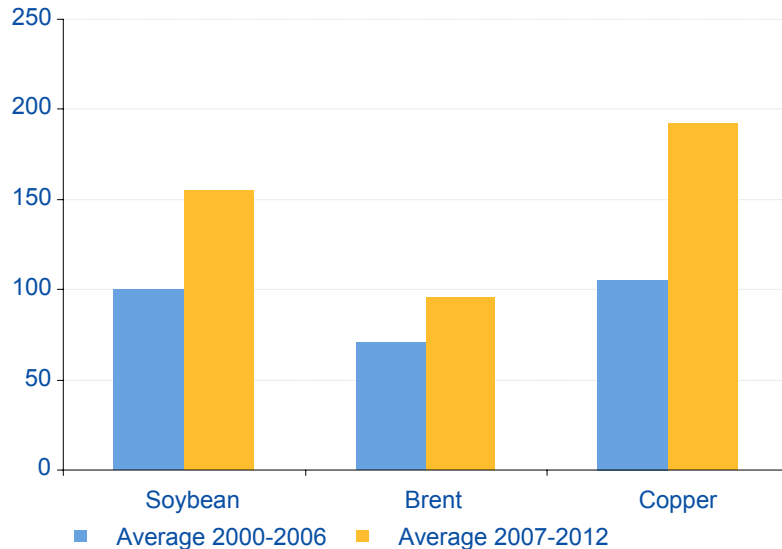
Short term challenges

Short term challenges

- Some new policy dilemmas: Stronger fundamentals means more appreciated currencies – in real terms – over the long – run

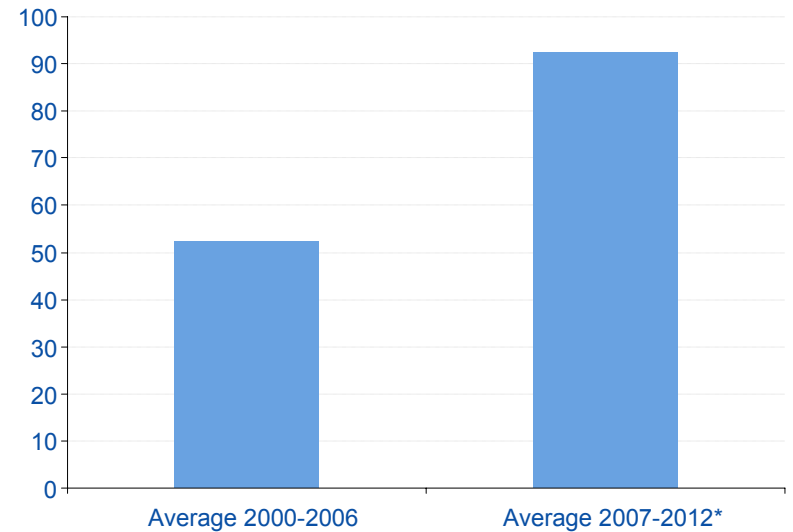
Real Commodity Prices
(Respect US CPI, base 2005=100)

Source: IMF and BBVA Research



Foreign Direct Investment to the region (US\$ bn)
Arg, Bra, Ch, Col, Mex, Per and Ven

Source: BBVA Research. *Forecast BBVA Research.

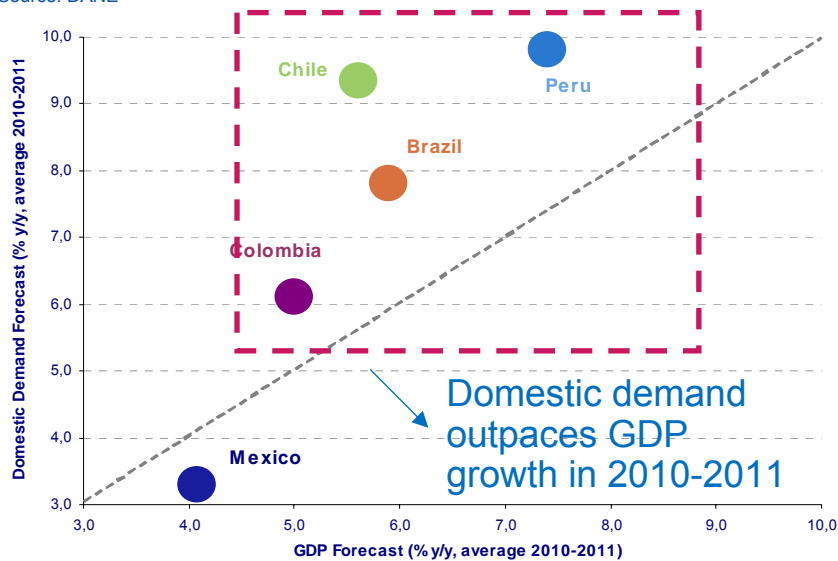


Short term challenges

- While domestic demand growth outpaces GDP growth in most countries in South America with rising risk of overheating, interest rates remain below neutral levels for fear of further appreciations
- Recent data show that moderation in domestic demand is insufficient. Central Banks, led by Brazil are raising interest rates, but they are far from being contractionary.

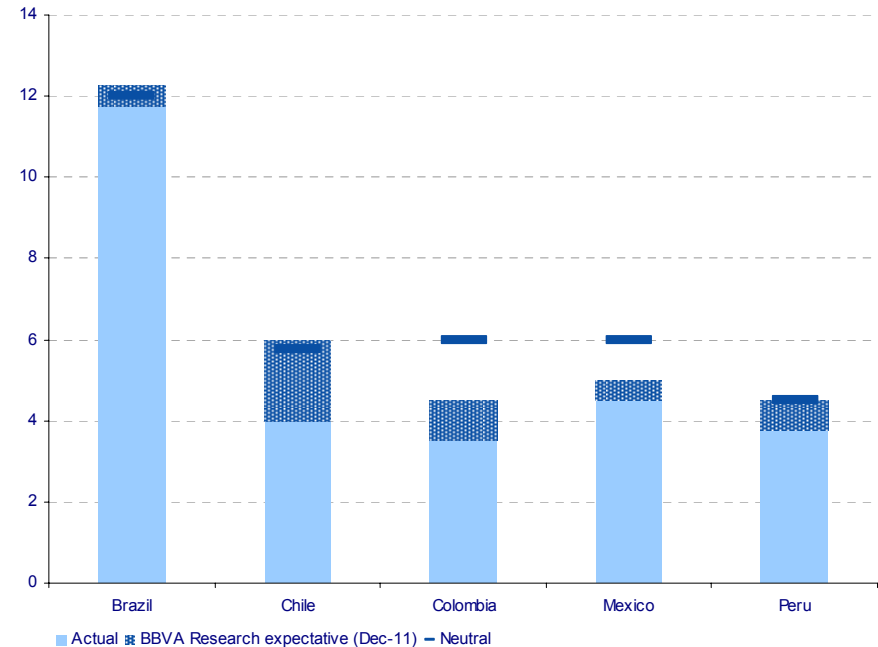
GDP and Domestic Demand Forecasts
(% y/y, average 2010-2011)

Source: DANE



Monetary Policy Reference Rates (%)

Source: BBVA Research

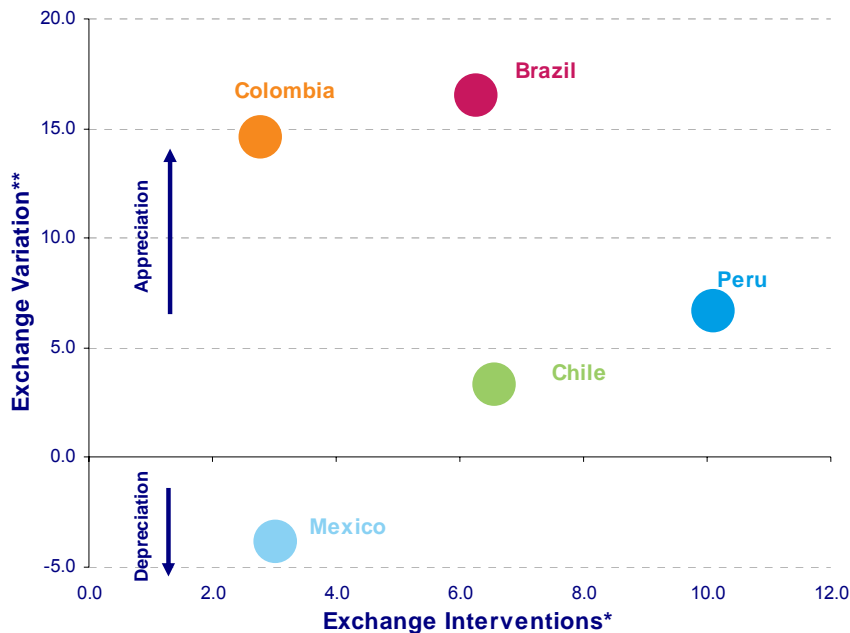


Short term challenges

- FX interventions have been used by most Central Banks, but with little success and limitations to interventions are showing up.
- Countries have moved to a second line of defense using higher reserve requirements on FX deposits and loans and in some cases (Peru) on all deposits, as well as other capital controls and taxes. If they are successful, inflation will rise.

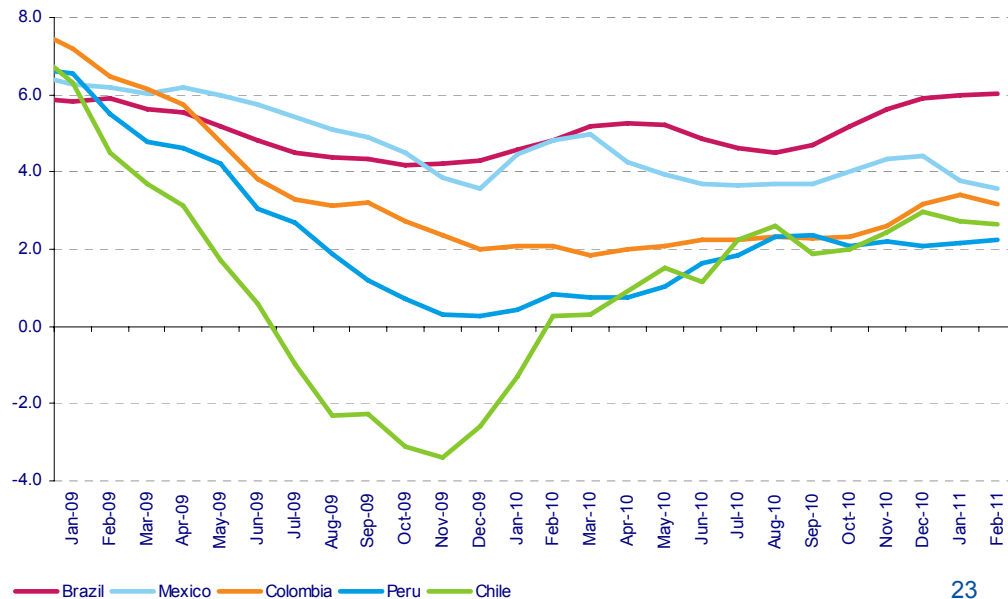
Exchange Rate: Appreciations and Interventions

Source: BBVA Research. *Exchange intervention: International Reserves: net purchase between Jan08-Dec10 (% GDP). **Exchange variation: Appreciation/Depreciation in Real Effective Exchange Rate between Jan08-Dec10



Inflation (%y/y)

Source: Central Banks and BBVA Research



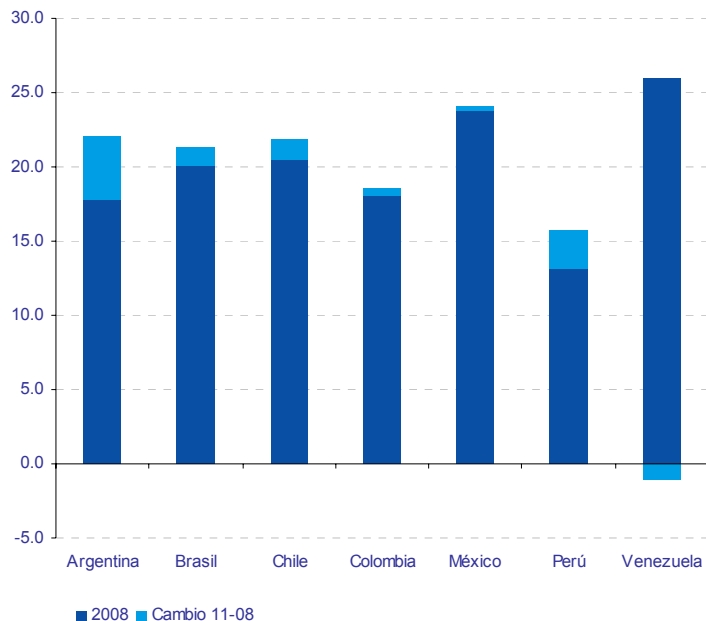
Short term challenges

Fiscal policies could help

- Only Brazil has announced a significant budget cut for 2011 in order to support monetary policy.
- In most countries fiscal expenses still remain above pre-stimulus levels as a fraction of GDP.
- Given the general optimism about the region and the strength of private domestic demand, a delayed withdrawal of the fiscal stimulus might force an excessive reaction of monetary policy, further appreciating the currency..

Fiscal expenses in 2008 and change 2011-08 (percent of GDP)

Source: BBVA Research



In Chile, Colombia and Venezuela government budgets are under pressure from reconstruction efforts after natural disasters.

Chile and Colombia introduced transitory tax increases to fund these extra expenses.

Peru and Venezuela are moving in the opposite direction, either cutting the VAT tax rate (Peru) or using the oil windfall to cancel already announced tax increases (Venezuela).

Short term challenges

Overheating might come in different flavors: higher inflation or further appreciation and a weaker current account.

Risks of higher inflation

Conditions favoring inflation:

- Strong expansion in domestic demand and positive Output Gap
- High initial inflation and lax monetary policy, and
- Expansionary fiscal policy

Likely policy instruments:

- Price controls
- FX interventions
- Capital controls
- Generalized FX controls

Risks of further appreciation

Conditions favoring appreciation:

- Strong expansion in domestic demand and positive Output Gap
- Strong commitment to inflation targets by the Central Bank, and
- Expansionary fiscal policy

Likely policy instruments:

- Higher interest rates
- FX interventions
- Capital controls
- Budget cuts

Regional Outlook

	GDP (% y/y)				
	2003-2008	2009	2010	2011*	2012*
Argentina	8.2	-2.1	7.5	4.6	2.8
Brazil	4.2	-0.2	7.4	4.1	4.2
Chile	4.7	-1.5	5.2	6.0	5.1
Colombia	5.0	0.8	4.2	5.0	5.5
Mexico	3.1	-6.1	5.5	4.3	3.8
Panama	8.3	3.2	7.4	7.0	6.7
Paraguay	4.6	-3.9	15.3	4.5	4.0
Peru	7.0	0.9	8.8	7.1	6.3
Uruguay	5.6	2.9	8.6	5.3	4.2
Venezuela	7.3	-3.3	-1.9	2.6	1.5
Latin America	4.7	-2.2	6.1	4.4	4.0

Source: BBVA Research. *Forecast.

	Inflation (% y/y, average)				
	2003-2008	2009	2010	2011*	2012*
Argentina	9.5	6.3	10.5	11.1	13.0
Brazil	7.0	4.9	5.0	5.5	4.7
Chile	3.9	1.6	1.4	3.0	3.2
Colombia	5.8	4.2	2.3	3.6	3.6
Mexico	4.3	5.3	4.2	3.7	4.3
Panama	5.0	2.4	3.5	4.7	4.4
Paraguay	8.9	2.6	4.6	8.8	8.1
Peru	2.9	3.0	1.5	2.6	2.7
Uruguay	9.4	7.1	6.7	6.6	6.7
Venezuela	22.1	28.6	29.1	25.4	28.0
Latin America	7.1	6.4	6.4	6.5	6.7

Source: BBVA Research. *Forecast.

	Fiscal Balance (% GDP)					Current Account (% GDP)				
	2003-2008	2009	2010*	2011*	2012*	2003-2008	2009	2010*	2011*	2012*
Argentina	1.5	-0.6	0.3	-1.0	-0.2	3.3	3.5	1.1	0.7	-0.4
Brazil	-2.9	-3.3	-2.6	-2.8	-2.3	0.6	-1.4	-2.4	-2.8	-3.1
Chile	4.7	-4.6	-0.3	1.4	-1.0	1.7	2.6	1.6	0.6	-1.7
Colombia**	-3.3	-4.1	-4.3	-4.1	-3.7	-1.8	-2.1	-3.0	-2.7	-3.0
Mexico	-1.5	-1.3	-3.2	-2.9	-2.7	-0.8	-0.6	-0.8	-1.2	-1.7
Panama	-0.6	-1.0	-0.7	-1.0	-0.7	-6.3	-0.2	-7.8	-7.9	-8.0
Paraguay	1.5	0.1	1.1	1.5	1.7	0.1	0.1	-1.4	2.8	1.7
Peru	0.3	-1.9	-0.9	0.1	0.3	0.1	0.1	-1.8	-2.8	-3.3
Uruguay	-1.2	-1.7	-0.7	-0.7	-0.4	-0.3	-0.9	-4.8	0.8	0.6
Venezuela	-0.5	-5.1	-3.7	-3.1	-0.9	13.3	2.4	5.7	8.9	10.9
Latin America	-1.4	-2.6	-2.4	-2.4	-2.0	1.1	-0.2	-0.9	-1.1	-1.4

Source: BBVA Research. *Forecast.

** Central Government