BBVA | RESEARCH

Latam: recovery and turbulence

Juan Ruiz

BBVA Research | Chief Economist for South America

Latam Outlook – Fourth quarter 2013 | Madrid, 20 November 2013

Main messages

1. **Global cycle strengthens as developed countries recover and deceleration of emerging economies comes to an end.** Global growth will be 2.9% in 2013, increasing to 3.6% in 2014.

2. **Financial stress in Latam in reduced and capital flows stabilize,** but the region will continue to face an external environment that is less benign than before May.

3. **Growth forecasts for Latam are adjusted downwards to 2.4% in 2013,** dragged by Mexico and Brazil. **Growth will pick up to 3.1% in 2014**, as external demand improves and Mexico recovers from the soft patch of 2013H1

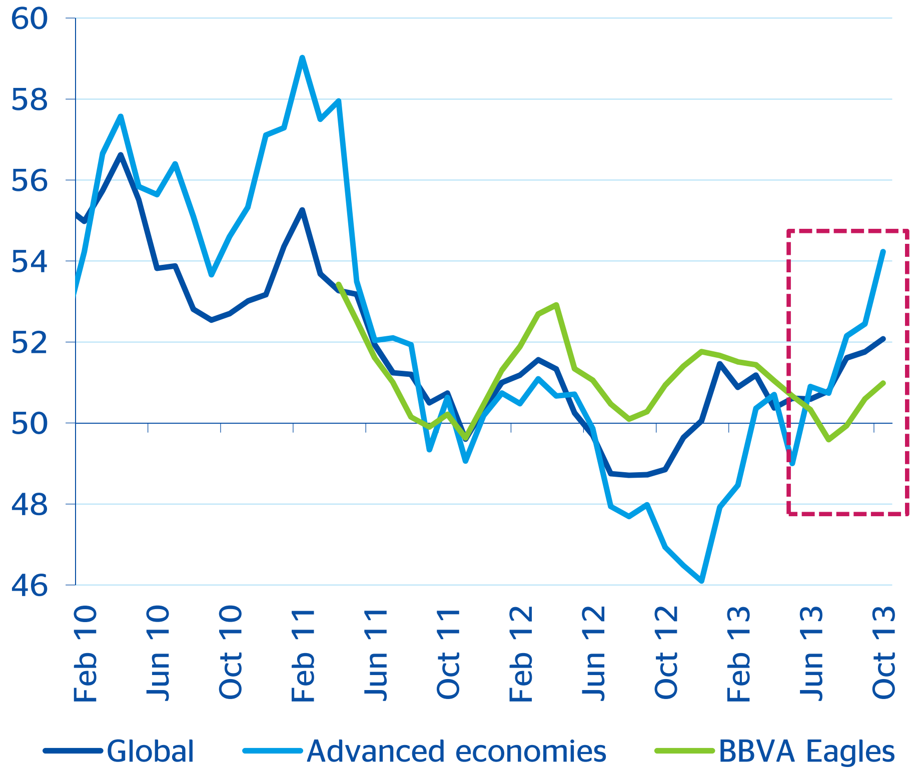
4. **Monetary policy will be heterogeneous, given different inflationary pressures (higher in Brazil and Uruguay).** Exchange rates will depreciate slightly in 2014, given lower global liquidity.

5. **Latam can withstand new external shocks,** but it is crucial to preserve what policy space is left and push reforms.

Outline

Advanced economies recover, deceleration in emerging economies abates

Manufacturing Confidence index (PMI)
Source: BBVA Research and Markit



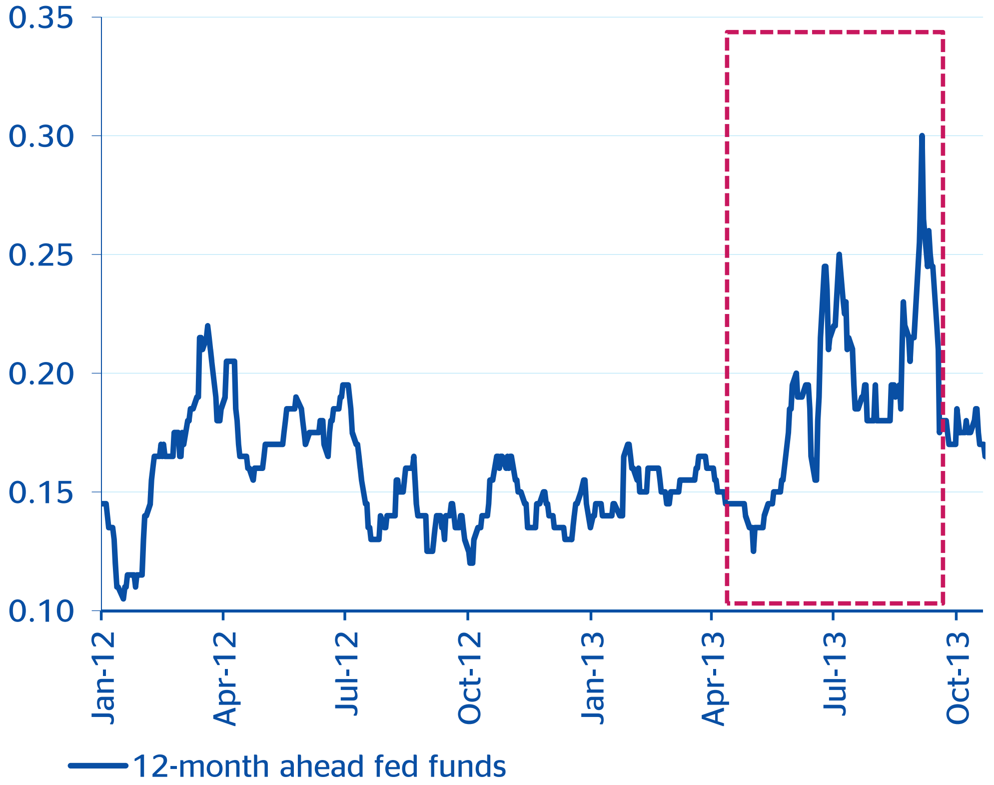
Rebalancing of global growth

Expectations on cycle in developed countries improve …

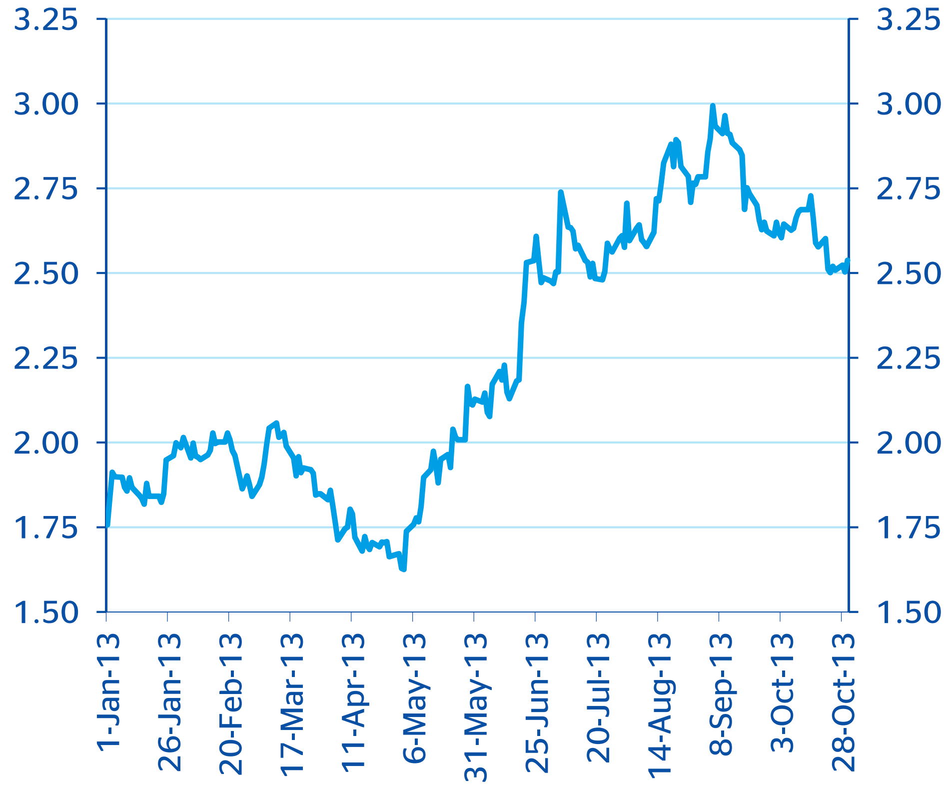
… and deterioration in emerging economies abates

Financial stress is reduced with postponement of start of Fed's tapering...

US: expectations of policy interest rates 12 months ahead
Source: BBVA Research and Bloomberg

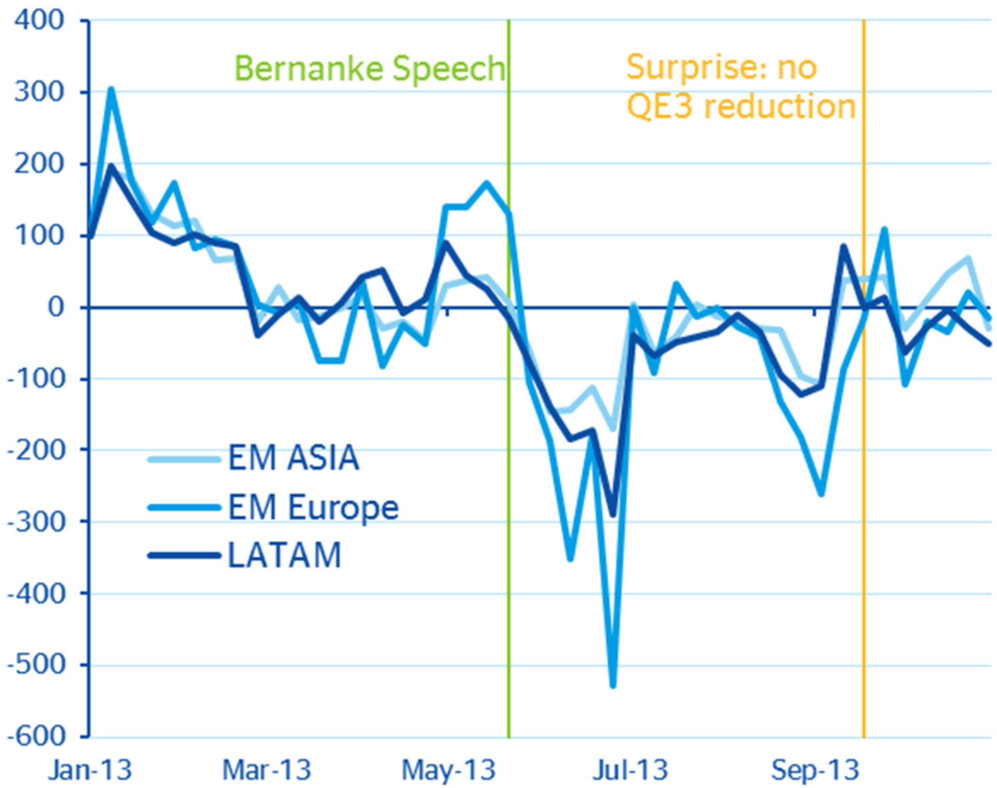


US: 10-year interest rates
Source: BBVA Research and Bloomberg

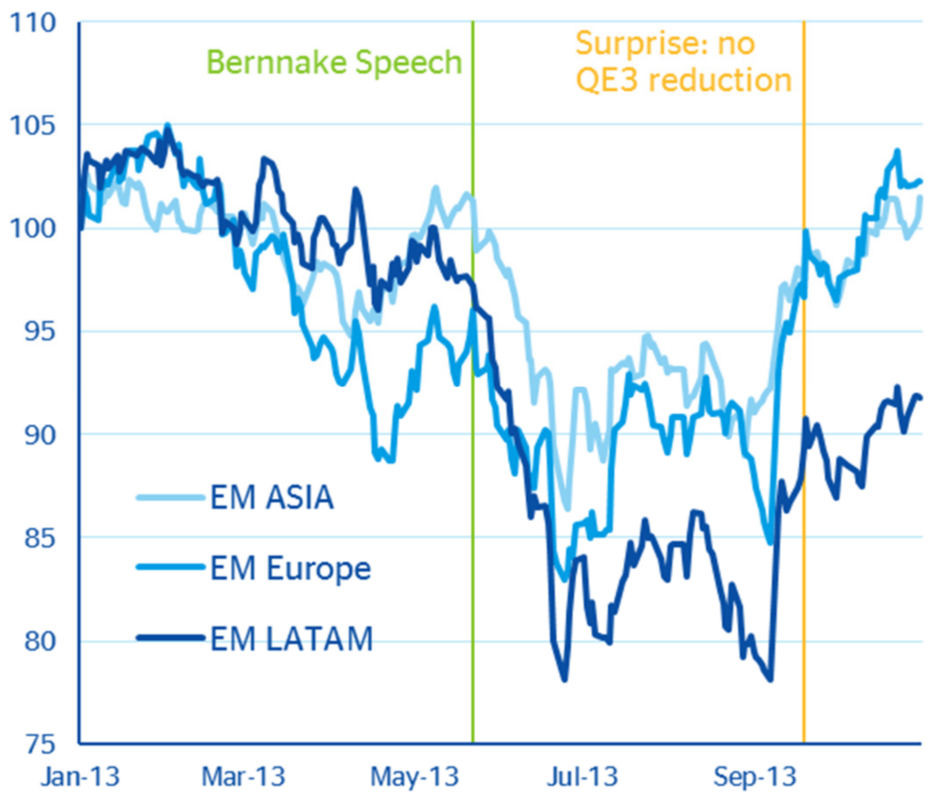


… which has stabilized capital flows and helped asset prices

Capital flows to emerging regions (index Jan 2013=100)
Source: BBVA Research and EPFR

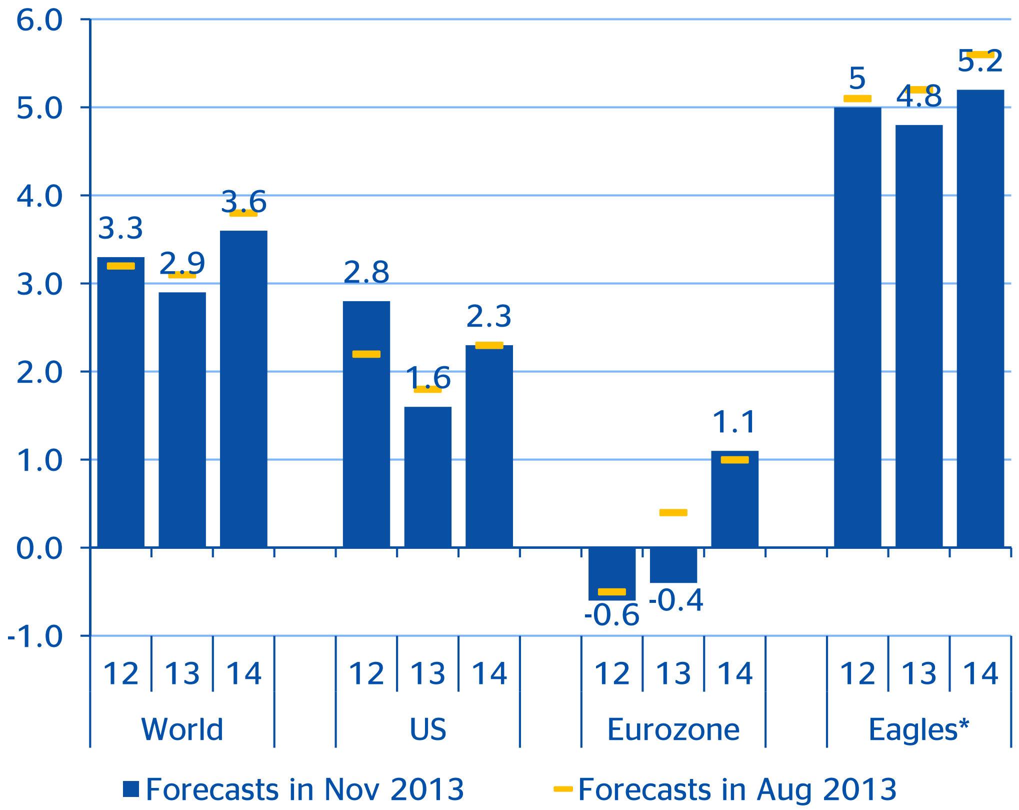


Stock market indexes in emerging regions (MSCI, index Jan 2013 = 100)
Source: BBVA Research y EPFR



Global activity to accelerate, with downside risks

GDP growth forecasts (%)
Source: BBVA Research



Global recovery helped by developed economies

China stimulates growth again, but less strongly than in the past

Global risks tilted to the downside, but with lower probability and lower impact

Outline

1 Global economy: developed countries recover and deceleration in emerging economies comes to an end

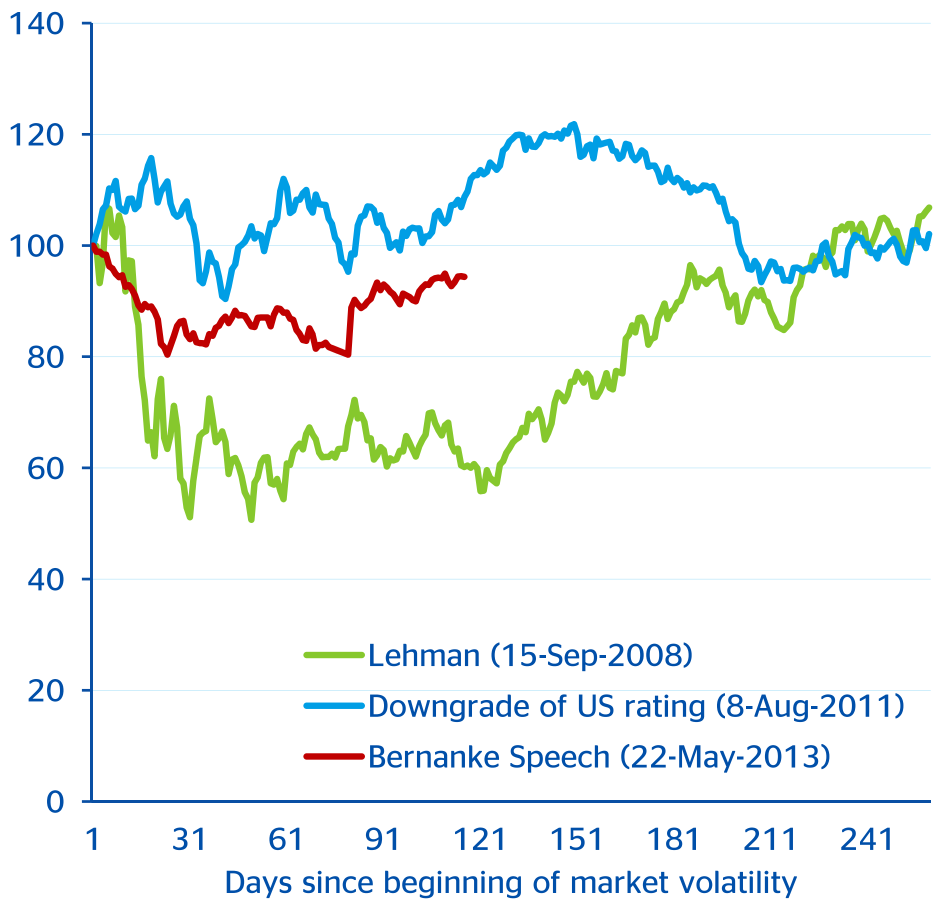
2 Latam: growth to increase in 2014 as external demand gradually improves

3 The Pacific Alliance: the real Latam giant

4 Preserve policy space and push reforms in Latam

Reduced financial stress gives Latam a break

Latam: stock market index in episodes of increased volatility
Source: BBVA Research and Bloomberg



Delay in start of Fed's tapering and end of deceleration in China help stabilize capital flows to Latam

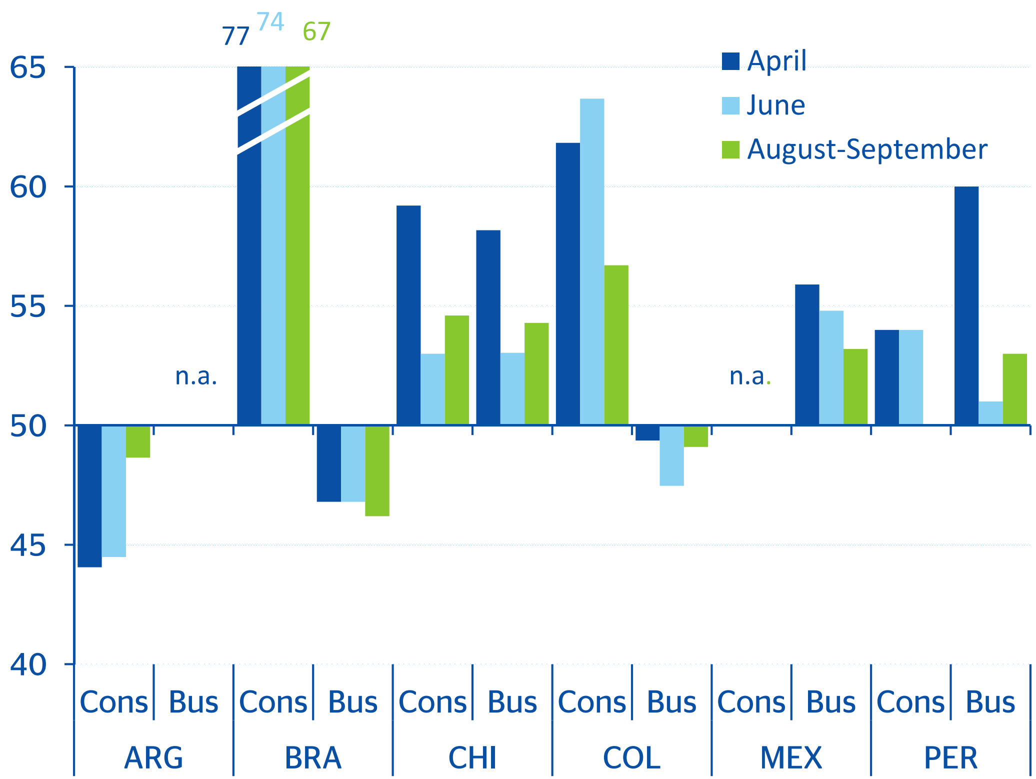
Recovery of stock markets, sovereign spreads and exchange rates , but not reaching levels before May

Adjustment in financial markets more similar to 2011 (US downgrade) than post-Lehman crisis

Less favorable financial environment than before May, but still benign in historical perspective

Domestic demand also gives signs of stabilization

Latam: confidence indicators (50=neutral)
Source: BBVA Research and national sources



Confidence indicators stabilize at slightly optimistic levels in most countries

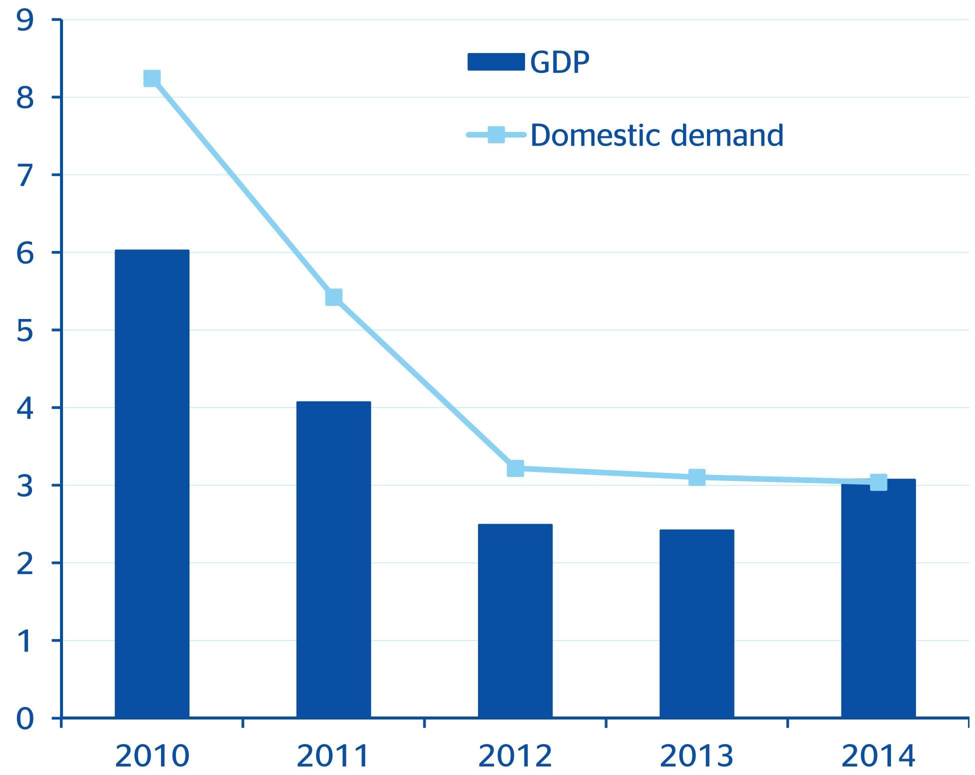
Retail sales and imports start to recover, but not at pace of 2012

Domestic demand will continue to be the main contributor to growth

Latam growth cut down to 2.4% in 2013. Set to increase to 3.1% in 2014

Latam*: GDP growth (%yoy)

Source: BBVA Research



*** Weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela**

Average regional growth in 2013 dragged down by Mexico and (to a lesser extent) Brazil

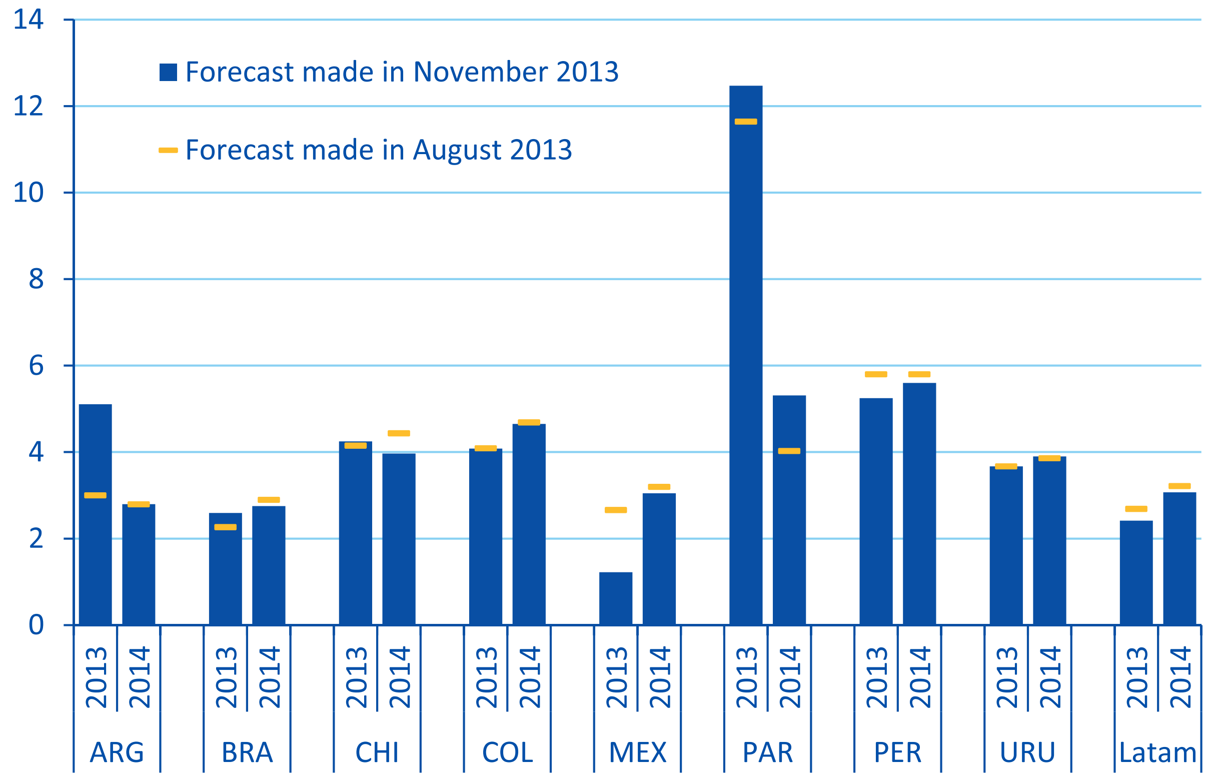
Growth in Q2 surprised to the upside, but offset by less-strong-than-expected Q3

Activity to accelerate in 2014 as Mexico recovers from temporary H1 soft patch ...

... and external demand gradually recovers in line with global growth

Andean countries and Paraguay will continue to display strongest growth in the region

Latam countries: GDP growth (%)
Source: BBVA Research

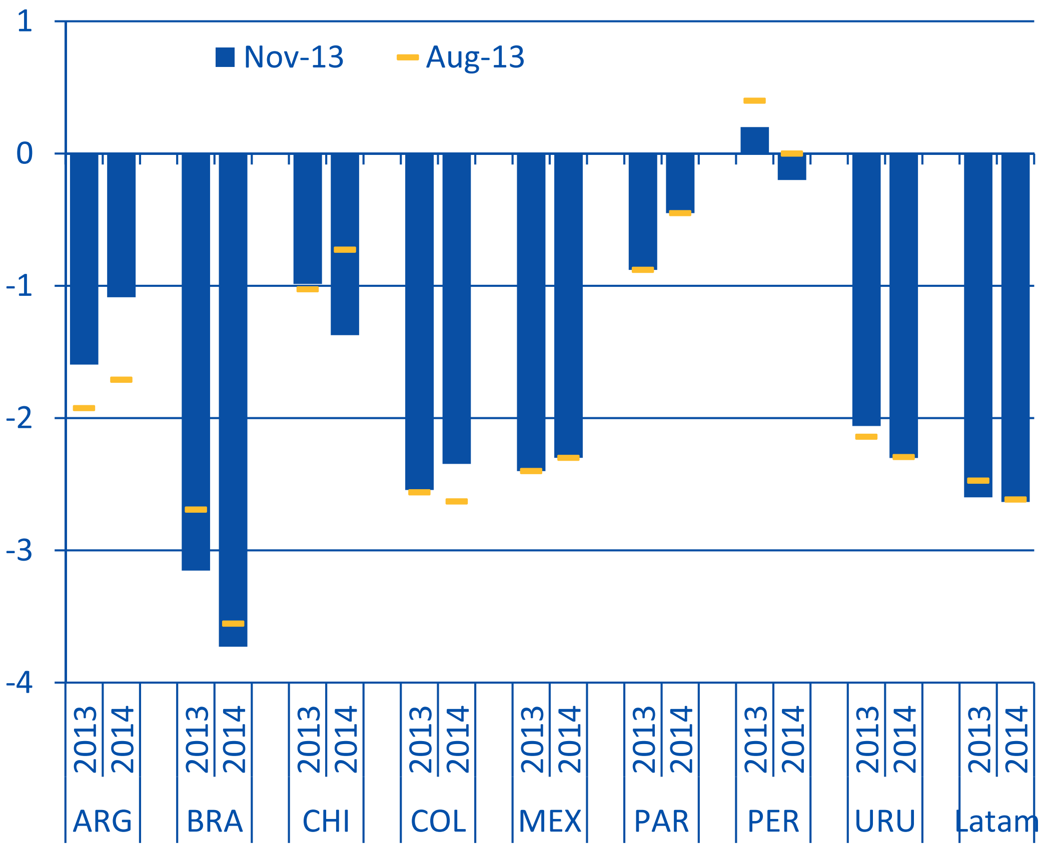


Brazil will continue to show moderate growth, due to tightening monetary policy, electoral uncertainty and structural problems.

Excluding Brazil and Mexico, the rest of the region will grow 3.5% en 2014, trending up towards its potential (close to 4%)

Fiscal outlook worsens, but deficits remain manageable

Latam: Public deficit (%GDP)
Source: BBVA Research and Haver



Weakness of domestic demand and a less favorable external environment worsen fiscal outlook

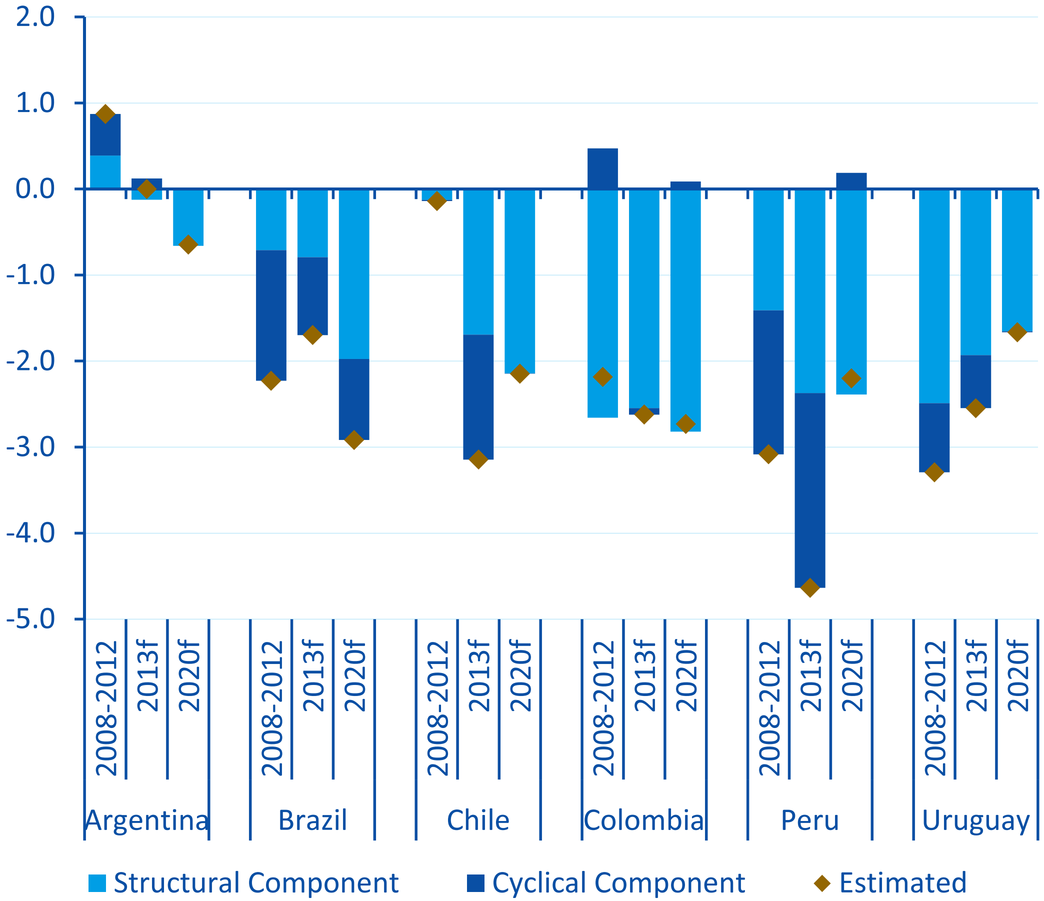
Higher interest rates impact negatively in Brazil

Cyclical conditions do not seem to justify an additional fiscal impulse in the region

High external deficits, but mostly cyclical

Current account balance, cyclical and structural components (%GDP)

Source: BBVA Research and Haver



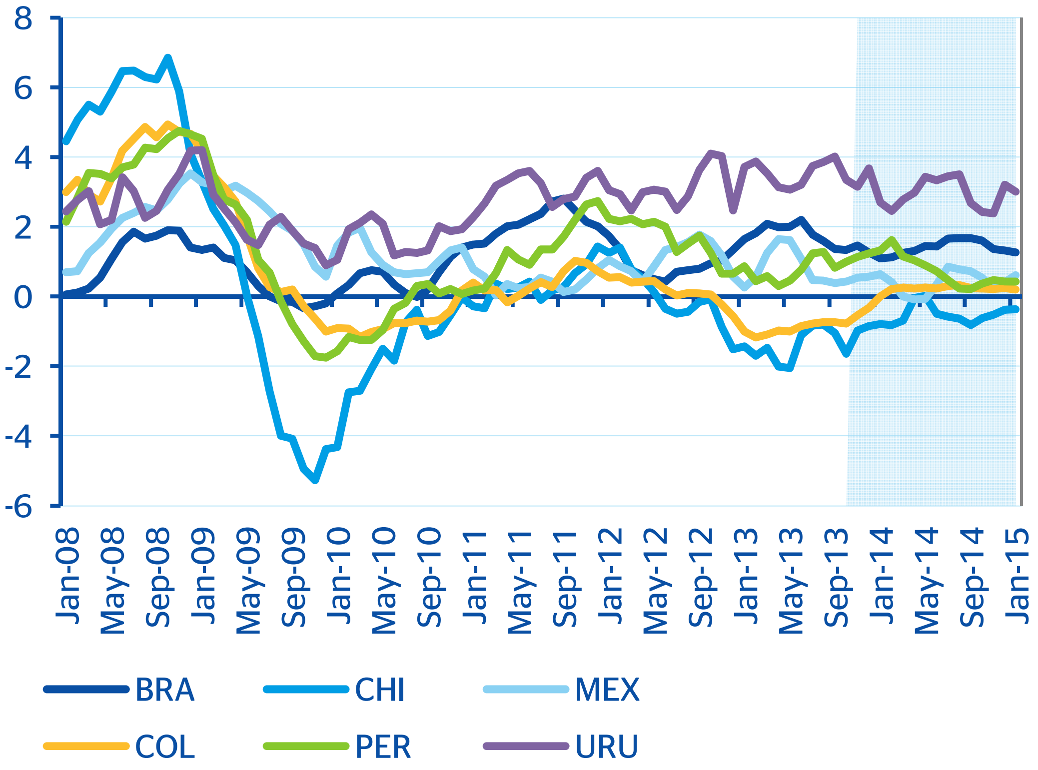
Slight improvement in outlook for CA deficits, because of weakness of domestic demand and the end of some supply-side problems in export sector (BRA, COL, PER)

CA deficits financed mostly by FDI, less volatile in case of renewed market turmoil

Structural deficits in Latam are below 3% of GDP, Sustainable given growth forecasts for the region

Inflation in line with central bank targets, except in Uruguay

Inflation in IT countries (% yoy)
Source: BBVA Research and Haver



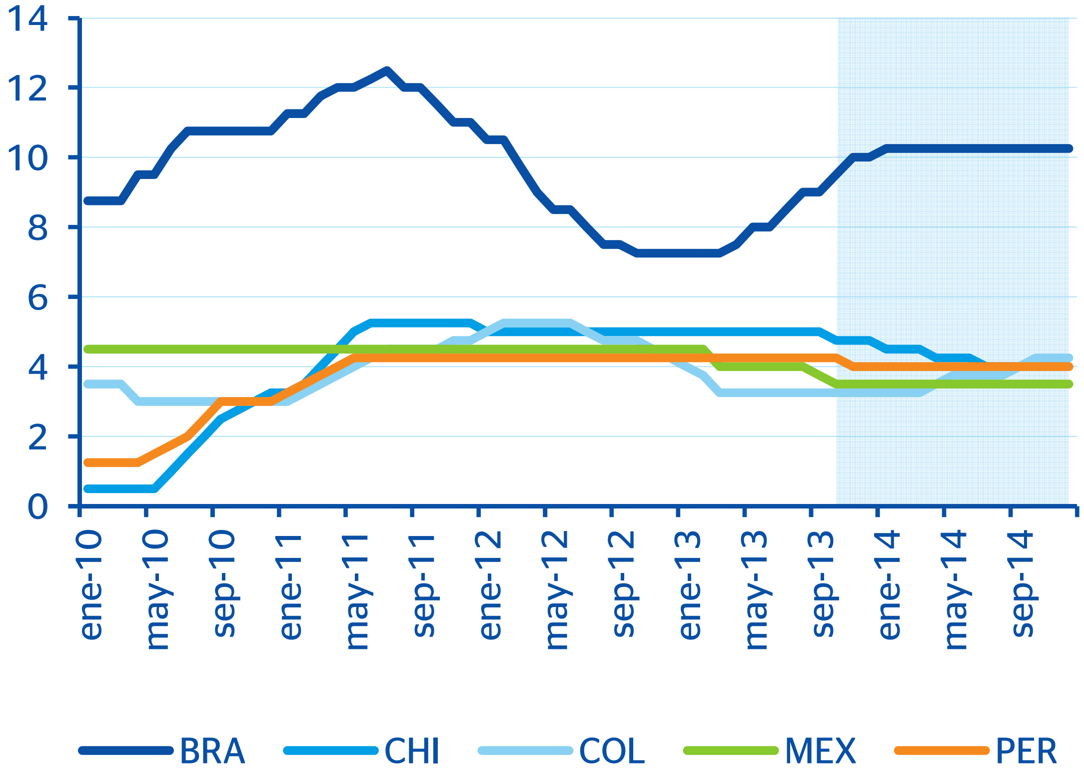
Inflation dynamics clearly differ between Brazil and Uruguay and the rest of inflation-targeting (IT) countries

Uruguay will keep inflation rates above its target band.
Inflation in Brazil will hover around 6%

Inflation in other IT countries will converge to their targets in 2014.

Different inflation pressures will condition a heterogeneous monetary policy response

Policy interest rates in IT countries (%)
Source: BBVA Research and Haver



Expect further monetary policy tightening in Brazil and Uruguay going forward, due to inflationary pressures

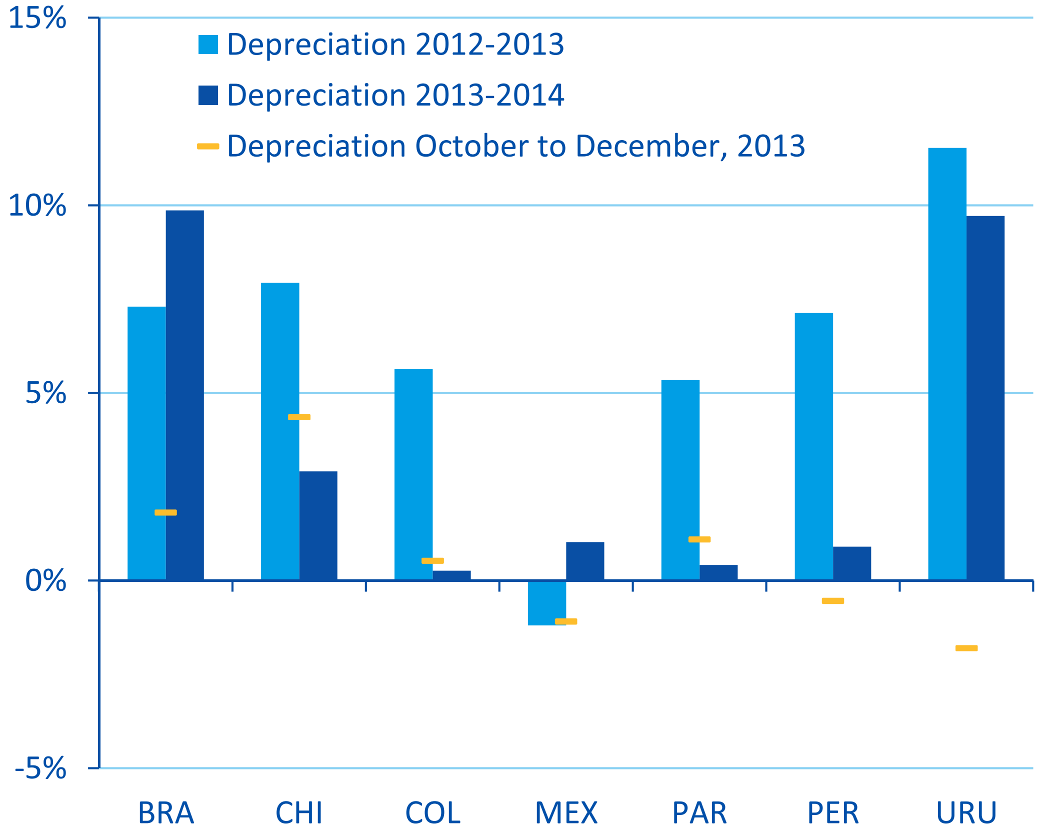
Interest rates to increase also in Colombia, because of cyclical recovery

Stable interest rates in Mexico and Peru

Deceleration in Chile will induce a further reduction of 50bp

Lower global liquidity will contribute to a slight depreciation of exchange rates in 2014

FX changes vis-à-vis USD in IT countries (% Jan-Dec)
Source: BBVA Research and Haver



Slight depreciation trend due to increase in long-term interest rates in US and sizable external deficits

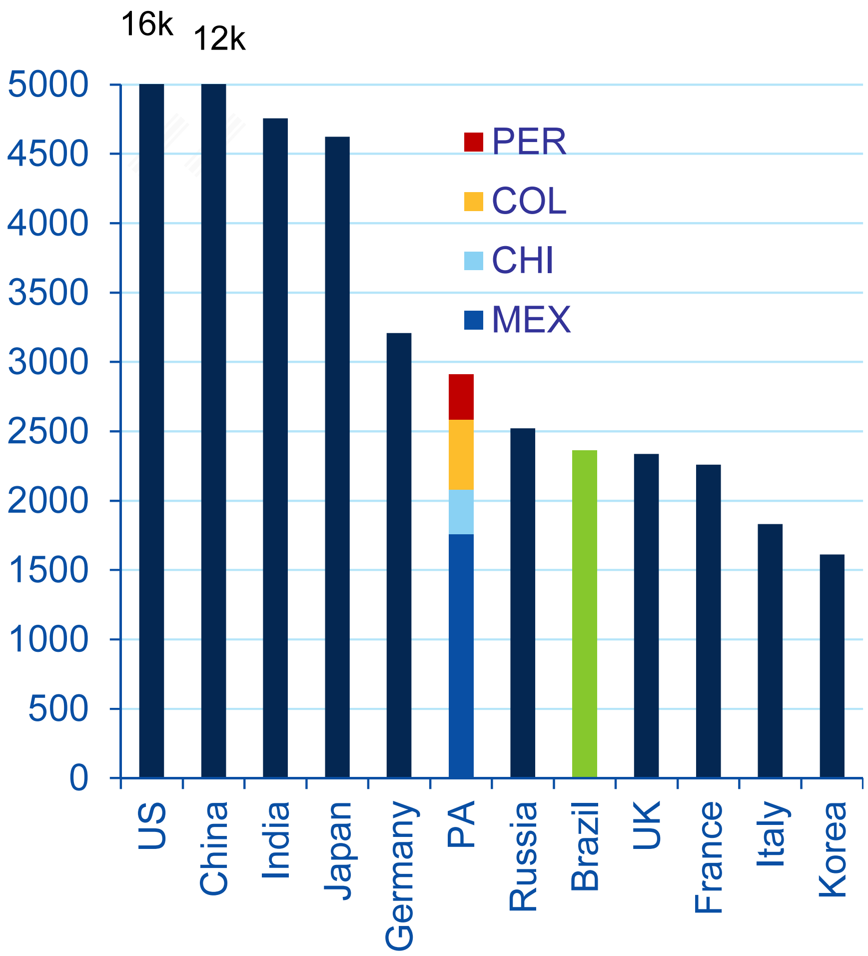
Slight depreciation: most of the effects of the Fed's tapering might have already been incorporated in depreciation seen in 2013

Main exception will be Brazil: 10% depreciation expected in 2014 will recover part of lost competitiveness. Will drag FX also in Uruguay.

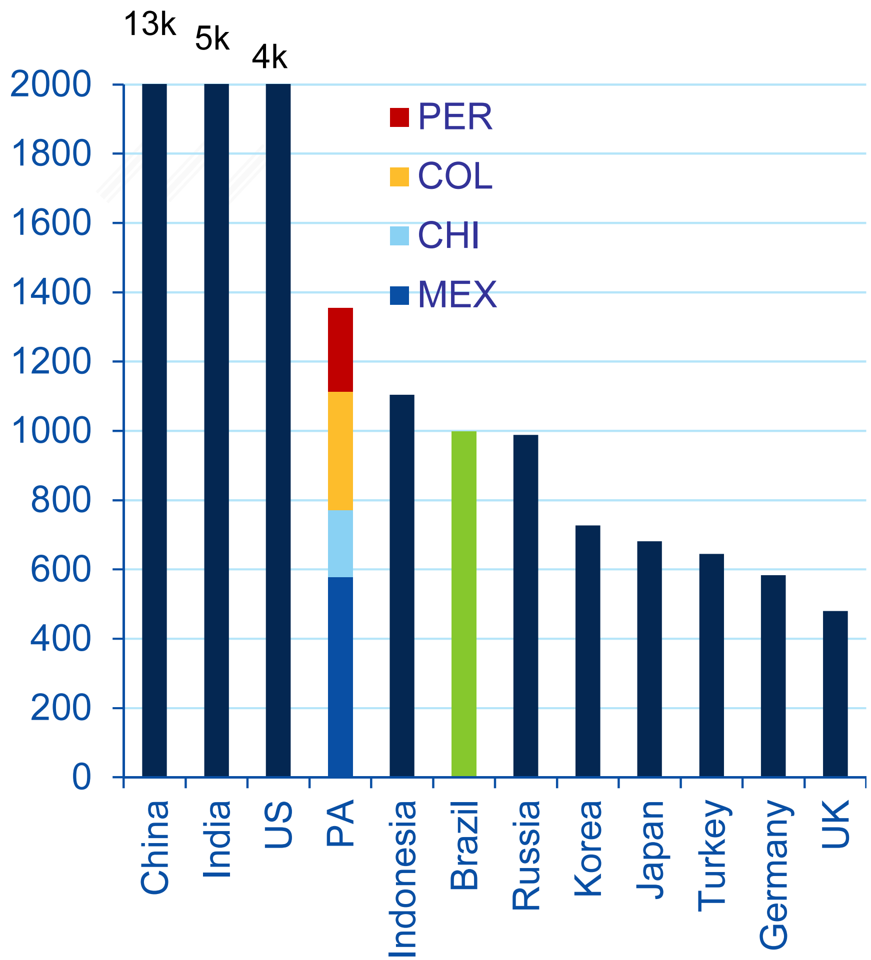
Outline

The Pacific Alliance: the real Latam giant

Biggest economies in 2012 (bn. USD, PPP adjusted)
Source: BBVA Research and IMF



Biggest contributions to GDP growth in the next 10 years (m USD, PPP adjusted)
Source: BBVA Research and IMF



Pacific Alliance attracts FDI in line with its high potential....

FDI: attraction and potential to attract it

Source: BBVA Research and UNCTAD

FDI Attraction index (2009-2011)	Fourth quartile (Low)	Third quartile	Second quartile	First quartile (High)
High – First quartile		Mozambique	Uruguay	**Chile, Colombia, Peru**
Second quartile	Nicaragua	Costa Rica	Portugal	**Mexico**, Spain, US
Third quartile	São Tome			
Low – Fourth quartile		Paraguay, Angola	Ecuador	

FDI potential index (2011)

Above expectations
In line with expectations
Belos expectations

PA countries among those with highest potential to attract FDI

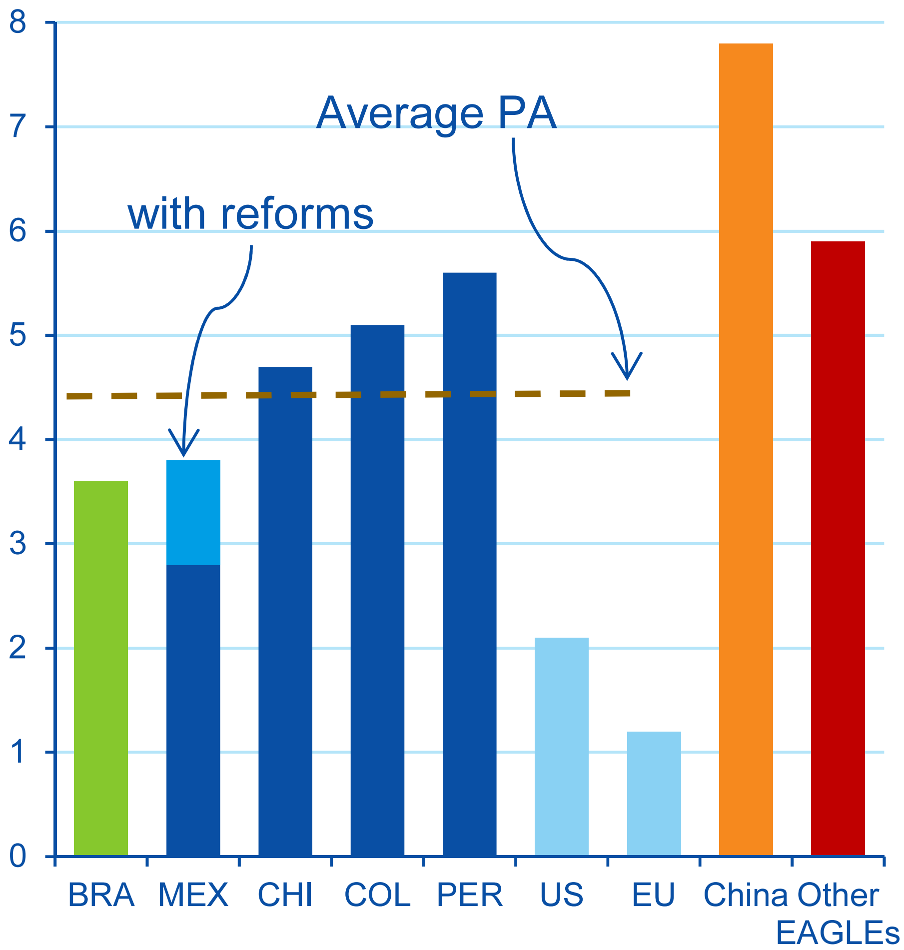
FDI potential index:

(i) attractiveness of domestic market;
(ii) productivity of labor force;
(iii) availability of natural resources;
(iv) infrastructures

FDI attraction:
ranking of inward FDI both in absolute terms and relative to country size

Pacific Alliance: high potential growth

Potential GDP growth next in the 10 years (%)
Source: BBVA Research



Besides a high contribution to global growth, a high potential growth rate

Commitment to reform will contribute to increasing potential growth

Outline

1 Global economy: developed countries recover and deceleration in emerging economies comes to an end

2 Latam: growth to increase in 2014 as external demand gradually improves

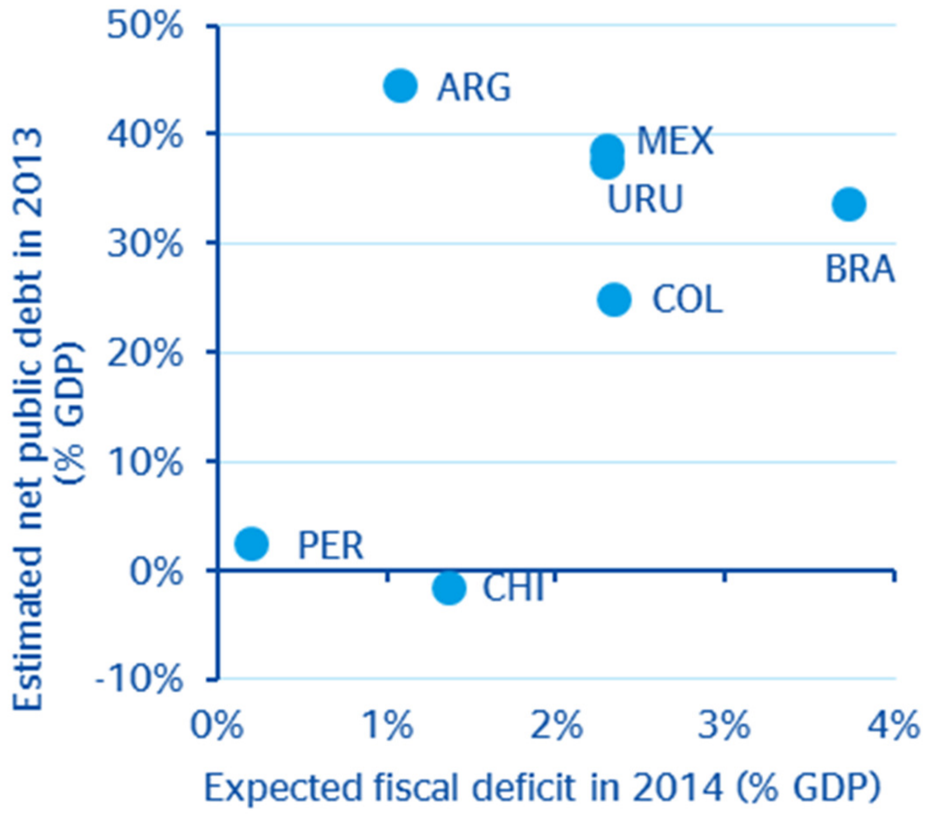
3 The Pacific Alliance: the real Latam giant

4 **Preserve policy space and push reforms in Latam**

It is key to keep what policy space is still left

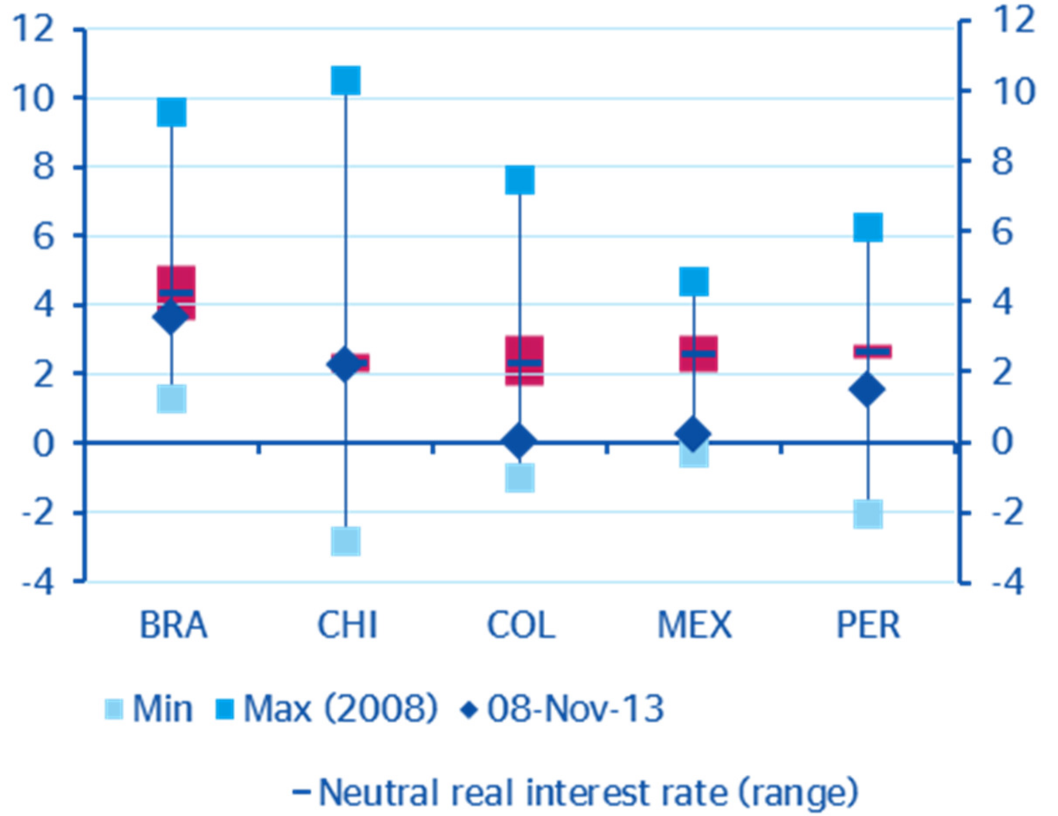
Public deficit and net debt (% GDP)

Source: BBVA Research and national sources



Policy interest rates in real terms (%)

Source: BBVA Research and Bloomberg



Resist temptation to over-stimulate demand. Push reforms instead.

Tight labor markets (and inflation pressures in some countries)	→	Deceleration, but output level close to potential, or even above in some countries
Infrastructure bottlenecks	→	A further fiscal impulse does not seem justified. Keep monetary policy space for start of tapering
Sizable current account deficits	→	Reforms to loosen supply-side bottlenecks and sustain long-run growth

Main messages

1. **Global cycle strengthens as developed countries recover and deceleration of emerging economies comes to an end.** Global growth will be 2.9% in 2013, increasing to 3.6% in 2014.
2. **Financial stress in Latam in reduced and capital flows stabilize,** but the region will continue to face an external environment that is less benign than before May.
3. **Growth forecasts for Latam are adjusted downwards to 2.4% in 2013,** dragged by Mexico and Brazil. **Growth will pick up to 3.1% in 2014**, as external demand improves and Mexico recovers from the soft patch of 2013H1
4. **Monetary policy will be heterogeneous, given different inflationary pressures (higher in Brazil and Uruguay).** Exchange rates will depreciate slightly in 2014, given lower global liquidity.
5. **Latam can withstand new external shocks,** but it is crucial to preserve what policy space is left and push reforms.

BBVA | RESEARCH

Latam: recovery and turbulence

Juan Ruiz

BBVA Research | Chief Economist for South America

Latam Outlook – Fourth quarter 2013 | Madrid, 20 November 2013