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Economic Outlook

Latam

Fourth Quarter 2013
Economic Analysis

- **The global economy will grow 2.9% in 2013 and 3.6% in 2014** with some slowdown in emerging economies and recovery in developed economies.
- **Financial tensions ease in Latam and capital flows stabilize,** but the region continues to face a less favorable external environment.
- **Growth forecasts for Latam are revised downward to 2.4% in 2013,** dragged by Mexico and Brazil. **Growth will rise to 3.1% in 2014** as foreign demand gradually improves and growth in Mexico recovers.
- **Heterogenous monetary policy in Latin American countries, due to different inflationary pressures and cyclical positions.** Fed's tapering will induce a slight exchange rate depreciation.
- **The region can withstand further external shocks** but it is important to keep what policy space is left and to promote reforms.

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Closing date: November 13, 2013

1. Summary

The global cycle is improving, above all in developed economies, although it is still far from being a strong recovery. Tensions on international financial markets, caused by the debate concerning the reduction in bond purchases by the Fed, have eased over the third quarter, providing a certain degree of support not only to the US but also to the global economy. China continues to stimulate growth, though in a more limited fashion, thus reducing doubts about the authorities' commitment to sustaining growth above 7.5% per year, albeit at the expense of increasing its mid-term vulnerabilities. In Europe, meanwhile, tail risks have eased and a timid recovery is expected in 2014. We slightly revise our global growth estimate in 2013 downward to 2.9%, rising to 3.6% in 2014.

The easing of international financial tensions has given Latin America a bit of breathing space after the turmoil in the second quarter. Both the delay in withdrawing the monetary stimulus by the Fed and sustained growth in China helped to stabilize capital flows to the region, to bring about a recovery in stock market prices, reduce sovereign spreads and slightly appreciate exchange rates, but without reaching pre-May levels. In the following months, volatility will continue in financial markets until uncertainty about the timing of Fed's tapering are fully known, but most of the effect of withdrawal of stimuli would already have been incorporated in asset prices in the region, which would now be closer to their fundamental values. Financial conditions will not be as favorable as they were before May, but it will still be relatively benign in historical perspective, with relatively low sovereign and corporate spreads.

Domestic demand has also shown signs of stabilization in most countries, with confidence indicators at levels consistent with moderate optimism and some recovery in retail sales and imports, though with still lower growth lower than in 2012.

Growth in the region is revised downward in 2013 from 2.7% to 2.4%, dragged in particular by Mexico's soft patch in the first and second quarter. Activity would gather pace to 3.1% in 2014. Growth indicators for the second quarter were higher than expected in most countries, the main exception being Mexico, which faced temporary shocks in industrial production and construction and a historical downward revision of GDP. In 2014, we expect activity to rise to 3.1% insofar as Mexico (and, to a lesser degree, Brazil, Peru and Colombia) leave behind the temporary supply-side shocks which impacted them in the first half of the year and foreign demand in the region gradually recovers, in line with global growth.

Peru, Chile and Colombia, together with Paraguay, should maintain the highest growth in the region in 2013 and 2014. On the other hand, Brazil will maintain moderate growth. There will be two extremes in the varied growth in the region: Peru should grow 5.6% in 2014, Colombia 4.7% and Chile 4%, while Paraguay will do so by 5.3%. On the other hand, we expect Brazil to report growth of 2.8% in 2014, due to monetary tightening, uncertainty associated with elections and the continuation of the economy's structural problems. Thereby, if we exclude Brazil and Mexico, growth in the region would be 3.5% in 2014, with an upward trend, converging towards its potential of 4% in coming years.

Fiscal outlook in the region is less optimistic due to sluggish domestic demand and a less favorable external environment, although expected deficits should keep within manageable ranges. Perhaps the biggest cause for concern is Brazil, where the rise in interest rates should have a negative impact on public balances. In the case of Peru and Chile (and, to a lesser degree, Colombia) there is still leeway for using expansive fiscal policies although, generally speaking, cyclical conditions do not appear to justify a fiscal stimulus in the region.

Still reduced domestic slack translates into a worsening of external balances since the 2008 crisis, although the slowdown in domestic demand and certain investments in the export sector coming online imply a reduction in coming years. The end of supply problems in the export sector in some countries such as Brazil, Peru or Colombia, has also played a role in the slight improvement in projected external balances. External deficits in most countries are still

largely financed by foreign direct investment, which is more stable vis-à-vis further possible financial turmoil. In addition, if we exclude the cyclical component of these external deficits, structural deficits in Latin America will remain below 3% of GDP in coming years - sustainable levels in view of the growth outlook for the region.

Inflation will remain under control in the region, in line with the central banks' inflation targets, except in Uruguay, where it is expected to remain above the target band during next year. However, there are clear differences in the core dynamics of inflation between Brazil and Uruguay, countries which will maintain upward pressure on inflation, and the other countries with inflation targets, where inflation should remain under control and converging to the central bank's target.

Because of varying inflationary pressures, central banks have had a different response to the turbulence in financial markets and forecasts differ regarding the future course of monetary policy in the region. While Brazil and Uruguay tightened monetary policy, even more than was expected three months ago, there were cuts in interest rates in Mexico, Chile and Peru, due to weaker domestic demand. Looking further ahead, we expect greater tightening in Brazil and Uruguay, taking into account the persistent pressure on inflation, but also in Colombia, insofar as growth recovers. Interest rates should remain stable in Mexico and Peru, while the slowdown in Chile would prompt a further 50bp cut in coming months.

Lower global liquidity should promote a slight exchange rate depreciation in most countries in the region. The depreciation will follow the trend towards the increase in long term interest rates in the US, and will also be favored by external balances which will remain sizable. However, it will be a contained depreciation given that most of these effects have already been factored in by markets in the depreciation observed since May. The main exception will be Brazil – where authorities would be ready to allow a depreciation of almost 10% in 2014 in order to recover part of the competitiveness lost in recent years – which would also impact Uruguay.

Generally speaking, the region can withstand new external shocks but it is important to keep space for countercyclical policies. The region continues to show relatively sound vulnerability indicators (high international reserves, falling foreign debt, sound banking system, flexible exchange rates). However, there has been little progress in recovering fiscal and monetary policy space, since they were used following the Lehman Brothers crisis. Now is not the time to recover those spaces - it should have been done at a time of looser financial conditions and higher commodity prices - but nor should the space left be used before it is necessary.

As the tailwinds of favorable financial conditions commodity prices are reduced, it is important not to overstimulate demand. Instead, supply should be expanded through reforms. It is necessary to overcome the temptation to maintain growth with demand stimuli given the remaining signs of constraints on the supply side, which are evident in the labor market, infrastructure bottlenecks, growing external deficits, and, in certain countries, still high core inflation. Spaces for fiscal and monetary policy will be necessary when monetary stimuli begin to be withdrawn in developed countries. In the meantime, it is essential that progress be made in the reforms process in order to ease supply constraints and sustain long term growth.

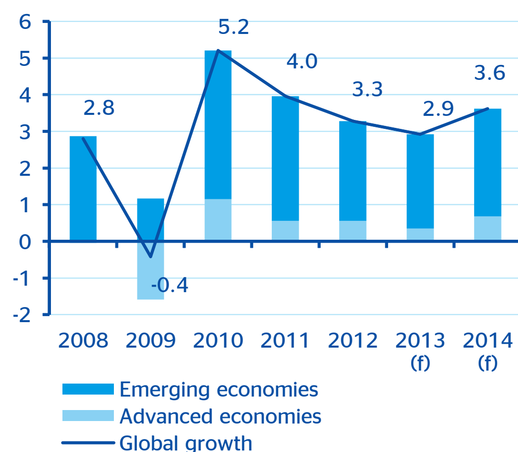
2. A slow global recovery with downward risks

The economic cycle is improving, above all in advanced economies, although it is still far from a strong recovery

Two general features have characterized the global economic scenario in the last quarter. First, the confidence indicators of businesses and the volatility of the financial markets have continued to reflect the low probability of tail risk events, those that could be disruptive for the global situation. Thus, economic recovery is picking up speed and there is less risk of it derailing. However, some events have contributed to a scenario of a feeble global recovery within a one or two-year horizon. They are events with a current impact (the partial closure of the U.S. government) but also a future one (the tightening of financial conditions due to the expected end of the exceptional support of monetary policy).

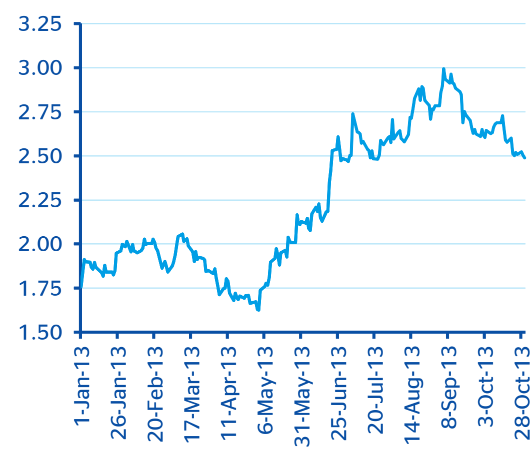
Overall, we have revised down by 0.2 p.p. the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision of 2013 growth is due to the worse figures recorded in the U.S. and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of the markets' expectation of an imminent tapering of QE following the Fed's announcement last May. Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision (except for China, where we stick to our forecasts), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain at the same levels.

Chart 1
Global growth & contribution by regions



Source: BBVA Research and IMF

Chart 2
U.S.: Yield on 10-year U.S. government debt



Source: Bloomberg and BBVA Research

The tension in the financial markets caused by the announcement of the Fed's tapering eases, providing a boost not only in the U.S.

The Fed surprised the markets when in September it decided not to start the process of tapering its quantitative easing (QE) program. By delaying the start, it underpinned the nature of the program as data-dependent, in addition to the effect from the uncertainty about the fiscal deficit and debt ceiling.

The clarifications on the process of tapering, which the Fed's members are preparing in the light of the unexpected reaction of the market to their first announcement and its delay until (possibly) the start of 2014, have reduced the risks of the recovery derailing.

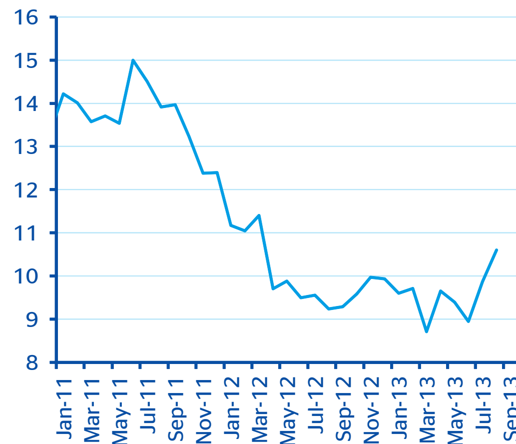
Much of the rise in long-term interest rates recorded since May has been reversed (Chart 2). The markets do not now anticipate rises in Fed Fund rates until 2015. In addition, volatility and financial tensions have eased at a global level, particularly in emerging markets in Asia and Latin America, which are also affected by a reduction in capital inflows, so that fears of a "sudden stop" of funding for emerging markets has gradually been losing intensity. At the same time, emerging markets show indications of a recovery in confidence, after the check in the middle of the year.

In any event, tapering will end up arriving, and change the global scenario of liquidity injections that resulted in indiscriminate flows to emerging markets. The impact of tapering, once it is effectively underway, will be a greater discrimination in flows toward emerging markets according to the fundamentals of each of them.

China once more stimulates its growth, but in a more limited fashion

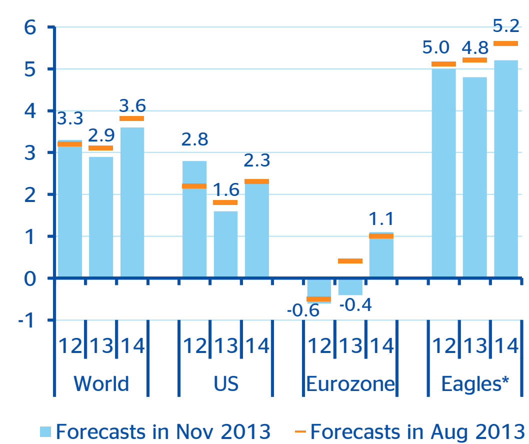
In China, the doubts at the start of the year on the possibility of a sharp adjustment in its economy have also dissipated, at least in the short term. The economy has maintained a high rate of growth, and the most recent data (third quarter) suggest that GDP is picking up (Chart 3). Better than expected figures triggered an upward revision, from 7.6% to 7.7%, in our 2013 GDP growth forecast. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off measures of tax policy and public spending with a renewed use of credit.

Chart 3
China: index of industrial output (y/y %)



Source: BBVA Research and Haver Analytics

Chart 4
GDP growth forecasts (%)



EAGLES is the group of emerging economies with the highest contributions to global GDP over the next 10 years. Group consists of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research and IMF

The perception of Europe improves and the most extreme risks have dissipated. The reforms geared toward better governance continue and growth returns

In Europe the forecasts have been confirmed and the economic situation has continued to improve, to the point that the Eurozone emerged from the recession with growth of 0.3% in the second quarter of 2013, after 6 quarters in recession. The reading of the data is positive in two respects: the recent recovery is based on an improvement in domestic demand and also extends to the periphery, contributing to eliminate the systemic risks characterizing previous quarters. The recovery of activity has been helped by a reduction in financial tensions in the area and by

a relaxation (de facto) of the more short-term targets of fiscal consolidation, implicitly tolerated by the European authorities.

GDP growth in this part of the year formed part of our scenario, and there has been no additional element to make us change our expectations of a weak recovery. In 2013 Europe's GDP will fall by 0.4% and grow by 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies in the area and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. The next few months will be decisive in making progress toward banking union, with the entry into operation of a single supervisor, the ECB, and the definition of the mechanisms for bank resolution, the model for implementing which is still under discussion.

The fiscal agreement in the U.S. has been another patch that does not address long-term fiscal sustainability and does not prevent a contractive short-term impact

The fiscal agreement reached on October 16 is a simple extension of the current situation, as it only includes that the Government will have finance until January, while the new debt ceiling will be reached in February.

Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already gone through in these months on previous occasions, and this can only have negative consequences. Most likely, the partial closure of government for 16 days has had a relatively marginal direct effect on GDP for the quarter, perhaps a few tenths of a pp. However, the threat of this process continuing may have an additional impact. In any event, the situation in which economic policies push in opposing directions will continue, with a loose monetary policy that will continue to be so for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (unlike in Europe) from 6.8% in 2012 to 4.0% in 2013, which can be considered a drain of 1.3 percentage points of GDP growth in 2013. And the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled. In our central scenario, a less pronounced fiscal adjustment in 2014 and the contagion of recovery will allow a rise in growth in the U.S., from 1.6% estimated for 2013 to 2.3% in 2014 (Chart 4).

Risks in the forecast: downward bias but a priori with less probability and lower impact

The risks to the moderate recovery scenario detailed above have been reduced. This does not take away the fact that the balance of risks continues to be downward. It is worth pointing out first, due to its nature, the possibility of a “disorderly exit” from the Fed's QE, which could generate an excessive increase in interest rates (in the U.S. and in other countries). Financial conditions that are too tight for the rest of the world could halt a global recovery if it is not especially dynamic, particularly in the Eurozone.

Second, another risk factor is the possible adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas that domestic policies have to address in a less favorable global financial environment.

Lastly, the resurgence of the euro crisis is a globally relevant risk. The authorities have to support the positive perception of the markets with decisive progress to strengthen monetary union, in particular banking union. In all, there are a number of elements that could lead the better perception to change: from the lack of necessary reforms to unexpected results in the review of the bank balance sheets and the stress tests, which are needed for the implementation of a single banking supervisor, the ECB. Finally, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms, may result in tensions and volatility in the financial markets.

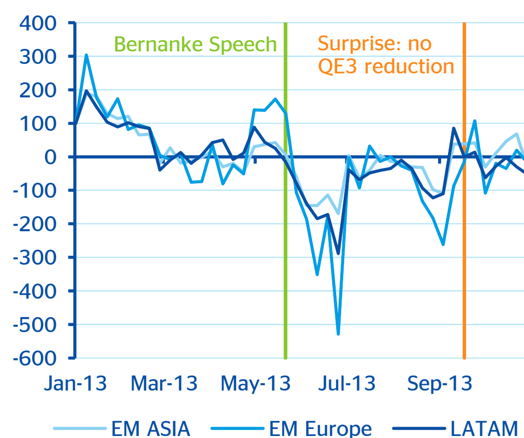
3. Latin America finds relief from stabilization in financial markets

Financial markets stabilized in emerging economies, after the turmoil in the second quarter

The dynamics of the global economy during the third quarter partially reversed the extremely volatile events which occurred in the second quarter, shaped on the one hand by higher volatility in international markets and the interest rate hike in developed economies, and, on the other, due to the gloomier growth outlook in several emerging markets, especially the doubts about a sharp slowdown in China.

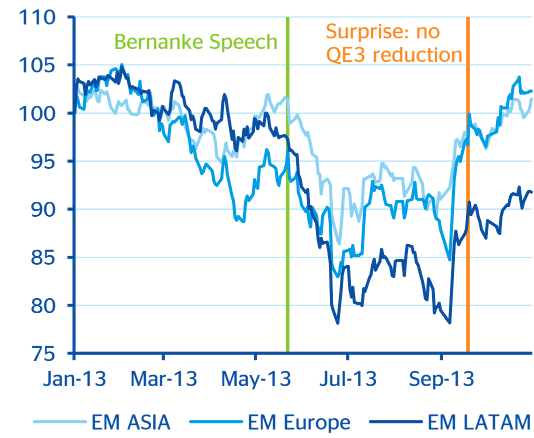
In the third quarter, however, these factors were partly reversed. First, the start of the reduction in US monetary stimuli was postponed, shown by the Fed's surprising decision not to start to reduce bond purchases on 18 September, when investor consensus was that it was certain. Subsequently, delaying the budget and debt ceiling debate in the US until early 2014 creates other additional uncertainties which would be weighing on the decision to reduce bond purchases by the Federal Reserve. Second, as we said in the above section, doubts about adjustment of growth in China were reduced, the result of the improvement in foreign demand, but also of one-off tax policy and public spending measures with a renewed use of credit. Although this raises doubts about the sustainability of growth in the mid and long term, it dispelled doubts about to what degree authorities would be committed towards growth targets of at least 7.5% per annum.

Chart 5
Capital flows in emerging markets (index January 2013 = 100)



Source: BBVA Research and EPFR

Chart 6
Stock market indices in emerging markets (MSCI, index January 2013 = 100)



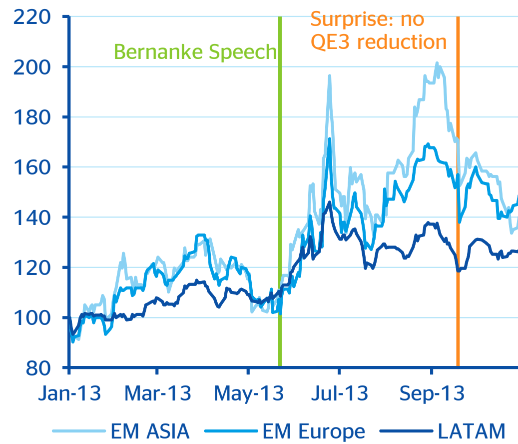
Source: BBVA Research and Haver Analytics

These two factors helped to reduce financial tensions in emerging markets, from the highs reached in late June. Thus, particularly from September on, capital flows were stabilized (Chart 5), stock market prices were recovered (Chart 6), sovereign spreads narrowed (Chart 7) and exchange rates strengthened (Chart 8). Nevertheless, pre-May levels - before the first discussion by Bernanke on beginning the reduction in bond purchases - have still not been regained, because financial markets have already assumed that this withdrawal will eventually happen, and this has been factored in to asset prices on emerging markets.

It is interesting to note that, in contrast to the way markets performed before May, the correlation has increased between changes in asset prices in Brazil and the other countries in South America - though to a greater extent in Brazil - because global factors have outweighed idiosyncratic

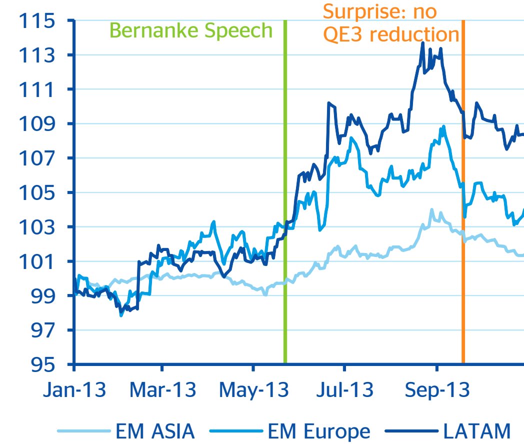
factors. However, capital flows to Latin America have stabilized to a greater degree in Andean countries and in Mexico than in Brazil (Charts 9 and 10).

Chart 7
Sovereign spreads in emerging markets (EMBI, index January 2013=100)



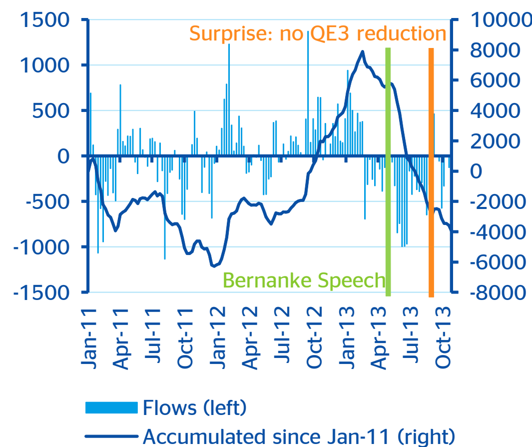
Source: BBVA Research y Haver Analytics

Chart 8
Exchange rate vs. USD in emerging markets (index January 2013=100)



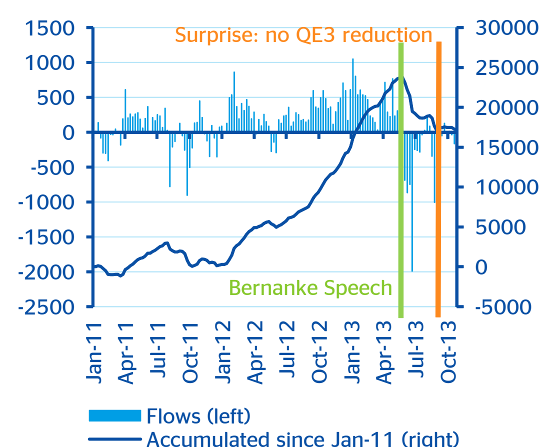
Source: BBVA Research y Haver Analytics

Chart 9
Capital flows in Brazil (millions of dollars)



Source: EPFR and BBVA Research

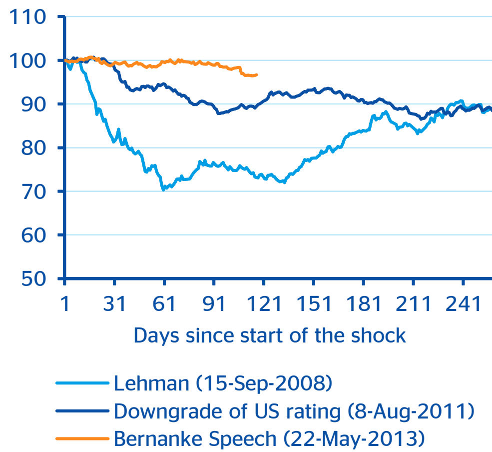
Chart 10
Capital flows in the rest of Latin America (millions of dollars)



Source: EPFR and BBVA Research

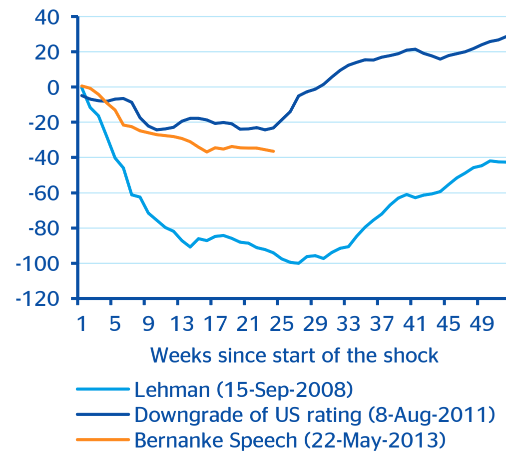
If we compare the dynamics of the financial variables with former episodes of high volatility in international markets, we see that this episode is more similar to the turbulence observed after the downgrade of the US credit rating by S&P in August 2011 than the episode which occurred immediately after the collapse of Lehman Brothers (Chart 11-14). In fact, in many cases the corrections observed since May have had the effect of bringing exchange rates more in line with their fundamentals and correcting a certain degree of overvaluation observed since the start of the year. In sovereign spreads, there has been an upward correction, although they still remain at moderate levels for the region's historical standards.

Chart 11
Changes in commodity prices during high volatility episodes (CRB index, start of volatility=100)



Source: National governments and BBVA Research

Chart 12
Changes in capital flows to Latin America in high volatility episodes (cumulated, % of assets under management)

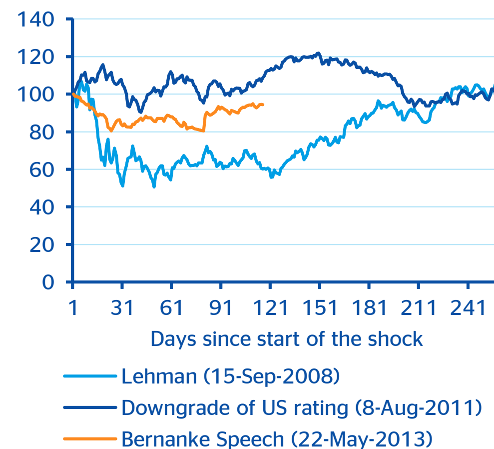


Source: EPFR and BBVA Research

Chart 13
Changes in Latam exchange rates during high volatility episodes (index start of volatility=100)

Source: National governments and BBVA Research

Chart 14
Changes in stock market indices in Latam during high volatility episodes (MSCI Latam index, start of volatility=100)



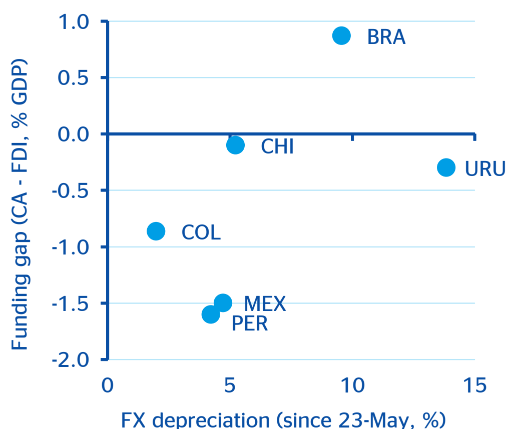
Source: Bloomberg and BBVA Research

Since the turmoil began in May, it has generally been economies with high inflation, higher foreign deficits (especially those financed to a higher degree by short term capital flows) and less prudent economic policies which have experienced the greatest falls in asset prices, including the depreciation of their currencies (Chart 15). This has been the same case scenario with other emerging markets.

Prices of the principal export commodities, however, have been relatively exempt from financial considerations (Chart 16), except perhaps copper (linked to doubts about the slowdown in China), where there was some recovery in the price in this last quarter. Oil is still shaped on the supply side by the OPEC's support and the continuing geopolitical tensions in production areas. In soy prices, the normalization on the supply side at global level should continue putting downward pressure on the price towards its long term equilibrium level.

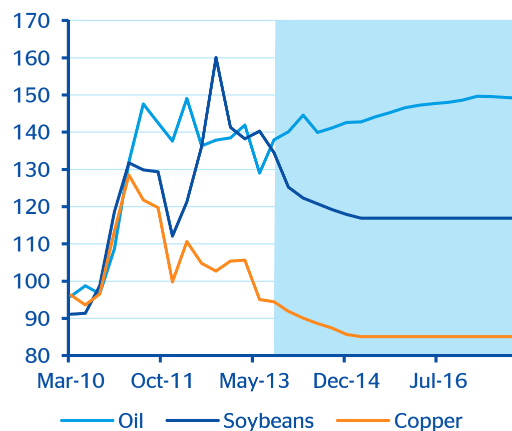
It is important to note that what we consider to be the key factors for long term commodity price estimates have not significantly changed against the way they were three months ago. In particular, we expect growth in emerging markets to remain higher than in developed economies, although we expect some degree of rotation towards a lower emphasis on investment and higher on consumption. This rotation leads us to lower long term price estimates than at present (except in oil where the current price would be maintained in real terms), but which are still higher than the average for the last 5-6 years, and will therefore continue to be a support factor for South America.

Chart 15
Changes in exchange rates and external financing needs not covered by FDI



Source: National governments and BBVA Research

Chart 16
Commodity price forecasts



Source: Bloomberg and BBVA Research

Over the next few months, we expect that financial markets will remain volatile, while awaiting the launch of tapering from QE by the Fed and during the withdrawal process, insofar as this process will depend on the data confirming (or not) the strength of recovery in the US, as well as on the doubts raised about the negotiations on the debt ceiling in the US. Although financial markets have already factored in the Fed's possible tapering of QE3 in asset prices, so that capital flows to the region and financial asset prices should be stabilized, it is also important to note that the outlook of higher long term interest rates will materialize in a more adverse setting and will have an impact on monetary policy strategies, as shall be analyzed later in this report. Nevertheless, even though the financial setting will not be as favorable as it was before May, over the next few quarters it will still be benign in terms of historical perspective, with sovereign and corporate spreads relatively low.

Domestic demand also shows signs of stabilization in most countries

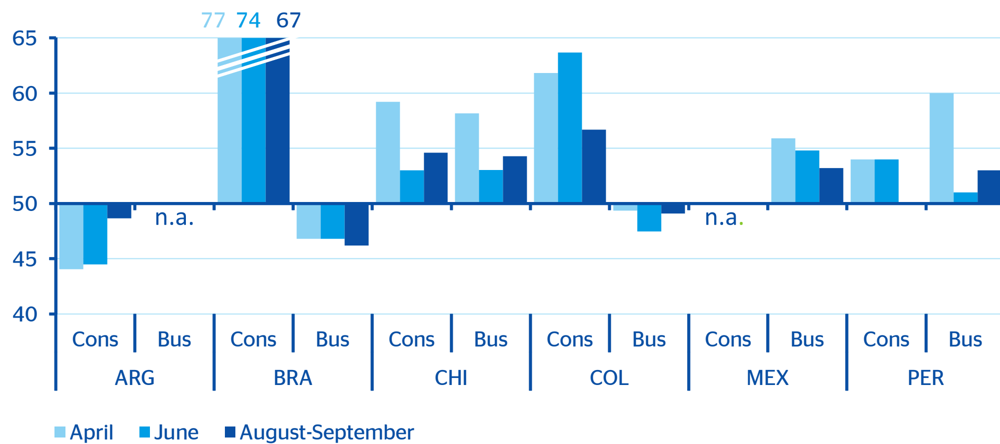
Undoubtedly, the less favorable international setting and turmoil on financial markets have prompted a loss of business confidence in the region since the start of the year. Furthermore, the outlook of lower growth in real wages and in employment (in some cases due to a less robust labor market and, in others, due to persistently high inflation rates) has also prompted adjustment in consumer confidence compared to first quarter figures (Chart 17).

However, the stabilization in international financial markets also brought about a certain degree of stabilization in confidence indicators in the last quarter, both in consumers and in businesses, in most Latin American countries, though Brazil and Mexico have been important exceptions, no doubt due to their cyclical weakness. From a business standpoint, the lower financial volatility and

announcements concerning public investment plans in certain areas (such as Peru or Colombia) have played their part in the stabilization and have in fact even improved confidence levels. Hence, although confidence indicators still stand at a level associated with moderate optimism in most countries (except in Argentina and in business confidence in Brazil), it is substantially less than was observed in the region at the start of the year.

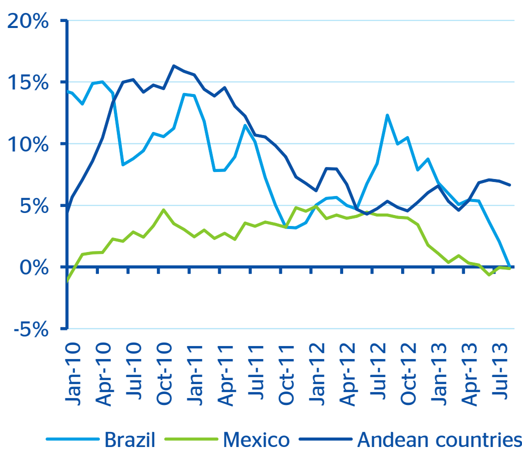
In keeping with the stabilization in confidence indicators, domestic demand, retail sales and imports figures have all shown greater stability and even an improvement in most countries, though not as buoyant as in 2012.

Chart 17
Confidence indicators



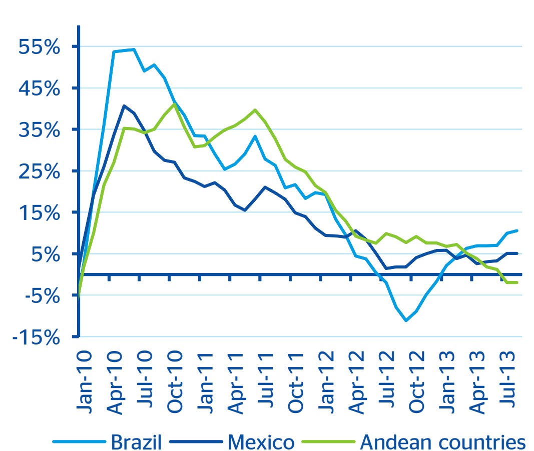
Source: National governments and BBVA Research

Chart 18
Retail sales (% y/y)



Source: National governments and BBVA Research

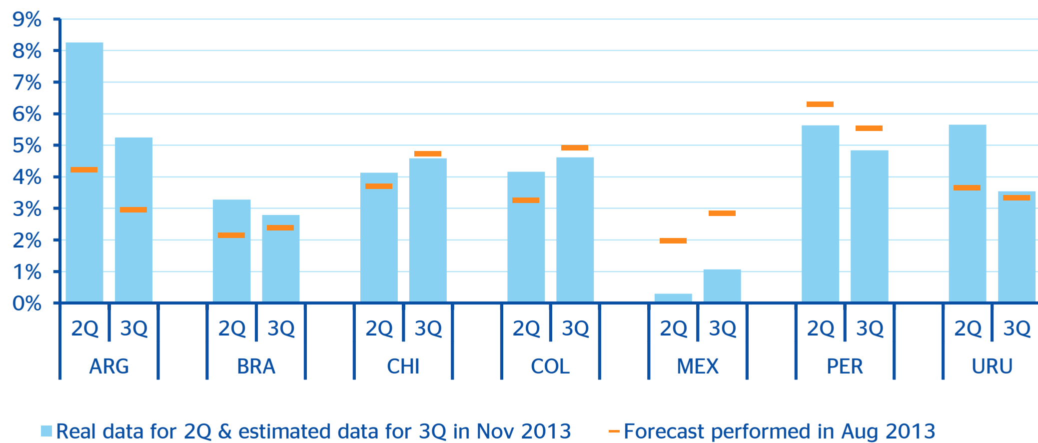
Chart 19
Imports (% y/y)



Source: Bloomberg and BBVA Research

In most countries, growth indicators in the second quarter were better than expected three months ago (Chart 19). This is the case particularly of Chile, Colombia and Uruguay, where growth was fuelled by higher than expected growth in industrial output and consumption (and in Uruguay's case, services). Consumption was weaker in Brazil, but there was a considerable rise in investment. In the case of Argentina, Brazil and Uruguay, growth in agricultural production also triggered sharp growth in the second quarter (higher than expected). On the other hand, in Mexico the second quarter activity data were hit by the slowdown in the industrial sector (in particular, the auto sector) and retail sales[1]. The downturn in Peru's case was significantly lower, and was caused by certain supply problems in the export sector and lower investment due to the downward revision of business confidence.

Chart 20
Surprises in growth forecasts in the second and third quarter of 2013 (% y/y)



Source: National governments and BBVA Research

1: What is more, in Mexico's case the year-on-year growth rate for the second quarter was also negatively impacted by the historical revision of GDP. In particular, growth in the first quarter was lowered from 0.5% year-on-year to 0.0%, which went together with a -0.7% quarter-on-quarter drop in the second quarter, a long way below the 0.4% estimated three months ago.

4. Growth slowdown in 2013 and recovery in 2014

Growth in the region is revised downward in 2013 to 2.4%, dragged in particular by Mexico's soft patch in the first half of the year and moderate growth in Brazil

In spite of the good second quarter figures mentioned in the above section (Mexico being an important exception), third quarter activity indicators suggest somewhat less favorable dynamics than were expected three months ago in most countries, which will tend to offset the positive effect on year-on-year growth of the surprises observed in the second quarter (Chart 20). So, generally speaking, the effects of the second and third quarter have tended to compensate each other.

Nevertheless, despite the less optimistic outlook than we were expecting three months ago, we still expect to see recovery in the second half of 2013 on the relatively weak growth in the first half of the year. This recovery should last until 2014 (Chart 21), while foreign demand recovers - particularly from developed countries - and the temporary soft patch in growth in Mexico is overcome.

The statistical effects of higher than expected growth in the second quarter have prompted a slight upward revision of growth estimates in Brazil (0.3 percentage points), and a larger one in Paraguay (0.8 pp), against our estimates three months ago. However, the aggregate Latin America growth figure is still impacted by the moderate growth in Brazil (2.6% in 2013), lower than the average for the rest of the region.

In contrast with Brazil and Paraguay, the higher than expected slowdown in the second quarter in Peru, and, in Mexico in particular, implies a significant downward revision of growth in 2013, particularly in the latter case. The revision for Mexico is on a sufficient scale (1.4 pp less than we expected three months ago) as to impact the aggregate figure for the region, lowering the growth forecast for 2013 from 2.7% estimated three months ago to the current 2.4%. It is important to note that not including Mexico, growth in South American in 2013 would rise from 2.7% to 2.9%.

The case of the revision of growth in Mexico is particularly noteworthy (from former 2.7% to 1.2% at present). In the first half of the year, a combination of temporary factors prompted surprisingly low figures. On the one hand, lower foreign demand was one of the factors which heightened the trend of slowdown in manufacturing output in the first months of the year, in addition to the sharp fall in automobile production which was already under way in the latter part of 2012. On the other hand, growth has fallen in the construction sector for six months in the yearly comparison, only comparable with the fall in 2009. In this regard, the delay in the implementation of public spending and the new housing policy have been key factors in the sharp adjustment in the sector. On top of this, growth in oil exports - an important source of resources for the country - was down due to lower prices and the slowdown in exported barrels. Many services with strong ties to industry reflected the fall in production, and so did employment, where the growth in terms of annual recruitment is increasingly lower. Furthermore, real wages, as a result of the rise in inflation in the first quarter, fell below the levels one year before, a phenomenon which was related with lower household spending. Lastly, it is important to take into account the negative impact, albeit small, on GDP (0.1 pp approximately) of the heavy storms and hurricanes in mid-2013.

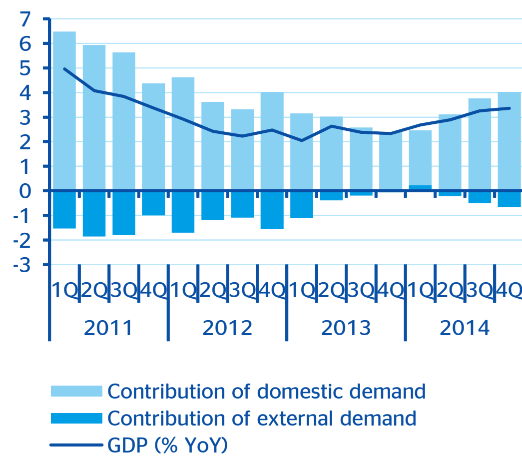
In this context, it is important to point out the temporary nature of the aforementioned effects. On the one hand, growth in manufacturing should be underpinned by the brighter outlook for growth in the US. In fact, there have already been substantial improvements in growth of industrial output last July and August. On the other, public spending will have to grow significantly

in the third and, above all, in the fourth quarter; and here the expected investment set forth in the National Infrastructure Plan and the promotion of public-private partnerships will be crucial. Lastly, the housing market is gradually adapting to the new law, which includes subsidies policies to increase supply.

Activity should gather pace to 3.1% in 2014, as the temporary negative shocks in Mexico are overcome and foreign demand gradually recovers

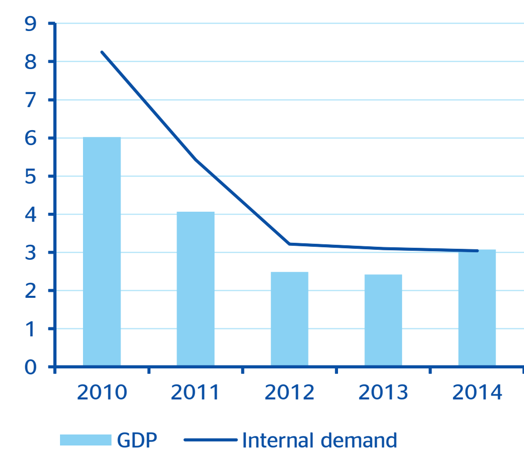
In 2014, activity in Latin America will rise from 2.4% to 3.1% (Chart 21), only slightly below (0.1 pp) than was estimated three months ago. This increased growth in activity will be underpinned by the improvement in foreign demand, in keeping with the increase in world growth, particularly in developed countries (the US in particular), but also of the main emerging markets which are recipients of South American export products (Chart 4). Internally, the temporary problems of supply which affected exports from several countries in the region (Brazil, Peru, Colombia) shall fade. Domestically, the recovery in growth in Mexico, after overcoming the aforesaid temporary shocks suffered in 2013 (and also propelled by the increase in growth in the US) shall also help to fuel greater regional aggregate growth.

Chart 21
Latam: Quarterly growth in GDP



Source: National governments and BBVA Research

Chart 22
Latam: growth in GDP and domestic demand (%)



Source: Haver and BBVA Research

Peru, Chile and Colombia, together with Paraguay, should report the most buoyant growth in the region in 2013 and 2014. Brazil, on the other hand, will have moderate growth

Brazil, on the other hand, will have moderate growth

Growth will vary greatly between the different parts of the region. On the one hand, the three Andean countries and Paraguay will again report the highest growth in 2013 and 2014 (Chart 22). In particular, Peru is expected to grow 5.3% in 2013 and 5.6% in 2014, as business confidence improves (and, with it, investment and private spending) and with the start-up of a series of major mining productions which should support production in the sector and exports, together with the continued expansion in public spending as in 2013. In Colombia, GDP should grow 4.1% in 2013 and would rise to 4.7% in 2014 with the recovery in private consumption and civil works, due to the transfer of interest rate cuts by the Central Bank during 2012 and the first half of this year. Lastly, Chile has shown clear signs of slowdown in growth in recent months,

bringing growth in GDP for 2013 to 4.2%, with slight correction to 4% in 2014, mainly due to a certain weakness in private consumption components, especially in the labor market, and of investment, which, nonetheless, should continue to grow at rates in the region of 4.5% in 2014.

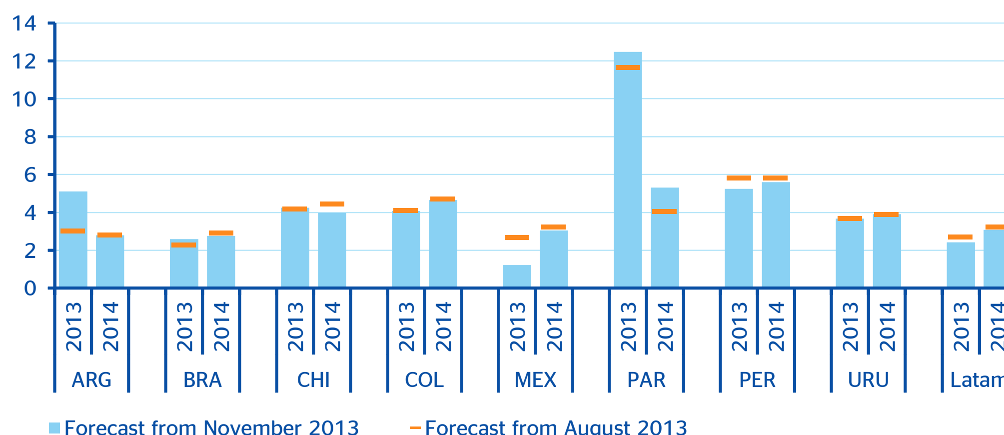
We expect Paraguay to report double-digit growth in 2013 (12.5%), rebounding after the shock in the agricultural sector in 2011. And in 2014, we expect growth of 5.3%, underpinned by the export sector and investments - still high, but more in line with the country's potential growth. Uruguay should continue to grow around its potential (3.7% in 2013 and 3.9% in 2014), though within a setting of slowdown in domestic demand marked by a certain degree of deterioration in the labor market and lower investment levels.

As we stated above, Mexico would report the lowest growth of the main countries in the region in 2013 (1.2%) due to the temporary soft patch in the first half of this year, which, once overcome, should allow Mexico to achieve higher growth of 3.1% in 2014 (Chart 22).

Lastly, in Brazil's case, the positive surprise in growth in the second quarter would largely be offset by a sharp slowdown expected for the third quarter, bringing growth in 2013 to 2.6%, below the regional average. In 2014, the lack of relevant space for fiscal policy and the tightening of monetary policy under way will restrict growth to 2.8%, on top of the uncertainty associated with the election process and the structural problems of the economic model[2]. In terms of the private sector, recently there has been progress in investment, and spending for the 2014 and 2016 sporting events should provide support. However, consumption (with a greater weight in GDP than in other countries) shall remain structurally restricted, insofar as lending slows, population trends begin to be adverse and the labor market has no more space for a greater reduction of unemployment.

Therefore, if we exclude Brazil and Mexico, growth in the other Latin American countries would be 3.5% in 2014, with an upward trend, converging towards its potential in the region of 4% in coming years. In the mid and long term, however, it is important to differentiate between the reform efforts recently carried out by Mexico, and the relative lack of action observed in Brazil. In the former, the reforms can potentially increase Mexico's long term growth by up to one percentage point. Furthermore, the joint initiatives of Mexico and the three Andean countries in terms of commercial and financial opening and integration within the Pacific Alliance and the coordination of their macroeconomic policies have the potential of building an economic area with greater weight and buoyancy than Brazil (see Box 1).

Chart 23
Latam countries: GDP growth estimates, 2013-2014 (%)



Source: BBVA Research

2: We also have to include the negative base effect in 2014 of the revision of the GDP historical series in Brazil.

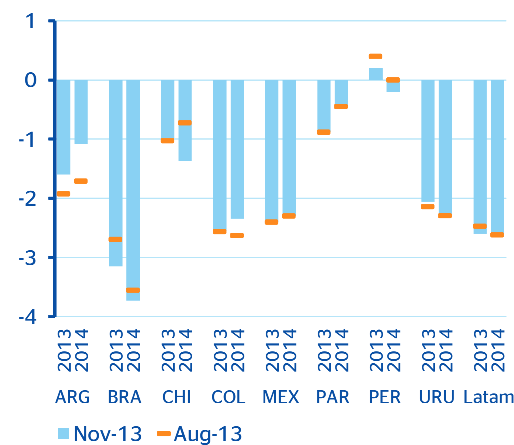
Fiscal outlook in the region worsens due to sluggish domestic demand and a less favorable external setting, especially in Brazil, Peru and Chile. However, fiscal deficits remain within sustainable ranges and in most countries would begin to shrink from 2015 on

In a less favorable external context (including less accommodative financing conditions and a downturn in commodity prices) and with gradual slowdown in domestic demand (Chart 21), generally speaking the countries face worse fiscal outlook than they did three months ago (Chart 23). On top of this, in certain countries, such as Peru, we also have to consider the continued fiscal stimulus to fuel domestic demand.

Perhaps the biggest cause for concern in terms of fiscal matters is Brazil, where the rise in the Selic rates should have a direct negative impact on public accounts. The higher Selic rate will increase the government's interest payments and hence the scale of the fiscal deficit in 2013 and 2014. All things considered, and despite the fact that factors such as the relatively high inflation and a possible sovereign rating downgrade (which will probably happen sometime in 2014) should to some extent limit fiscal policy, we do not expect the target deficit to be complied with in 2013, nor in 2014, the latter impacted by the presidential elections.

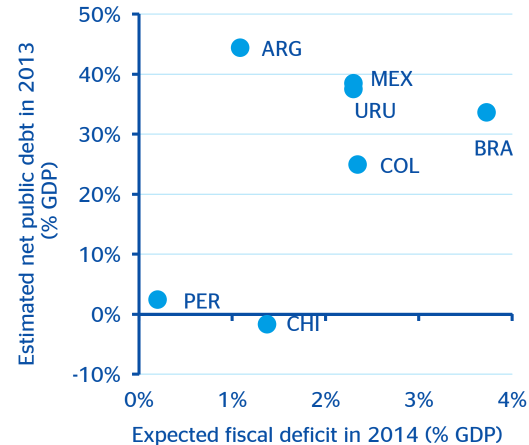
On the other hand, the Fiscal Reform proposed and recently approved in Mexico was a step in the right direction, though it was not sufficient, given that the project originally proposed implied an additional tax collection of 1.4 percentage points of GDP, while the approved project was of 1.1pp. The reform does not resolve structural problems which are to blame for the country's very low level of tax collection, meaning that in proportion with its size, Mexico will continue to collect the least tax within the OECD. It does not address subjects relating to tax evasion and low quality of tax collection. The approved reform does not generate additional resources to increase public federal investment, nor does it include the heavily debated application of VAT on food and drugs although on the other hand it does eliminate a series of exemptions on consumer goods[3], increases the upper limit for personal income tax and eliminates special regimes for companies. One of the most successful aspects of the reform is that it includes countercyclical mechanisms to expand spending responsibly in low parts of the cycle and offers the possibility of generating savings. It also offers unemployment insurance - with the worker's own resources - which is an appropriate step in terms of social protection.

Chart 24
Latam countries: fiscal deficit (% GDP)



Source: National governments and BBVA Research

Chart 25
Latam countries: fiscal deficit expected in 2014 and estimated net public debt in 2013 (% GDP)



Source: IMF and BBVA Research

3: Taxes will be charged on goods such as soda drinks, chewing gum, pet food and fast food.

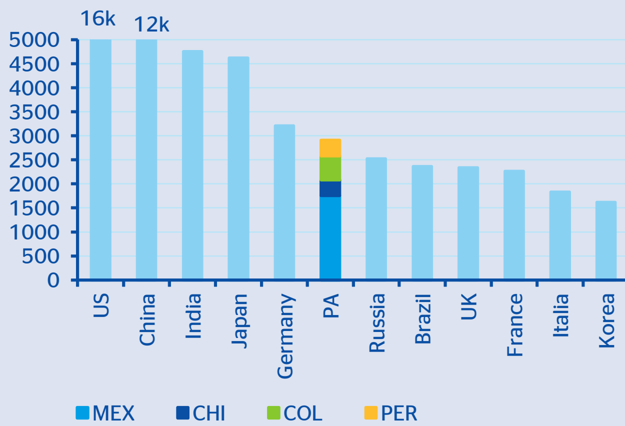
In the case of Chile and Peru, there is still room for maneuver for cyclical support policies, if it is necessary, due to the low deficit and net debt levels (Chart 25). Except in the case of Colombia, where in fact it is already being used. Generally speaking, although growth forecasts have fallen, in many countries a fiscal stimulus does not seem to be justified in the region. There is no space to do so in countries which have a controlled exchange rate. In the other countries in the region, their cyclical position does not seems to warrant it, either because there are positive production gaps such as in the case of Chile and Peru, or because of the strength of the labor market or even due to inflationary pressures which remain high (Brazil, Uruguay). In many cases, this dynamism in activity is evident in the deterioration in external balances since the 2008-9 global crisis, as analyzed in the following section.

Box 1. The Pacific Alliance: the Latin American giant committed to trade and financial integration

The Pacific Alliance (PA) is an ambitious process for economic and trade integration. One of its pillars is the building of an area of close integration through participation and agreement, progressing gradually towards the free movement of goods, services, capital and persons. At present it is made up of Chile, Colombia, Mexico and Peru (Costa Rica and Panama are in the process of joining). It not only aims to extend integration between its members but also with the rest of the world, with particular emphasis on the Asia-Pacific region.

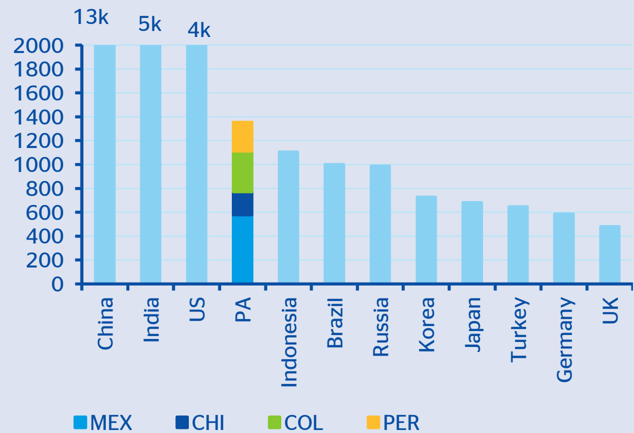
The commitment to integration between these four economies means that it makes increasing sense to see this bloc as a whole, and not as isolated countries. From this perspective, the four countries making up the Alliance represent the sixth biggest world economy, behind Germany but ahead of Russia and Brazil (Chart 17). More important still, it will be the fourth biggest economy in terms of contribution to world growth in the next ten years, behind China, India and the United States (Chart 18). It appears clear that the Pacific Alliance (PA) is becoming Latin America's real giant.

Chart 26
The biggest economies in 2012 (USD million adjusted for PPP)



Source: BBVA Research and IMF

Chart 27
Biggest contributions to global growth in the next 10 years (USD million adjusted by PPP)



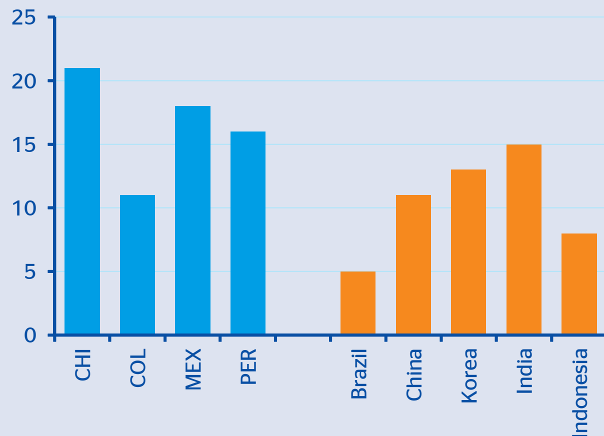
Source: BBVA Research and IMF

But size is not everything. Also important is the type of policies that can be expected from the countries making up the Alliance. Here the PA is also notable for its commitment to integration, not only between its members but also with the global economy. The countries in the Alliance are the emerging markets with the greatest number of free trade agreements signed (Chart 19); in the case of Peru and Chile this includes agreements with the four main economic areas: the US, the European Union, Japan and China. This contrasts with Brazil, for example, which does not have free trade agreements with any of them.

The commitment to trade integration also involves boosting trade flows between the members of the PA. There has been significant progress in this respect, with 92% of the customs tariffs being eliminated completely, and an additional 6.5% due to be eliminated within a very short period. Overall, given the current structure of exports (mainly manufacturing in Mexico, compared with the significant level of commodities in the Andean countries), there is some asymmetry in the potential for increasing the trade of goods within the Alliance. In principle, this should favor Mexico more than the three Andean countries (Chart 20). Even so, there is a great deal of potential for cooperation, transmission of know-how and investment in the infrastructure and capital markets[4].

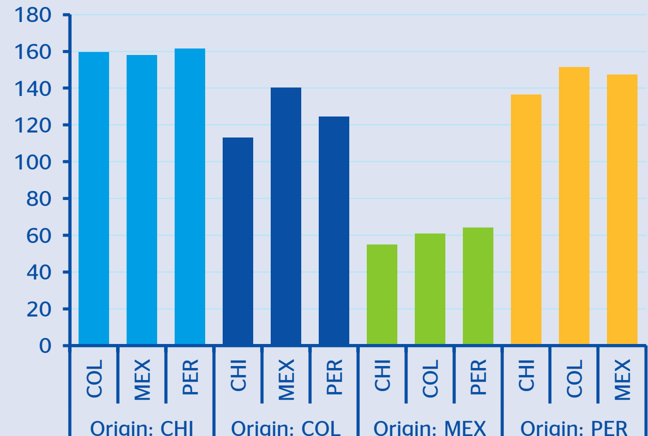
4: For a more detailed analysis of trading links in the Pacific Alliance, see our Economic Watch, August 2012: "New Pacific Alliance Bloc: Mexico and Andeans look towards Asia", available at http://www.bbvaresearch.com/KETD/fbin/mult/120822_EW_EAGLEs_New_Pacific_Alliance_Bloc_tcm348-355823.pdf?ts=25102013

Chart 28
Number of trade agreements signed



Source: BBVA Research and WTO

Chart 29
Export potential index (0 = very high; 200 = very low)



Source: BBVA Research and COMTRADE

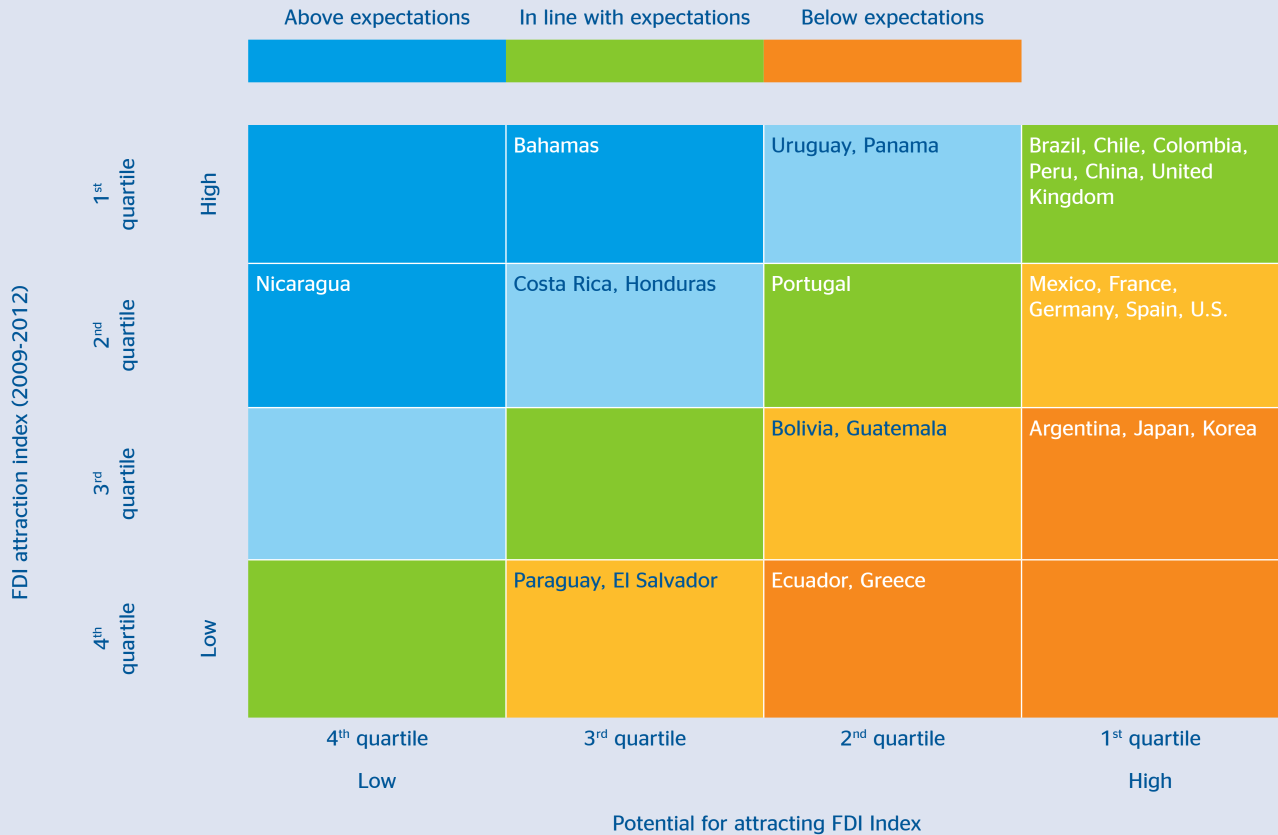
The PA is also firmly committed to financial openness and integration, both with the rest of the world and between the countries in the alliance. The countries of the PA have been major recipients of direct investment (in absolute terms and in relation to the size of their economies), above all from the U.S. and Europe, but increasingly from Asia as well. Even more importantly, according to UNCTAD, the countries in the PA are in the top 25% of the global ranking of countries with potential to attract FDI. Chart 21 shows that in a comparison of the two dimensions (observed FDI flows and potential for attracting FDI), the Pacific Alliance countries not only have a high potential for attracting FDI flows, but they actually achieve the rates to be expected by this high potential[2], unlike many other countries in the region[3].

As in the case with trade flows, if we observe the FDI flows within the PA, the first thing to note is its limited percentage in terms of the total FDI received by the four countries (3% of the total in 2009-2012). Further, they are also strongly concentrated in FDI flows from Chile to Peru and Colombia (Chart 22), probably due to the smaller size of the Chilean economy leading some of its companies to diversify and expand their operations within the region. There is no doubt that the maturity of the pension system in Chile has also enabled capital to be injected into companies with regional expansion policies, particularly in the retail sales and financial sectors. The concentration of FDI flows to Peru and Colombia is conditioned by their geographical and cultural proximity, which is associated with the lower costs of monitoring and controlling these investments. The foregoing is also reflected in the aggregate figures from 2009 to 2012, when Peru absorbed 42% of intra-PA foreign investment, followed by Colombia with 27% (Chart 23).

5: Mexico only appears in the second quartile of the world ranking for attracting FDI, although it has to be taken into account that in this case non-equity modes of production (NEMs) such as manufacturing by contract or service outsourcing are very important, but are not counted as FDI, even though they include many of its advantages, such as transfer of know-how and technologies.

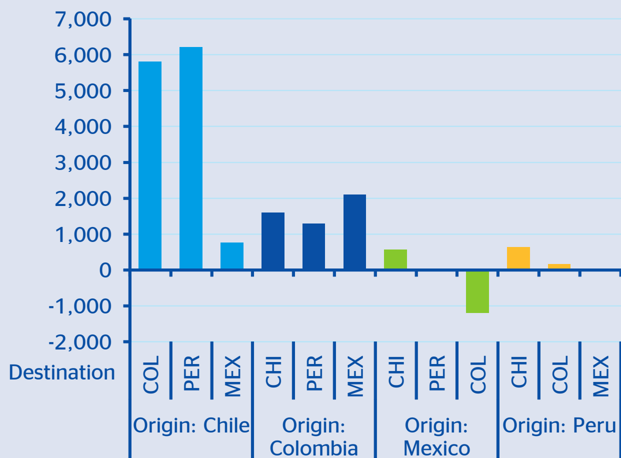
6: A more detailed analysis of the potential to attract FDI and FDI flows within the PA can be found in our Economic Watch, November 2013 "Integración financiera en la Alianza del Pacífico: alta potencialidad y grandes desafíos para una integración exitosa", available at http://www.bbvaresearch.com/KETD/fbin/mult/131028_Observatorio_Alianza_Pacifico_tcm346-407163.pdf?ts=4112013.

Chart 30
Ranking of FDI inflows (2009-2012) and potential to attract FDI (2012)



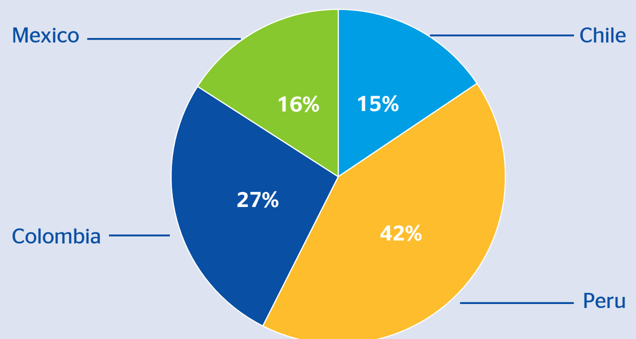
Note: The ranking and distribution by quartiles are based on a total of 177 countries. The table only shows the Latin American countries and some selected countries outside the region.
Source: BBVA Research and UNCTAD

Chart 31
Cumulative intra-PA FDI flows, 2009-2012. By origin and destination (USD million)



Source: BBVA Research and Central Bank of Chile

Chart 32
Destination of intra-PA FDI. Cumulative 2009-2012 (% of total)



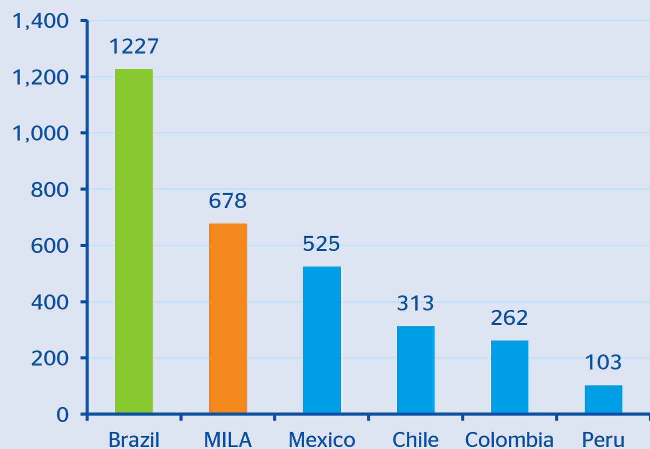
Source: BBVA Research and Central Bank of Chile

It is true that the integration of portfolio flows is still at its early stages, but initiatives such as the integrated Latin American market (MILA), with the full incorporation of Mexico at the start of 2014, have the potential to create a stock market with a capitalization similar to that of Brazil (Chart 24), although with less depth and market liquidity. In this context, we expect the cross flows to begin to increase, using and generating synergies toward deeper and more integrated markets, particularly if the process of harmonization, clarification and coordination of the tax treatment by the authorities of each country continues.

What is the economic outlook for the PA in the short-term? This is a region with a high growth potential, around 6% in Peru and 5% in Colombia and Chile. In the case of Mexico, the current reform agenda could increase potential growth to around 4%. This means an average potential growth for the PA of close to 4.5% per year, higher than in Brazil and nearly three times the figure expected in developed economies (Chart 25).

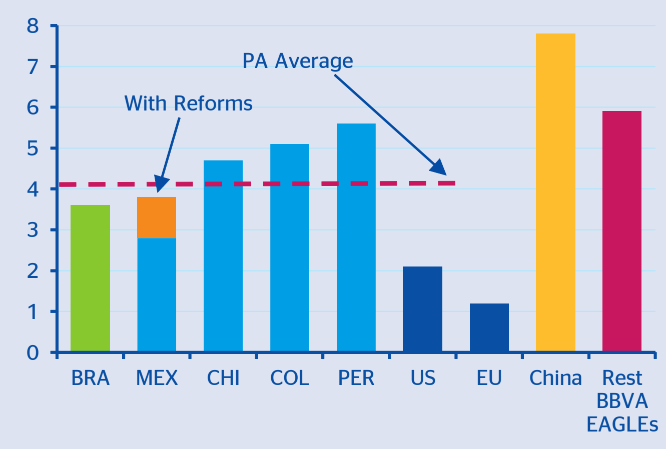
Although the region still has major challenges ahead (high informality, inadequate infrastructures, low quality of education and health), progress has been made in recent years in the right direction. A firm commitment to reform in these areas could increase their high potential growth still further.

Chart 33
Stock-market capitalization, December 2012 (USD million)



Source: BBVA Research and Bloombreg

Chart 34
Potential growth (%)



Source: BBVA Research and COMTRADE

5. The slowdown improves the outlook for external deficits in Latam

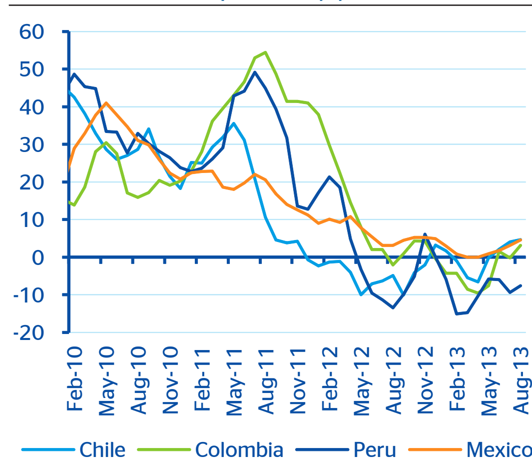
The outlook for the external balance of the region improves slightly due to sluggish domestic demand and the end of supply problems in the export sector in some countries

One of the consequences of the less buoyant tone in domestic demand for most countries in the region, and a slight improvement in the price of certain commodities (for example, copper), is the general improvement in the current account outlook, due to the expected fall in the pace of imports.

Furthermore, the weakness shown in exports in recent quarters has been prompted by a slowdown in foreign demand and to supply problems in the export sector in Brazil, Peru and Colombia. In Brazil's case, local oil production was reduced due to a series of operational problems, boosting imports and curbing exports. In Peru, the mining sector is gradually recovering and heavy investments will be started up in the sector, which will increase the volumes exported at the start of 2014. In Colombia, there were fewer strikes and demonstrations, which had a particular impact on agriculture and coal exports.

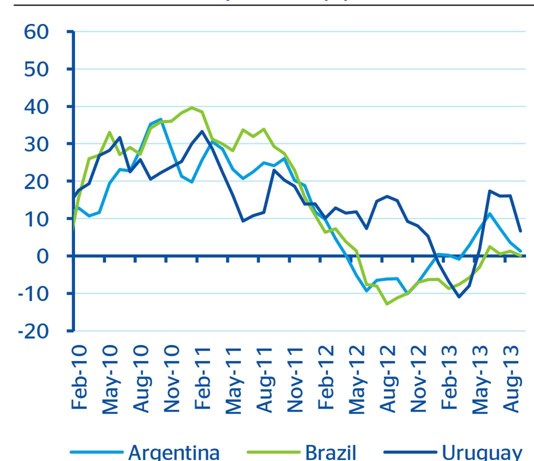
As the temporary supply shocks have faded, they have helped to recover a strong tone in exports in the last quarter, albeit still far below the strong level observed in 2010 and 2011 (Charts 35 and 36). At the same time, the rise in foreign demand expected to happen with the resurgence in global growth will make a decisive contribution. In this regard, the recovery in the United States in 2014 will be crucial for Mexico, and maintaining growth in China will be equally important for South America as a whole.

Chart 35
Latam countries: exports (% y/y)



Source: BBVA Research and Haver Analytics

Chart 36
Latam countries: exports (% y/y)



Source: BBVA Research and Haver Analytics

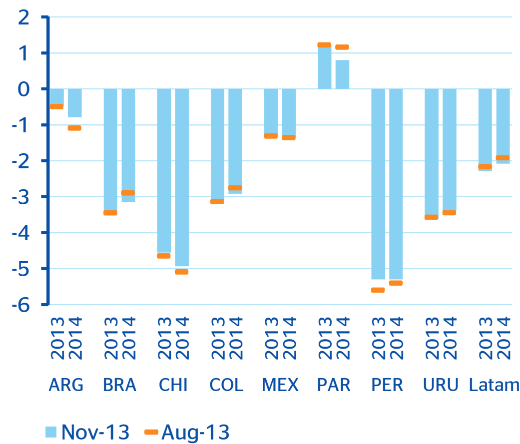
However, domestic demand will continue to be more dynamic than GDP, thereby maintaining the external imbalance, although the gap between them both should gradually be closed (Chart 22). This means the region will continue to report heavy external deficits in 2013 and 2014, particularly in Peru and Chile, but also in Brazil, Uruguay and Colombia (Chart 37). However, these external deficits would begin to drop from 2015 on, and in a more pronounced way in Peru and Chile (towards levels of around 3.5% of GDP in 2017): in the former, due to the start-up of some of the investment projects in mining sectors, and in the latter also due to a sharper slowdown in activity and a greater real depreciation of the exchange rate.

Most of the external deficits will continue to be financed by foreign direct investment, thereby limiting external vulnerability

Turning now to financing of external deficits, as we saw before over the last few months there have been fewer gross capital flows other than FDI, though they remain positive and they have also been offset by repatriations of assets by residents. However, total capital flows remain strong, largely due to the resistance of FDI, which continues to finance most of the external imbalance (Chart 38), substantially lowering external vulnerability in most countries. Furthermore, as we stated in our Latin America Economic Outlook report in August 2013, the growth in deficits in most countries in the region has largely been caused by an increase in investment and, to a lesser extent, by falls in saving (public or private).

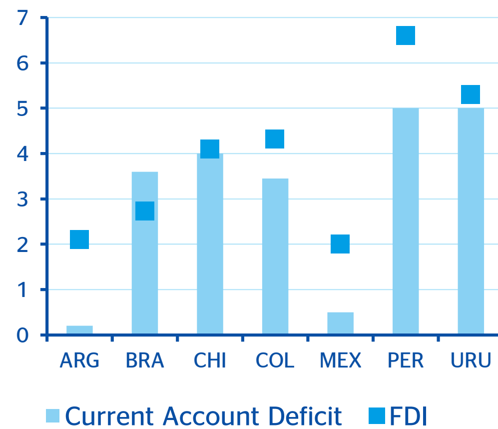
If we exclude the effect of the cyclical position and other short term elements on the current account, we can analyze its structural factors. Box 2 uses this methodology, and allows us to see the degree of imbalance of the external balance. As shown in our estimates, the structural current account in Latin America shows a deficit in the region of 3% in Andean countries and Uruguay, a moderate imbalance, and in light of the expected growth rates for these countries, one which is sustainable in the midterm, in that external liabilities as a percentage of GDP remain low.

Chart 37
Latam countries: Current account deficit forecasts (% GDP)



Source: National governments and BBVA Research

Chart 38
Current account deficit and FDI (last available data, % GDP)



Source: Bloomberg and BBVA Research

Box 2. Structural external balances in Latam: what do they tell us about Current Account sustainability?

The current account balance can be understood to be the difference between savings and investment (public and private), so that variations in the external balance, such as a deficit, can be derived from an increase in investment, a fall in savings, or a combination of both. Higher or lower deficits may be due to intertemporal relations to smooth consumption in the economy. For example, when faced with external shocks which may imply lower public revenue or lower foreign demand which limits exports, a current account deficit can help to smooth the aggregated consumption of the economy over the course of time.

Given that the current account deficit also represents the country's debt in respect of the rest of the world, a deficit can be unsustainable if the financing flows which uphold it are abruptly cut off - in situation such as when the breakdown of the inflow of capitals is more favorable to short term flows than foreign direct investment - or due to the breakdown of liabilities between domestic and foreign currency-denominated (situations which were all unfavorable in Mexico in 1995).

The measure of the current account, however, usually has an important cyclical component. In fact, some of the patterns which have marked the current account balance are the result of cyclical effects arising from the recent crises and the dynamics of the determining factors of the current account through them. In order to better assess whether a certain deficit is or is not sustainable, an interesting analysis consists of separating the structural component from the component merely relating to the cycle.

The methodology used here consists of analyzing the effect of a series of variables which are broken down into their long, medium and short term contributions, and so to estimate the impact they might have on the current account position. The long and midterm components are considered to make up the structural component, while the short term one constitutes the cyclical component. Through this exercise, we obtain an "adjusted current account" generated by extracting the long and midterm components from the explanatory variables and their corresponding estimated effects (structural component) to which we add the component merely relating to the cycle. The question of whether large current account deficits in certain years imply a greater or lower vulnerability than lower deficits held over the course of time depends on what factors are behind those amounts. The following analysis is relevant for shedding more light on the "permanent" or "temporary" nature of the deficits.

The analysis includes a set of variables which can be classified as follows: (1) variables relating to population factors (2) variables relating to investment, (3) variables relating to saving, (4) credit variables (5) trade variables. The following table describes the expected effects of each variable included in the group[7].

The results of the model's fit are good in the sense that the estimated current account with the factors considered closely reflects the current account observed for each country: the correlation between the observed series and the series estimated by the model is higher than 80% in the total sample (1980-2012) for all countries except Brazil. Although there are some years with deviations between the model and the observed data, these deviations are usually reversed in the following period. The conclusion we may draw is that the variables considered are adequate for modeling the dynamics of the current account in the period taken into consideration. With this methodology, predictions are also obtained for the current account balance in the horizon from 2013 to 2020, for its structural and cyclical components and for the factors which, based on the estimated evolution of the explanatory variables, will influence that pattern (see Charts 39 and 40). These predictions are also consistent with models elaborated based on other previous methodologies.

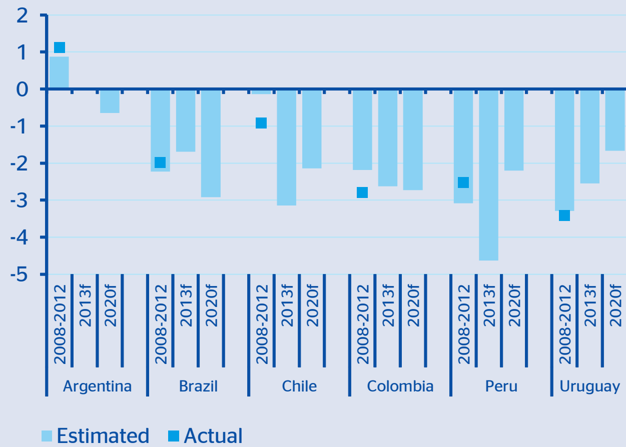
7: For further details on the estimate see: Spain Economic Watch. An analysis of the trend and the determining factors of the current account balance in Spain. http://www.bbvaresearch.com/KETD/fbin/mult/131028_Observatorio_Cuenta_Corriente_Espa_a_Esp_tcm346-407130.pdf and Economic Watch. Structural twin deficits, a problem of the developed world rather than the emerging one. http://www.bbvaresearch.com/KETD/fbin/mult/111216_Economic_Watch_Twin_Deficits_in_G7_final_tcm348-287802.pdf?ts=762012

Table 1
Explanatory variables of the current account

Variable	Expected correlation	Theoretical Mechanism
Demographic Variables		
Old dependency ratio (% of total population)	(-)	A greater proportion of economically-dependent inactive individuals is associated with lower national savings
Young dependency ratio (% of total population)	(-)	
Population growth	(-)	Variable that approximates the future working-age population
Spending on public health care (% GDP)	(-)	Variable that approximates structural gaps in economic policy
Investment variables		
Investment (% GDP)	(-)	The current account deficit correlates with future productivity gains derived from higher current investment as a result of, for example, a convergence or "catching-up" process (-). If the rate of long-term investment is high, the return on this investment -through gains in productivity - will improve the current account balance (+). The (-) correlation tends to dominate the literature
GDP per capita (PPA adjusted, U.S. dollars, in logs)	(+)	Countries with lower income and, as a result, a lower degree of development, tend to have high current account deficits, due to the combination of investments they make in order to foster economic convergence
Fiscal balance (% GDP)	(-)	Budget deficits are associated with a worse performance of the current account balance, as the income of future generations is distributed to the current generation
Credit to the private sector (% GDP)	(-)	A more developed financial system can give rise to greater savings (+); in contrast, it can also signal excessive ease of indebtedness, which would give rise to less savings (-)
NIIP (% GDP)	(+)	A better initial NIIP tends to be associated with a better performance in the current account balance, due to a better performance of the income balance (+). On the other hand, the better initial NIIP could facilitate the accumulation of trade deficits over a long period of time (-). The (+) correlation tends to dominate in the ilterature
Savings variables		
Trade liberalization (% GDP)	(+)	Variable that approximates the existence of barriers to international trade -or, in a broader sense, the costs of international trade. This variable can include other attributes, such as the degree of attractiveness for foreign direct investment
Oil trade balance (% GDP)	(+)	High oil prices erode the energy balance of importing countries, which is associated with a worsening of the current account deficit
Credit variables		
Output gap (% GDP)	(+)/(-)	Variable that approximates demand shocks
Trade variables		
Terms of trade (% change)	(+)	An improvement in the terms of trade is associated with an increase in real disposable income and, as a result, of savings
Real effective exchange rate	(+)	Gains in exports price-competitiveness improves the current account balance
U.S. short-term interest rate (%)	(+)	Adverse movements in the capital markets are associated with a worsening of the current account balance
VIX (% change)	(+)	An increase in risk aversion is associated with greater savings

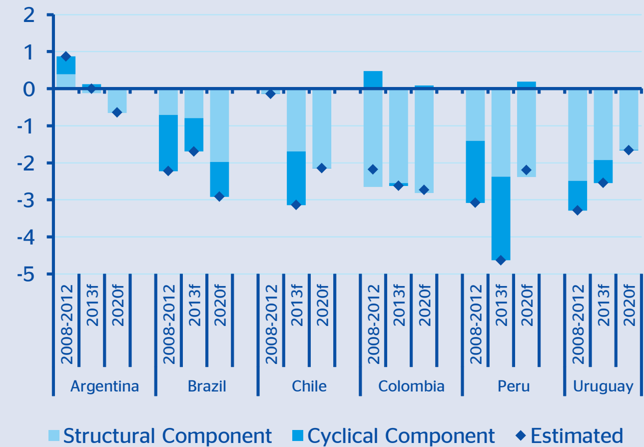
Source: BBVA Research

Chart 39
Current account balance: observed and estimated by model (% GDP)



Source: BBVA Research

Chart 40
Estimated current account: cyclical and structural components (% GDP)



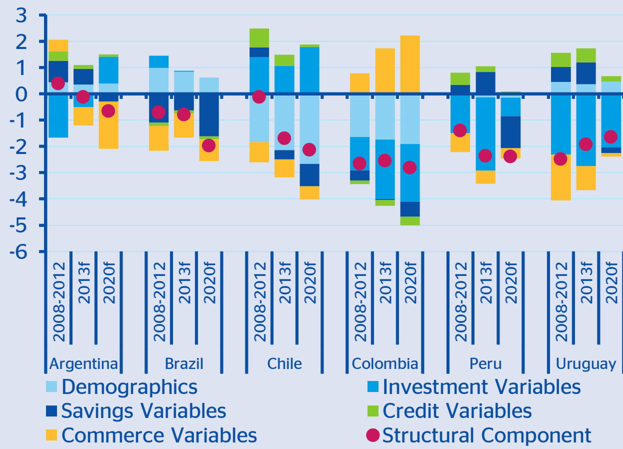
Source: BBVA Research

Once the good fit of the model has been checked, it is estimated that for a midterm horizon (2013-2020), the current account balance will be a deficit in all economies in the region. The expected deficit level is projected from near 0.5% in Argentina's case towards the end of the decade, to close to 3.0% in Colombia's case. In other cases such as Peru, cyclical factors will imply growth in deficit size in the short term (up to almost 5.0%) which will have to be compensated later. The origin of the deficit and its expected trend are even more relevant; both for the observed period and for the predicted years, in general, the structural component will help to explain most of the deficit (except cases such as Peru, mentioned above). In the recent period, between 2008 and 2012, approximately 70% of the current account deficit stemmed from the structural component, particularly relevant in Andean countries, while over the next five years the aforesaid structural component will provide approximately of 80% of the expected deficit. All in all, the structural deficits of the region would be limited at levels which might be considered to be manageable.

Considering a point by point comparison of the projected period, it is interesting to examine the cases of Argentina and Brazil, economies which are expected to reach a higher current account deficit towards 2020, particularly by the structural component. In Argentina's case, this increase in deficit will be influenced by the energy balance (commercial factors). In Brazil, commercial factors tend to be more important in the midterm, while other factors such as investment play a lesser role. On the other hand, in Chile and Peru we expect the current account gap to narrow significantly in following years, where the cyclical component will be particularly relevant. In Peru, for example, the terms of trade are expected to be lower than have been observed to date, while investment will remain high against the levels observed in recent years. In Chile's case, the effects of growth relating to the higher financial integration in recent years offset the effects of lower potential growth, and, towards the future, the higher expected depreciation should help to close the gap in the midterm. In Colombia's case, the forecast points to converging at a current account deficit level of close to 3% at the end of the decade, with a structural component which will continue to account for almost all this deficit and with few changes in comparison with the current situation. All things considered, the combined effect of higher economic opening, greater productive capacity and expected continued improvements in the government's fiscal balance should help to offset the increase in structural deficit.

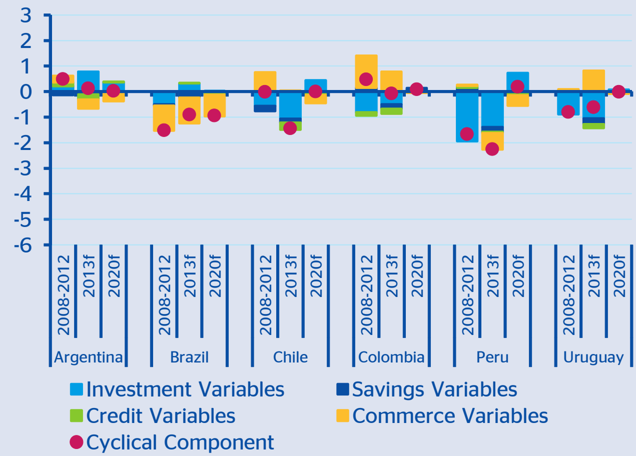
In an inter-temporal context, most countries' fundamentals allow them to withstand a short term increase in the current account if it implies an increase in productive capacity, for which they can use external financing. In that regard, it is important to note that from an inter-temporal perspective the estimated deficit levels are consistent given the level of expected potential growth, the expected financing conditions for the region and the levels of expected external debt in the future. Generally speaking, external financing has been largely linked to private sector investment projects such as mining and infrastructure (and not consumption), productive activities that lead to sustainable increases in the region's potential growth. This explains the high expected negative contribution to the structural deficit of the investment component, such as is the case particularly of Colombia, Peru and Uruguay (see charts 41 and 42).

Chart 41
Breakdown of structural component of the current account balance (% GDP)



Source: BBVA Research

Chart 42
Breakdown of cyclical component of the current account balance (% GDP)



Source: BBVA Research

As stated above, the cyclical component will make a contribution of around 20% of the estimated deficit. In most cases, the cyclical component of the trade balance and, in particular, the commercial factors component, will help to partially offset the effect on the balance, via the high expected level in terms of trade, such as is the case of Argentina, Chile and Colombia.

In conclusion, the mostly deficit-dominated balance of the current account of Latam countries in recent years had a high structural component. Towards the end of the decade, the model predicts that the current account deficit will continue for all the analyzed countries, though it will tend to close in most of them. The structural component will continue to make the highest contribution; and the cyclical component will be critical in closing the gap. Structural deficits will be maintained or will tend to close in the Andean countries and Uruguay at levels of around 2% of GDP, while they will tend to open though to a lesser degree in Argentina and Brazil. The analysis shows the viability of Latin American countries to increase their productive capacity underpinned by external finance as a complement of domestic financing. This viability based on structural factors will be crucial in order to increase productivity in the long term, and in the context of the reforms necessary to promote productivity and external competitiveness.

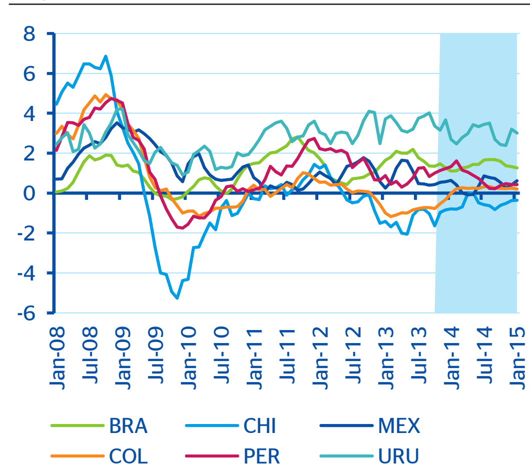
6. Heterogeneous monetary policy given different inflationary pressures

Inflation returns to central banks' target ranges, with the important exceptions of Uruguay, and, to a lesser degree, Peru. But inflationary pressures persist in Brazil

During the third quarter, inflation fell in most countries with inflation targets, except - importantly - for Uruguay, where it kept above 8% year-on-year. The main factors behind this downturn in inflation were sluggish domestic demand (Chile and Paraguay) and the lower pressure from food prices (Mexico, Colombia, Brazil) and fuel prices (Chile, Colombia).

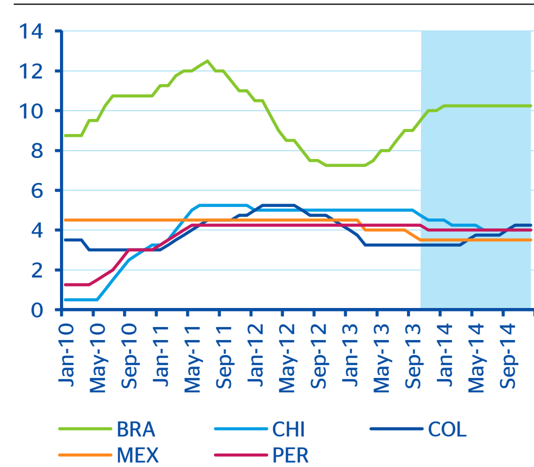
However, there are clear differences in the core dynamics of inflation between Brazil and Uruguay, on the one hand, and other countries with inflation targets. In Brazil, even though inflation has returned to the (broad) target range of the central bank, it is still above the goal (4.5%) and is expected to continue hovering around 6% in coming quarters, due to the existing pressures on installed capacity and partly underpinned by an expected adjustment in fuel prices. In Uruguay, the labor market tightness and salary indexation keep inflation above the target range of the Central Bank (even the extended one which will be applicable from July 2014 on). Meanwhile, in the other countries with inflation targets it will tend to converge towards the central target (Chart 43). In Peru, this will mean a reduction in inflation from slightly higher levels to the target range, as demand pressures are eased and food prices are normalized. At the other end of the spectrum is Chile, where inflation should rise towards the target of the central bank, underpinned by tradable goods and the effect of exchange rate depreciation.

Chart 43
Latam: deviation of inflation (% y/y) from the target of the Central Bank (pp)



Source: National governments and BBVA Research

Chart 44
Latam countries: Official interest rates (%)



Source: Bloomberg and BBVA Research

Different inflationary pressures induce different monetary policy responses in the region: tightening in Brazil and Uruguay compared with a laxer approach in the Andean countries and Mexico

Although the impact of international financial turmoil triggered by the discussion regarding the reduction in bond purchases by the Fed (the so-called tapering) was similar across the board, the differences in inflationary pressures prompted a different response from central banks during the quarter (Table 2), with an increase in interest rate in Brazil and a trend towards restriction in the monetary aggregates of Uruguay (after the change of monetary policy instrument). In contrast, interest rates fell in Mexico, Peru and Chile given the slowdown in domestic demand, and in Peru's case, reserve ratios were also lowered in order to promote lending and economic activity, while promoting a greater depreciation of the exchange rate. In Peru the reduction of interest rates in early November was relatively surprising given that inflation persisted above the target range and the apparent trend towards improvement in external indicators and domestic demand in recent months. Colombia, meanwhile, went from a certain bias towards continued interest rate cuts - which occurred in mid-2012 - towards a trend of stability as economic activity showed signs of recovery following the stimuli in previous quarters.

In response to the financial turmoil and exchange rate depreciation pressures between May and June, authorities in almost all countries (though, importantly, not Chile) also responded with measures geared towards reducing obstacles on capital inflows (reduction of taxes on financial transactions in Brazil or reduction of reserve ratios to deposits in foreign currency in Peru) or by taking actions on the exchange markets, through the sale of dollars (or reducing the purchase program) or currency swaps (Table 2).

Table 2
Measures taken from the onset of financial turmoil (23 May 2013)

	Monetary policy				Exchange rate policy		
	Policy rate hikes	Higher upward bias in policy rates	Policy rate cuts	Softening liquidity measures	FX Swaps	FX intervention	Easing of capital controls
ARG						More depreciated sales of USD	
BRA	Yes	Yes			Increased, Forward commitment		Yes
CHI			Yes				
COL						Reduction in purchases of USD	
MEX			Yes				
PER			Yes	Reduction in reserves requirements		Sales of USD	Lower reserve requirements
URU	Yes*	Yes*				Pause in purchase of USD	

* In Uruguay, the pegging of benchmark interest rates was abandoned and monetary aggregates were used instead, but interest rates have tended to increase.
Source: BBVA Research

Looking ahead, central banks will continue to focus mainly on inflation and domestic demand outlook, albeit not overlooking the effect of their policies in the exchange rate. Hence, we expect there to be laxer policies in Chile and Peru, stable interest rates in Mexico and additional tightening in Brazil and Uruguay, which will be joined by Colombia in 2014 (Chart 44).

In particular, we expect further cuts in interest rates in Chile in the coming quarters, so as to reach an accumulated total reduction of 100 bp (including the recent 50 bp cuts since October) and continued reductions of reserve requirements in Peru, keeping interest rates unchanged after the surprising cut in early November. In both countries, the slowdown in domestic demand and interest rates close to neutral levels (Chart 45) will cause this laxer monetary policy, although in Peru's case the greater dollarization of liabilities affects the choice of policy instrument by the Central Bank.

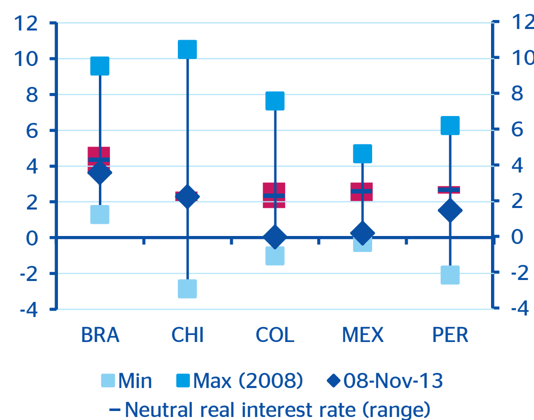
In Mexico's case, over the last few months Banxico completed the 50 bp cut in the monetary policy rate and it has ruled out an additional reduction in the foreseeable future, so that we expect stable interest rates in our forecast horizon. The central bank stressed the low inflation levels and the lack of demand pressures for 2013 and 2014. And although it considers that downside risks in activity prevail, it has ruled out a further cut in the foreseeable future, which might be due to the central bank's goal of not keeping real interest rates a long way from zero in a context of rising inflation and close to the upper limit of its variability range.

In Brazil's case, although inflation has returned to the target range (though it remains in the higher part of the range) still latent pressures on prices will mean it is necessary to continue with interest rate hikes, by at least a further 50 bp. Also in Uruguay's case, pressures on inflation (which will keep above the target range, even after the extension to be made in July 2014) will necessitate a restrictive monetary policy.

A different motivation is behind the expected interest rate hike in Colombia in the first half of 2014: outlook for recovery in growth from the end of 2013 on, which would force BanRep to bring interest rates towards more neutral levels from present levels of around zero in real terms (Chart 45).

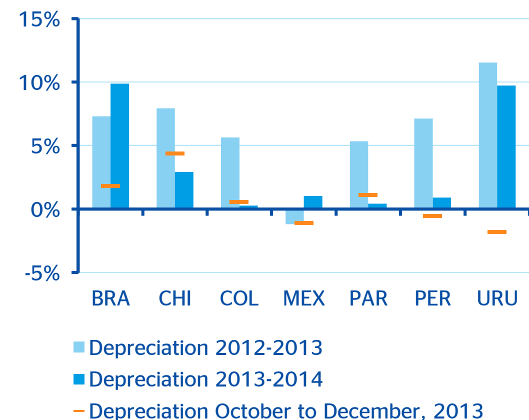
In Paraguay, there are still risks of supply shocks which could have a negative impact on prices and also possible exchange rate risks, so that we estimate the BCP will begin to normalize its policy rate in 2014 and would increase it by 50bp to ensure that inflation keeps within the target range.

Chart 45
Latam countries with inflation targets: real official interest rates*



* Nominal interest rates minus year-on-year inflation observed 12 months afterwards. For the November observation the 12 month inflation forecasts are used.
Source: Bloomberg and BBVA Research

Chart 46
Latam Countries: exchange rate depreciation (%)



Source: Bloomberg and BBVA Research

Uncertainties about the schedule for the Fed's tapering will maintain exchange rate volatility in the region. The trend towards lower global liquidity should induce a slight depreciation of the exchange rate in most countries in the region

Exchange rate patterns in the region will be heavily impacted - as has been the case over the last two quarters - by the reduction in bond purchases by the Fed (tapering) and by the start of official interest rate increases in the US. As we have stated in the sections above, this monetary stimuli tapering process in the US will depend greatly on figures of the rate of recovery in the US, so that markets will be subject to natural ups and downs depending on whether their assessments are more positive or negative. Furthermore, negotiations on the fiscal budget and the debt ceiling in the US add further uncertainties to this process. Over the next few quarters, therefore, we expect volatility in financial markets and in exchange rates in the region will be relatively high, against the levels observed before May. Another factor which may increase this volatility, in the Andean countries and in Brazil, is the high current account deficit , particularly if there were important reductions in prices of the main export commodities.

With the background of this greater exchange rate volatility, we believe that in what is left of 2013 and in 2014 the trend towards a slight depreciation of exchange rates in countries with floating regimes shall continue (Chart 46), except for Brazil, Uruguay and, to a lesser degree Chile, where this depreciation would be higher. The depreciation will continue the trend towards rising long term interest rates in the US (compared with a laxer approach in Latam), a slightly higher aversion to risk and external balances which are still to show significant recovery. However, we do expect this depreciation to be restrained - within a background of high volatility - because a good deal of the Fed's tapering of monetary stimuli would already have been factored in by the markets. Moreover, the depreciation observed throughout 2013 has had the effect of bringing about a better alignment of the floating exchange rates in the region with fundamentals.

As shown in Chart 46, the countries which are the main exceptions to a slight depreciation in 2014 will be Chile and, in particular, Brazil and Uruguay. In Chile's case, the expected depreciation in 2014 has a close relationship with our forecast of a decline in copper prices over the course of the year (Chart 16). On the other hand, the end of the dollar swap program and the need to recover part of the competitiveness lost in recent years and to bring down the current account deficit would mean that authorities are willing to accept a higher degree of depreciation (around 10% during the year). This depreciation in Brazil would also probably trigger a similar one in Uruguay.

7. The challenges of economic policy in Latam in a more adverse setting

By and large, the region is ready to withstand further external shocks...

The international economic backdrop still contains different risk factors which can affect Latin America. As indicated in section 2 of this report, both a possible disorderly withdrawal from monetary stimuli in the US and a possible sharp fall in growth in China (which would affect export commodity prices) are negative shocks for the region, posing a considerable impact, although for the time being with a low probability.

As we have stated in our most recent Latam Economic Outlook reports, it is our opinion that the region continues to show relatively sound vulnerability indicators in relation to other emerging regions and to its historical standards. Thus, in most countries international reserves remain at relatively high levels, external debt is relatively moderate (despite an increase in external deficits), banking systems are solid and adequately supervised, and, very importantly, there is no doubt about the flexibility of exchange rates as an important buffer against an external shock.

In the fiscal area, deficits remain at manageable levels and public debt continues to fall as a percentage of GDP in most countries, although in some countries interest rates which are higher than nominal GDP growth rates can pose an important challenge in terms of future debt patterns. Lastly, the prudence of economic policies in most Latin American countries has also increased credibility, while for the first time they have been used in a countercyclical fashion in the region.

... but it is important to keep room for maneuver for economic policies, if they were necessary. Furthermore, exchange rate flexibility would be the first buffer

It is important to bear in mind that good fiscal and external indicators largely depend on the high price of export commodities, and have occurred in a context of relatively favorable external financing conditions due to the accommodative policies of the central banks in developed economies. Furthermore, in many Latin American countries the margins for countercyclical policies are less than in 2008. There is less leeway for reducing official interest rates (nominal and real) than in the months prior to the collapse of Lehman Brothers (Chart 45) and, on the fiscal side, the public deficits and spending shall keep above the levels observed immediately after the 2008 crisis.

As we have stated in our earlier reports throughout 2012, the good period of loose financial conditions and high raw materials prices, shaped by lax policies in developed economies (the US in particular) had to be taken advantage of to reset this room for maneuver in monetary and fiscal policy. There has been little in the way of progress since then, and we are now reaching the point in which the monetary stimuli will begin to be reduced in the US, there will be less global liquidity and commodity prices will not continue to increase to provide this strong support to growth. Now is not the right time to reset those policy spaces, but nor should the space which still remains be used before its time,

Maintaining exchange rate flexibility (with the possibility of some degree of intervention to mitigate volatility, but not the underlying trends) will have to remain the first line of defense against an external shock, particularly after the progress in reducing dollarization in the region allows there to be a substantial reduction in the harmful effects on agents' asset position due to an exchange rate depreciation.

As the impulse of commodity prices is reduced and financial conditions become less favorable, economic policies should not overstimulate demand. It is necessary to continue stimulating on the supply side through a reforms agenda

Against this background, the main temptation of authorities may be to switch the focus of economic policies towards maintaining similar growth rates as those observed between 2010-2012 through demand policies, when the signs of constraints are maintained on the supply side, as shown by the pressure still supported by labor markets, the bottlenecks in infrastructures and the widening external deficits. Although growth has slowed in the region, the GDP level is very near its potential, and even above in some countries.

As we stated in the fiscal policy section, a higher fiscal stimulus in the region does not appear to be entirely justified, as it may add additional pressure on both labor markets and external imbalances. On the monetary side, the focus should not be switched towards underpinning economic activity, particularly in countries which maintain substantial inflationary pressures, but in general in countries in which there is now very little room for monetary maneuver (Chart 44). The space for monetary policy will be highly necessary when the central banks begin to withdraw liquidity in developed countries, beginning with the Fed.

What then can be done in a context of headwinds both in commodity prices and tighter financial conditions? It is essential to make progress in reforms in order to release the constraints on the supply side in the midterm and to ensure that growth in per capital income will be sustained in the long term. It is also important to take into account that in a setting of less global liquidity, markets will discriminate to an increasing degree in accordance with fundamentals and with the ability to improve them through enduring reforms. Reforms recently proposed in Mexico have the potential to improve efficiency and to increase productivity and growth in that country. The crucial question for the region will be to what degree these reforming efforts may be extended to other countries and generate an increase in productivity through saving in order to finance the necessary investment in physical capital (infrastructures, in particular) and human capital (education and health).

8. Tables

Table 3
GDP (% y/y)

	2011	2012	2013*	2014*
Argentina	8.9	1.9	5.1	2.8
Brazil	2.7	0.9	2.6	2.8
Chile	5.9	5.6	4.2	4.0
Colombia	6.6	4.2	4.1	4.7
Mexico	4.0	3.6	1.2	3.1
Paraguay	4.3	-1.2	12.5	5.3
Peru	6.9	6.3	5.3	5.6
Uruguay	6.5	3.9	3.7	3.9
Latin America	4.1	2.5	2.4	3.1

* Forecasts.
Source: BBVA Research

Table 4
Inflation (% yoy. average)

	2011	2012	2013*	2014*
Argentina	9.8	10.0	10.5	10.7
Brazil	6.6	5.4	6.2	5.9
Chile	3.3	3.0	1.7	2.5
Colombia	3.4	3.2	2.2	3.2
Mexico	3.4	4.1	3.8	3.4
Paraguay	8.3	3.7	2.6	5.0
Peru	3.4	3.7	2.8	2.7
Uruguay	8.1	8.1	8.5	7.9
Latin America	6.8	6.2	7.4	7.7

* Forecasts.
Source: BBVA Research

Table 5
Exchange rate (against USD, average)

	2011	2012	2013*	2014*
Argentina	4.13	4.55	5.45	6.93
Brazil	1.68	1.96	2.15	2.34
Chile	484	486	493	520
Colombia	1.848	1.798	1.863	1.896
Mexico	12.48	13.15	12.68	12.76
Paraguay	4.188	4.417	4.305	4.515
Peru	2.75	2.64	2.70	2.77
Uruguay	19.23	20.23	20.48	22.62

* Forecasts.
Source: BBVA Research

Table 6
Interest Rate (%, average)

	2011	2012	2013*	2014*
Argentina	13.34	13.85	16.79	18.03
Brazil	11.71	8.46	8.44	10.25
Chile	4.75	5.00	4.90	4.13
Colombia	4.10	4.94	3.35	3.75
Mexico	4.50	4.50	3.94	3.50
Paraguay	8.49	6.00	5.50	5.85
Peru	4.04	4.25	4.21	4.00
Uruguay	18.97	18.59	16.74	17.12

* Forecasts.
Source: BBVA Researchs

Table 7
Current Account (% GDP)

	2011	2012	2013*	2014*
Argentina	-0.5	0.0	-0.5	-0.8
Brazil	-2.1	-2.4	-3.5	-3.1
Chile	-1.3	-3.5	-4.6	-4.9
Colombia	-2.9	-3.3	-3.1	-2.9
Mexico	-0.9	-1.2	-1.3	-1.4
Paraguay	1.1	1.6	1.2	0.8
Peru	-1.9	-3.6	-5.3	-5.3
Uruguay	-2.9	-5.3	-3.6	-3.4
Latin America	-1.6	-2.1	-2.0	-2.0

* Forecasts.
Source: BBVA Research

Table 8
Fiscal balance (% GDP)

	2011	2012	2013*	2014*
Argentina	-1.6	-2.3	-1.6	-1.1
Brasil	-2.6	-2.5	-3.2	-3.7
Chile	1.3	0.6	-1.0	-1.4
Colombia	-2.9	-2.3	-2.5	-2.3
México	-2.6	-3.1	-2.4	-2.3
Paraguay	0.7	-1.4	-0.9	-0.5
Perú	1.9	2.1	0.2	-0.2
Uruguay	-0.9	-2.8	-2.1	-2.3
Latin America	-2.2	-2.5	-2.6	-2.6

* Forecasts.
Source: BBVA Research

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