PANTHEON MACROECONOMICS

INDEPENDENT • INCISIVE • ILLUMINATING

THE **LATIN AMERICAN ECONOMIES** IN H2 2016

ANDRES ABADIA,SENIOR ECONOMIST

The Second Half Will be Better... But the Recovery Will be Modest

* The worst of the downturn in Latin America likely is behind us. **We expect growth to improve as domestic demand picks up and the severity of Brazil's recession eases.** The oil hit is gradually fading, commodity prices have stabilized and inflation is falling, as the effects of last year's FX sell-off and El Niño wane. An accelerating U.S. economy and steady growth in China also will be helpful.

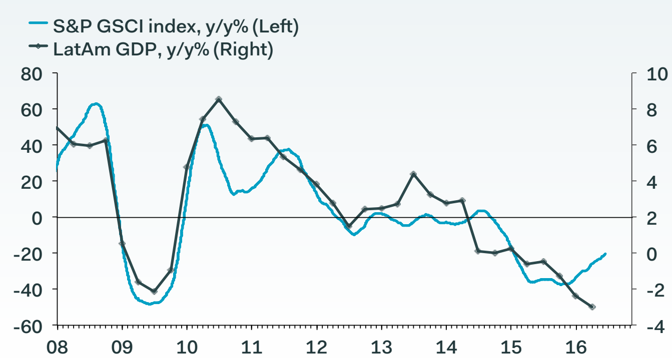
* The upturn, though, will be modest, as many governments are tightening fiscal policy in order to rein-in budget deficits. And monetary policy will have to remain relatively tight in order to keep inflation pressures in check. **We expect LatAm GDP to *fall* by 1.0% in 2016, after a 0.6% drop in 2015.** Currencies will come under renewed pressure as the U.S. hikes rates in late Q4, but the depreciation will be smaller than in 2015.

* **The outlook is still uneven across the region, with Mexico, Colombia, Peru and Chile in a relatively good position.** At the other extreme, Venezuela is still a disaster area, with inflation rampant. The country is moving closer to economic collapse, with food scarcity, looting and riots on the rise. In the middle stands Brazil, which will remain very fragile this year, due to intense political and fiscal stress, low—albeit improving—consumer and business confidence, and high inflation and interest rates.

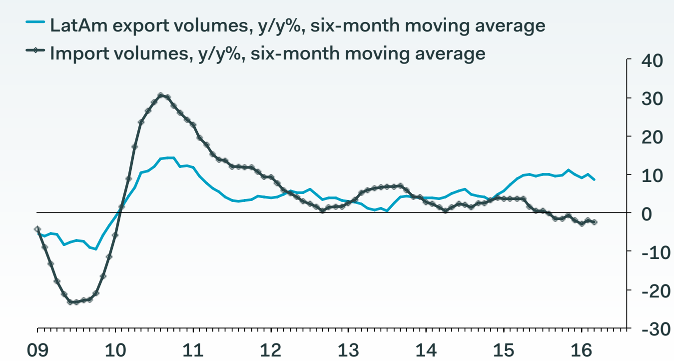
* **Brazil's** recession, however, is easing. We expect 2016 GDP to fall by 3¼%, as the country battles severe structural and cyclical challenges. But the combination of stable commodity prices, falling inflation, rising exports and interest rate cuts will help the stabilization process. Business and consumer confidence will improve further. **We expect the BCB to cut rates by at least 50bp in Q4,** provided inflation, and inflation expectations, fall as far as we expect. But growth will not resume until 2017, and it will be slow. The BCB will be able to ease further in the first half of 2017, pushing rates down to 10.5% and then leaving them on hold. Interim President Michel Temer will improve Brazil's fiscal metrics, easing concerns on this front.

* Economic activity in **Mexico** is improving, but it will not *accelerate* this year. Robust—though slowing—domestic demand, coupled with low inflation, will help to offset the fading hit from low oil prices, the lagged effect of the MXN's depreciation, and the modest recovery of non-oil exports. A short monetary tightening cycle and the government's belt-tightening will hamper consumption and sentiment. Next year will be better as the US economy gathers strength and Mexico's manufacturing sector improves. **Banxico likely will raise rates by 25bp at the final meeting of the year, following the Fed, ending the year at 4.50%.**

ECONOMIC GROWTH WILL IMPROVE OVER THE SECOND HALF



EXPORTS WILL OFFSET MODEST DOMESTIC DEMAND



THE **LATIN AMERICAN ECONOMIES** IN H2 2016

* **Argentina's** economic outlook has improved significantly since Mauricio Macri took office. The country has returned to the overseas bond market and is addressing an array of complex economic problems, including high inflation, an artificially strong currency, and untrustworthy statistics. **But the economic adjustment, specifically the ARS's depreciation and regulated price hikes, will trigger a short recession this year.** The country's prospects will gradually improve in 2017 as confidence strengthens.

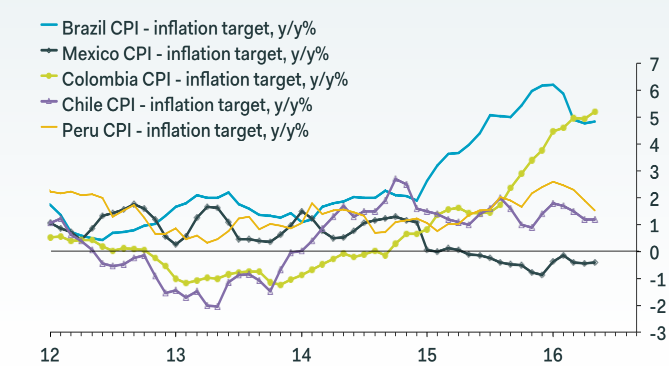
* The economy in **Colombia** will remain under pressure over the coming months, due mostly to the tightening of monetary and fiscal policy, and the lagged effect of the drop in oil prices. These factors will be partially offset by falling inflation, the strength of the manufacturing sector and the execution of part of the 4G infrastructure program. The current account deficit likely will improve, thanks to the impact of the COP's sell-off last year, weaker import demand and the modest rebound in oil prices. **We expect BanRep to hike rates one more time in July, by 25bp, and then hold at 7.75%.** Rates will then be cut in the first half of 2017, to 6%. The peace deal with the FARC will boost support for the government as it seeks blessing for fiscal reform.

* **Chile's** economy will continue growing, but at a modest pace. Domestic demand will improve only marginally over the coming quarters, constrained by depressed consumer and business confidence. Low copper prices and China's sluggish—albeit improving—growth, also will limit the pace of recovery over the near term. Chile will have to adjust to a new, slower trend unless commodity prices rebound substantially. Inflation will slow, but it will hover around the upper-bound of the 2-to-4% BCCh's target. **We believe the central bank will leave interest rates on hold at 3.50% for the foreseeable future.**

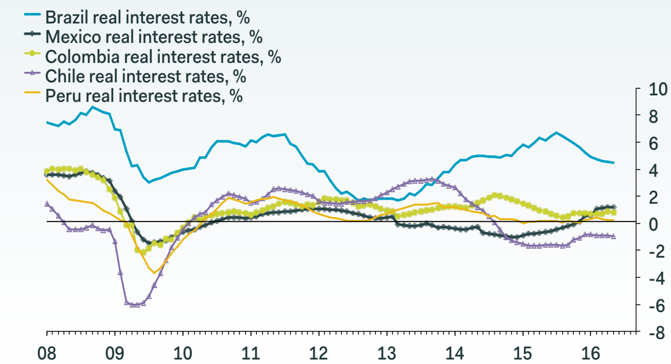
* **Peru's** economy will gather further momentum during the second half, thanks mainly to a recovery in the mining industry, and a gradual improvement in private investment and consumption. Mr. Kuczynski's recently elected government will be supportive to growth as infrastructure projects gather steam. The current account deficit, Peru's main headache, will narrow this year, supported by strong export growth and still-modest domestic demand. Inflation will soon fall into the BCRP's 1-to-3% target range, but it will hover around the upper part of the range. **Monetary policy is likely to be tightened next year as domestic demand gathers further steam, but rates will remain at 4.25% through the end of this year.**

* Finally, **Venezuela's** FX rationing, extremely high inflation and irresponsible economic policies have increased the likelihood of a sovereign default next year. Low oil prices are making life even harder, and international reserves are still plunging. To add insult to injury, oil production is falling rapidly, due to mismanagement, reducing the country's capacity to service its debts. **The recent modest upturn in oil prices and help from China likely will advert a default, but peoples' lives and economic conditions will remain under severe pressure.** Social instability will remain a serious problem, due to the desperate state of the economy and the government's incompetence.

INFLATION WILL EASE AHEAD, THANKS TO THE FADING EL NIÑO



RATES ON HOLD IN H2, BUT BRAZIL WILL START TO EASE SOON



GDP (year-over-year, %)	2014	2015	2016	2017	2018
Argentina	-2.6	2.4	-1.0	2.0	3.0
Brazil	0.1	-3.8	-3.2	0.6	1.2
Chile	1.9	2.1	1.6	2.4	2.7
Colombia	4.4	3.1	2.1	2.8	3.6
Mexico	2.2	2.5	2.1	2.7	3.4
Peru	2.4	3.2	3.6	4.0	3.6
Venezuela	-3.9	-6.0	-9.0	1.5	0.4
Latin America	*0.5*	*-0.6*	*-1.0*	*1.5*	*2.0*
Prices, CPI (year-over-year, %, average)					
Argentina	37.2	28.7	35.0	15.0	10.0
Brazil	6.4	10.7	8.6	5.8	5.5
Chile	4.4	4.3	3.6	3.5	3.2
Colombia	2.9	5.0	7.5	3.6	3.3
Mexico	4.0	2.7	2.9	3.2	3.5
Peru	3.3	3.5	3.5	3.2	2.6
Venezuela	61.8	120	220	140	300
Latin America ex-Venezuela and Argentina	*4.1*	*6.2*	*5.5*	*3.8*	*3.5*
Central Bank Rate (end of year)					
Argentina	29.50	--	--	--	--
Brazil	11.75	14.25	13.75	10.50	6.00
Chile	3.00	3.50	3.50	3.50	4.25
Colombia	4.50	5.75	7.75	6.00	4.50
Mexico	3.00	3.25	4.50	5.00	5.00
Peru	3.50	3.75	4.25	4.75	4.75
Venezuela	18.73	--	--	--	--
Latin America	*6.6*	*8.0*	*8.1*	*6.4*	*4.2*