

# LATIN AMERICA ANALYST

Q3 2011



20<sup>th</sup> September 2011

## Heading into choppy waters

- The economies of Latin America are likely to slow by more than most expect over the next year. We do not anticipate a prolonged downturn, but the marked deterioration in the external environment means that regional growth will probably moderate to around 2.5% in 2012, before rebounding to 3.5% or so in 2013.
- The slowdown over the coming quarters will be driven primarily by external factors. Export demand, especially from G7 economies, is likely to soften with the ongoing sluggish recovery in the US a particular concern for Mexico. At the same time, the deepening crisis in the euro-zone threatens to slow capital inflows to the region, while a drop in commodity prices would worsen its terms of trade. Some home grown problems are brewing too – in particular, rapid credit growth has left Brazilian consumers looking stretched. That being said, growth is unlikely to slow by as much as it did in 2009, and if the global environment deteriorates by even more than we expect, falling inflation means that central banks have plenty of room for manoeuvre. Indeed, we now expect rate cuts across the region next year, with most central banks starting to ease policy from Q1 2012.
- In **Brazil**, we expect growth to slow to 2.5% next year, bringing further cuts in interest rates to around 10% by end-12. (Page 4.) Meanwhile, **Mexico** looks set for an extended period of sluggish growth and interest rates will cut to new record lows. (Page 5.)
- **Peruvian** growth will cool further over the remainder of the year and, with business confidence still fragile post-election, the new president needs to live up to his market-friendly pledges (page 10). Meanwhile, **Chile** (page 9) and **Colombia** (page 11) will see growth slow on lower commodities prices, but healthy domestic conditions mean that it is unlikely to collapse.
- In **Argentina**, (page 6) the current government looks set to triumph in October's elections making any reform of the current tax policy framework unlikely, and a hard landing probable further ahead. Elsewhere, **Ecuador** (page 11) and **Venezuela** (page 7) are exposed to a fall in oil prices over the next 12-18 months. This will cause growth to slow sharply and may generate shortages of hard currency.

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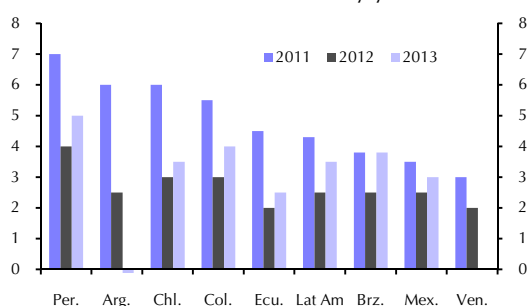
## Key Forecasts

**TABLE 1: REAL GDP & INFLATION**

% y/y	Share of World <sup>(1)</sup>	GDP				Inflation <sup>(2)</sup>			
		2010	2011f	2012f	2013f	2010	2011f	2012f	2013f
Brazil	2.94	7.5	3.8	2.5	3.8	5.0	6.5	5.0	4.5
Mexico	2.09	5.5	3.5	2.5	3.0	4.2	3.5	3.0	3.0
Argentina <sup>(3)</sup>	0.85	9.2	6.0	2.5	-0.5	10.5	25.0	20.0	28.0
Colombia	0.58	4.3	5.5	3.0	4.0	2.3	3.5	3.0	3.0
Venezuela	0.47	-1.7	3.0	2.0	0.0	29.1	27.5	27.5	20.0
Peru	0.37	8.8	7.0	4.0	5.0	1.5	3.0	2.5	2.8
Chile	0.35	5.2	6.0	3.0	3.5	1.4	3.0	2.5	3.0
Ecuador	0.15	3.6	4.5	2.0	2.5	3.6	4.5	3.0	3.5
Guatemala	0.09	2.6	3.0	2.5	3.5	3.9	5.1	5.9	5.2
Costa Rica	0.07	4.2	3.5	2.5	2.5	5.6	6.0	5.0	5.0
Bolivia	0.07	4.1	4.5	3.0	3.0	2.5	10.0	4.0	4.0
El Salvador	0.06	0.7	2.5	2.0	4.0	1.2	3.5	3.8	2.8
Uruguay	0.07	8.0	5.5	3.5	4.5	6.7	8.5	6.5	7.0
Panama	0.06	7.5	7.0	5.0	6.5	3.5	5.0	3.0	3.0
Honduras	0.05	2.8	3.5	3.0	4.0	4.7	7.5	6.5	6.0
Paraguay	0.04	15.3	5.0	3.5	4.0	4.7	9.5	7.5	6.0
Nicaragua	0.02	4.5	3.5	2.5	4.0	5.5	8.5	7.5	7.0
Suriname	0.01	4.4	5.0	3.0	5.5	6.9	18.0	9.0	5.0
Guyana	0.01	3.6	4.5	4.0	5.5	3.7	6.0	5.0	5.0
Belize	0.004	2.0	2.3	2.0	2.5	0.5	3.0	3.0	3.0
<b>Latin America</b>	<b>8.58</b>	<b>6.0</b>	<b>4.3</b>	<b>2.5</b>	<b>3.5</b>	<b>7.0</b>	<b>8.0</b>	<b>7.0</b>	<b>7.0</b>
<b>G4 Countries</b>									
US	19.74	3.0	1.7	1.5	2.0	1.6	3.0	1.5	1.0
Euro-zone	14.62	1.7	1.7	-0.5	-1.0	1.6	2.8	1.5	0.5
Japan	5.82	4.0	-0.2	2.5	1.0	-0.7	-0.4	-0.6	0.0
UK	2.94	1.3	1.0	1.0	1.5	3.3	4.5	2.6	1.3

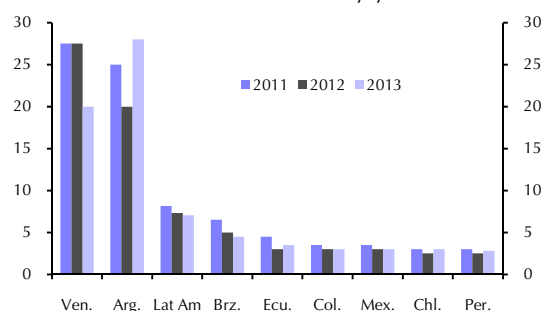
(1) %, 2010, in PPP terms. (2) All % y/y annual average. (3) Historical data are official figures, forecasts are for CE proxies.

**Chart 1: Real GDP (%/y)**



Sources – Thomson Datastream, Capital Economics

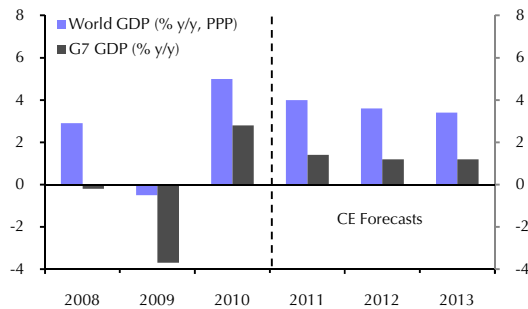
**Chart 2: Inflation (%/y)**



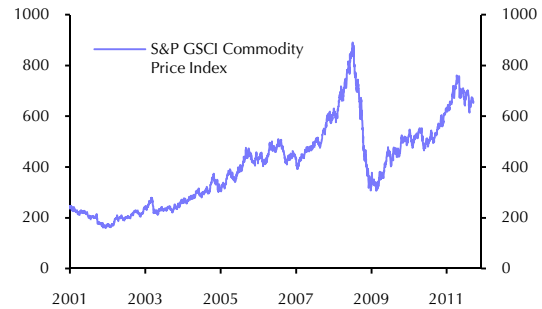
Sources – Thomson Datastream, Capital Economics

## Overview

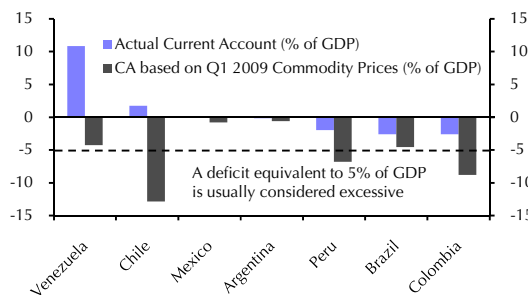
**Global growth will slow throughout the remainder of 2011 and into 2012, led by weakness in the G7 countries ...**



**... meaning that commodities prices are likely to fall further from their current levels.**



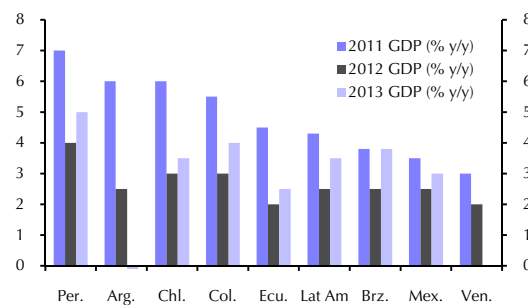
**As the region's terms of trade deteriorate, current account balances will start to look less healthy...**



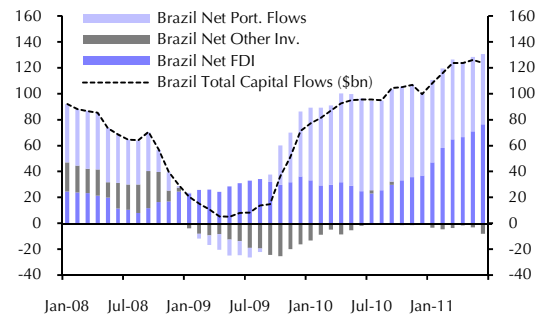
**... implying that the import bill will have to fall in order to return the current account balance to a sustainable level.**

Country	Actual (% GDP)	Based on Q1 2009 Commodity Prices	Cut in Imports to Return Current Account Deficit to 3% of GDP
Argentina	-0.2	-0.6	n/a
Brazil	-2.6	-4.5	1.5
Chile	1.7	-13.0	10.0
Colombia	-2.6	-8.8	5.8
Mexico	-0.1	-0.8	n/a
Peru	-2.0	-6.8	3.8
Venezuela	10.8	-4.3	1.3

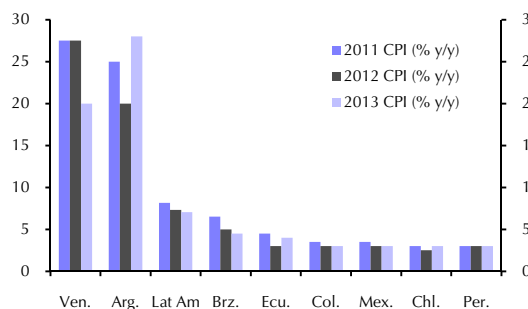
**All of this means that that domestic demand and GDP growth will fall across the region in 2012 ...**



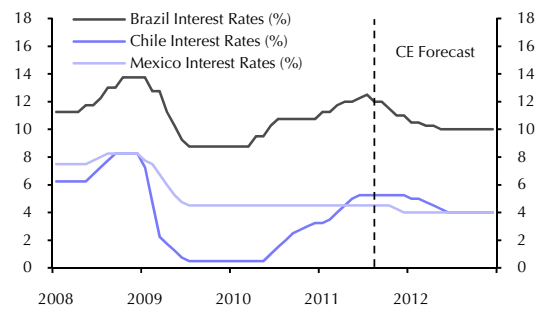
**... but is likely to recover fairly swiftly in 2013 assuming that capital inflows bounce back to the same extent as in 2009.**



**Meanwhile, inflation should fall back as earlier commodity price shocks unwind, however core pressures will remain elevated in a number of countries.**



**Accordingly, interest rates are set to be reduced across the board, but not on the same scale as 2008.**



## Brazil

### The limits of “dual-speed” growth

- The limits to Brazil’s “dual-speed” growth spurt, in which consumer facing sectors have boomed while industry has stagnated, are becoming increasingly clear. Indeed, the deepening crisis in Europe could prove to be the trigger for a sharper-than-expected slowdown in Brazil – we now expect GDP to grow by just 2.5% next year.
- Brazilian industry remains stuck in a rut. Forward looking indicators suggest that, thanks to a combination of an overvalued currency and weaker global demand, the sector is now in recession. (See Chart 1.) More importantly, the current pace of domestic demand growth looks unsustainable too.
- The recent boom in consumer spending has been built on three pillars: rapid credit growth, record high terms of trade and bumper capital inflows. All three are now at risk. We estimate that 20% of disposable income is now eaten up by debt servicing costs – well above what is sustainable. At the same time, slower global growth and the associated flight to safety stemming from the euro-crisis could see commodity prices fall and Brazil’s terms of trade weaken, as well as capital inflows slow.
- Unlike in the G7, Brazilian growth should rebound in 2013. But the slowdown over the coming quarters should ultimately justify the BCB’s decision to pre-emptively cut interest rates – even if widespread indexation does mean that inflation is slow to fall back to target. (See Chart 2.) We expect the Selic rate to be cut by 200bps to 10% by mid-2012, well below what is currently priced into the market. At the same time, the real is likely to weaken too, perhaps falling to around 1.90/\$ by end-11. This should bring some relief to industry. But the key to better balanced growth in the future remains tighter fiscal policy and a higher domestic savings rate allied with looser monetary policy. Radical reforms on this front remain politically difficult and unlikely.

Chart 1: Brazil Manufacturing PMI & Industrial Production

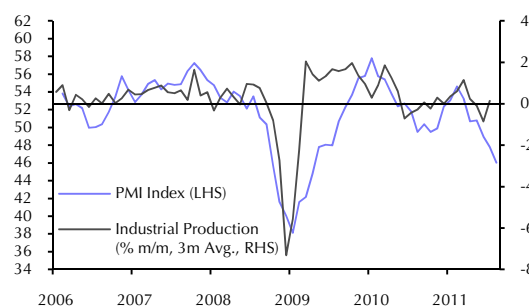


Chart 2: Consumer Prices (% y/y)

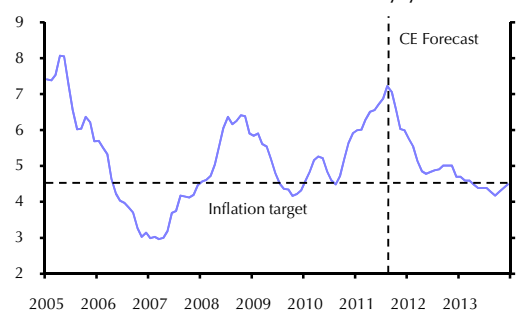
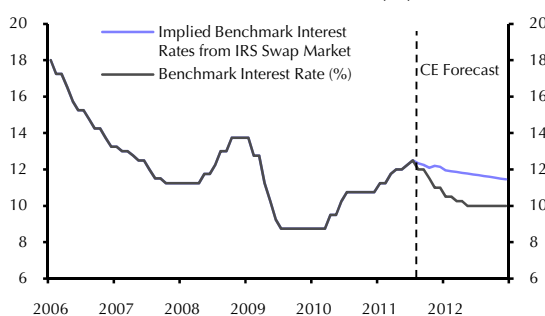


Chart 3: Selic Interest Rate (%)



#### KEY FORECASTS

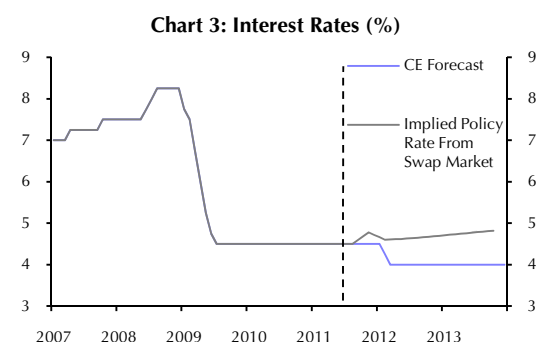
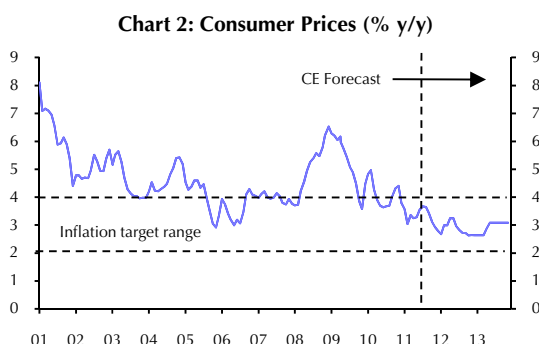
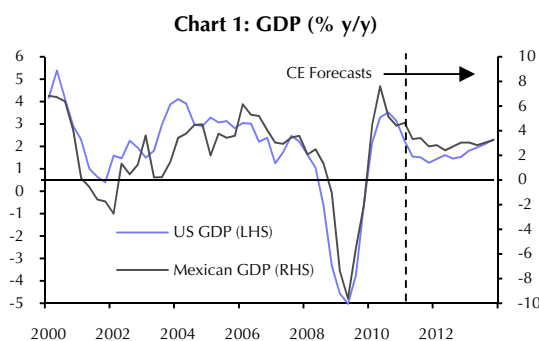
	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	4.0	6.5	5.0	2.0	3.5
Total fixed invest.	-10.0	25.0	7.0	4.0	5.0
GDP	-0.2	7.5	3.8	2.5	3.8
Unemp. rate (%)	8.1	7.0	6.0	6.5	6.3
CPI inflation <sup>(1)</sup>	4.9	5.0	6.5	5.0	4.5
Pub. Sector bal <sup>(2)</sup>	-3.3	-2.5	-2.5	-2.8	-2.5
Gen. gov't debt <sup>(2)</sup>	67.9	66.1	65.0	65.0	63.0
Current account <sup>(2)</sup>	-1.6	-2.5	-2.5	-2.0	-2.5

(1) Year average. (2) as % of GDP

## Mexico

### *Weak demand from US to drag on growth*

- Given that exports to the US are equivalent to almost 25% of GDP, the deterioration in the outlook for the US economy has clear ramifications for Mexico. (See Chart 1.) Weak demand from the north of the border over the next 6-9 months means that industry, which has been the cornerstone of Mexican growth during the last two years, will struggle.
- Meanwhile, there are still no signs that domestic demand will be able to take up all of the slack. Unemployment is likely to remain high and real wages will probably continue to contract. That will underpin comparatively weak growth in private consumption. What's more, with the opposition PRI holding a majority in Congress, policymakers are unlikely to sanction looser fiscal policy ahead of July's Presidential election. The upshot is that we expect GDP growth to slow from about 3.5% this year to just 2.5% in 2012, while there may only be some gradual improvement to 3.0% or so in 2013. (Again, see Chart 1.)
- With growth set to remain below its potential rate of about 3.5% for the foreseeable future, the output gap will remain in negative territory. As a result, the outlook for inflation is benign. The unwinding of the food price shock, coupled with weak core price pressures, should ensure that headline inflation remains close to the Bank's 3% target until end-2013. (See Chart 2.)
- Accordingly, interest rates will remain low for an extended period. Indeed, we now expect policymakers to lower rates in a bid to kick-start the domestic economy. We have pencilled in a 50bp cut in the benchmark rate to 4.0% in Q1 of next year, with rates then remaining unchanged well into 2013. (See Chart 3.)



KEY FORECASTS	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	-7.2	5.0	4.5	2.5	3.0
Total fixed invest.	-11.9	2.4	7.5	3.0	5.0
GDP	-6.1	5.5	3.5	2.5	3.0
Unemp. rate (%)	5.5	5.4	5.2	5.2	5.0
CPI inflation <sup>(1)</sup>	5.3	4.2	3.5	3.0	3.0
Gen'l gov't bal <sup>(2)</sup>	-4.7	-4.0	-3.0	-3.0	-2.8
Cent'l gov. debt <sup>(2)</sup>	29.0	30.0	30.0	30.0	30.0
Current account <sup>(2)</sup>	-0.7	-0.5	-0.5	-0.5	-0.5

(1) Year average (2) as % of GDP. Budget balance is augmented govt balance.

## Argentina

### One-horse election race signals hard landing ahead

- Argentina's President, Cristina Fernández, is odds-on favourite for re-election in October following a resounding win in August's primaries. As such, we do not foresee any departure from the current super-loose policy stance, making a recession increasingly likely at some point over the next electoral term.
- According to our own estimates, GDP grew by 5.5% over the first half of the year. Of course, official statistics continue to show a much more favourable rate of growth. With agricultural commodity prices still high and public spending rising to record levels as the election approaches, we believe growth should be close to 6% for 2011. (See Chart 1.)
- Elsewhere, inflation shows no real signs of slowing, bolstered by rapid growth of the money supply. Again, the official measure is notoriously unreliable and we estimate that the true rate of inflation, which has run at 20-25% over the year to date, may hit 25% by year-end. (See Chart 2.) This will continue to put upward pressure on the real exchange rate. At the same time, however, markets appear to be growing increasingly bearish on the peso and, notably, the central bank has been forced into regular intervention to prevent a sharper depreciation in the nominal exchange rate.
- Admittedly, selling pressure on the domestic currency is partly due to the recent global turmoil, however capital flight looks set to accelerate further as participants assess the prospects of another Fernández term. Despite record terms of trade gains, foreign reserves will probably continue to fall and the current account deficit looks set to widen. (See Chart 3.) This leaves Argentina highly exposed to slowing external demand and a correction in commodities prices ahead. We expect growth to slow to 2.5% in 2012 and forecast a 0.5% contraction in 2013.

Chart 1: CE AAI & Official GDP (% y/y)

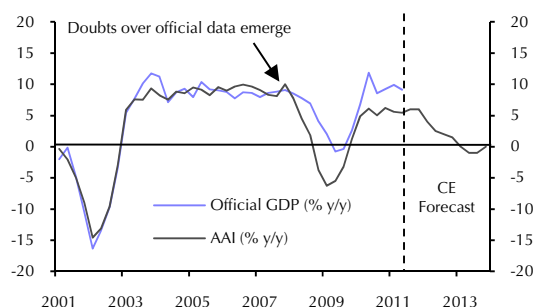


Chart 2: Consumer Prices (% y/y)

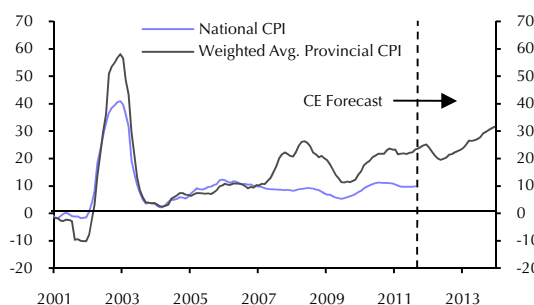
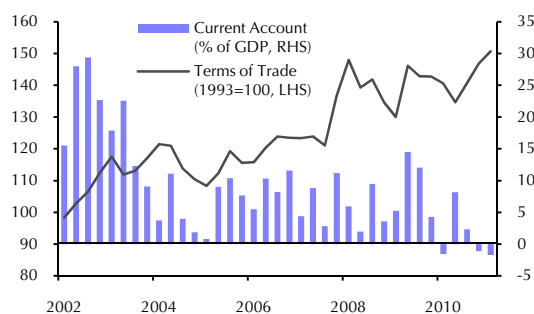


Chart 3: Current Account Balance & Terms of Trade



**KEY FORECASTS** %y/y unless stated

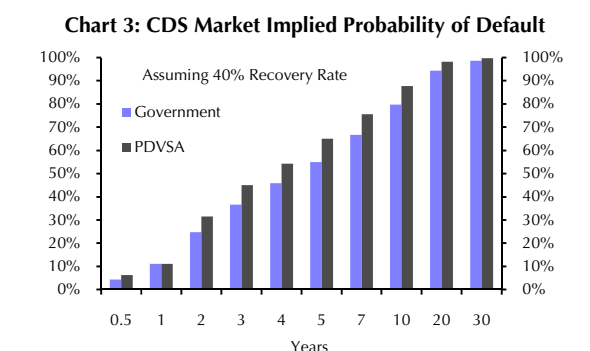
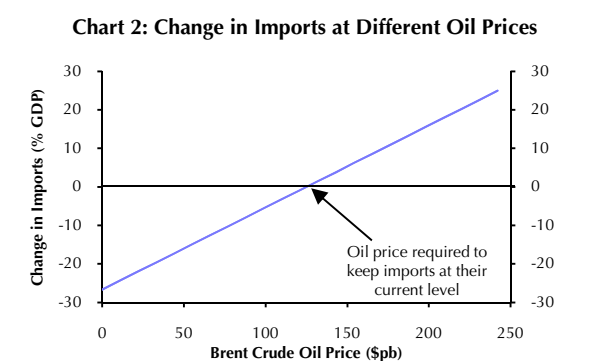
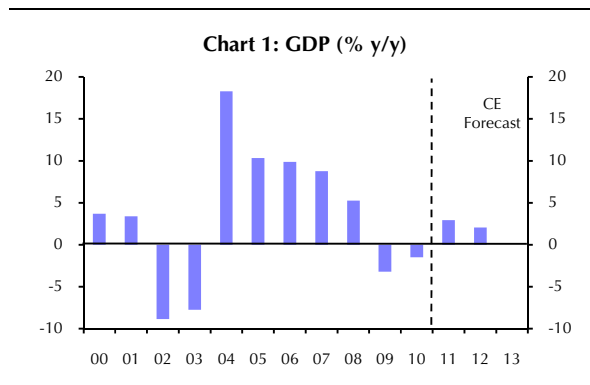
	2009	2010	2011	2012	2013
Private cons'ptn	0.5	9.0	6.0	2.5	0.0
Total fixed invest.	-10.2	21.2	5.5	0.0	-7.5
GDP <sup>(1)</sup>	0.9	9.2	6.0	2.5	-0.5
Unemp. rate (%)	8.7	7.8	7.5	8.5	10.0
CPI inflation <sup>(2)</sup>	6.3	10.5	25.0	20.0	28.0
Cent'l gov't bal <sup>(3)</sup>	-0.6	0.2	-1.5	-2.5	-3.5
Pub. Sect. debt <sup>(3)</sup>	45.4	43.3	40.0	37.5	35.0
Current account <sup>(3)</sup>	2.8	1.0	-1.0	-1.5	-1.0

(1) Historic data are official figures, forecasts are for CE AAI. (2) Year average official inflation, forecasts are for CE inflation proxy. (3) as % of GDP

## Venezuela

### Bumpy path to presidential elections

- The Venezuelan economy is in for a bumpy ride over the next couple of years. Extremely strong growth in Q1 of this year was followed by a poor performance in Q2, underlining the fragile nature of the current growth model. Even so, the economy is still on track to expand by 3.0% this year, which will be a welcome return to growth. (See Chart 1.)
- President Chavez will look to maintain that momentum via strong government spending ahead of next October's presidential election. But while he can print bolivars to spend in the domestic economy, his programme of expropriations has hollowed out the economy and made it reliant upon imports. As a result, the success of his campaign may hinge on his ability to supply FX to the economy.
- If oil prices rebound to \$115-125 per barrel, then he should be able to achieve this. But if oil trends lower towards \$85 per barrel, as we expect, then Mr. Chavez will be forced to reduce the import bill – perhaps by as much as 10% of GDP. (See Chart 2.) While he will pursue other funding options, such as loans from China and the sale of gold FX reserves, the bigger picture is that last year's shortages look set to return and Mr. Chavez may struggle to drive growth any higher than 2.0% in 2012.
- It remains to be seen whether that will be sufficient for Mr. Chavez to defeat the Opposition, while his rivals face a multitude of obstacles (such as finding a unifying leader, gerrymandering and media censorship). If they do win, the onset of market-friendly reforms would brighten the medium-term outlook considerably. By contrast, if Mr. Chavez prevails, the current, unsustainable, growth model means that there may be a large correction during the next Presidential term. We have pencilled in no growth for 2013. But there is a risk of an outright contraction, coupled with a default on external debt and a devaluation of the exchange rate. (See Chart 3.)



KEY FORECASTS	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	-2.9	-1.9	3.0	2.0	0.5
Total fixed invest.	-8.3	-6.3	4.0	5.0	0.0
GDP	-3.5	-1.7	3.0	2.0	0.0
Unemp. rate (%)	7.2	8.5	8.5	8.5	9.0
CPI inflation <sup>(1)</sup>	28.6	29.1	27.5	27.5	20.0
Cent'l gov't bal <sup>(2)</sup>	-5.1	-4.5	-4.5	-5.0	-5.0
Public debt <sup>(2)</sup>	22.0	27.0	30.0	35.0	40.0
Current account <sup>(2)</sup>	2.7	6.0	6.0	4.0	3.0

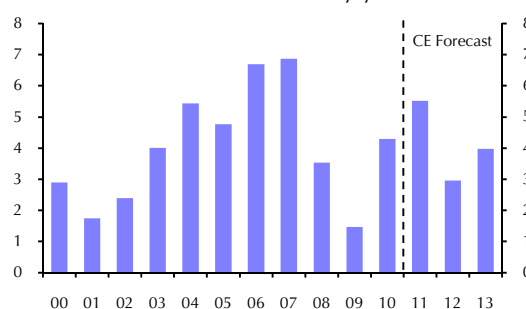
(1) Year average (2) as % of GDP. Official figures for current account.

## Colombia

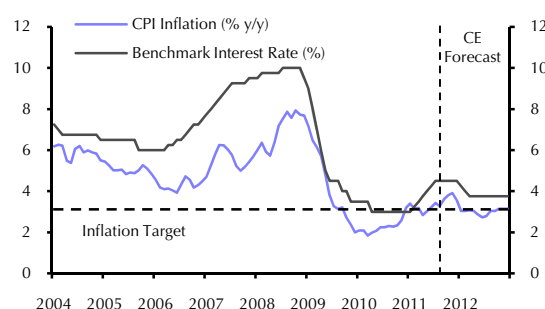
### *Growth to slow, but not collapse*

- Although Colombia is still a relatively closed economy, recent history shows that it will not be immune to a slowdown in the developed world. Exports to the US are equivalent to 5% of GDP, while shipments to Europe are worth a further 2% of GDP. More importantly, though, the recent period of rapid growth has been supported by a commodities-induced improvement in the terms of trade, along with strong capital inflows. Both of these props are likely to weaken over the next 6-9 months.
- Nonetheless, growth is unlikely to collapse. For a start, we are not yet forecasting outright recessions in the developed world, while investment into Colombia's burgeoning commodities industry should remain resilient. What's more, the government has room to loosen fiscal policy in order to smooth any downturn. We expect growth to slow from around 5.5% this year, to 3.0% next year with some pick-up to 4.0% in 2013. (See Chart 1.) Disappointing, but by no means a disaster.
- The good news is that slower growth will ease inflation pressures. Food inflation may cause the CPI rate to rise further in the very near-term, but it should quickly fall back to target next year. That, coupled with mounting political pressure to tackle the strength of the currency, may trigger some interest rate cuts. We have pencilled in a 75bp reduction to 3.75% in Q1 of next year. (See Chart 2.)
- However, any weakening of the currency will only give temporary relief to concerns about imbalances in the economy. With more commodities production set to come on line there will be renewed upward pressure on the real exchange rate. (See Chart 3.) The government has already highlighted the threat of Dutch Disease and it will need to press ahead with its plans for fiscal and supply-side reform in order to prevent concerns about an unbalanced boom resurfacing again in 2013.

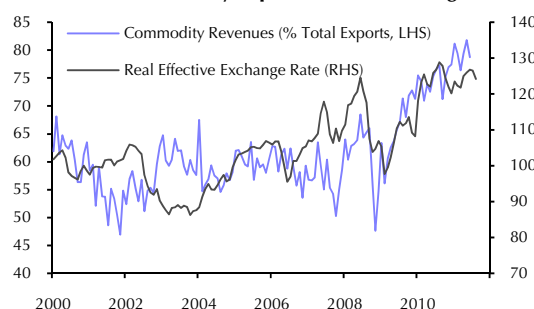
**Chart 1: GDP (% y/y)**



**Chart 2: Inflation & Interest Rates**



**Chart 3: Commodity Exports & Real Exchange Rate**



**KEY FORECASTS**

%/y unless stated

	2009	2010	2011	2012	2013
Private cons'ptn	0.9	5.1	6.0	3.0	4.0
Total fixed invest.	-3.0	12.5	10.0	7.5	10.0
GDP	1.5	4.3	5.5	3.0	4.0
Unemp. rate (%)	12.0	11.8	11.5	11.0	11.0
CPI inflation <sup>(1)</sup>	4.2	2.3	3.5	3.0	3.0
Cent'l gov. bal <sup>(2)</sup>	-4.2	-3.5	-3.3	-3.3	-2.5
Cent'l gov. debt <sup>(2)</sup>	35.0	35.0	35.0	37.0	37.0
Current account <sup>(2)</sup>	-2.1	-2.5	-2.5	-2.5	-3.0

(1) Year average (2) as % of GDP

## Chile

### Growth to moderate in 2012

- Chile's relative openness and dependence on commodities leave it exposed to a slowdown in the West. With copper prices still less than 15% below their all-time highs, strong domestic demand will support growth in the very near-term, but further ahead the road looks more arduous.
- Recent months have seen a gradual cooling of domestic activity and, going forward, global PMIs suggest that external demand will lose momentum. Since export revenues are worth more than a third of Chile's GDP, it seems likely that the pace of expansion will continue to slow over the remainder of 2011. We are forecasting growth of 6.0% in 2011, slowing to a below-consensus 3.0% in 2012 and then 3.5% in 2013. (See Chart 1.)
- Domestic industry could see some respite over the next 12-18 months due to an expected weakening of the peso, however this will be tempered by a less favourable external demand picture. Inflation should remain close to target, with expectations well anchored, and slowing growth will ease core pressures. (See Chart 2.) This will open up space for some policy easing and we have pencilled in 125bps of cuts from Q1 next year, taking the benchmark rate to 4% by end-12. (See Chart 3.) This is below consensus, but now largely priced into the market – and there is scope for the central bank to ease by more if global conditions deteriorate faster than we expect.
- Finally, Chile's ample buffer of savings and a spate of planned infrastructure projects should help to offset lower global demand in the near-term. As such, growth is expected to slow, rather than collapse. This will help to dispatch any lingering concerns about overheating and, combined with a weaker peso, could potentially help to rebalance the economy away from domestic demand.

Chart 1: GDP Growth

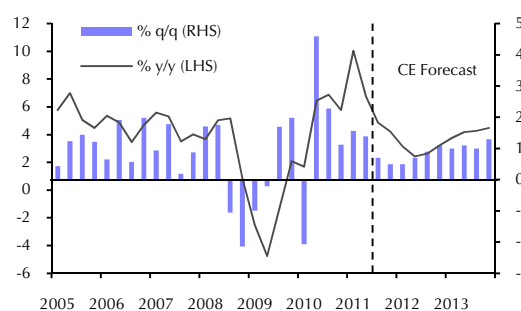


Chart 2: Consumer Prices (% y/y)

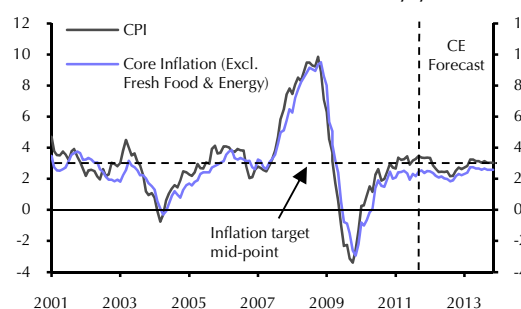
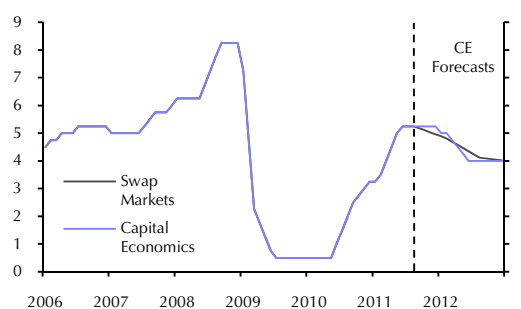


Chart 3: Interest Rates (%)



#### KEY FORECASTS

	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	0.9	10.4	7.5	4.0	5.0
Total fixed invest.	-15.9	18.8	12.5	7.5	10.0
GDP	-1.7	5.2	6.0	3.0	3.5
Unemp. rate (%)	10.7	8.3	7.5	8.0	7.8
CPI inflation <sup>(1)</sup>	0.4	1.4	3.0	2.5	3.0
Cent'l gov't bal <sup>(2)</sup>	-4.6	-0.3	1.5	1.0	0.5
Cent'l gov. debt <sup>(2)</sup>	6.2	9.2	7.0	6.0	5.0
Current account <sup>(2)</sup>	1.6	1.9	-0.5	-1.0	-1.0

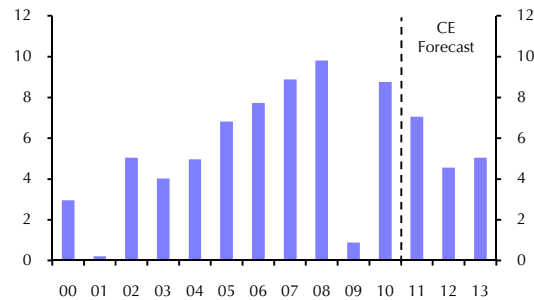
(1) Year average (2) as % of GDP

## Peru

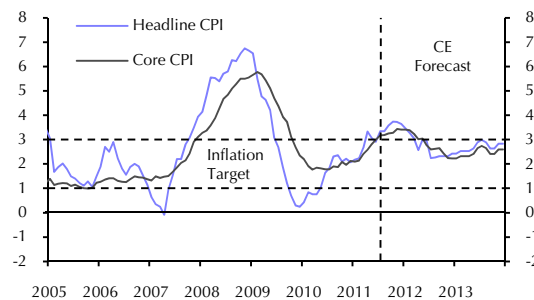
### *Humala must fulfil pro-market pledges*

- The near-term outlook for Peru has been dominated by investor uncertainty following the emergence, and subsequent victory, of left-wing Ollanta Humala in June's presidential elections. Despite a slump in business confidence in Q2, foreign investment appears to be returning after a number of business-friendly concessions, including a less-punitive than expected mining tax announcement.
- Growth will cool further over the next 12-18 months as the external environment weakens. We do not, however, expect to see a collapse. Peru's public finances are in a healthy state and the government has already outlined a contingency plan to stimulate growth in the event of a renewed global downturn. Base metal export prices also remain high by historical standards, supporting robust domestic demand. We have pencilled in 7% growth in 2011, slowing to a still-respectable 4-5% in 2012/13. (See Chart 1.)
- Inflation, meanwhile, should benefit from an easing of food price pressures before year-end. Even so, with core pressures and expectations building, the central bank's inflation-fighting resolve in the context of weaker global growth may be tested. (See Chart 2.) With CPI likely to remain close to its target upper bound, and investors scrutinising the government's macroeconomic credentials, the bar to rate cuts may be higher than in other countries. As such, we expect rates to stay at 4.25% through 2011 and would be surprised to see a cut before Q1 2012. Thereafter, we expect rates to fall to 3.50% by end-2012 (See Chart 3.)
- Lower external demand and commodities prices may help to take some of the heat out of a strong domestic currency, which has seen manufacturing growth slow sharply 2011. All told, as long as Peru stays an open and business-friendly destination for foreign capital, it should be relatively well placed to weather the effects of a global economic downturn.

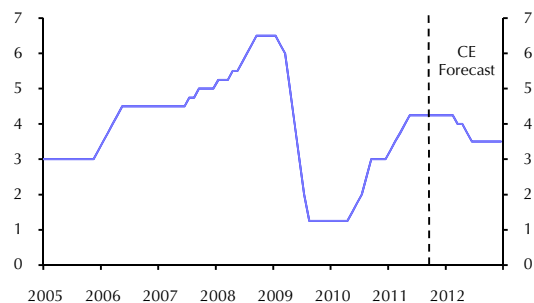
**Chart 1: GDP (% y/y)**



**Chart 2: Consumer Prices (% y/y)**



**Chart 3: Interest Rates (%)**



KEY FORECASTS	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	2.4	6.0	6.0	4.0	4.5
Total fixed invest.	-9.2	23.2	12.5	5.0	7.5
GDP	0.9	8.8	7.0	4.0	5.0
Unemp. rate (%)	8.4	7.9	7.5	8.0	7.5
CPI inflation <sup>(1)</sup>	3.0	1.5	3.0	2.5	2.8
Cent'l gov't bal <sup>(2)</sup>	-1.9	-0.2	0.5	0.0	0.0
Public debt <sup>(2)</sup>	26.6	25.0	23.0	21.0	19.0
Current account <sup>(2)</sup>	0.0	-0.4	-2.0	-3.0	-3.0

(1) Year average (2) as % of GDP

## Ecuador

### Still at the mercy of oil prices

- Lower oil prices look set to apply the brakes to Ecuador's recent acceleration of growth. With the evidence suggesting that very little of the recent terms of trade windfall has been saved or invested, the government has next to no protection against a renewed dip in crude prices. Indeed, our forecast for ICE Brent to reach \$100/bbl and \$85/bbl by the end of 2011 and 2012 respectively means that growth will inevitably slow. We are forecasting an expansion of 4.5% this year followed by 2.0% in 2012 and 2.5% in 2013 (See Chart 1.)
- Petrodollar revenues currently account for around a third of government income, and the rise in revenues over the past couple of years has largely been spent. (See Chart 2.) At the same time, the current account deficit has widened, despite the increase in oil export revenues and the subsequent improvement in the terms of trade.
- This means that Ecuador is heavily exposed to a fall in oil prices. If Brent crude prices were to decline to \$85/bbl in 2012 (in line with our forecast), we project that, all else equal, the current account deficit would widen to 6.5% of GDP. (See Chart 3.) In a dollarised economy such as Ecuador's, these net outflows need to be financed by inflows on the capital account otherwise shortages of hard currency may occur. Bilateral loans from China have so far plugged the gap, however there is no guarantee that this will be true in future.
- As such, there is a very real possibility of dollar shortages and, ultimately, a fiscal and currency crisis over the medium term. President Correa has expressed concern over the vulnerability of the economy to capital flight and recently moved to restrict imports and currency outflows. Nonetheless, the big picture is that a sustained fall in oil prices may lead to a messy correction and hard landing over the next few years.

Chart 1: GDP (% y/y)

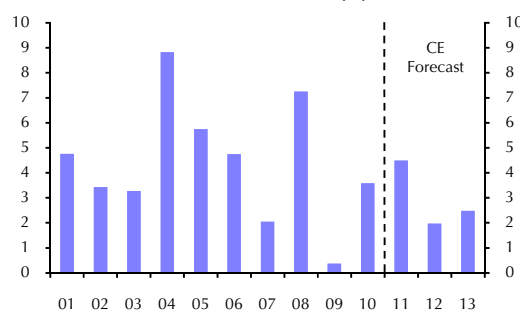


Chart 2: Oil Price & Government Balance

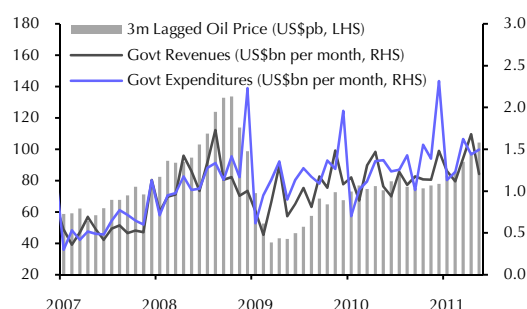
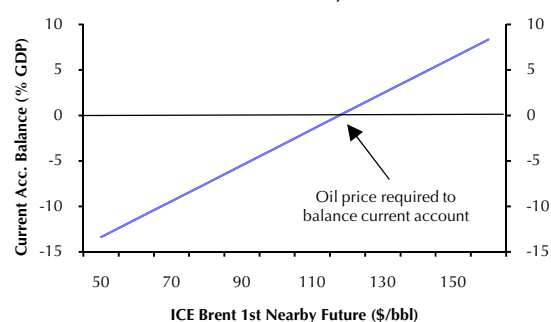


Chart 3: Current Account Sensitivity to Oil Price (% of GDP)



#### KEY FORECASTS

	%y/y unless stated				
	2009	2010	2011	2012	2013
Private cons'ptn	-0.7	7.7	5.0	3.0	5.0
Total fixed invest.	-4.3	10.2	9.0	1.5	5.0
GDP	0.4	3.6	4.5	2.0	2.5
Unemp. rate (%)	8.5	7.6	7.0	7.5	7.5
CPI inflation <sup>(1)</sup>	5.2	3.6	4.5	3.0	3.5
Cent'l gov't bal <sup>(2)</sup>	-5.1	-2.9	-3.0	-2.5	-3.5
Cent'l gov. debt <sup>(2)</sup>	20.0	23.0	24.0	26.0	28.0
Current account <sup>(2)</sup>	-0.5	-3.1	-3.5	-1.5	-1.0

(1) Year average (2) as % of GDP

## Costa Rica, Bolivia, Uruguay

### Growth will slow next year

- Costa Rica's** close economic ties with the US mean that we are likely to see growth slow over the 12-18 month horizon. Strong service sector and retail activity have supported growth of 3.5% over the year to date and we expect a similar figure for full-year 2011. Domestic manufacturing will remain sluggish due to weak demand from the US, Costa Rica's key export destination. With developed world growth forecast to slow further in 2012, we anticipate a reduction in tourism receipts and reduced inflows of foreign capital. We have therefore pencilled in growth of 2.5% in 2012 and 2013. (See Chart 1.)
- Bolivia's** growth appears to have held up well in 2011, mainly due to price strength in its commodity export basket. Nonetheless, growth remains leveraged on energy prices and external demand from Argentina and Brazil. Underinvestment in infrastructure over recent years, due to a hostile business environment, is likely to lead to diminishing hydrocarbon output in the medium term. With lower commodities prices and weaker external demand expected ahead, growth will slow from 4.5% in 2011 to 3.0% in 2012/13. Inflation is still above 10%, prompting a series of increases in the currency peg, but should fall back in 2012 as food price pressures unwind. (See Chart 2.)
- Uruguay** should deliver growth of around 5.5% in 2011, on the back of high agricultural prices and strong domestic demand. Over the next 12-18 months we expect weaker demand from regional trade partners to temper growth, although solid fundamentals may make Uruguay less vulnerable to risk aversion and capital outflows. We expect growth to cool to 3.5% in 2012 and 4.5% in 2013. (See Chart 3.) Strong domestic demand and high inflation make the bar for rate cuts higher than elsewhere in the region.

Chart 1: Costa Rica GDP Growth (% y/y)

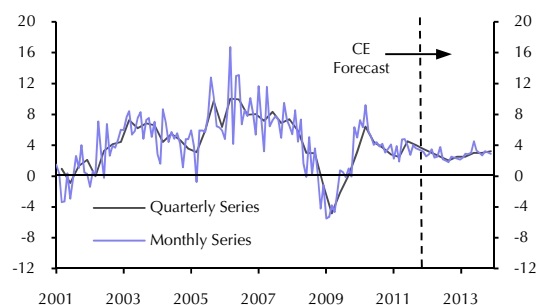


Chart 2: Bolivia Consumer Prices (% y/y)

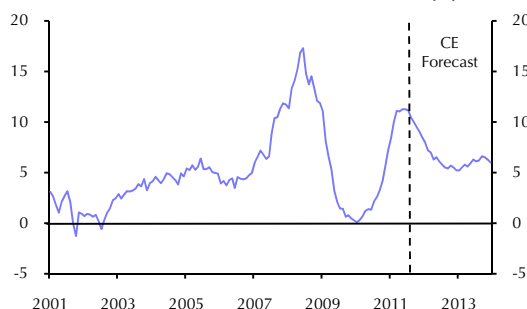
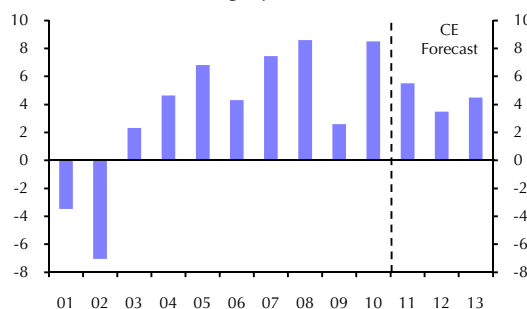


Chart 3: Uruguay GDP Growth (%)



#### KEY FORECASTS

%/y unless stated

	2009	2010	2011	2012	2013
<b>Costa Rica</b>					
GDP	-1.1	4.2	3.5	2.5	2.5
CPI inflation <sup>(1)</sup>	7.8	5.6	6.0	5.0	5.0
<b>Bolivia</b>					
GDP	3.4	4.1	4.5	3.0	3.0
CPI inflation <sup>(1)</sup>	3.5	2.5	10.0	4.0	4.0
<b>Uruguay</b>					
GDP	2.8	8.0	5.5	3.5	4.5
CPI inflation <sup>(1)</sup>	7.2	6.7	8.5	6.5	7.0

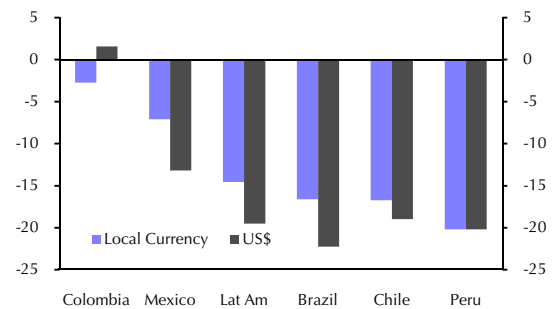
(1) Year average

## Financial Markets

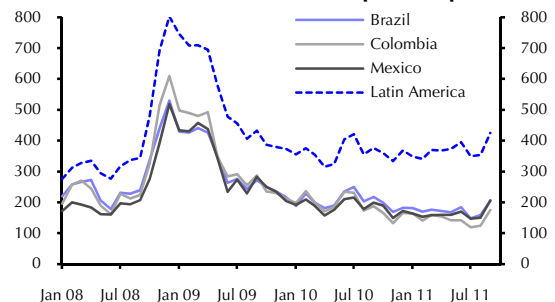
### *More turbulence ahead*

- Having underperformed in the first half of this year, Latin American markets have slumped further since the start of July – particularly in Brazil and Peru. Renewed fears about a double-dip recession in the developed world, coupled with the ongoing debt crisis in the euro-zone, have sparked a retreat from risky assets. Equities are down by 15-20% this year, while bond spreads have widened and currencies have weakened. (See Charts 1&2.)
- To be clear, we remain upbeat on the medium-term outlook for Latin American assets. The region’s relatively good growth prospects mean that returns should be healthy in comparison to the developed world. But in the near term, there are good reasons to think that the rocky ride in the region’s markets will continue. (See Key Forecasts over the page.)
- For a start, the news regarding growth and debt in the US and Europe looks set to go from bad to worse over the coming months. Even though the markets have begun to price in those concerns, there will probably be further losses by year-end. We think that equities may fall by another 5-10%, while the Latin America EMBI Global bond spread may rise to 500bps. Meanwhile, capital outflows and expectations of interest rate cuts throughout the region are likely to cause currencies to weaken further.
- Of course, any sell-off will make Latin American assets look more attractive and, with the region’s growth prospects set to improve over the course of next year, there may be some rally in the second half of 2012 – but we doubt that the markets will reach the highs seen in 2010. (See Chart 3.) Risk appetite will fluctuate with changes in the news flow, while investors appear to have woken up to the reality of low global growth. What’s more, we continue to expect commodity prices to fall. While the correlation between equities and commodity prices has weakened, the region is still vulnerable to a correction. (See Chart 4.)

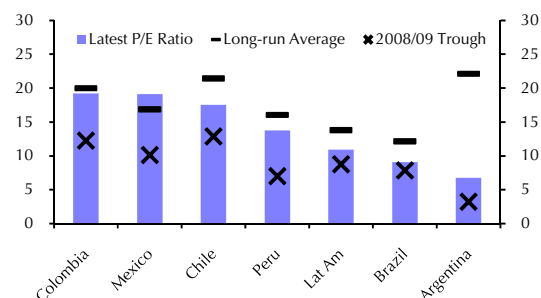
**Chart 1: MSCI Equity Market Indices**  
(%-change 1<sup>st</sup> January 2011 – 19<sup>th</sup> September 2011)



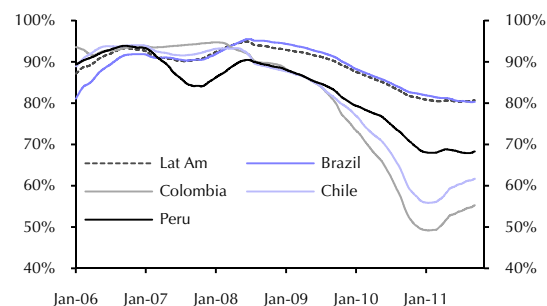
**Chart 2: EMBI Global Bond Spreads (bps)**



**Chart 3: MSCI P/E Ratios**



**Chart 4: Correlation between S&P GSCI and Lat. Am. Equities**



Source – Thomson Datastream, Bloomberg

**TABLE 1: CENTRAL BANK POLICY RATES**

%	Policy Rate	End 2010	Latest (20 <sup>th</sup> Sep.)	Last Change	Next Change	Forecasts	
						End 2011	End 2012
Brazil	Selic Target	10.75	12.00	Down 50bp (Aug '11)	Down 50bp (Oct '11)	11.00	10.00
Mexico	Overnight Rate	4.50	4.50	Down 25bp (Jul '09)	Down 25bp (Q1 '12)	4.50	4.00
Colombia	Intervention Rate	3.00	4.50	Up 25bp (Jul '11)	Down 25bp (Q1 '12)	4.50	3.75
Chile	Overnight Rate	3.25	5.25	Up 25bp (Jun '11)	Down 25bp (Q1 '12)	5.25	4.00
Peru	Reference Rate	3.00	4.25	Up 25bp (May '11)	Down 25bp (Q1 '12)	4.25	3.50
Euro-zone	Refinancing Rate	1.00	1.50	Up 25bp (Jul '11)	Down 25bp (Dec '11)	1.25	1.00
US	Fed Funds Target	0.25	0.25	Down 75bp (Dec '08)	None on horizon	0.25	0.25
Japan	Overnight Rate	0.10	0.10	Down 20bp (Dec '08)	None on horizon	0.10	0.10

**TABLE 2: FX RATES VS. US DOLLAR & EQUITY MARKETS**

	Currency Vs. US\$	Latest (20 <sup>th</sup> Sep.)	Forecasts		Equity Market	Latest (20 <sup>th</sup> Sep.)	Forecasts	
			End 2011	End 2012			End 2011	End 2012
Brazil	BRL	1.78	1.90	1.75	Bovespa	57,100	53,000	60,000
Mexico	MXN	13.07	13.50	12.50	Bolsa	35,075	32,500	36,000
Argentina	ARS	4.20	4.40	5.00	Merval	2,715	2,500	2,000
Venezuela	VEF	4.29	4.29	4.29	IBVC	100,458	95,000	105,000
Colombia	COP	1,856	1,900	1,850	IGBC	13,840	13,000	14,250
Chile	CLP	486	500	480	IPSA	4,060	3,900	4,300
Peru	PEN	2.74	2.80	2.75	IGBVL	20,320	19,000	21,000
Ecuador	USD	n/a	n/a	n/a	BVG	130	120	135
Euro-zone	EUR	1.37	1.30	1.20	DAX 30	5,535	5,000	5,500
US	USD	n/a	n/a	n/a	S&P 500	1,205	1,100	1,200
Japan	JPY	76.5	85.0	90.0	Nikkei 225	8,720	8,500	9,500

## Long-term Growth Prospects

Country	Potential GDP Growth (% y/y)	GDP Per Capita as a % of US (2010)	Comments
1. Peru	6.0%	10.9%	Well managed economy, and plenty of scope for catch up. But heavily dependent on commodities.
2. Chile	5.0%	25.0%	Best managed economy in the region, with close ties to China. Heavily dependent on copper exports but revenues are well managed.
3. Brazil	4.5%	22.9%	Sustaining growth of 5% y/y is contingent on deepening reforms to raise both investment and domestic savings.
4. Colombia	4.0%	13.3%	Market-friendly government and restoration of national security and stability following period of civil war means outlook is amongst the best in the region. Biggest risk is 'Dutch disease', which threatens the development of non-commodity sector.
5. Mexico	3.0%	20.2%	Fluctuations in the economy closely linked with that of the US since NAFTA signed in mid-90s. Over-dependence on dwindling oil reserves means fiscal risks remain high.
6. Argentina	3.0%	19.3%	Political uncertainty is high, but overheating remains the dominant concern for now. Growing risk of a hard landing over a two year horizon.
7. Venezuela	2.5%	21.1%	Poor policy continues to constrain economy's supply potential, while heavy reliance on oil means fiscal position vulnerable to swings in commodity prices. Sharp drop in oil prices could spell disaster.
8. Ecuador	2.5%	8.4%	Heavy reliance on oil continues to cloud medium-term outlook.