Global Economics Monthly Review

June 3rd, 2018

Arie Tal, Research Economist

Gili Ben Avraham, Research Economist

The Capital Markets Division, Economics Department

Please see disclaimer on the last page of this report

Key Issues

The Latin America Economy (p. 3)

- *The recovery in the Latin American economy is expected to continue in 2018… …but it is expected to be accompanied by major risks for some of the economies.*
- *Inflation has surprised downwards in some of the major economies.*
- *The lower inflation in tandem to rising risks may support a dovish, or a less-hawkish stance in the short-run, at least in some of the economies.*

Global Economic Forecast Table (p. 4)

Brazil (p. 5)

- *Brazil has been experiencing a recovery recently, following a number of years characterized by a substantial deterioration in the macro-economic environment.*
- *One of the risks to the macro-economic forecasts is the high degree of corruption, together with the rise in political risks against the backdrop of the uncertainty surrounding the upcoming October elections.*
- *Inflation declined recently to a multi-year low, but is expected to rebound along with the economic recovery. Has the current cycle of interest rate cuts reached its end?*

Mexico (p. 11)

- *There has been moderate economic growth in recent years, yet the growth rate is expected to accelerate slightly this year*
- *Higher political risks (Morena and NAFTA) weigh on economic sentiment and on the financial markets.*
- *Continued monetary tightening in Mexico is limited against the backdrop of the slowdown in growth and the decline in inflation, yet it will be affected also by the policies of the US Fed.*
- *The rise in energy prices is likely to support an improvement in the country's risk profile. Developments in the current account will be affected by the changes that are expected to occur in the NAFTA agreement.*

Columbia (p. 17)

- *The rise in energy prices is likely to support an improvement in the country's risk profile. Developments in the current account will be affected by the changes that are expected to occur in the NAFTA agreement.*
- *The annual growth rate is expected to climb gradually to an average of 3.6%.*
- *Risks to our macroeconomic forecasts are tilted to the downside.*
- *On May 25th, the OECD officially invited Colombia (together with Lithuania) to join the Organization. Improvement in Colombia's standards in variety of areas, including business environment, banking system, regulation, education, and healthcare, may bring the country closer to a status of developed economy.*

The Big Picture – The Latin American Economy

The recovery in the Latin American (LATAM) economy is expected to continue in 2018: recently released activity data suggest that Latin America's economic recovery probably continued in the first quarter. That said, based on national data, the recovery was probably uneven among the economies in the region. Activity data from Brazil and Argentina have been weak recently. However, figures from the rest of LATAM have been somewhat better. Growth in Mexico accelerated for the second quarter in a row and remained relatively robust. Growth also accelerated in Chile, Peru and Colombia strengthened.

Despite the disappointing start in some of the economies in the region, we expect an improvement in the region's growth environment this year compared to 2017, after a long-period of a relative weakness and moderation in economic activity from 2011 until 2016, while other emerging and developing economies moderated to a lesser extent. The region is most likely to benefit from a further recovery in global trade (albeit by a slower pace in 2018), an increase in commodity prices, accommodative economic policies, and base effects.

The recovery in the region is expected to be accompanied by risks for some of the economies. This is mainly due to: the increase in uncertainty surrounding US trade policy; domestic political risks, mainly due to the uncertainty surrounding the elections in Mexico and Brazil; the political and economic crisis in Venezuela; and an increase in the US interest rate expectations, which caused to significant depreciations in some of the fundamentally-weak economies, such as Argentina and Brazil. It should be noted that Latin American economies are exposed unequally to possible changes in US monetary, fiscal and trade policies. With almost 80% of total exports destined for the US, Mexico is the most exposed, followed by Colombia. Trade links are lower for Brazil and Argentina and are composed of items that are less likely to draw US policy attention.

On the other hand, it should be noted that expansionary fiscal policy in the US, which will most likely encourage investment and consumption, should support an increase in demand for commodities and support an increase in commodity prices as well. Hence, some of the commodity-exporting countries, such as Brazil, Chile and Peru, which export capital goods and raw materials to the US, and are less likely to by targeted by US trade policy changes, are expected to benefit in net terms. All in all, we expect that Latin American economies will grow on average around 2%, similar to IMF estimates, after 1.2% in 2017 and negative growth of 0.6% in 2016. In our opinion, risks to our growth outlook are currently tilted to the downside.

Monetary and fiscal policies may vary substantially by country: The recently released inflation data have surprised to the downside in some of the major economies. Due to the inflation trends and the increase in risks, we expect a more dovish stance among some of the central banks. On the fiscal front, there are substantial variations among the region's economies. Both Brazil and Argentina's fiscal profile are characterized by large budget deficits and high government debt, which may limit the flexibilities of these governments to support their economies. On the other hand, Chile and Peru are characterized by much smaller budget deficits and relatively low debt which may allow their government to support economic growth.

Leumi Global Economic Forecast, As of June 2018

	2015	2016	2017E	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.9%*	*3.9%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.7%*	*2.5%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.4%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.6%*	*1.7%*
Eurozone	*2.0%*	*1.7%*	*2.5%*	*2.2%*	*1.9%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.1%*	*4.9%*
China	*6.9%*	*6.7%*	*6.9%*	*6.7%*	*6.4%*
India	*7.9%*	*7.1%*	*6.7%*	*7.6%*	*7.8%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*2.0%*	*2.4%*
Israel	*2.5%*	*4.0%*	*3.3%*	*3.7%*	*3.4%*
Trade Volume, Growth (%)					
Global	*2.5%*	*2.3%*	*4.6%*	*4.0%*	*3.8%*
CPI, Annual Average (%)					
USA	*0.1%*	*1.3%*	*2.1%*	*2.4%*	*2.4%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.5%*	*2.2%*
Japan	*0.5%*	*1.0%*	*0.5%*	*1.3%*	*1.6%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.4%*	*1.5%*
Israel	*-0.6%*	*-0.5%*	*0.2%*	*0.8%*	*0.7%*
Interest rates, Year End					
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.25%*	*2.75-3.00%*
Bank of England	*0.50%*	*0.25%*	*0.50%*	*0.75%*	*1.00-1.25%*
Bank of Japan-Policy Rate	*0.00%*	*-0.10%*	*-0.10%*	*0.00%*	*0.00%*
ECB-Main Refi	*0.05%*	*0.00%*	*0.00%*	*0.00%*	*0.10-0.30%*
Israel	*0.10%*	*0.10%*	*0.10%*	*0.10-0.25%*	*0.50-1.00%*

Brazil

Population (2017)	208m
GDP (2017)	US$2,055bn
GDP per capita PPP (2017)	US$15,603
CDS (May 27, 2018)	189bps
Credit rating - S&P Rating downgrade in January 2018	BB- Stable
Credit rating - Moody's Rating outlook revised to negative in May 2017	Ba2 Negative
Credit rating – Fitch Rating downgrade in February 2018	BB- Stable

	2013	2014	2015	2016	2017	2018F	2019F
GDP growth, % change	3.0	0.5	-3.8	-3.6	1.0	2.3	2.5
CPI inflation,%, average	6.2	6.3	9.0	8.7	3.4	3.5	4.2
Govt. balance, % of GDP	-3.0	-5.4	-10.3	-9.0	-7.8	-8.3	-8.3
Govt. debt, % of GDP	60.2	62.3	72.5	78.3	84.0	87.3	90.2
CA balance, % of GDP	-3.0	-4.2	-3.3	-1.3	-0.5	-1.6	-1.8

Source: IMF.

Main Findings

- Brazil's economy has been experiencing a recovery following a period of economic weakness during 2014-2016. The recovery in 2017 was supported primarily by private consumption as a result of monetary expansion, a decline in inflation, and a slight improvement in the labor market, together with an increase in exports against the backdrop of the improvement in external demand from trade partners.
- A slight acceleration in growth is expected in 2018, led by the improvement in external demand and in increase in local demand.
- The high degree of corruption, and the political risks surrounding the uncertainty towards the upcoming October elections, remained high and are likely to weigh on local demand at least in the short-term.

- The country's fiscal profile has deteriorated in recent years. The budget deficit and government debt are notably high.
- Core inflation declined recently to an historic low, but is expected to rebound in parallel to the recovery in the economy.
- It is likely the current cycle of interest rate cuts has come to a conclusion, but additional cuts cannot be ruled out in the short-term in the event of deterioration in the balance of risks.
- Brazil's external accounts indicate weakness. Foreign currency reserves are high.
- Recently there has been a renewed trend of depreciation in the Brazilian real vis-à-vis the US dollar against the backdrop of the rise in interest rate expectations in the US, and also due to the weakness in fundamental factors together with the rise in political risks.
- In light of the deterioration in Brazil's macro-economic environment, the international credit rating agencies downgraded the credit rating of the economy a number of times in recent years, and currently the rating is below investment grade.

Strengths:

- A large economy (seventh in the world, and the largest in Latin America) that is diversified and productive.

- A large domestic market, with only limited effects from external shocks.

- An abundance of natural resources, primarily oil, gas, agricultural goods, and minerals.

- Diversified exports in terms of products and trade partners.

- A slight improvement in terms of transparency, against the backdrop of recent political scandals.

- Relatively high foreign currency reserves (approximately 19 months of imports).

Weaknesses:

- A weak fiscal profile that is characterized by high government deficits, together with one of the highest debt/GDP ratios among developing countries.

- High political risk, with weakness in the institutions of government and the rule of law.

- A high degree of corruption (96th in the world), with a high level of crime.

- Ranked poorly in the ease of doing business (125th in the world) due to complicated bureaucracy. A level of public infrastructure that needs repair. A low level of investment.

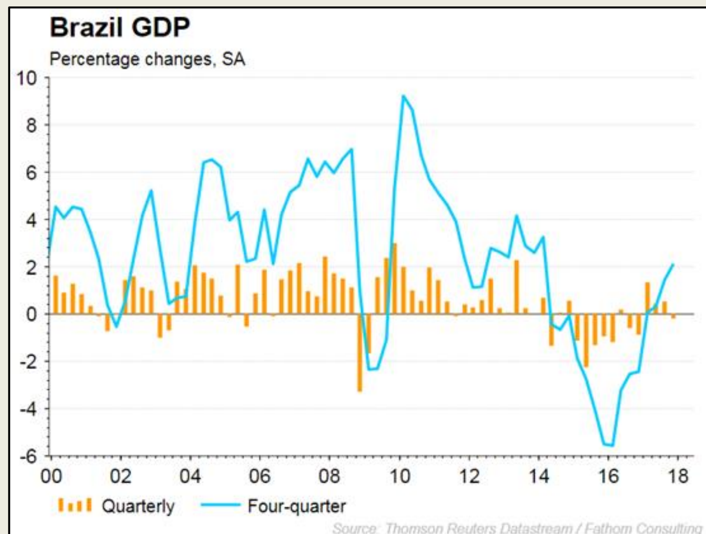
- Relatively high costs of production (wages, energy, logistics, and high costs of credit due to the high interest rate), together with a complex tax system and high tax rates.

- A shortage of professional workers, low human capital, and an educational system in need of repair. Income inequality. High poverty level.

- A continuing deficit in the current account due to, among other things, a low level of competitiveness. A surplus of overseas liabilities over assets. A low degree of net foreign direct investment (FDI).

Macroeconomic Review:

Brazil has been experiencing a recovery recently, following a number of years characterized by a substantial deterioration in the macro-economic environment: The economic data on Brazil attest to signs of recovery in economic activity last year, this after the economy suffered a deep recession in 2015-2016 (a cumulative 7.3% decline in GDP). It is important to note that also the three years that preceded the recession were characterized by economic weakness with average growth of 1.8% in the years 2012-2014, compared to average growth that was double in the Latin American economy, on aggregate, and a 5% growth rate in all of the developing economies of the world.



In light of the economic weakness in recent years, only in 2017 did GDP per capita return to the level that prevailed back in 2012, which reflects the damage that occurred in the standard of living of Brazilian households. These households were hurt during the same years by a number of factors, including: a substantial rise in the unemployment rate, which reached a peak of 13.7% in the beginning of 2017; an especially high inflation environment during the years 2015-2016 (around 9% on average); high interest rates during these years that at their peaks reached 14.25%; a hardening in credit conditions against the backdrop of the rise in risks in the financial system; and more. The damage to households was expressed in a drop in private consumption, in housing demand, and in investment in construction, but not only these.

The decline in economic activity stood out also in exports and in investments (investments declined 30% since the beginning of 2014). Actually, there were a number of actors that supported the economic weakness in the business sector over recent years, including a decline in commodities prices, while in some of the categories of commodities, including agriculture and metals (Brazil is one of the largest exporters of iron ore, soya, coffee, and sugar), price declines started in 2012, whereas the decline in crude oil prices (5% of commodities exports) started in mid-2014. The drop in commodities prices caused damage to manufacturing and industrial exports, as well as to in investments in the industrial sectors. Another factor that hurt exports was the rise in import prices against the backdrop of the trend of depreciation in the real that began in 2011. This caused a rise in manufacturing prices and hurt the profitability of companies in the economy.

An additional factor cost that hurt the profitability of companies was the upward trend in interest rates that began 2013. This caused an increase in the financing expenditures of companies. Furthermore, credit conditions were hardened over recent years against the backdrop of the deterioration in the financial system. Other factors include low productivity; a low degree of competitiveness; relatively high labor costs; a slowdown in economic activity among some of Brazil's trade partners in recent years, including Argentina and China; and of course the rise in political risk in recent years, a development that also hurt business sector sentiment and consequently investments.

Brazil's economy registered a positive growth in 2017. The year 2018 started on a soft note. Last year, the economy increased 1% (still in terms of growth per capita this is near – zero growth). The factors that supported Brazil's exit from its crisis include: the recovery in commodities prices; an increase in external demand against the backdrop of the improvement in economic activity among Brazil's trade partners; the return to a more moderate inflation environment; substantial interest rate cuts since the end of 2016; an easing in credit conditions in the banking system that was expressed in positive growth in credit in the beginning of 2018, for the first time after 18 months of negative growth in credit; a slight improvement in the labor market and a rise in consumer confidence that support a recovery in private consumption.

The recovery in economic activity continued in the beginning of 2018, as Brazil expanded modestly by 0.4% in the first quarter compared to 0.2% in the previous quarter. On a year-over-year basis, growth moderated to 1.2% from 2.1%. The main drag came from government consumption and net trade, while private consumption growth accelerated further and investment expanded for a fourth consecutive quarter.

The second quarter GDP growth may also be weak, among other things, due to the truck-drivers' strike against the backdrop of the increase in fuel prices as oil prices increased and the real dropped. The strike had a negative impact on economic activity mainly during the second half of May, but the side effects may also roll to June as the disruption to supply chains may linger for a few more weeks, before "correcting" upwardly.

According to the forecasts of the IMF and other financial organizations, the economic recovery is expected to continue at least in the short-term. This comes against the backdrop of the improvement in external demand, the drop in unemployment, and the recent cycle of interest rate cuts (which apparently came to an end in March). The growth rate in 2018 is expected to accelerate to 2.3%, a level that also reflects the potential growth rate of Brazil in the medium-term (according to IMF estimates). The modest growth in Q1 and expectations for further weakness in Q2, may lead to downward revisions of the 2018 GDP growth forecast.

One of the risks to the macro-economic forecasts is the high degree of corruption, together with the rise in political risks against the backdrop of the uncertainty surrounding the upcoming October elections: The last few years in Brazil were characterized by high profile scandals within the Brazilian government elite, which included jail sentences for senior officials in the Brazilian political system, as well as managers and owners of large corporations. One of the more well-known incidences is known as "Car Wash". The incumbent president of Brazil, Mr. Michel Temer, was suspected of being involved in bribery in the famous case; however, the parliament of Brazil voted against his suspension and bringing him to trial. It is important to note that police investigations are still taking place against the backdrop of suspicions of corruption by the president.

The previous president, Ms. Dilma Rousseff, who Temer replaced after her impeachment, was also accused of corruption offenses that include violation of budget rules, and her name is linked to the large corruption case at government oil company Petrobas. It is important to note that a very high number of Brazilian members of parliament are currently under investigation.

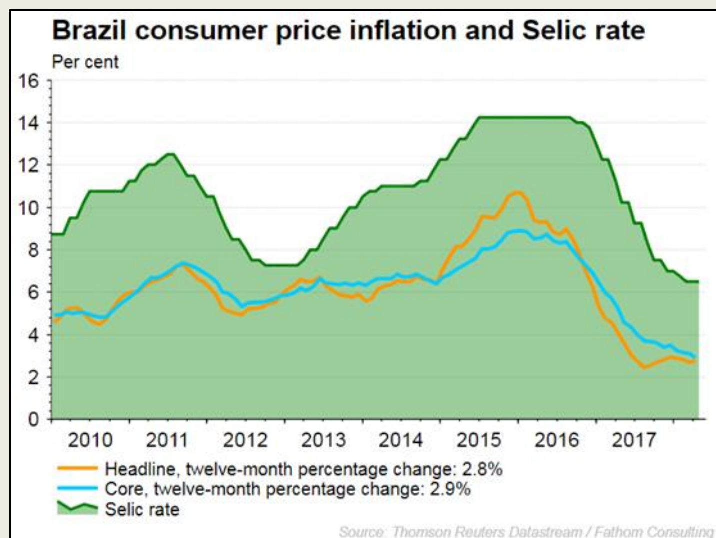
The recent shake-ups in the business and public sectors, and the struggle against corruption in Brazil, are occurring close to the time of elections, expected to occur in the beginning of October this year. Also the popular president who served before Rousseff, Mr. Lula da Silva ("Lula"), the candidate for president of the Workers' Party (Partido dos Trabalhadores), was recently convicted of violations of corruption and money laundering and is now jailed.

According to Brazilian law, candidates with a criminal record are not allowed to run for the office of president. However, these laws are subject to various interpretations, and thus there is still a slight degree of uncertainty regarding the possibility of him competing in the upcoming elections. In our opinion, there is currently a high degree of political uncertainty that is expected to weigh on local demand, and on investment in the economy, particularly in the short-medium term.

Deterioration in Brazil's fiscal risk profile: Recent years have been characterized by deterioration in the fiscal data, expressed in high government budget deficits and a rise in government debt as a percentage of GDP. The deterioration in the data is the result of expansionary government policy that was intended to support growth over recent years, and also against the backdrop of weakness in tax revenues caused by economic weakness. The budget deficit, which is expected to equal 9.3% of GDP this year, is expected to begin to decline in the coming years against the backdrop of government targets on government expenditures and the expected improvement in tax revenues. Despite the decline in the deficit, it is still expected to remain high and to support an increase in government debt. It is important to note there are a number of states in Brazil that are characterized by very large deficits, and they receive financial assistance from the Brazilian government. These states include Rio de Janeiro and Rio Grande do Sul.

Brazil's external accounts attest to weakness. Foreign currency reserves are high: Since the breakout of the global crisis in 2008 Brazil has been characterized by a deficit in its current account. In recent years the deficit declined slightly against the backdrop of a more rapid recovery in exports compared to imports. In addition, Brazil is characterized by a surplus of overseas liabilities over assets by a relatively high degree equal to 40% of GDP, following a deterioration that occurred in recent years. The rise in Brazil's external debt represents a slight risk. On a positive note, it is important to note Brazil's high level of foreign currency reserves, which are likely to help at a time of crisis.

Inflation declined recently to a multi-year low, but is expected to rebound in parallel to the economic recovery. Has the current cycle of interest rate cuts reached its end?: Inflation in Brazil has been in a downward trend since the beginning of 2016, against the backdrop of a number of factors, including a substantial moderation in the rise in wages, and a base effect after there were transient and temporary factors that supported a rise in inflation before it started to decline, including government measures, substantial depreciation especially during the years 2014-2016, and supply shocks that caused a rise in food prices. The decline in inflation enabled the central bank to lower its interest rate starting from the end of 2016 and up until the rate fell to an historic low of 6.5% in March this year.



Looking forward, and according to the forecasts of the central bank, the interest rate is expected to remain in place at least in the short-term. In our opinion additional interest rate cuts should not be ruled out in the event the economic recovery will remain moderate and/or if it will surprise on the downside, together with a low inflation environment, and against the backdrop of fiscal and political risks. Looking over the longer-term, we assume in our central scenario that the trend of recovery in economic activity will continue, this together with a gradual rise in inflation. In this scenario, these developments are expected to support a change from expansionary to tightening policy towards the end of 2018 or during 2019.

Mexico

Population (2017)	123.5m
GDP (2017)	US$1,149bn
GDP per capita PPP (2017)	US$19,903
CDS (May 15, 2018)	121bps
Credit rating - S&P (2013) Rating outlook revised from negative to stable in 2017	BBB+ Stable
Credit rating - Moody's (2014) Rating outlook revised from negative to stable in 2018	A3 Stable
Credit rating – Fitch (2013)	BBB+ Stable

	2013	2014	2015	2016	2017	2018F	2019F
GDP growth, % change	1.4	2.8	3.3	2.9	2.0	2.3	3.0
CPI inflation, %, average	3.8	4.0	2.7	2.8	6.0	4.4	3.1
Govt. balance, % of GDP	-3.7	-4.5	-4.0	-2.8	-1.1	-2.5	-2.5
Govt. debt, % of GDP	45.9	48.9	52.9	56.8	54.2	53.5	53.4
CA balance, % of GDP	-2.4	-1.8	-2.5	-2.1	-1.6	-1.9	-2.2

Source: IMF. Forecasts and estimates from April 2018.

Main Findings

- Moderate economic growth over recent years, against the backdrop of: a high inflation environment that eroded the purchasing power of households, a high interest rate environment, deterioration in economic sentiment, an increase in political risk, and declines in energy prices in the years 2014-2016. Furthermore, the overall economic weakness in the Latin American region affected negatively on Mexico as well.
- The government is leading reforms that are expected to support an increase in the potential growth rate in the long-term.

- The country's economic dependence on the US is likely to have a negative impact on the economy in the event there will be substantial changes in the NAFTA trade agreement. Other changes may also have a negative impact, particularly effective limitation on the level of immigration and number of deportations of illegal immigrants, which will likely impact money transfers from the US to Mexico.
- Presidential elections will take place this year on July 1st. The political changes and economic policy of the US are likely to impact public opinion in Mexico. The left-leaning political party Morena continues to lead in the polls. This is likely to lead to a change in the authorities and thus represents a source of economic-political risk. This comes against the backdrop of forecasts for deterioration in Mexico's fiscal profile due to an increase in government expenditures, together with a rise in uncertainty in the business sectors against the backdrop of possible changes in current government reforms. It is important to note that the leader of the Morena party, Andres Manuel Lopez Obrador, spoke out against the president of the US, Donald Trump, in the past and charged that changes need to be made in the trade agreement between the countries.
- The challenges in the Mexican economy in recent years, together with the rise in interest rate expectations in the US, caused a trend of substantial depreciation in the exchange rate of the peso vis-à-vis the US dollar over the last years. Consequently, inflation accelerated significantly in 2016-2017 and as a result a process of substantial monetary tightening was implemented. It is likely this process of monetary tightening is close to reaching its potential.
- Recently there has been an improvement in the country's fiscal profile together with a slight improvement in the external accounts, and this has caused the credit rating agencies to raise their rating outlooks on Mexico.

Strengths:

- A large, open, and diverse economy with natural resources as well as developed industries in the areas of oil, gas, and metals.

- Free trade agreements with many countries, including comprehensive agreements with some of the largest countries in the world, primarily with the US and Canada within the framework of NAFTA.

- Membership in international organizations, including the OECD and the G-20.

- A proven track record of fiscal discipline.

- The business sector and households maintain low leverage in an international comparison.

- An US$88bn line of credit from the IMF; and the country holds a large amount of foreign reserves.

Weaknesses:

- High dependence on the development of business cycles and economic policies of the US, in light of the high interdependence between the countries.

- Political risks against the backdrop of upcoming elections on July 1st and potential changes that may not be to the benefit of Mexico in the NAFTA agreement represent risks to the macro-economic forecasts of Mexico.

- A very high level of corruption in the institutions of government (ranked 135 in the world), with a trend of deterioration in recent years. Corruption has a broad, negative impact on the economy, which is reflected in economic growth, fiscal data, the black market, crime, lower competitiveness, weakness in education, low human development, and more.

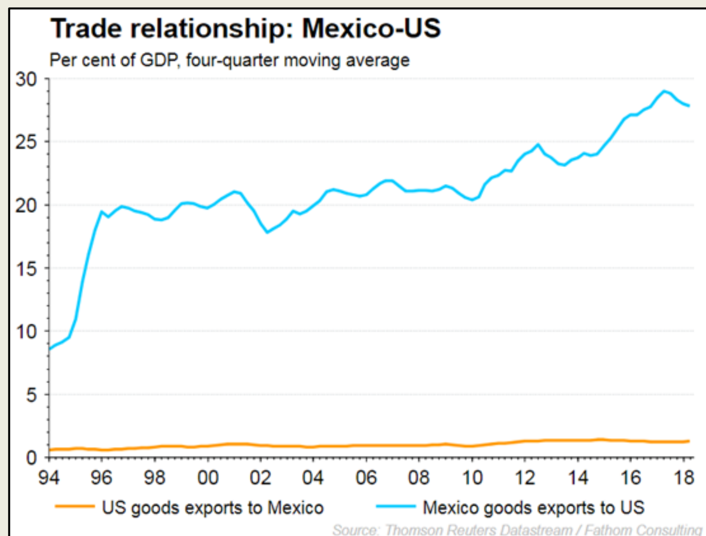
- Ranked 49th in the world in the ease of doing business (similar to Moldova, Thailand, and Israel).

- High sensitivity to commodities prices.

- High fiscal dependence on revenues from the energy market.

Macroeconomic Review:

Increased economic dependence of Mexico on the US in recent decades: The Mexican economy has become more industrialized and more open in terms of international trade activity over the last three decades. This is due to the economic ties and the rise in trade relations with the US, particularly following the signing of the NAFTA free trade agreement that went into effect in 1994 (the agreement includes the US, Canada, and Mexico). Goods exports and services from Mexico account for 28% and 8% of GDP, respectively, whereas before the signing of the NAFTA agreement total exports accounted for only 12% of GDP. Exports to the US account for almost 80% of total exports, that is to say, exports to the US on their own account for more than one-quarter of Mexican GDP. The economic ties with the US, which also include extensive foreign direct investment (FDI), and money transfers from Mexican workers in the US, contributed greatly to the Mexican economy. However, these inflows also have disadvantages due to the substantial dependence of Mexico on the business cycles and economic policies of the US.



Higher political risks (MORENA and NAFTA) weigh on economic sentiment and on the financial markets: The disadvantage of the economic dependence on the US comes into expression at the current moment as the US is demanding to make changes in the trade agreement, due to, among other things, the trade deficit that the US maintains in its activity vis-à-vis Mexico, and with the goal of encouraging local manufacturing in the US at the expense of manufacturing in other countries. The deficit in the trade account of goods and services of the US vis-à-vis Mexico amounted to US$70bn in 2017. This deficit level is high compared to deficits that the US maintains vis-à-vis other countries. The topics being discussed in negotiations include: new rules regarding the possibility to cancel the trade agreement; the rate of spare parts in automobiles manufactured in the NAFTA countries; changes in the rules of trade of clothing and shoes; changes in the amounts and prices of imports of agricultural products; and more.

Parallel to the trade agreement negotiations, tension exists between the US and Mexico on the topic of borders (the construction of a separation wall on the border between the countries) and surrounding the question of immigration. Currently there is great uncertainty regarding the trade agreement, especially in light of the estimate that the chances are increasing for the Morena party, which is considered anti-establishment, to win in the elections that will take place on July 1 this year. The candidate for president who stands at the head of the party is Mr. Andres Manuel Lopez Obrador, who has declared a number of times that he opposes the NAFTA agreement in its current framework, and opposes economic reforms, and especially reforms in the energy market that the current president, Mr. Enrique Pena Nieto, is implementing. In addition, during the course of the campaign the leading candidate for president noted that he intends to lower energy prices for households, and to carry out substantial changes in the education reforms that the current president is implementing.

The uncertainty surrounding the expected changes in the trade agreement, together with additional changes that are likely to occur in economic policy in the event the Morena party will win the elections, are currently weighing on business confidence, support heightened currency and interest rate risks, and are likely to continue to weigh on growth in the economy at least in the short-term.

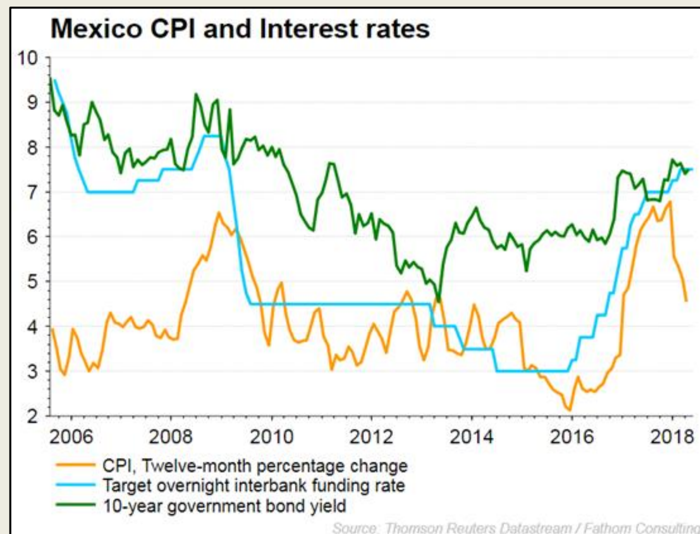
There has been moderate economic growth in recent years, yet the growth rate is expected to accelerate slightly this year: The Mexican economy grew in recent years at a relatively slow rate. The average growth rate in the years 2013-2017 equaled 2.5%, or approximately 1.4% in per capita terms. Looking over a broader span, the average annual growth rate since the breakout of the last financial crisis was 2.0%. This compares to an average annual growth rate of 3.4% in the years 2003-2007, and 2.9% in the years 1994-2007, which includes, among other things, the big “Tequila Crisis” in 1995.

The moderation in the Mexican growth environment occurred primarily due to a slowdown in manufacturing in the industrial sectors. In contrast to this, the services sectors grew over recent years similar to the long-term trend. Last year the economy grew 2.0%, concluding two consecutive years of slowdown in the growth rate. The primary growth engine was private consumption, which was supported by money transfers of Mexicans who work abroad (primarily in the US), an improvement in the labor market, and a rise in wages. Also, exports contributed to economic growth, against the backdrop of the improvement in economic activity in the US and the depreciation in the Mexican peso.

On the other hand, investments and activity in the industrial sectors were characterized by weakness against the backdrop of the rise in the degree of uncertainty. According to estimates, the growth rate this year is expected to climb to 2.3%. This comes against the backdrop of a continued improvement in the labor market and expectations for an increase in exports. On the other hand, the uncertainty against the backdrop of political risks is likely to weigh on investments. Furthermore, the cycle of interest rate hikes that began at the end of 2015 against the backdrop of the substantial depreciation in the currency is also likely to weigh on investments, at least in the short-term.

The government is implementing broad government reforms that are expected to support a rise in the potential growth rate in the long-term: Since the formation of the current government at the end of 2012, a number of large and substantial economic reforms were launched. The reforms focus on government policies in various sectors, among them: the labor market – professional training in accordance with the needs of the economy, and also streamlining and increasing the official workforce; improving the rule of law, law enforcement, and reducing corruption in the public sector; fiscal policy – limiting government expenditure; the electricity and energy sectors – encouraging foreign investment, and opening markets to competition; the financial sector; and the communication sector – removing barriers to entry and encouraging competition. It is estimated that the various reforms are expected to support acceleration in the potential growth rate of the economy and to bear substantial results in the coming years. The International Monetary Fund (IMF) estimates that the potential growth rate of the economy in the medium-term is 2.5%.

Continued monetary tightening in Mexico is very limited against the backdrop of the slowdown in growth and the decline in inflation, yet it will be affected also by the policies of the US Fed: After the interest rate had stayed at an historic low of 3% starting from June 2014, towards the end of 2015 the central bank started to hike the rate due to the rise in inflation that was affected by, among other things, the continuing depreciation in the exchange rate of the Mexican peso. From November 2015 the rate increased at a relatively rapid pace. In total the central bank rate increased 4.5 percentage points since its low and today it stands at 7.5%. Heightened growth risks together with a decline in core inflation recently to a level of 3.7% compared to a level of around 5% during the second half of 2017, are likely to support a cessation, at least temporarily, in the process of monetary tightening.



The rise in energy prices is likely to support an improvement in the country's risk profile. Developments in the current account will be affected by the changes that are expected to occur in the NAFTA agreement: In terms of economic policy, the Mexican government has a proven history of economic policy discipline in recent decades, which is expressed in relatively low fiscal deficits over the years compared to many developed and developing countries. However, it is important to note that since the breakout of the global crisis in 2008-2009 there has been a slight step-up in the budget deficit as a percentage of GDP against the backdrop of the weakness in tax revenues due to moderate growth.

Due to the reforms of the authorities there has been a slight improvement in the fiscal data recently, and it is possible the rise in oil prices is expected to also support an increase in revenues since one-third of state revenues from taxes derive from oil. On the other hand, it is important to note that the amount of oil production in Mexico is likely to decline in the coming years due to heightened energy production on US territory. Due to the slight improvement in Mexico's fiscal profile and the continued implementation of economic reforms, the international credit rating agencies recently changed the rating outlook on Mexico from negative to stable. Mexico's credit rating currently ranges between BBB+ (close to the lowest bound of investment grade) and A-.

Columbia

Population (2017)	49.3m
GDP (2017)	US$309.2bn
GDP per capita - PPP (2017)	US$14,485
CDS (May 24, 2018)	109bp
Credit rating (S&P) December 2017	BBB- Stable
Credit rating (Moody's) February 2018	Baa2 Negative
Credit rating (Fitch) May 2018	BBB Stable

Economic indicators	2013	2014	2015	2016	2017	2018F	2019F
GDP growth, % change	4.9	4.4	3.1	2.0	1.8	2.7	3.3
CPI inflation,%, average	2.0	2.9	5.0	7.5	4.3	3.5	3.4
Govt. balance, % of GDP	-0.9	-1.8	-3.4	-3.0	-3.1	-2.7	-1.9
Govt. debt, % of GDP	37.8	43.6	50.6	50.7	48.5	49.4	48.2
CA balance, % of GDP	-3.3	-5.2	-6.4	-4.3	-3.3	-2.6	-2.6

Source: IMF, April 2018.

Main Findings

- Due to its high exposure to commodities prices, in light of the proportion of oil in Columbia's commodities exports and oil's contribution to government revenues, the country, which is an energy exporter, experienced a substantial shock in 2014 when oil prices dropped and the country's terms of trade deteriorated sharply. Consequently, the decline in exports and investments in the oil production sector weighed on economic activity. The sharp depreciation in the Columbian peso vis-à-vis the US dollar contributed to a rise in inflation and led to tightening monetary policy that, all combined, weighed on domestic demand. Additionally, the twin deficits began to expand and government debt increased.

- Recently inflationary pressures subsided to some degree, from 9% to 3%, thus enabling the central bank to lower the monetary interest rate, such that together with a forecast rise in government investment and the expansion in exports, against the backdrop of a forecast increase in oil prices and acceleration in global trade, the country's growth rate is expected to increase in 2018. However, risks to the growth forecast are tilted to the downside, among them being: spillover of the humanitarian crisis from Venezuela and weakness in global trade due to trade protection measures.
- The peace agreement with the FARC guerrilla force is expected to encounter difficulties in the coming years, yet it has positive potential to increase security within the country and to improve sentiment among investors. On the other hand, it is likely that its implementation will cause a deviation in government expenditures and will weigh on the country's fiscal profile.
- The deficit in the current account is expected to decline in the medium-term; however, the external profile reflects an increase in risk that stems from volatility in capital flows. This is in light of a high rate of holdings by non-residents in local government debt.

Strengths:

- High fiscal credibility.

- Substantial reserves of natural resources.

- Adequate foreign currency reserves and an IMF credit line that moderates any potential risk of an external shock.

- The peace agreement with the largest guerilla force in the country enhances the level of security within the country and is likely to positively affect investor sentiment and economic activity.

Weaknesses:

- High exposure to volatility in commodities prices, mainly to oil prices, due to the high proportion of commodities out of total exports.

- A multi-year slowdown in the annual growth rate, against the backdrop of tightening policy through the beginning of 2017 and deterioration in the terms of trade.

- Deterioration in fiscal metrics due to the decline in government revenues from oil and the sharp depreciation in the peso.

- A relatively high level of corruption, relatively inferior infrastructure, and a high presence of organized crime.

- A rise in external risk, stemming from exposure to volatility in capital flows.

Macroeconomic Review:

Columbia is highly exposed to volatility in commodities prices. The fourth largest economy in South America is among the largest oil producers in the region (as well as other types of energy), and is one of the largest coal producers and coffee exporters in the world. The leading industries within the country include: oil, coal, textiles and clothing, food and beverage, chemicals, and gems. The trend in oil prices has a tight correlation with the macro-economic indices of Columbia, since the proportion of energy exports out of total exports is very high (45% in 2013, a peak year) and government revenues are dependent on the sector's performance.

The level of corruption in Columbia is considered high in international as well as in regional comparisons (96/180 in the TI corruption index), while the country's rating has been in a multi-year decline, primarily due to reports of public servants being involved in bribes. Columbia maintains a business friendly environment relative to other countries within Latin America (59/190 in the ease of doing business index), but the human capital within the country is low compared to these countries. However, a number of constraints weigh on the business environment, such as: difficulties in enforcing contracts, constraints in international trade (import and logistics difficulties), and complex tax payment schemes. Confrontation with guerrilla groups over many years, the presence of organized crime, and heightened activity in the drug trade have weighed on stability and security within the country; however, improvement in these areas has been registered in recent years.

A challenging external environment has weighed on economic activity in the country recently. Erosion in the terms of trade, primarily due to the drop in oil prices that began in 2014, and moderate growth among some of Columbia's notable trade partners in goods, excluding oil, (Ecuador, Venezuela, Brazil, and Peru) substantially weighed on goods exports, which shrunk 50% in the years 2013-2016 in nominal US dollar terms. In addition, the weakness in local demand, particularly the decline in investments, against the backdrop of, among other things, high inflation and monetary rates, brought the multi-year weakness in the growth rate to 2% in 2016 (reflecting only 0.9% GDP growth per capita), this compared to 4.6% on average in the decade preceding this year. It is important to note that one-time events, such as a two-month strike in the transport industry in 2016, also weighed on economic activity within the country. The slowdown in growth continued also in 2017, again because of weakness in domestic demand and despite stronger exports in the year. It is important to note that the growth rate negatively surprised, because forecasts from the middle of the year indicated growth above 2%.

Looking forward, the annual growth rate is expected to climb gradually to an average of 3.6%, due to a recovery in domestic demand against the backdrop of expansionary monetary policy, a rise in government expenditure within the framework of an infrastructure investment plan ("4G"), and improvement in exports that is supported by strengthening global trade and the forecast increase in oil prices. Meanwhile, the first quarter of 2018 data indicate a slight acceleration in the growth rate, which amounted to 2.2% (y/y), against the backdrop of strengthened private consumption and exports. In addition, in April 2018, for the first time since 2016, the consumer confidence index increased into positive territory. The survey indicates, among other things, optimism among consumers regarding the future.

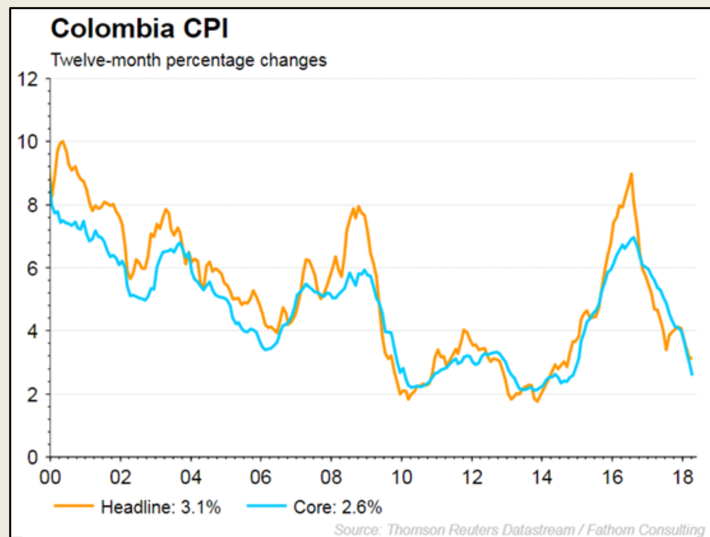
The risks to the forecast are tilted to the downside, and include: a negative impact from trade protection measures on trade activity and global growth. It is important to emphasize that the implementation of trade protection measures in the US is likely to weigh on Columbia's attempts to diversify its exports, because the export of non-traditional products to the US represents one-fifth of these goods exports. There is also the issue of spillover of the humanitarian crisis from Venezuela in the form of the entrance of refugees into Columbia's territory. This is likely to weigh on government expenditures and on economic activity. In 2017 the number of Venezuelan residents that lived in Columbia doubled in number to 600,000. Therefore, the presence of police on the shared border will be strengthened and also daily entrance visas that were issued to hundreds of thousands of Venezuelan citizens were cancelled. Furthermore, a retreat from OPEC's production customs agreement is likely to lead to a decline in oil prices and to weigh on exports. On the positive side, a faster than expected implementation of the peace agreement with the FARC guerrilla organization is likely to support growth.

According to IMF estimates, in the coming years the potential growth rate will equal 3.5%, which is slightly below the higher than 4% rate that characterized the last decade. This decline occurred in light of reaching the full potential of the increase in the workforce participation rate and the forecast decline in investment in machinery due to the decline in oil prices, which slows investments in this realm.

The peace agreement with the largest guerrilla organization in the country, FARC, is likely to support economic activity in the medium-term. The agreement, which was signed in late 2016, was initially rejected in a referendum; however, after controversial components of the agreement were revised it was approved in Congress in December 2016 and thus brought 50 years of violence to an end. The agreement has positive potential for the local economy since it removes a central source of political uncertainty, and thus is expected to support security, business activity, and investment in the country. Implementation of the agreement is expected to be slow and complex, this due to the possibility of a change in leadership of the country in elections that will

take place in May 2018 and the expenditures that are dependent on implementation of the agreement. It is important to note that according to forecasts, no dramatic changes are expected in economic policy as a result of the parliamentarian elections (that were held in March) and the presidential elections (to be held in May) that will be held in 2018. However, taking into consideration the results of the parliamentarian elections, it appears that a president from the right or centrist camps will have an easier time passing reforms in Congress.

Inflation returned to within the target range (2%-4%) after temporary shocks had pushed it above this range in the beginning of 2015. The annual inflation rate reached a multi-year peak in July 2016 as it climbed to 9%. This was primarily due to sharp climate changes that raised food prices, and also due to the depreciation of the peso vis-à-vis the US dollar, which began in 2014 and peaked in the beginning of 2016. The central bank reacted by tightening monetary policy and hiking the interest rate by a total of 4.5 percentage points to 7.75% in a series of hikes that ended in December 2016. Since then, after inflationary pressures subsided, the central bank reversed its policy and lowered the interest rate 3.5 percentage points by April 18. Last year inflation moderated and stabilized within the upper portion of the target range thanks to the stabilization of the peso and a decline in food prices, and despite a 7% increase in the minimum wage and a 3% hike in the VAT rate in 2017 that supported a rise in prices. In April 2018 inflation stabilized near the center of the target rage at 3.1%, as the impact of the hike in the VAT rate faded.

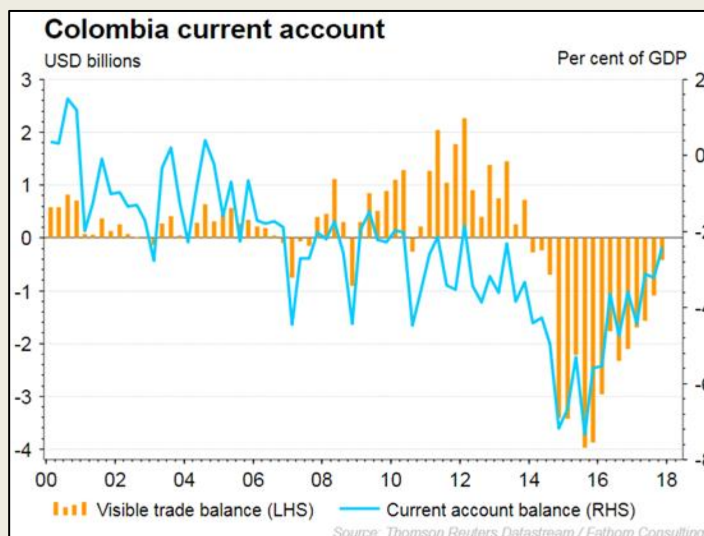


The fiscal profile weakened due to the drop in oil prices and its implications. The budget deficit expanded over recent years and stands at around 3% of GDP, compared to an average of 1.5% during 2010-2014. The primary contributors to this budget deficit were the drop in government revenues in terms of GDP, which stemmed from the weakness in the oil sector (revenues from oil – 1% of GDP in 2016 compared to 5% in 2013), and the increase in interest expenses. Looking forward, a forecast rise in oil prices and acceleration in the growth rate will support government revenues and a reduction in the fiscal deficit.

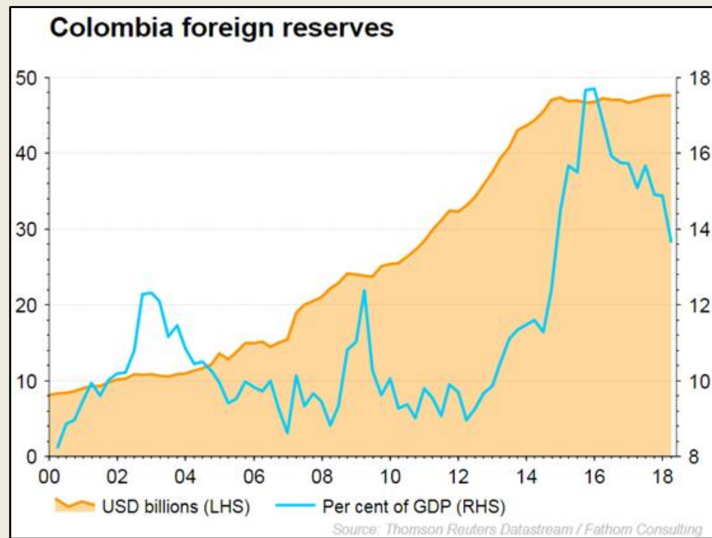
On the other hand, implementation of the peace agreement with FARC is likely to produce expenditures that will deviate from the budget framework. On this regard, we note that in February 2018 Moody's changed its rating outlook on Columbia to negative, against the backdrop of the weakness in the fiscal indices, expectations for a slow return to fiscal stability, and the concern that the new authorities will find it difficult to implement tightening fiscal policy. Government debt increased sharply over recent years due to the peso depreciation and the rise in fiscal deficits, even though the level of debt is very similar to that of comparison countries (Brazil, Mexico, and Argentina).

Looking forward, government debt is expected to stabilize and to decline gradually due to the stability of the peso and a reduction in the deficits. The structural reform of the tax system carried out by the government, within the framework of which, among other things, raised the VAT rate 3% starting in January 2017, in order to compensate for the drop in revenues from oil, is expected to help reduce the fiscal deficit in the medium-term. Additional components of the reform included a drop in the high corporate taxes, which was a primary obstacle to conducting business in the country, starting from 2018, and reducing the complexity of the tax system. It is important to note that the tax reform was approved by the government during a tense period that was characterized by high polarization caused by disagreement relating to the peace agreement with FARC. This reflects the politicians' commitment to maintain fiscal policy stability, also during times of division.

The deficit in the current account is moderating, but risks relating to shocks in capital flows have increased. The drop in oil prices led to a substantial increase in the current account deficit to approximately 6.3% of GDP in 2015, the highest deficit in the last 20 years. However, even though the decline in oil prices continued also in 2016, the deficit in the current account shrunk that year, due to a stronger reduction in imports, against the backdrop of the weakness in household demand resulting from, among other things, government policies (the hike in the monetary interest rate and VAT rates). The positive trend in oil prices, together with an increase in revenues from tourism and strengthening exports of non-traditional goods, supported exports and a decline in the current account deficit in 2017.



Looking forward, a rise in global trade and optimistic forecasts regarding oil prices for 2018 are expected to support an additional decline in the current account deficit this year. It is important to emphasize that Columbia's exposure to capital flows volatility has increased, this against the backdrop of the notable rise in the percentage holdings of non-residents in locally denominated government bonds to around 25%. The increase in the percentage of holdings held by non-residents derives from, among other things, the relatively strong economic policies of Columbia compared to countries in the region and an increase in demand for emerging markets debt assets. The risk that stems from this is a sudden and rapid sell-off of non-residents' holdings, for example, in a scenario involving a global shock of some sort. On the other hand, substantial foreign currency reserves (US$46bn, which is equivalent to nine months of imports), flexible foreign currency rate policy, and a credit line from the IMF (US$11.5bn) moderate the risk.



Disclaimer Notice

- Any statements, data, and information in the Economic Outlook which appears to be factual in nature are based on sources, including published sources, which Bank Leumi UK believes to be reliable but has not independently verified. Bank Leumi (UK) plc does not make any guarantee, representation, or warranty as to the accuracy or completeness of such statements. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. Consequently, Bank Leumi (UK) plc is not responsible for its contents nor any losses, expenditure or damages which may be incurred as a result of relying on such contents. We reiterate that no representation, warranty or undertaking, express or implied is given to the accuracy or completeness of the information contained in this presentation, and Bank Leumi (UK) plc does not accept any liability for losses which might arise from an attendee making use of the information.
- **Bank Leumi (UK) plc is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.**

BANK LEUMI LE-ISRAEL, THE CAPITAL MARKETS DIVISION
The Economics Sector, P.O. Box 2, Tel Aviv 61000
Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: Gilbu@bll.co.il
http://english.leumi.co.il/Home/