Global Economics Monthly Review:

Latin American Economy

January 11, 2017

Arie Tal

The Finance Division

Economics Department

Please see important disclaimer on the last page of this report

Key Issues

Latin America economy review (p. 3)

- **Latin American economic growth is expected to recover modestly in 2017.**
- **Overall, an acceleration of US growth will be positive for the region.**
- **Risks are still high for several economies.**

Brazil (p. 5)

- **The latest activity data were mostly disappointing. Heightened political risks.**
- **The easing cycle is expected to continue.**

Argentina (p. 7)

- **Positive expectations, but reality is still tough.**

Chile (p. 8)

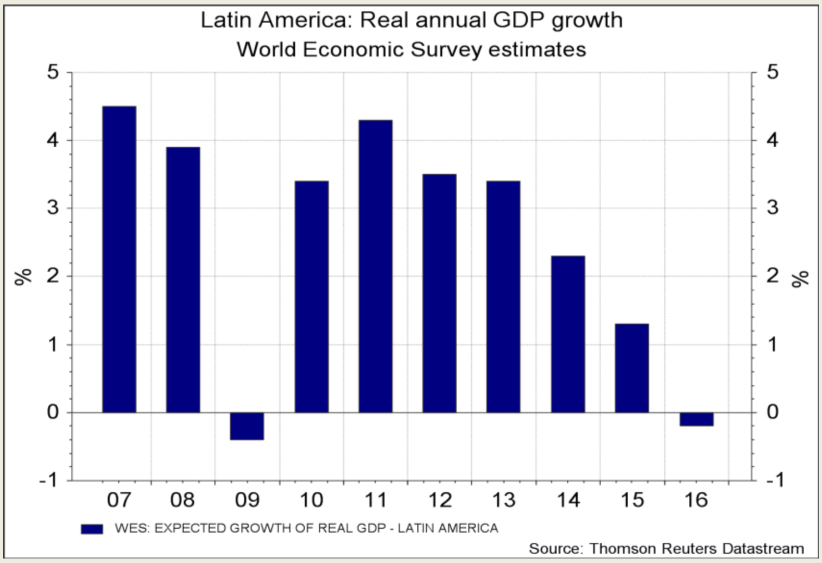
- **Weak growth and low inflation may support a comeback to an easing cycle.**

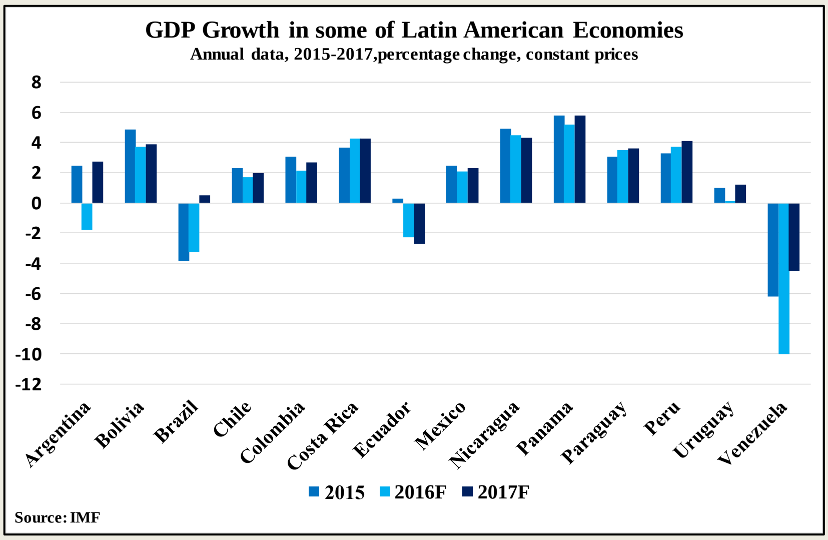
Mexico (p. 9)

- **High uncertainty with regard to Mr. Trump's foreign policy agenda – trade and immigration.**

Latin American economies are expected to recover modestly in 2017, but risks are still high among some of the economies: Latin American economies have faced major challenges over the past few years, mainly as a result of: a moderation in external demand; the drop in commodity prices; heightened political risks in several major countries; relatively high inflation; and high level of uncertainty among businesses and households, which had negative effects on domestic demand as well.

Based on national accounts data from the first three quarters of 2016 and monthly indicators from the fourth quarter of 2016, we believe that Latin American economies contracted on average in 2016. Based on IMF forecasts, GDP in the region contracted 0.6% last year, after having stagnated in 2015. According to the World Economic Survey of the IFO, Latin American GDP growth was minus 0.2%.





It should be noted that the region's annual economic growth has been falling constantly since 2012. The weakness in growth had a negative effect also on the external accounts and fiscal profiles of some of the economies in the region. Moreover, there are meaningful differences in the economic trends and fundamentals among the countries in the region, as some of the economies have shown a relatively high degree of resilience, while others have struggled. This year, Latin American economies are expected to recover modestly and record a positive growth rate. We expect Latin America's GDP to increase 1.7%

in 2017, albeit with a differentiation in growth trends among the economies in the region. The region is most likely to benefit from a possible acceleration in US GDP growth. However, 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 the global trade outlook in the aftermath of Donald Trump's victory in the US presidential election and the existing vagueness regarding foreign policy, which is weighing on sentiment towards several countries in the region.

Latin American economies are exposed unequally to the possible changes in US policies. Mexico exports almost 80% of its total exports to the US, being 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.

In terms of FDI (foreign direct investment) flows and holdings, the region is also widely exposed. Mexico gets almost half of its FDI from the US, but other countries such as Argentina, Brazil, and Peru are exposed as well. Central America exposed to risks pertaining to remittances, as these are a relatively large as a percentage of GDP, and consumption relies on these flows. There is uncertainty regarding the magnitude of potential protectionist measures, with no clarity yet on their timing or scope.

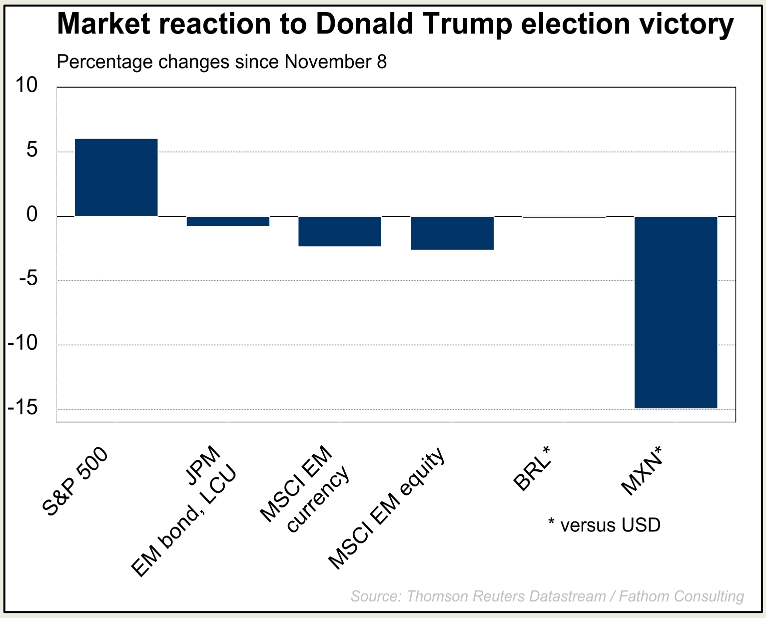
The newly elected president, Mr. Trump, did not articulate a detailed foreign policy towards Latin America during his campaign, but he did emphasize two main topics, trade and immigration, which are likely to dominate US foreign policy. Protectionism and restrictions on immigration toward Central and South America may harm some of the region's economies. If Mr. Trump will pursue a highly protectionist agenda and will, among other things, modify NAFTA or impose other, direct or indirect, trade barriers, Mexico's economy will be affected substantially. Other trade relations could also be affected, including the Trans-Pacific Partnership (TPP), a free trade agreement that includes 12 countries, including Chile, Mexico, and Peru.

Moreover, the prospect that a Trump presidency might favor substantial fiscal expansion has altered expectations for a somewhat more aggressive tightening of monetary policy compared to previous expectations. These expectations have prompted an increase in US Treasury yields. In turn, some emerging-market currencies have weakened, raising risks for tightening of monetary policy in some Latin American economies, despite the relatively slow growth environment.

It should be noted that expansionary fiscal policy in the US, mainly by investment in infrastructure and tax policy, that would encourage investment and consumption, would 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.

Moreover, the latest indicators attesting to the resilience of China's economic activity are expected to have a differential impact on Latin American economies. Commodity producers like Brazil and Chile stand to benefit most from China's recently increased demand for raw materials, in part as its middle class grows and generates aggregate demand.

BRAZIL - The easing cycle is expected to continue



The latest activity data were mostly disappointing. In Q3 2016, real GDP contracted 0.8% q/q, doubling the pace of contraction compared to Q2. However, on a y/y basis, GDP recorded the smallest decline in over one year. The poor results stem from a weakness in domestic demand, caused by, among other things, high unemployment, high borrowing costs, and political instability. On the political front, it seems that the political uncertainty that has affected negatively the economy for a considerable period already remains high, and this may continue to weigh on investments and domestic demand in general. Also, external demand has been in a downward trend since 2011, weighing as well on growth.

The economy should exit recession this year, after falling 3.8% in 2015 and 3.3% last year (estimate). However, the pace of recovery is likely to be low amid austerity measures and modest external conditions. Brazil is expected to grow 0.5% in 2017. Some sectors may recover more than others, like the materials sector following the recovery in commodity prices and companies "cleaning up" their balance sheets. Brazilian utilities should benefit from rate cuts and a recovery in energy demand. That should also be the case with industrial manufacturing, especially if there is an acceleration in US growth and demand.

The activity slump, together with lower food prices, have been driving inflation down. In December, the inflation rate fell from 7% to 6.3% (the lowest level since March 2014), which is within the target inflation band (4.5%, +/- 2%). Inflation is expected to fall further in 2017, allowing the central bank to loosen its monetary policy stance further.

In the last monetary policy meeting of 2016, the authorities cut rates by 25bps for the second time in a row, to 13.75%, and argued that the cautious move had been mostly related to uncertainty on the pace of monetary policy normalization in the US. However, policymakers indicated that they would consider stepping up the pace of monetary easing if warranted by the global backdrop.

We expect additional interest rate cuts. According to Bloomberg's consensus forecasts, the interest rate is expected to decrease below 11% by the end of 2017. Consequently, government bond yields may decline further throughout the year, and the recent appreciation of the Brazilian real may come to a halt.

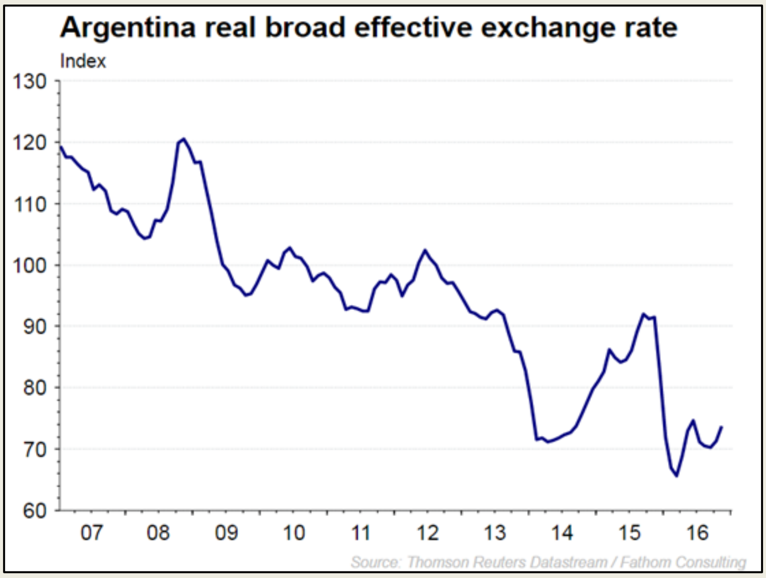
Economic Indicators and consensus forecasts	2013	2014	2015	2016F	2017F	2018F
Real GDP (YoY%)	3	0.5	-3.8	-3.5	0.8	2.2
Household Consumption (YoY%)	3.5	2.3	-3.9	-4.3	0	2.2
Government Spending (YoY%)	1.5	0.8	-1	-1.3	-0.2	0.6
Gross Fixed Investment (YoY%)	5.8	-4.1	-13.9	-10.3	2.6	6
Exports (YoY%)	2.2	-0.9	6.3	3.8	4	3.9
Imports (YoY%)	7.3	-1.9	-13.9	-10.4	1.5	5.4
Unemployment (%)	5.4	4.8	6.8	11.4	11.9	11.6
Curr. Acct. (% of GDP)	-3	-4.3	-3.2	-1.1	-1.4	-1.8
Budget (% of GDP)	-2.7	-3.8	-8.1	-9.1	-8.9	-8.3
CPI (YoY%)	6.2	6.3	9	8.8	5.1	4.7
Central Bank Rate (%)	10	11.75	14.25	13.75	10.85	-
USD-BRL	2.36	2.66	3.96	3.26	3.5	3.54

Source: Bloomberg

Argentina – positive expectations, but reality is still tough

The Argentinian economy fell by a sharp rate of 3.8% y/y in the third quarter of last year – the worst performance in the last eight quarters. Recently released monthly data reveal that the weakness has continued into the fourth quarter as well. High inflation and interest rates and significant slack in the labor market are expected to keep weighing on economic growth in the short-run at least.

However, it should be noted that prospects regarding the future economic condition are more optimistic, as the relatively new government has been leading economic reforms that may assist future growth. Furthermore, this new government is implementing fiscal policy and other steps that are expected to improve Argentinian economic fundamentals. These steps and other factors have enabled Argentina to return to global capital markets, after a long separation, with bond offerings by the government and by few large corporates, such as Pampa Energia. Another offering is that of Argentina's province of La Rioja that has been forging ahead with plans for its first international bond sale.



Argentina is expected to return to positive GDP growth this year as it may benefit from higher real wages and consumption, economic reforms, and improved business sentiment. Stronger regional growth, led by the recovery in Brazil and other countries, supported by the rise in commodity prices, and a weaker currency will also support the economy in 2017. Moreover, the expansionary monetary policy conducted by the central bank is also expected to support growth in the near future.

The economy is expected to grow 2.7% in 2017 and by approximately 3.0% over the medium-term, supported by an expected pickup in private consumption, an improving external environment, and a rebound in private investment. That said, with strong policy actions, and expectations for significant changes in the economy, the outlook on the Argentinian economy remains subject to a high degree of uncertainty.

Economic indicators and consensus forecasts	2013	2014	2015	2016F	2017F	2018F
Real GDP (YoY%)	-0.1	-2.8	2.3	-2	3.1	3.2
Private Consumption (YoY%)	3.6	-4.3	3.6	-0.5	3.4	3
Government Consumption (YoY%)	5.3	3	6.6	-0.8	1.3	1
Fixed Capital Investment (YoY%)	2.5	-6.6	4.1	-2.7	8.2	7.4
Exports (YoY%)	-3.7	-6.8	-0.6	2.6	6	4.5
Imports (YoY%)	4.1	-11.2	5.8	3.7	7.1	7.3
Unemployment (%)	6.9	7.3	7.2	9.1	8.8	8.7
Curr. Acct. (% of GDP)	-2.2	-1.5	-2.8	-2.7	-2.8	-3.2
Budget (% of GDP)	-0.2	-0.2	-0.4	-5.3	-5.3	-5.2
CPI (YoY%)	10.6	-	19	40	23.7	15.3
Central Bank Rate (%)	14.5	29.5	22	24.75	-	-
USD-ARS	6.52	8.47	12.93	15.75	18	19.53

Source: Bloomberg

Chile – weak growth and a low inflation environment may support a comeback to an easing cycle: Growth has been weak in the past year, with activity growing at a slow pace. GDP grew by 1.6% y/y in the third quarter of last year, similar to the growth rate in the second quarter. In terms of GDP per capita, economic growth was around half a percent. For all of 2016, economic growth is expected to equal approximately 1.7%. Looking forward, conditions are in place for the economy to recover. Growth is forecast to increase to 2.0% in 2017, as faster growth in main regional partners and more stable copper prices are expected to lift exports and investment. However, the recovery is projected to be gradual, restrained by slow wage and job growth and continued low business confidence.

Moreover, there are several factors that may weigh on Chile's economic growth. The main risks are external, and they include: an unexpected slowdown in Chile's main trading partners, China and Brazil; and possible changes to US policy with regard to trade agreements, although less likely to be directed at commodity countries such as Chile, that may add some indirect regional uncertainty to the outlook. That said, and as mentioned above, an increase in US infrastructure investments may have a positive effect on commodity-producing countries such as Chile. Half of Chile's exports are copper and copper-related products, mostly bought by China, but there could substantial indirect and direct impact for an increase in US growth on copper demand.

Materialization of the external risks could be magnified by high corporate leverage and reliance on foreign currency debt. Domestically, the main risks involve a delayed recovery in business confidence and investment, related to expected uncertainties surrounding a new labor bill.

Inflation has been falling recently, in tandem with the slowdown in the economy. However, the interest rate has remained unchanged throughout 2016. A further decrease in inflation, in tandem with a slow growth environment, may support an easing cycle throughout 2017.

Economic Indicators and consensus forecasts	2013	2014	2015	2016F	2017F	2018F
Real GDP (YoY%)	4	1.9	2.3	1.7	2	2.6
Private Consumption (YoY%)	-	-	1.8	1.9	1.6	2.8
Government Spending (YoY%)	3.5	5.3	5.7	3.9	3	3.4
Gross Fixed Investment (YoY%)	3	-4.2	-1.5	0.7	1	3.5
Exports (YoY%)	3.5	1.1	-1.8	0.3	2.2	2.6
Imports (YoY%)	2.5	-5.6	-2.9	-1.5	3	4
Unemployment (%)	6	6.3	6.3	6.9	7.3	-
Current Account (% of GDP)	-3.8	-1.3	-2.1	-2	-2.1	-1.8
Government Budget Balance (% of GDP)	-	-	-3.2	-2.9	-2.9	-2.1
CPI (YoY%)	1.8	4.4	4.3	3.9	3	3.3
Central Bank Rate (%)	4.5	3	3	3.5	3.8	-
USD-CLP	525.45	606.45	708.6	676	687	675
Source: Bloomberg						

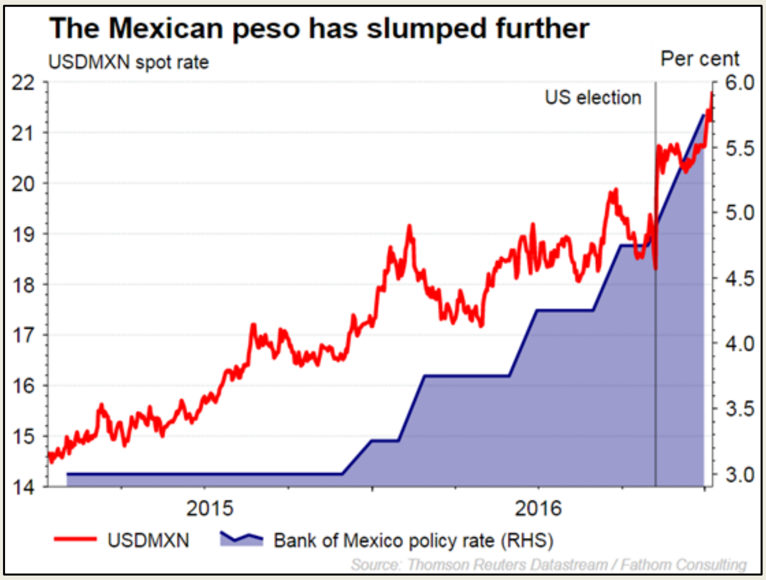
Mexico – High uncertainty with regard to Mr. Trump's foreign policy agenda – trade and immigration

The Mexican economy grew 2.0% y/y in the third quarter of last year, compared to an average of 2.5% in the previous four quarters. One of the main concerns among policy makers is the continuing divergence between the expansion of services and the poor performance in the industrial sectors. Economic growth in Mexico probably decelerated in 2016 to 2.1% from 2.5% in 2015. Growth last year was affected primarily by weakness in investment, weaker growth of exports, and a moderation in private consumption. Growth is expected to edge up to 2.3% in 2017.

Looking ahead, the uncertainty regarding the future development of Mexico's economy has increased significantly following the victory of Donald Trump in the US presidential election. Mr. Trump's protectionist rhetoric during his presidential campaign focused on the two most important issues in the US-Mexico relationship: immigration and the North American Free Trade Agreement (NAFTA). Implementation of some of his plans may weigh on Mexico's economic growth, which has been decelerating in the past few quarters. It should be noted that currently there is still not enough information to make any strong assumptions. And in any case, meaningful renegotiation on trade agreements may take a long time and it is too early to draw conclusions.

Moreover, there are other alternatives to renegotiate NAFTA and other agreements, among them taxing American companies based on their destinations, such as the "border adjustment tax", which allegedly has already affected business decision of major automotive companied, among them Ford and Fiat Chrysler which withdrew their decisions of building assembly plant in Mexico. Trump's administration will be able to provide other tax incentives to US corporations to keep their business at home instead of harming US international relations.

Unlike most of its Latin American peers, Mexico exports mainly industrial goods like vehicles, electronics and machinery, which account for more than two thirds of total foreign sales and these are in risk of being targeted by US trade policy changes. Although Mexico started to open up its energy sector to foreign investors, that could be a source of growth, it needs more funding and better technology to boost output and exports over time. Mexico's oil output has been declined since 2013 and the rebound in oil prices is not as beneficial as it was in previous years. Lastly, while Mexico's industrial proficiency and access to the US may potentially attract investment by Chinese exporters looking to cut costs, this is likely to become a reality only when the fate of NAFTA becomes clearer.

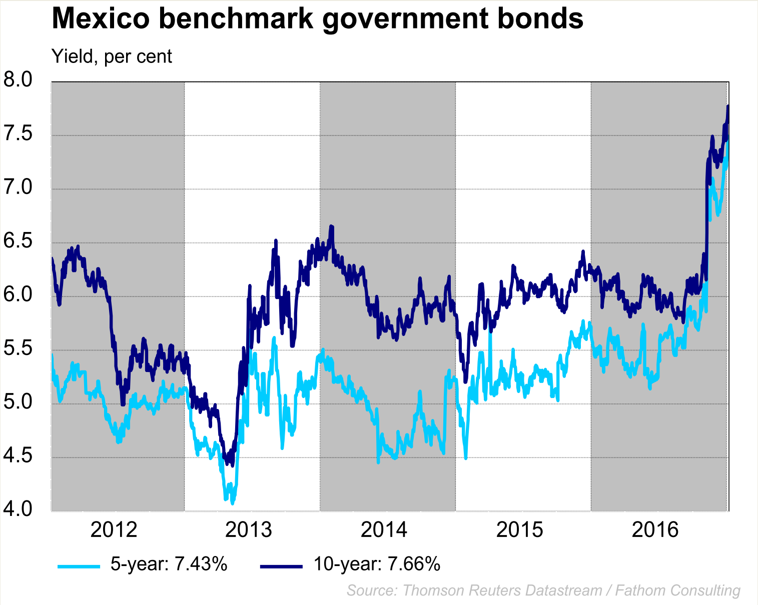


The trend of inflation changed recently following the recovery in commodity prices and the outcome of the US elections which supported the depreciation in the Mexican peso. Following the pass-through from the weakening of the Mexican peso, which translated into higher import prices, inflation has increased recently to 3.3%, from an all-time low of 2.1% in December 2015. The peso's depreciation has continued recently, despite the interest rate hikes. In January 2017, the currency reached its all-time low against the USD, at 21.4 MXN/USD. The depreciation may be reflected in a further rise in producer and consumer prices in the short-run.

The depreciation in the Mexican peso over the last few years stemmed mainly from the weakness in the Mexican economy that caused a deterioration in the country's fiscal profile and the external accounts. That said, the increase in the economic uncertainty with regard to the future of the trade agreements with the US and Trump's foreign policy agenda in general, has been the major factor in the depreciation over the last two months.

We don't rule out that the investors' concerns, as reflected in the foreign exchange market, may have been exaggerated. The pricing in the Mexican peso probably had been taking into account the "worst case scenario" outcomes with regard to the future relationship between Mexico and the US. A decrease in the level of uncertainty, after Trump's administration actually moves ahead with his foreign policy plan, may restrain the forces acting for the peso's depreciation.

Last month, the central bank of Mexico, Banco de Mexico, raised the interest rate by 50bps to 5.75%. The decision was driven by two main factors: the continuing depreciation of the Mexican peso, which pushed up inflation and inflation expectations; and the recent US Fed decision to raise the Federal Funds rate. We expect the central bank will continue to hike rates in tandem with the Fed throughout the current year, which may drive government bond yields further up, and may somewhat hinder the depreciation of the currency.



Economic indicators and consensus forecasts	2013	2014	2015	2016F	2017F	2018F
Real GDP (YoY%)	1.4	2.2	2.5	2.1	1.8	2.2
Private Consumption (YoY%)	-	-	3	2.7	2.6	3
Government Spending (YoY%)	1	2.2	2.3	0	0.5	1.8
Gross Fixed Investment (YoY%)	-1.5	2.9	4.4	0.6	1.8	3.3
Exports (YoY%)	2.3	6.9	10.5	1	3.6	4.8
Imports (YoY%)	2.6	5.9	8.7	1.2	3	5
Unemployment (%)	4.9	4.8	4.3	4	4.2	4.2
Current Account (% of GDP)	-2.4	-1.9	-2.8	-3.1	-3	-2.9
Government Budget Balance (% of GDP)	-2.3	-3.2	-3.5	-3	-2.5	-2.1
CPI (YoY%)	3.8	4	2.7	2.8	3.9	3.5
Central Bank Rate (%)	3.5	3	3.25	5.75	6	-
USD-MXN	13.04	14.75	17.21	20.5	20.35	19.75

Source: Bloomberg

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 FINANCE 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