Mexico

- **Positive trends in several variables lead us to expect a gradual improvement in the Mexican economy for this year and the next.**
- **The most important factors to consider are the evolution of the NAFTA renegotiation process and the results of Mexico's July elections.**

DEFINING MOMENTS AHEAD

Several recent indicators suggest that the Mexican economy is gaining traction. The Global Indicator of Real Economic Activity (IGAE) grew 2.1% y/y in January, which was the highest in the last four months, despite the chronic weakness in mining production (-5.0% real y/y) due to the particular problems affecting oil extraction. Construction, on the other hand, grew 4.0% y/y in January, following growth of 3.6% in December, returning to a stronger pace after negative readings during most of 2017. This rebound is especially relevant in the current highly uncertain environment in which we are living. Services sector grew 2.9% y/y in January, with positive performance of commerce (+5.4% y/y on the retail side), restaurants and hotels (+4.4% y/y) and transportation (+3.2% y/y).

Much in line with the economic activity, employment figures are showing good results: in the first two months of 2018, 278 thousand new jobs were created, 17% more than one year ago. The open unemployment rate reached 3.21% in February, the lowest level for a similar month since 2003. There is also a positive start to the year for inflation adjusted retail sales, which grew 0.5% y/y in January, after five months of contraction. Financial activity joined the train of positive news, with real deposits growing 4.8% y/y in February, accelerating from the previous four months, while banking credit to the private sector grew 6.3% y/y, the fastest pace in eight months. Worth noting is that part of the improvement observed in real rates of growth is explained by a rapid descent in y/y inflation, that reached 5.55% in January and 5.34% in February after ending 2017 at 6.77%.

On the external front, and despite the negative rhetoric coming from the Trump administration, Mexican trade is booming, as can be seen in chart 2. In the first two months of the year, total exports grew 12.4% y/y, with oil exports expanding 30.4% and auto exports rebounding 13.9%. Total imports grew 12.9%, with capital goods imports showing a formidable increase of 19.4% y/y, which suggests that investment is on the rise. Total trade expanded by USD 75 bn in the last year to February. Export growth could be explained by the increasing strength of the US economy, higher oil prices and an undervalued peso, while import dynamism suggests there is also an ongoing recovery in the internal pace of economic activity. Additionally, remittances inflows keep growing at strong rates (+6.9% y/y in February), totaling USD 29.1 bn in the last 12 months until February.

Looking ahead, we are expecting a gradual improvement in the pace of economic activity, with real GDP growth of 2.4% in 2018. The internal market is expected to keep providing support to the economy, as private consumption remains growing at healthier rates (+3.1%) and investment manages to reach a modest but positive growth (+1.2%). Job creation is anticipated to continue at a similar pace (+806 K)

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Mexico	2017	2018f	2019f
Real GDP (annual % change)	2.0	2.4	2.8
CPI (y/y %, eop)	6.8	4.3	3.8
Central bank policy rate (%, eop)	7.25	7.75	7.00
Mexican peso (USDMXN, eop)	19.66	19.46	19.71

Source: Scotiabank Economics.

Chart 1

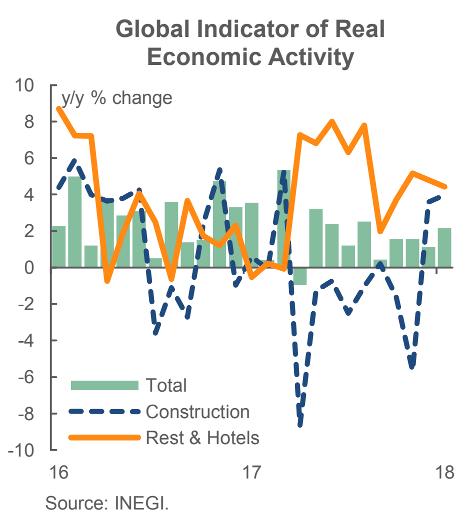
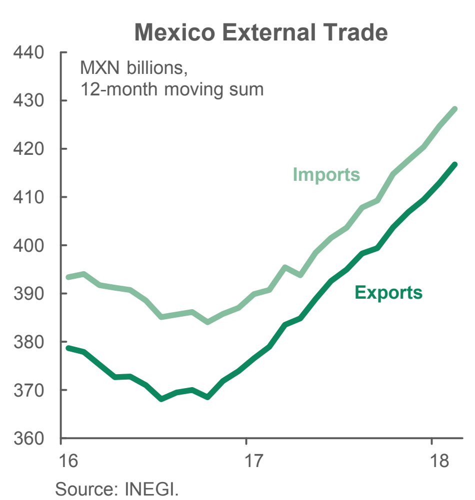


Chart 2



while remittances are forecast slightly above USD 30 bn). Inflation will descend in our base scenario to 4.3% by the end of the year, and Banco de Mexico is expected to deliver one more hike to the monetary policy interest rate by the middle of the year.

If we consider only the current economic trends, things look relatively good for the future ahead. However, there are many other factors that will have a significant impact on the performance of the Mexican economy and provide a great deal of uncertainty regarding the forecasts. The first and perhaps more relevant factor is the NAFTA renegotiation process, which has been subject to many ups and downs and different points of view. Our base scenario has been constructed under the assumption that the renegotiation process will go until 2019, and then we will end up with a modestly better agreement. If NAFTA is either ended abruptly by Trump or a NAFTA 2.0 is reached, our economic forecast may change materially.

The second factor of increasing relevance are the elections in Mexico, with Lopez Obrador leading all the recent polls. There have been many controversial pronunciations from the leading candidate, who is talking about significantly changing economic policies to return to a more centralized model where the government has the leading role in shaping the economy, and also indicated he may suspend the ongoing construction of the new Mexico City airport. One of the key assumptions of our base scenario is that sound economic policy continues, no matter who wins the election. If there are significant changes and the consistency of economic policy is weakened by the next administration, there could be material changes to the economic outlook.

Brazil

- **Politics on both the reform and Presidential election front are likely to remain a source of volatility for both FX and rates markets. Major reforms look unlikely at least until 2019, and at the moment, it's not even clear who the presidential election contenders will be—or what their reform and fiscal adjustment plans will be.**
- **Growth remains the likely main source of good news, with base effects, lower rates, and rebounding commodity prices all providing tailwinds to the Brazilian economy. With lower rates and inflation, households are becoming stronger contributors to domestic demand. Industrial production disappointed in February, but remains on the right path.**
- **On monetary policy, like most market players we expect another 25bps cut by the BCB in the upcoming May meeting, but we also expect the policy normalization cycle to begin earlier than most, possibly late 2018, or early 2019.**

REFORMS SEEM AT BEST A 2019 STORY NOW—MARKETS REFLECTING IT

With expectations being that pension reform is now at best a 2019 story after the failed bid to approve the reform in February, and elections painting a very hard-to-read picture, there are mounting concerns that the fiscal improvement markets have been anticipating will remain elusive. It is not at this point clear who the main contenders in October's presidential election will be, but recent polls have consistently put candidates that market players see as right- or left-leaning populists consistently near the top. With major candidates not clear at this point, we can't even begin to guess what their government plans will look like—including plans for reforms or fiscal adjustment. Hence, for now, the good news hitting Brazil in 2018 is likely to come from the macro data front—and so far, it has been solid. Reform disappointment, alongside political uncertainty, has made the BRL (-0.1%) the worst-performing major LATAM FX not called VEF or ARS. On credit, the story is similar. After trading at lows around 140 bps, Brazil's 5yr CDS is now back above 160 bps, nearer those of countries like Russia, Turkey and South Africa—all of which face important challenges.

GROWTH AND INFLATION BOTH PROVIDING POSITIVE NEWS

Brazil's economy kicked-off 2018 on solid footing, with the monthly GDP proxy coming in at +3.0% y/y in January. Overall, the data by sector seem to suggest a fairly broad-based rebound, with domestic demand, exports and industrial production showing there may finally be light at the end of the tunnel. January's retail sales were a slight disappointment with their +3.2% y/y print (vs consensus +3.5% y/y), but continued to show that consumers are finally making a stronger contribution, which likely comes from favorable inflation (IPCA has been printing sub-3.0%) as well as lower interest rates which are providing some relief to still quite-levered households.

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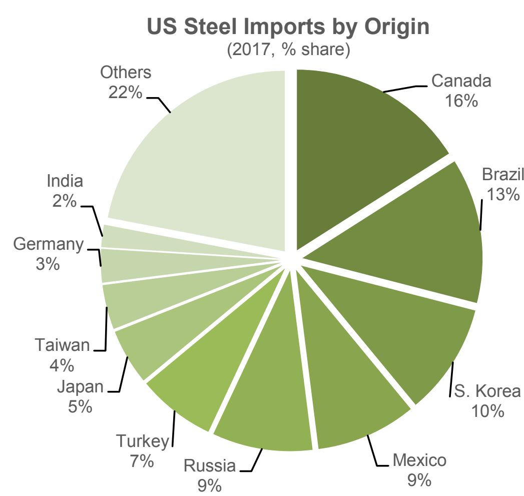
Brazil	2017	2018f	2019f
Real GDP (annual % change)	1.0	2.5	2.7
CPI (y/y %, eop)	2.9	4.1	2.6
Central bank policy rate (%, eop)	7.00	6.75	8.50
Brazilian real (USDBRL, eop)	3.31	3.25	3.35

Source: Scotiabank Economics.

Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, US Commerce Department.

On the industrial production front, the gradual upswing remains true, even if the last print was a disappointment. Industrial production was expected at +3.9% y/y in February, and instead came in at +2.8%. It was a moderate disappointment after the strong +5.8% y/y print we got to kick off 2018, but the story remains that after constant contraction in 2014–2016, the industrial sector seems to be coming alive. On the trade front, the improvement in commodity prices is giving Brazil's economy a boost, lifting exports about 15% in y/y terms during 2017. This impulse may fade in 2018, given commodity prices seem to have stabilized, but the volume improvement in global trade should still be positive. A risk to consider is that, outside of Mercosur, Brazil does not currently have any major trade agreements, which could make it more vulnerable than most if a global trade war does indeed ensue. We don't see a global trade war as a base case by any means, but it's still a risk. During the recent discussion of steel tariffs in the US, Brazil emerged as one of the countries potentially most affected. Brazil was subsequently exempted from the potential tariff (see chart 2), but it was nonetheless a relevant scare to keep in mind.

MONETARY POLICY MORE DOVISH WITH LOW INFLATION SURPRISE

The Brazilian Central Bank (BCB) delivered a 25bps cut at its last Copom meeting, and seemed to signal that going forward, we are likely to get one more 25bps cut, and after that the main courses it sees are either an interruption of the easing cycle, or some moderate additional end-of-cycle easing. The final paragraph in the latest minutes said: "The *evolution of the baseline scenario made it appropriate to reduce the Selic rate by 0.25 percentage point at this Copom meeting.* ***Regarding the next meeting, at this time the Copom views an additional moderate monetary easing as appropriate****. The Committee judges that this additional stimulus mitigates the risk of delayed convergence of inflation toward the targets. This view regarding the next Copom meeting might change in favor of the interruption of the monetary easing process, if risk mitigation proves unnecessary. Beyond the next meeting, absent relevant additional changes to the baseline scenario and balance of risks, the Copom deems appropriate to interrupt the monetary easing process, with the aim of evaluating next steps, in light of the relevant horizon for monetary policy at that time.*"

Basically, our take is that the BCB saw it necessary to deliver a couple of additional cuts to avoid deflationary risks given consistent low inflation surprises, but by now, the DI (the local interest rate swaps market) curve seems to be in line with the BCB's guidance, pricing in the additional 25bps cut the Copom signaled, and a pause beyond. Consistent with the BCB's guidance, we also expect a 25bps cut next meeting, and a pause beyond. However, we are a tad earlier than most in when we think the tightening cycle will begin, seeing a cut to 6.25% in the SELIC next meeting (May 16th), rates staying put till the end of the year, and a 25bps hike taking place at either the December 12th meeting, or the first meeting of 2019. Why do we expect an earlier start to the policy normalization cycle? There are a number of factors:

1) Growth is gaining traction quickly, and if inflation normalizes to levels nearer 3.5%–4.0%, current SELIC rate settings will quickly become "quite loose". Given the country's highly volatile inflation, and indexation effects, it would be risky to once again fall behind the curve. We expect the BCB to have learned its lesson from the last cycle. It would also be prudent to leave the ship sailing tight heading into a change in government.

2) With the fiscal adjustment likely to remain elusive at least for all of 2018, the BCB may be forced to start offsetting the loose fiscal stance with higher rates as the economy swings back to near potential growth, to which we are getting closer.

3) How much slack is there? We are not quite convinced that slack is as large as current production levels imply. Even though industrial production in volume terms currently sits at 2005 levels, when capacity sits idle so long, it tends to deteriorate.

4) Uncertainty is high and, with a high FX-inflation pass-through, inflation risks are not immaterial: Brazil has among the higher FX-inflation pass-through in LATAM, sitting closer to 20%. Hence, if a combination of political uncertainty, and global trade risks materializes, we could see the BRL weaken significantly. Brazil's lack of free trade agreements could make it particularly vulnerable to a deterioration in the global trade environment…which we don't see as a "base case", but we do see as a risk.

MARKET OUTLOOK

We are somewhat concerned that recent polls don't seem to support what we think the consensus view is, that a reformist candidate is likely to win the upcoming presidential elections, and do so with a mandate to push through reforms and fiscal adjustment. A large share of players are of the view that with Lula potentially out of the race, due to his prison sentence, moderate candidates will get a larger share of the vote. We think there is at least the potential that Lula and Bolsonaros voters may be compatible, despite one being on the right and one on the left as they are both anti-establishment. We could also see angry Lula supporters rally behind the candidate they see as most against the current government, despite ideological differences.

We are early in the electoral process and polls are likely to change, but until very recently we think markets were being too complacent on political risk. Hence, with higher political and reform risks we have a somewhat less optimistic forecast for the BRL, based in part on assigning a higher probability to the fiscal story not getting better in 2019, souring sentiment. This is also in part the reason why we have pushed forward our expected kick-off for the BCB's interest rate normalization process as, given a relatively high FX-inflation pass-through, the BCB may have to be cautious.

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Colombia

- **Elections are arguably the main source of uncertainty hanging over Colombia, with recent polls, as well as the results of the primaries, suggesting we are likely to see a second round run-off between Ivan Duque (supported by former President Uribe), and Gustavo Petro—the former Mayor of Bogota, who is seen as "left-leaning". Results in the primaries held March 11th are seen as suggesting Duque currently has stronger backing, and has momentum on his side (he received about 1/3 more votes than Petro in the primaries).**
- **On the growth front, activity remains slow (+1.3% y/y for December), but is showing signs of improvement. We expect stronger global trade and higher oil prices to help boost growth to 2.5% in 2018 and 3.5% in 2019. Our forecasts are 50bps on the "bullish side" for 2019.**
- **Local markets in Colombia have been firm, with COP being the second strongest currency in LATAM so far this year (+7.0%). In bond markets, the fact that Colombia (BBB-) continues to trade tight to Mexico (BBB+) suggests that markets are more uncertain over the Mexican elections and NAFTA's renegotiation than they are about the political process in Colombia.**

ELECTIONS ARGUABLY TOP UNCERTAINTY IN COMING QUARTER

Elections have kicked off with a fair bit of turbulence in Colombia. The first week of March saw violent attacks on both Gustavo Petro (former Mayor of Bogota and current candidate), as well as aimed at former President Alvaro Uribe, the sponsor of current contender Ivan Duque. If the elections do indeed prove to be a contest between Duque and Petro, we are likely to see a very polarizing election process—with fairly important differences in the economic and political platforms of the current front-runners: Ivan Duque and Gustavo Petro. An early indication of how polarizing this contest is likely to be was the result of the primaries, where we saw a record-breaking over 9 mn votes cast to select candidates, suggesting voters are taking the contest seriously. To avoid a run-off, a candidate must secure on vote more than half the total of votes cast, which looks possible, but unlikely given recent polls.

At the moment, the results of the primaries that took place in March are being taken as an indication of both momentum and support being in Ivan Duque's favor, as he received the backing of 4.0 mn votes, versus Gustavo Petro, who got 2.8 mn votes in the left's coalition primary. Overall, the right got almost twice as many votes as the left in the primary elections.

Gran Consulta Colombia, the right-leaning coalition, tallied 5.9 mn votes, and left Ivan Duque as the candidate for the right:

- Ivan Duque 4.0mn
- Marta L. Ramirez: 1.5mn
- A. Ordoñez: 0.4mn

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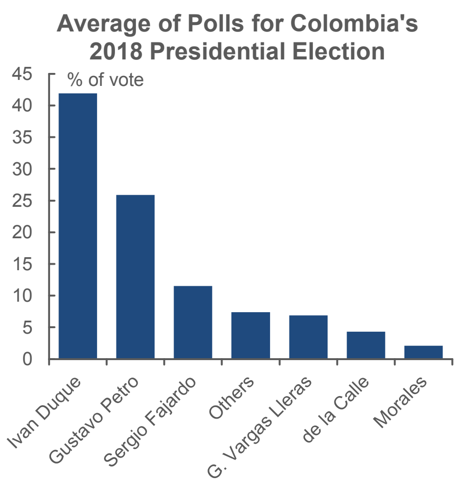
Colombia	2017	2018f	2019f
Real GDP (annual % change)	1.8	2.5	3.5
CPI (y/y %, eop)	4.1	3.3	3.1
Central bank policy rate (%, eop)	4.75	4.25	5.00
Colombian peso (USDCOP, eop)	2,986	2,900	3,050

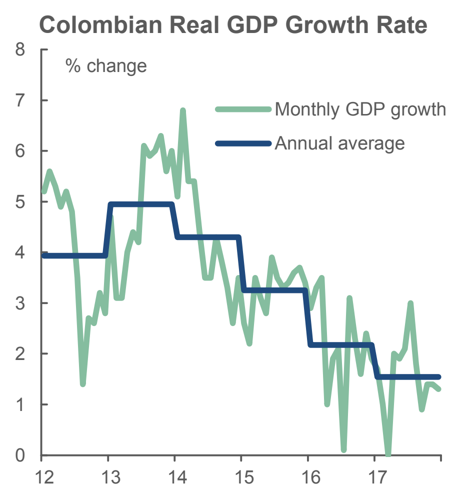
Source: Scotiabank Economics.

Chart 1



Sources: El Pais (March 28), Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Inclusion Social por la Paz, the left-leaning coalition, garnered 3.3mn votes, and saw Gustavo Petro as the strong contender:

- Gustavo Petro: 2.8mn
- C. Caicedo: 0.5mn

Who are the contenders?

- **Gustavo Petro** (polling in the low 20% to high 20% range—but appears to have found a ceiling): A former M-19 Guerrilla member as well as Mayor of Bogota, Petro is the left-most contender now that Rodrigo Londoño (the former FARC leader) bowed out for health reasons. The former Mayor was stripped of his office due to corruption and mismanagement allegations. However, his political rights were re-instated in International courts. Petro has pledged to increase taxes on multinationals, and to strengthen the public sector's role in both the pension and banking sectors. Some of his proposals are seen as a break from the status-quo. Petro is aiming to position himself as an anti-establishment candidate to capitalize on low approval ratings of President Santos.
- **Ivan Duque** (polling around 40%, with a rising trend): The former Senator is widely seen as former President Alvaro Uribe's protégé. He is arguably the most right right-leaning of the main four contenders, and has been gaining traction lately. A polarizing element of Mr. Duque plans could end up being his posture on the Peace Process. Former President Uribe was highly critical of Santos' peace process, and this could be a differentiating factor for Duque from the current governor if he carries on with Uribe's torch. So far, his posture seems to be that Santos' agreements will not be torn up, but could see some modifications. In economic terms, he is expected to be prudent, and status-quo.
- **German Vargas Lleras**: He ran for the Presidency in 2010, and was formerly a Senator. The center-right leaning candidate was VP under President Santos, but quit his job in 2017.
- **Sergio Fajardo**: Arguably the centrist contender among the top-4, the former Governor of Antioquia, and Mayor of Medellin was also a former running mate of Antanas Mockus. He is arguably the candidate with the strongest claim to being a "true independent", and is seen as pragmatic, rather than ideology-driven. He pledged to focus his presidency on institution building, education (he pledged a 10% annual increase in education spending), and employment creation.

GROWTH AND INFLATION

BanRep has reacted quite aggressively to the economic slowdown, by cutting the overnight rate from 7.75% in 2016, to 4.50% at the moment, with another 25 bps cut not being ruled out over the coming few meetings as growth remains subdued in an environment of improving inflation. In the last print we saw, inflation dropped from 3.68% to 3.37%, and members of the board have suggested they could support additional easing if inflation drops to target (so we need another 40 bps or so of lower CPI). Economic activity closed 2017 very weak (the economic activity index for December printed at 1.3%), but is expected to start gaining traction gradually this year due to returning confidence, as well as to lower interest rates and higher oil prices. The first print of the year (January) came in at a stronger 2.2% y/y.

We expect growth to improve over the coming two years, going up to 2.5% y/y in 2018 (it was 1.8% in 2017), and to get back to potential (3.5%) in 2019. Our forecasts are exactly in line with the Bloomberg consensus for 2018, and 50bps on the bullish side of consensus for 2019. The reason why we are more constructive is a combination of a positive trend for global trade—on which trade war risks need to be monitored, relatively low levels of uncertainty which should help investment, and commodity prices. We are also on the side of the market that expects BanRep to ease its monetary policy a little bit further, to help prop up growth, given still-sluggish activity.

MARKETS: STILL STEADY, BUT JITTERINESS RISING

Foreign holdings in TES do not seem to have been affected by election uncertainty so far, staying fairly steady at 26.2% in February, marginally down from the 26.46% we saw the previous month. The yield gap between Mexico and Colombia has narrowed substantially over the past month, going from around 120–130 bps a month ago, to around 60 bps on April 2nd. With Colombia rated BBB-, and Mexico rated BBB+, this yield difference suggests investors still see a higher degree of uncertainty in Mexico—likely driven by the looming elections as well as NAFTA. From the start of the year, until March 8th, the Colombian peso has been the second best performing LATAM FX (+7.0%), following MXN (+7.2%).

Peru

GETTING GROWTH BACK ON TRACK

- **We have lowered our GDP growth forecast for 2018 to 3.3% from 3.7%, as political turbulence has affected the government's investment schedule.**
- **Market reaction to the change in government was mild and short-lived.**
- **Over the past few months, growth has been fairly stable at around 3.0%. The main issue going forward is how quickly the government can get investment back on schedule.**
- **With inflation well below the CB target floor, the CB may lower its reference rate one last time to 2.50% in May.**

We have lowered our GDP growth forecast for 2018 to 3.3% from 3.7%. We already had a downward bias on growth, but had been waiting for the political air to clear and the change in government and cabinet to take place. Our lower growth figure takes into account delays in fiscal stimulus as political turbulence and changes in the cabinet have affected the government's investment schedule.

With two impeachment attempts, one new President, two new cabinets, five ousted cabinet members, and prominent construction companies, businessmen and political party leaders under investigation for corruption, all in under two years, the wonder might be not why GDP growth has slowed, but, rather how the country has been able to grow at all. However, political change never really posed a threat to economic management, and turbulence has occurred in an environment of improving terms of trade, and robust macro balances. As a result, negative market reaction was mild and short-lived. The PEN did not really move much, the bond and equity markets reacted little, and Rating Agencies have mostly ratified Peru's rating and outlook.

The year began modestly in terms of GDP growth: 2.8%, YoY, in January. Over the past few months, and leaving aside short-term volatility in fishing, growth has been fairly stable at around 3.0%. The main issue going forward is how quickly the government can get investment back on schedule. Despite the damage done, (March and April GDP will be telling in this regard) growth may begin to pick up under the Vizcarra regime, as the opposition-dominated Congress seems more willing to work with the new government. Peru's new cabinet is market friendly. Although many members are experienced in public administration, the cabinet will need to prove itself in terms of managing the State and overcoming obstacles to infrastructure investment.

Yearly inflation fell to 0.4% in March, well below the Central Bank's target range floor of 1.0%. March is likely to be the last month of declining inflation, resulting from the base effect of high El Niño inflation in 2017. Inflation should rebound henceforth, most likely returning to the Central Bank target range. The CB lowered its reference rate from 3.0% to 2.75% in March, and seemed to signal the

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Peru	2017	2018f	2019f
Real GDP (annual % change)	2.5	3.3	3.7
CPI (y/y %, eop)	1.4	2.0	2.5
Central bank policy rate (%, eop)	3.25	2.75	3.25
Peruvian sol (USDPEN, eop)	3.24	3.18	3.12

Source: Scotiabank Economics.

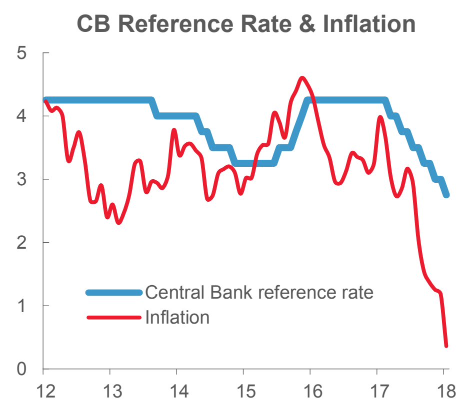
Table 1

GDP Growth - Demand Components

	2017	2018f
GDP	2.5	3.3
Domestic Demand 1/	1.8	3.3
Private Sector Consumption	2.5	2.8
Public Sector Consumption	1.6	4.0
Total Fixed Investment	0.0	4.6
Private Sector	0.1	3.7
Public Sector	-0.1	8.4
Exports	8.5	3.3

F: Forecast. 1/ Excluding inventories
Source: Scotiabank Economics.

Chart 1



Sources: BCR, INEI, Scotiabank Economics.

possibility that it would lower again in May to 2.50%. If it does, it is likely to be the last time. The CB is aware that inflation will rebound soon, and must also be growing concerned over the narrowing spread with the Fed rate.

The fiscal deficit in the past 12 months to February came in at 3.3% of GDP, slightly above the 3.2% at the close of 2017 and broadly in line with expectations. Both revenue and spending were up significantly—8.7% and 17.1%, YoY, respectively—reflecting higher metal prices on the one hand, and the fiscal stimulus policy on the other. It's early for a full-year picture, which will depend crucially on the increase in revenue in the March–April income tax period. However, concern over fiscal accounts is on the rise, which may affect government policy at some point, although 2019 is likely to be the key year, rather than 2018.

After rising to 3.22–3.27 during most of the February/March period of political turbulence, the PEN appears to have returned to the 3.20–3.23 range of before. We see no reason to alter our year-end forecast of 3.18. Peru's external accounts are improving significantly. The heavy volume of USD sales by mining companies to pay domestic income taxes has been compensating political events, and will continue weighing on the FX rate, especially, but not exclusively, in April. Fundamentals continue to favor a mildly stronger PEN going forward, even after the recent correction in base metal prices. The Central Bank has largely stayed out of the market except for sending signals of intent that have effectively acted as USD buy stops at 3.27 and sell stops at 3.20–3.21.

Chile

SOME TURBULENCE, BUT READY FOR THE TAKEOFF

- **Once again, growth forecasts for the current year are being revised up, this time to 3.6%, confirming the strong upward bias we saw three months ago. Most of the improvement should come from sectors linked to investment and exports. Consumption should gather momentum at a slower pace.**
- **Policymakers will not be applying brakes, as the Central Bank thinks there are no signs of a normalization of inflation in the near term. Monetary policy will likely remain supportive for longer than earlier thought. Fiscal policy should not be a hurdle, but not provide a boost either.**
- **Foreign conditions are more turbulent than in January, and potential risks for the Chilean economy increased, but do not seem strong enough to jeopardize the acceleration in coming quarters.**

MACRO UPDATE: HOPING THAT EXPECTATIONS BECOME ACTUAL RESULTS

In the last three months, expectations strongly improved as the political outlook became much more business-friendly and copper price forecasts became more solid (above US$3.00/lb for current year). Despite the fact that most of this new paradigm has yet to be realized, our forecast for growth for the current year rose from 3.1% to 3.6%, with risks tilted to the upside. For 2019, growth is set to accelerate to 3.9%.

Despite this generally bullish environment, risks remain. Copper prices have been declining from their peak, and there has been a resurgence of protectionist risks coming from the US. Additionally, the political situation in the region became riskier (which will continue in the current year). Finally, although we are seeing stronger data for investment, it will become clearer in coming months that a huge part of the pent-up investment will not start in 2018, but next year. Some indicators, like business confidence, are already moderating, though we expect that a widely upbeat tone will prevail.

The economy will reach its potential growth, estimated around 3.5%, this year and will be above it next year, as also laid out in the Central Bank's forecast. This critical fact allows us to keep our forecast of inflation around 2.8%, despite market expectations up to a half percentage point below that. Of course, the exchange rate is the wildcard in the very short term, but a dramatic slide is just a possibility so far, while part of the last correction seems to be already in prices. Accordingly, the monetary policy rate will likely stay at the current level (2.5%) for longer than expected. Although most of the market thinks the start of the normalization will be towards year-end, a move in September is likely as evidence of recovery becomes more intense and definitive and effectiveness of political actions becomes clearer. It must be said that though the exchange rate can help to contain inflation, in the Chilean economy long-term effects linked to the productive gaps (potential growth vs. actual growth) are slower but much more powerful.

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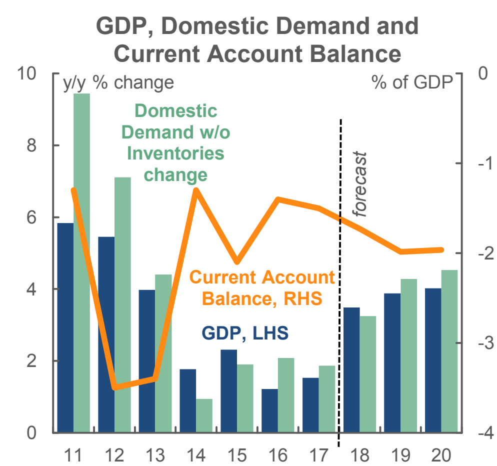
Chile	2017	2018f	2019f
Real GDP (annual % change)	1.5	3.6	3.9
CPI (y/y %, eop)	2.3	2.8	3.0
Central bank policy rate (%, eop)	2.50	3.00	3.50
Chilean peso (USDCLP, eop)	615	595	584

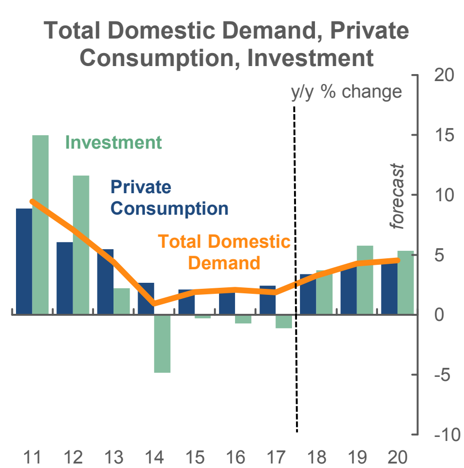
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



Source: Scotiabank Economics, Banco Central de Chile.

POLITICAL PANORAMA: ENTERING IN THE DECISIVE STAGE

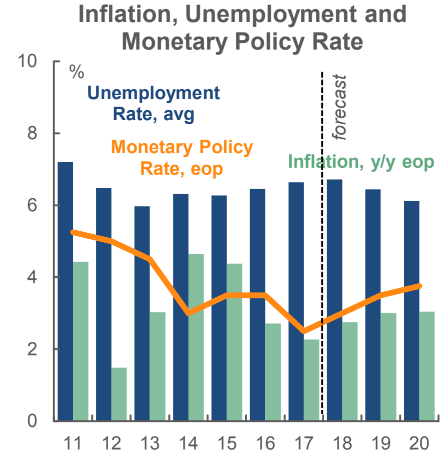
The political front seems promising, but the process in still in the first or, at most, second stage. Most of the new Government's key appointments have been completed (just a few public services appointments must be confirmed or changed), but now begins a more decisive test for the Government: its ability to negotiate with opposition to reach agreements to improve economic conditions, among other things. The discourse thus far has been aimed toward the widest possible agreements, not just enough to get the approval but to give stability to new policies in the very long run. The President is very committed to the process, which underlines the high importance attributed to it. Moreover, the less traditional leftist opposition seems divided about reaching agreements with the Government. We believe the Government will successfully navigate these challenges, but there are risks that it will not.

MAIN RISKS ARE THE SAME…WITH A DIFFERENT FACE

Risk of potential deterioration of the international trade, especially between the two major commercial partners of Chile, has surged and this would be, no doubt, negative. Though the very early effects may be positive in some areas (new markets for some exports and lower prices for some imports), it would be very shortsighted to think that will be the bottom line. The second round of effects for the Chilean economy would be related with higher probability of problems in some markets due to extreme concern resulting from a new era of protectionism.

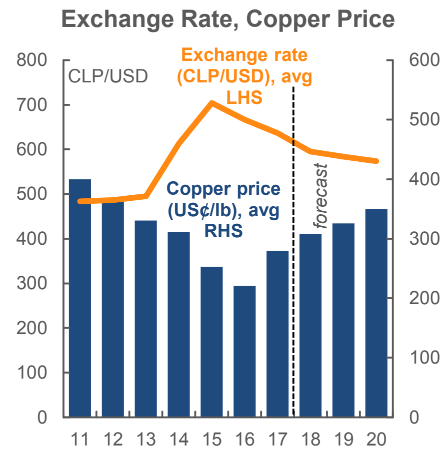
Other risks are related to domestic political conditions. The most obvious is the possibility of a failure of the Government to reach minimal agreements with the opposition on economic issues. It would mean a delay or the cancelation of a significant part of the productive agenda and would force revised forecasts of growth.

Chart 3



Sources: Scotiabank Economics, INE, Banco Central de Chile.

Chart 4



Sources: Scotiabank Economics, Reuters Eikon.