Mexico

IF-THEN

- **A number of uncertainties are affecting the economic outlook in the next quarter. The results of the Presidential election could bring a significant change to economic policy in the context of global policy uncertainty. Accordingly, our macroeconomic forecasts are best characterized as "if-then" statements and could change materially in coming months.**
- **Currently, the high uncertainty levels are having some impact on the economy, so we are making some adjustments to incorporate more cautious behavior by consumers, weaker investment, a higher path for the MXN and a significant change in the trade balance.**

Mexico held its most consequential elections in recent memory on July 1. While focus has been on the presidential campaign, which was decisively won by AMLO, 3,400 government officials at federal and local levels were also elected, AMLO had built his campaign on the premise that it is time to change the so called neo-liberal model that, according to his narrative, has not worked and has only produced poverty and inequality.

It is not at all clear, at this time, what his administration will change. There have been many reassuring messages, such as the maintenance of fiscal discipline, that there will be no growth in public debt and the central bank's autonomy will be respected. On the other hand, there have also been troubling messages, particularly around his desire to stop or rollback some of the structural reforms, or that large social promises will be fulfilled by increasing public spending and direct participation by government in the economy. It is worth noting that there is virtually no fiscal space in Mexico, as the International Monetary Fund has said, and if the new administration puts pressure on the public finances despite its pledge to maintain fiscal discipline, there could be negative reactions in financial markets. Maintaining market confidence will be important, with about US$11bn of foreign currency debt coming due in 2019, which will have to be rolled.

Financial markets are largely assuming a scenario in which economic policy is not significantly changed due to constraints of reality and pragmatism. Markets will carefully parse his first few speeches, cabinet choices and early policy decisions to assess how AMLO may change Mexico's policy orientation.

The political process in Mexico is not the only factor that will affect the performance of the economy. There are many key issues that could be defined in the coming months with the potential to radically change the economic outlook. Perhaps the most important of these issues is the NAFTA renegotiation process, which continues at a slower pace, since a new agreement will need to be processed and signed by the new government. Unfortunately, the economic outlook could get dramatically darker if the US President decides to terminate the agreement. Although this is an outcome that we continue to believe is unlikely, the risk exists, even as signs of a trade war with China become more prominent. In

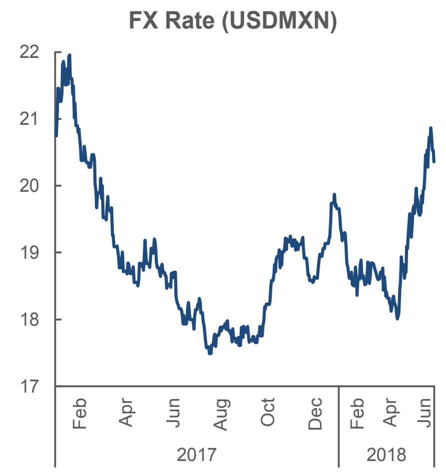
CONTACTS

Mario Correa
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Mexico	2017	2018f	2019f
Real GDP (annual % change)	2.0	2.1	2.5
CPI (y/y %, eop)	6.8	4.2	3.8
Central bank policy rate (%, eop)	7.25	8.00	8.00
Mexican peso (USDMXN, eop)	19.66	20.20	20.48

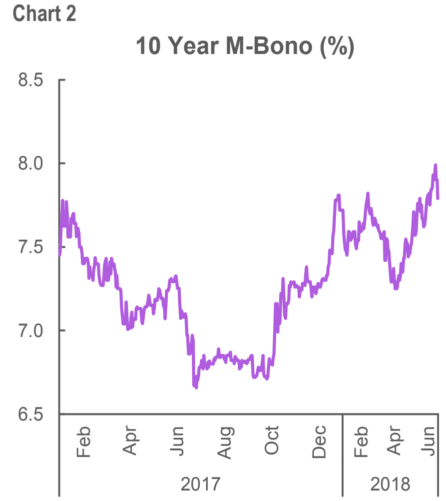
Source: Scotiabank Economics.

Chart 1



Source: Banco de Mexico.

Chart 2

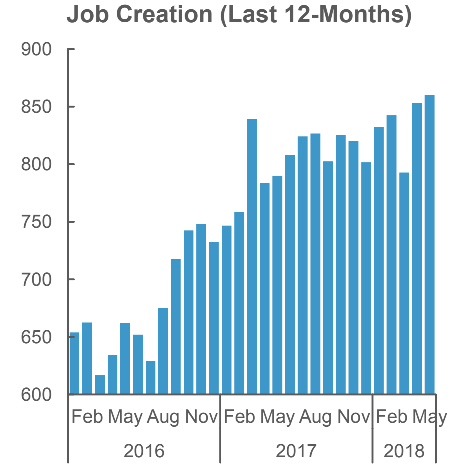


Source: Banco de Mexico.

addition to this, the global financial environment for emerging markets has been deteriorating, not only because the US government is increasingly protectionist, but also because global interest rates could be under pressure from the monetary policy normalization in developed countries coupled with higher financial requirements in the US.

There is then a high level of uncertainty over the economic outlook, and our financial variables are reacting to it, as can be seen in the MXN behavior in the last weeks, as depicted in chart 1; and in the yield of the 10 year M Bono, in chart 2. We have adjusted our macroeconomic framework to incorporate this more uncertain future, as well as the most recent economic data. Accordingly, we are now expecting more modest GDP growth rates for 2018 and 2019 (2.0% and 2.5%, respectively), since private consumption may be not as strong and investment could be weaker. Despite the latter, job creation is doing quite well, as can be seen in chart 3, so we are expecting strong numbers for this year and the next (852K and 865K). Our forecast for the MXN now recognizes a higher path, reaching 20.20 MXN/USD by the end of this year and 20.48 by the end of next year.

Chart 3



Source: INEGI.

A couple of the relevant unknowns are inflation and interest rates. If the peso remains under pressure, then there could be higher inflation, which in turn will require further action from Banco de Mexico's monetary policy through higher interest rates. For the time being, we keep thinking inflation will end 2018 slightly above the upper level of the reference range for the monetary policy, while next year could get into this range. We are still expecting two more interest rates hikes by Banco de Mexico this year, and one more in 2019, reaching 8.25%. If everything goes well, then Banco de Mexico could start cutting a bit its interest rate in the last quarter of 2019. However, our interest rate forecast has a clear upward bias. One interesting revision could be observed in our trade balance that is now presenting a smaller deficit—thanks to the strength of the global economy and to the impulse provided by a weaker currency. As a consequence, the current account deficit is also lower.

We still assume that reason will prevail, meaning that NAFTA will not be terminated and eventually a renewed and better NAFTA will be signed in 2019, and that the new President will maintain reasonably unchanged economic policies without dramatic changes to the structural reforms. If these assessments are incorrect, then our forecasts could change materially in the coming months. The most sensitive variables would be the exchange rate and interest rates, where there is an upward bias in the most likely outcomes. These are uncertain times, and as Niels Bohr once said: "making predictions is extremely difficult, especially about the future".

Brazil

A CLOUDY (STORMY?) HORIZON

- **Brazilian markets have experienced among the heaviest pressure in the Emerging Markets space over the past couple of months, arguably only being more stable than Turkey and Argentina. The 5yr node of the curve has widened about 200bps in a 2-month span, and the Brazilian real (BRL) is down over 10%. The BRL's fall risks affecting inflation dynamics.**
- **Brazil's central bank (BCB) is at risk of falling behind the curve, refusing to hike rates, despite surging PPI inflation, rising IPCA inflation, and very loose fiscal settings.**
- **The BCB's FX war-chest remains strong, leaving space for further intervention, but it cannot sustain the recent pace of swap sales, or it risks undermining one of Brazil's few remaining buffers—strong reserve liquidity.**
- **On the political front, the outlook remains cloudy, and a "positive scenario", where we get a reformist government with strong legislative support today appears far from a base case.**

MARKET VOLATILITY RISKS CONTAMINATING FUNDAMENTALS FURTHER

Brazilian assets have come under severe pressure, with BRL down -10.2% over the past couple of months, and the 5yr part of the yield curve widening 200bps. The price action has suggested a strong deterioration in liquidity, as buyers have remained mostly absent in risk-off days. The gapping price action points towards uncertainty over the October presidential elections adding to concerns that urgent issues such as pension reform and fiscal adjustment may not be part of the agenda for the next administration or that, even if they are, the new government may lack a strong enough mandate to make necessary adjustments. A risk is that the pressure on the BRL and longer-end rates could force the BCB to tighten rates earlier than it would like, which could in turn derail the already faltering macro rebound.

GROWTH STILL AMONG THE BETTER NEWS, BUT LOSING MOMENTUM

Although the most recent print of monthly economic activity is still strong (+3.7% y/y for April), some indicators are starting to flash warning signs (i.e., retail sales for April were a soft +0.6% y/y), and consensus for the year is at +2.45% y/y—with a downward trend in more recent polls (expectations peaked at +2.7% y/y back in April). Our sense is that this seeming deceleration in the Brazilian economy is what's stopping the BCB from turning more hawkish, despite the escalating risks on the inflation front.

There are a number of factors that we think will at some point serve as a drag on growth, potentially worsening in 2018-H2: even without the BCB formally tightening, we have seen a sharp move higher and a steepening of the Brazilian yield curve, which should hit still highly indebted households (their debt burden as

CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

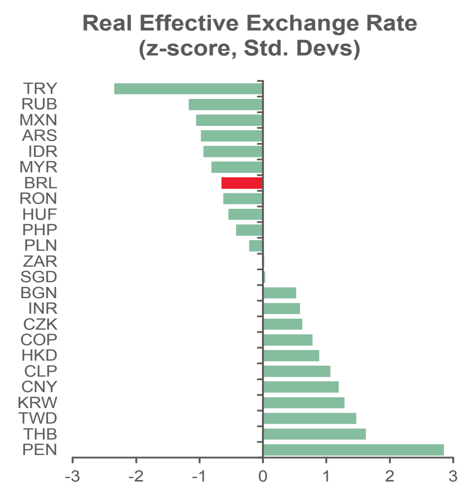
Brazil	2017	2018f	2019f
Real GDP (annual % change)	1.0	2.3	2.5
CPI (y/y %, eop)	3.0	4.1	4.6
Central bank policy rate (%, eop)	7.00	7.25	9.00
Brazilian real (USDBRL, eop)	3.31	3.90	3.70

Source: Scotiabank Economics.

Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

a % of disposable income remains above 21%, with a short average life, meaning rate-resets hit quickly). We also see higher inflation hurting consumer confidence as we move further into the year, as we expect it to erode real wages. In addition, uncertainty over the elections, as well as higher interest rates should also hurt the corporate sector. We don't see these two shocks yet dragging growth below 2%, as base effects and high commodity prices should remain supportive, but they are enough to make us among the more pessimistic out there on growth prospects (we are 20bps below consensus for 2018, and 30bps below consensus for 2019).

BCB UNDER PRESSURE TO STABILIZE BRL

With the BRL down sharply, and Brazil's FX-inflation pass-through relatively high (about 20%–30%) markets are starting to price rate hikes into the DI curve (local interest rate swaps). As of mid-June, the curve was pricing in about 100bps of hikes by year-end. We think part of this may not necessarily reflect actual expectations of policy tightening by the BCB, but rather is the result of loss of investor appetite for local assets pressuring rates higher. However, we do think that with PPI inflation drifting much higher (now at 7.4% y/y in April), CPI also moving higher (consensus for IPCA's print this week is at 3.56%, a 90bps move higher from the previous month if confirmed), pent up FX-inflation pass-through potentially being about 200bps–300bps, and the government expected to post a fiscal deficit of around -8.3% of GDP (in the General Government Overall Balance), the odds that the BCB is falling behind the curve are rising. To be on "neutral settings", our estimates suggest that the SELIC should currently sit somewhere between 8.0% and 8.5% based on inflation expectations and the "transmission lag", and our sense is that could be biased to the low side, given the risk of a higher-inflation surprise is material—in part due to the lax fiscal stance. Brazil is one of the LATAM economies where once an upward inflation spiral catches on, it can become self-reinforcing.

From a real effective exchange rate perspective (REER, see chart 2), the BRL is cheap, but not materially so—it's within 1 standard deviation of "fair-value"—the lack of particularly attractive valuations, combined with low-ish interest rates make the BRL vulnerable still. The good news, is that the BCB still has some ammo to step in and support the BRL. At the moment, the central bank's outstanding position in swaps is around US$65bn, and with FX reserves of around US$360bn, there is still ammo to protect the real. However, it is also true that the pace at which it is increasing its swaps position is concerning—in one week in June, the swaps position increased by US$26bn!! According to the IMF's Reserve Adequacy Metric (see table below), the country's FX reserves are among its few remaining buffers—it cannot afford to squander them.

Emerging market reserve adequacy

Country	ARA metric	Country	ARA metric
Brazil	1.55	Chile	0.82
China	0.86	Colombia	1.26
India	1.51	Mexico	1.07
Russia	2.77	Peru	2.74
South Africa	0.64		

ARA metric: the IMF's measure of reserve adequacy is considered adequate when it stands between 1.0 and 1.5. The measure is based on a series of metrics that includes short term debt coverage, imports, etc.

We expect BRL to continue weakening further, as real yields get eroded by rising inflation, at the same time as political uncertainty and lack of progress on fiscal consolidation and urgent reforms (i.e., pensions) hit appetite for Brazilian assets. It's possible that in the coming months, the BRL could be seen as a carry-currency for MXN longs, given that the yield differentials between the two have compressed—especially on a quality-adjusted basis. We continue to see USD/BRL drifting higher—getting to 3.90 by year end, and we don't discount that, as the election draws closer, we could see temporary moves above 4.0, although in those moves we expect the BCB will intervene heavily through swaps, and in more extreme scenarios—potentially even in spot. We do see the BCB kicking-off an earlier-than-consensus rate hike cycle, but to some degree they will be chasing inflation, rather than getting ahead of it. As a result, we see inflation drifting higher and faster than consensus, but we also don't yet see it getting out of hand—although this is a risk if the BCB remains too complacent on the inflation front.

POLITICS—BLURRY OUTLOOK, WITH SEEMINGLY LOW ODDS OF A PRO-REFORM GOVERNMENT WITH A MANDATE

It's still very hard to call how the elections can play out given former President Lula remains the most popular politician, and the door has not been fully shut on his presidency. In addition, second place in the polls seems to belong to right-leaning populist Jair Bolsonaro. Many locals we have spoken to believe that ultimately the "establishment vote" will consolidate behind a single name, which will carry the election. However, there are risks that the anti-establishment (i.e. Bolsonaro and the PT) could do the same, and consolidate the "blow up the system vote". Bolsonaro's campaign has been relatively short on details, but he has said he would pursue tax-cuts and spending restraint, but has made no commitment to "urgent" issues such as fiscal consolidation, tax reform, and pension reform, without which the country's fiscal position will remain extremely vulnerable, and arguably in a continued fast-deterioration trend. We would argue that even the "optimistic scenario", where the establishment vote consolidates behind a single candidate to carry the election is not without risks. With what seems like quite fragmented politics in the pro-market parties, a government with a robust reformist mandate that can make the reforms to stabilize deteriorating fiscal dynamics does not appear to be anywhere near a base case.

Colombia

- **With the elections out of the way, and the results mostly in line with expectations, it is now time for the details to be fleshed out in terms of Duque's campaign agenda. Some of the proposals are likely to be welcomed by markets—but as always the devil is in the details. One of the areas we'd like clarity on is how the government plans to deal with the country's heavy oil dependence both in external and fiscal accounts.**
- **Twin deficits have materially compressed, but heavy oil dependency remains, meaning the country is still at risk if the issue is not addressed. This to us is the key issue that Duque needs to address soon, as there is no certainty that the external environment (i.e. oil prices) will remain as supportive as it currently is.**
- **We expect the economy to hit its potential growth rate in 2019, accompanied by inflation moving back to the top-half of the central bank's (BanRep) target range. As that move happens, we expect BanRep to start tightening rates very late in 2018, and to start "following the Fed" more closely.**

ELECTION RESULTS IN LINE WITH PRE-VOTE POLLS

The results of the second round of Colombia's Presidential election were very aligned with pre-vote polls. Center-right/right-leaning Ivan Duque won the election by securing 54% of the vote in the second round (vs Petro with 42%), now putting focus on the specifics of the government plan—which was broad in its coverage, but with scant details. In terms of proposals, the Duque campaign included the following, within a very long list of promises:

- Fiscal simplification, cutting the number of taxes and reducing exemptions, with the overall tax burden on companies falling. The idea makes sense, but the details and the legislative capacity to push this through will be key.
- Adjusting the fiscal rule to strengthen it and ensure that there is no permanent debt build-up. This is an important point. We would argue that Chile's rule is fairly effective, a move in that direction would be welcome.
- Strengthening fiscal federalism. We haven't seen many LATAM economies succeed in this.
- Creating new funding mechanisms to channel savings to productive activities: are they planning to create vehicles to channel pension fund savings to firms and infrastructure?

Details are scant, with some key elements that need to be clarified, including: 1) which taxes will be changed/eliminated in the process of fiscal simplification, 2) what is the net impact on the overall fiscal revenue, and how does this reduce dependence on oil-related revenues, 3) how will the fiscal rule be strengthened—

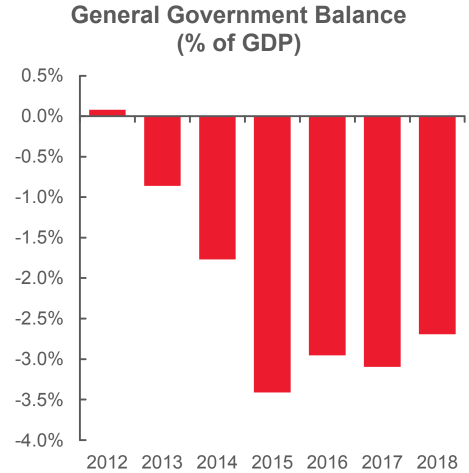
CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Colombia	2017	2018f	2019f
Real GDP (annual % change)	1.8	2.5	3.5
CPI (y/y %, eop)	4.1	3.3	3.4
Central bank policy rate (%, eop)	4.75	4.50	5.50
Colombian peso (USDCOP, eop)	2,986	3,000	2,850

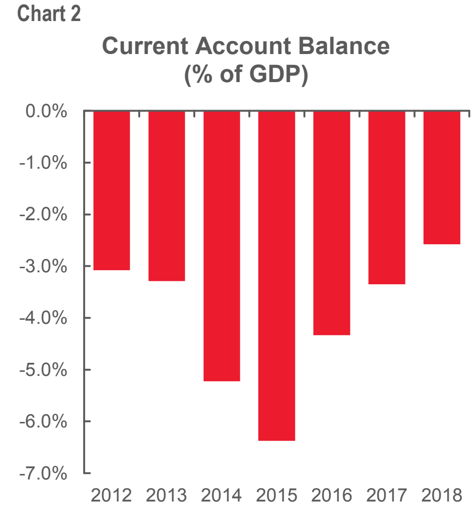
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Scotiabank Economics, IMF.

will its supervisory body be made stronger and more independent, and, 4) is Colombia planning to use vehicles similar to Mexico's FIBRAs and CKDs to channel pension system savings to private equity, infrastructure, etc? (this report highlights how successful they were—although there is likely to be growing pains).

VULNERABILITIES HAVE SUBSIDED, BUT REMAIN LATENT

So far, during the ongoing sell-off, the strongest pressure on EM markets has been focused on countries with weak fundamentals, such as wide current account deficits, a shaky fiscal stance, and/or low real rates/high inflation. Colombia is no longer in the group that has particularly large "twin deficits" (fiscal and current account), but we would caution that both are still relatively wide, and vulnerable to a shock of lower oil prices—which is not by any means part of our "house call", but which cannot be discarded as a risk for the next couple of years.

Colombia is rated: Baa2 (Moody's), BBB- (S&P's), and BBB (Fitch), which means it still has a "notch of margin" before becoming junk by 2 of the 3 main rating agencies (with the third it is right at the limit). Looking at the country's debt burden (gross general government debt is expected to close 2018 just south of 50% of GDP), as well as institutions—such as BanRep, which we see as credible, we don't think a junk status is close to being justified at the moment. However, we would also say it does not have a huge amount of margin, and dealing with the vulnerabilities in the current benign external environment is much better than during an adverse shock. As we noted above, one of the main risks we see for Colombia, which we don't expect, but can't discard either, is a potential drop in the price of oil:

- From the fiscal side, a US$10/bbl drop in the price of crude roughly translates to a 40bps of GDP deterioration in the country's fiscal stance. The rebound in oil prices helped Colombia's fiscal deficit by about 100bps of GDP, to a still not ideal 2.5% of GDP expected for 2018. The continued high reliance on oil of public finances is a risk.
- Oil represents 31% of Colombian exports, and as we saw with the 2014 oil price shock, a drop in the price risks re-widening the country's current account gap. The country lacks "integrated clusters", and as a result has un-correlated imports and exports, which leads to the current account being quite sensitive to oil price swings.

MONETARY POLICY AND GROWTH

We expect the Colombian economy to gradually gain traction over the coming months, as high oil prices support investment in the sector, at the same time as election uncertainty fades—boosting private sector confidence. It's worth noting that up to now, consumer confidence has been strong (last print at 28.7), but we have seen industrial confidence remain very weak (last print at 2.0). Our sense is that as confidence in the industrial side drifts higher—supported by a more benign external environment (i.e. stronger global trade and oil prices), we will also see investment pick up. An indication that things are materially improving on the industrial side was last month's industrial production print which came in at a very impressive +10.5% y/y (+5.6% y/y consensus), and, alongside continued 5.0%–7.0% retail sales (the recent range for the print), suggests the economy is settling down into a more solid and broader-based growth rebound.

At the same time, as the Colombian economy continues to strengthen towards its potential growth rate—which we see being reached next year, we expect inflation to also start moving higher towards the upper half of BanRep's target range, but we also expect the central bank to shift tack responsibly, moving back into tightening mode at the very end of this year. Contrary to what has been the case until now, we expect BanRep to start "accompanying the Fed" (hiking alongside the Fed, more like Banxico); the sharp increase in foreign holdings in TES (from the low 20%s to the high 20%s share) should to some degree force BanRep to give up some policy independence with regard to the Fed in order to preserve rate-market stability.

Peru

ROOM FOR OPTIMISM

- **An all-around improving economy.**
- **Strong 2Q GDP growth, led by the private sector, with robust growth continuing going forward.**
- **Positive surprises in fiscal and external accounts.**
- **Stable monetary policy, with inflation under control.**

Things are definitely looking up, on multiple fronts, in Peru. Well, at least on multiple economic fronts. Politics are still a concern.

Since our last *Global Outlook* report, GDP growth has surprised to the upside, employment growth has improved significantly, inflation has dropped, the fiscal deficit has plummeted, and external accounts have been stronger than expected. There have been few areas of disappointment. Outside of the expected slowdown in mining output growth (but not in mining investment growth), all disappointments have come from government stimulus policy.

Given the wealth of favourable news, we've raised our GDP growth forecasts for 2018 from 3.3% to 3.5%, with some upside still possible, and for 2019 from 3.7% to 4.0%. This reflects our opinion that the growth trend has changed direction, slowly but clearly. A (still) favourable world growth environment has certainly helped.

The second quarter is coming in particularly strong, with 7.8% growth, YoY, in April, leading us to raise our growth forecast for 2Q2018 from 4.0% to 4.8%. To put this in perspective, GDP growth has accelerated from 2.5%, YoY, in 4Q2017 to 3.2% in 1Q2018, to nearly 5% in 2Q2018. Note, however, that 2Q will be the last quarter to benefit from a low YoY base comparison, due to El Niño in 2017, so growth should slow in future quarters. However, even if one excludes all exceptional factors (El Niño last year, an unusually strong fishing season), GDP growth would still have been in a healthy 3.5% to 4.0% range. Non-resource manufacturing growth of 12.4% was especially revealing of the strength of demand, both export and domestic.

Not everything is positive, though. Government spending has continued to lag, and will not be the driver of growth it was initially meant to be. The multiple changes at the Ministry of Finance, and in the cabinet in general, has delayed the investment spending Schedule and raises questions over how post-Niño reconstruction will be confronted. Thankfully, the private sector has taken up the slack. Private investment (5.3% growth in 1Q) and domestic demand (4.0%) have clearly become the main drivers of growth. The private sector is rebounding nicely from the 2017 shocks, and has proven more resilient than expected in light of political turbulence and corruption investigations. Non-resource manufacturing has risen 4.1% YOY in the year to April breaking a three-year downtrend—yet another sign that the tide has turned.

CONTACTS

Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Peru	2017	2018f	2019f
Real GDP (annual % change)	2.5	3.5	4.0
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

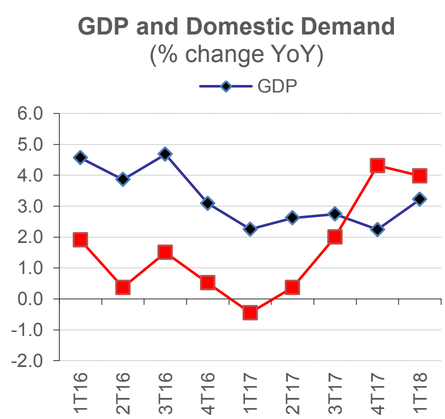
GDP and Domestic Demand Growth Rates

	2017	2018P	2019P
GDP	**2.5**	**3.5**	**4.0**
Domestic Demand	**1.6**	**3.5**	**4.0**
Private Consumption	2.5	2.8	3.3
Public Consumption	1.0	4.4	2.0
Gross Fixed Investment	-0.3	5.2	6.6
Private	0.3	4.1	6.2
Public	-2.3	9.8	8.0
Exports	**7.2**	**3.8**	**3.8**

P: Projected.

Sources: Research Department - Scotiabank Peru.

Chart 1



Sources: BCR Elaboration: Research Department- Scotiabank Peru.

To compound the good news, Peru's fiscal deficit in the twelve months to May fell to 2.4% of GDP, from 2.7% in April (and 3.2% at the start of 2018). The improvement is for the right reasons, as tax revenue rose 22.5%, YoY, in May, compared to government spending, up 8.9%. Note that May is the second and last month in the major tax season, which has been very strong this year. We had already lowered our fiscal deficit figure for full-year 2018 to 3.2% from 3.5%, but even 3.2% now seems a bit high. None of these figures take into account the new increase in excise taxes, which should only have a mild impact on revenue growth.

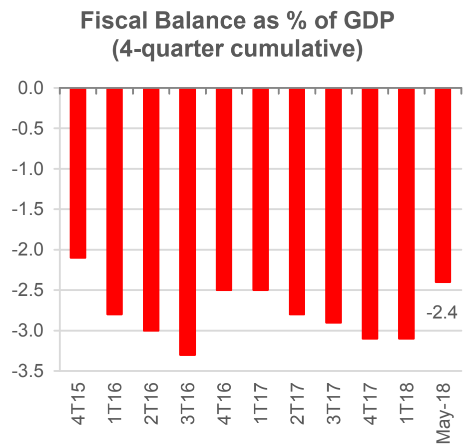
The recent fiscal figures have allayed some of the concerns the markets have had that the fiscal deficit could get out of hand, and that Peru's fiscal debt could surpass 30% of GDP in a few years time. As always, these concerns may resurface if metal prices were to decline sharply, which is always a risk for Peru.

What is less of a (direct) risk for the country is the impact of trade wars. Peru does not produce the type of manufactured goods that could see new tariffs applied. The risk for Peru is the indirect impact that would occur it trade wars hurt world growth, but also potential impacts on metals prices given the recent concerns about US trade policy being priced into those markets.

Peru's economy has suffered less than feared from domestic political turbulence, largely because politics have not altered proper economic management. Since 2016, there have been four ministers of finance, and yet there is no sense of disruption in the general guidelines of economic policy. The latest appointment, Carlos Oliva, has been well received by the markets, which view him as mainstream and with sufficient experience as former vice-minister at the Ministry of Finance in 2011-2016.

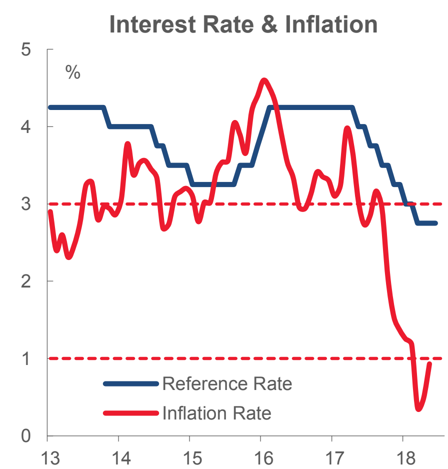
Meanwhile, the Central Bank (CB) ended its expansionary policy, which had taken its reference rate from 4.25% in April 2017, to 2.75% currently. Inflation is rebounding mildly, and should return to the 2% middle of the Central Bank target range fairly soon. We expect the CB reference rate to remain stable for the remainder of the year. The CB should be in no hurry to start raising rates again, despite a narrowing gap between the CB and Fed rates. Historically, the CB has maintained a period of rate stability before changing policies.

Chart 2



Sources: BCR Elaboration: Research Department - Scotiabank Peru.

Chart 3



Sources: BCR, INEI, Scotiabank Economics.

We haven't changed our year-end FX rate forecast of 3.18… yet. However, our doubts about the duration of USD strength are giving us pause. Fundamentals continue to point to a stronger PEN, with a foreign trade surplus consistently coming in stronger than expected. But, fundamentals have taken a back seat to USD strength, and commodity price volatility, in recent weeks. Although the PEN has, as always, been more stable that its regional peers, it has not been immune to the forces in play for regional currencies, and has been fluctuating in the upper half of the 3.20-3.30 band that has formed over the past year and a half. We're tempted to take another look at our year-end forecast; however, it's still early in the year, and we want more certainty that the current strength in the USD is more than just temporary before making any revision.

Chile

TAXIING IS OVER; A SHAKY TAKEOFF IS UNDERWAY

- **A faster-than-expected recovery is underway, despite a more challenging external environment.**
- **We have raised our forecast for GDP growth in 2018 to 3.7%, and consider the risks to be tilted to the upside as business sentiment and activity are rebounding strongly post-election.**
- **We anticipate slightly stronger inflation than the Central Bank, but have for now kept our year-end target for the policy rate at 3%, slightly higher than the 2.75% priced in markets. Given our view on growth, commodity prices and interest rates, we forecast the peso (CLP) will appreciate a bit less than expected in our previous forecast, ending the year at 602.**

MACRO UPDATE: RISKIER ENVIRONMENT AND BETTER DOMESTIC DATAFLOW

The Chilean economy has generally been unaffected by the Fed-induced reassessment of emerging market prospects. We think this will remain the case owing to: (1) Chile's risk factors are comparatively low (low foreign debt and current account deficit, for example), (2) strong institutional frameworks, including a completely flexible exchange rate, an independent monetary authority, a government pledged to improvement of fiscal conditions and growth, and (3) exports to the most troubled economies in the region are generally low.

Domestically, dataflow has been strengthening. Confidence indices remain strong, and are expected to remain so as suggested by an increasing amount of qualitative supporting information. This set of conditions is strong enough to raise our GDP growth by one tenth to 3.7% and to keep a moderate upward skew. As we have been saying for a long time, this recovery will be of "classic style", that is, led by investment, though not necessarily in big projects, and an inventory rebuild.

The stubbornly strong exchange rate and rising oil prices led the Central Bank and markets to raise inflation expectations substantially to 2.8% this year. In order to accommodate those factors, but also due to an expected faster recovery in non-tradable products (services) we raised our inflation forecast from 2.8% to 2.9%. Most of the market brought forward the first MPR (currently at 2.5%) rate hike to December, while we still keep our view that the rate could be at 3% at the end of the year. The bar is high for the Central Bank to raise rates more than we expect, as it will seek to allow the recovery to become more fully entrenched prior to raising rates.

Though we expect some relief for the peso in coming months, the risk of a further appreciation in the exchange rate owing to increased optimism in Chile cannot be discounted. We have incorporated only a modest amount of additional appreciation, as we now expect the peso to close the year at 602 CLP/USD.

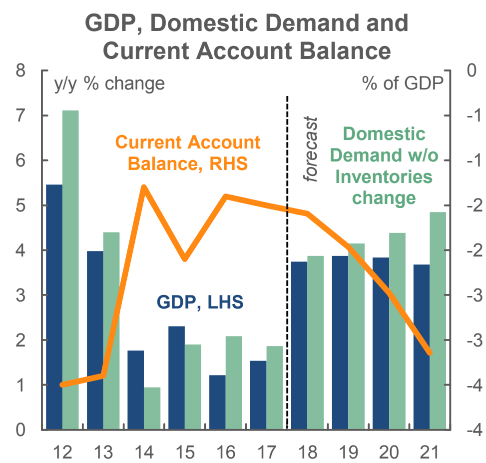
CONTACTS

Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chile	2017	2018f	2019f
Real GDP (annual % change)	1.5	3.7	3.9
CPI (y/y %, eop)	2.3	2.9	3.0
Central bank policy rate (%, eop)	2.50	3.00	3.50
Chilean peso (USDCLP, eop)	615	602	590

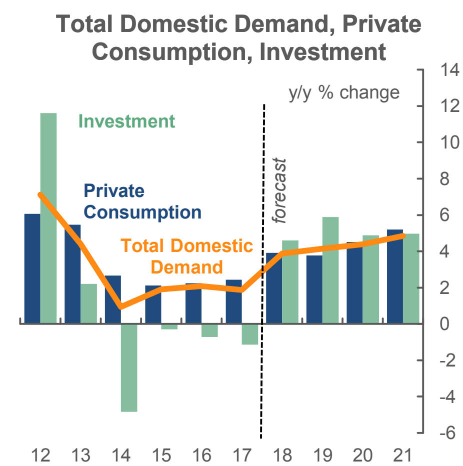
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



Source: Scotiabank Economics, Banco Central de Chile.

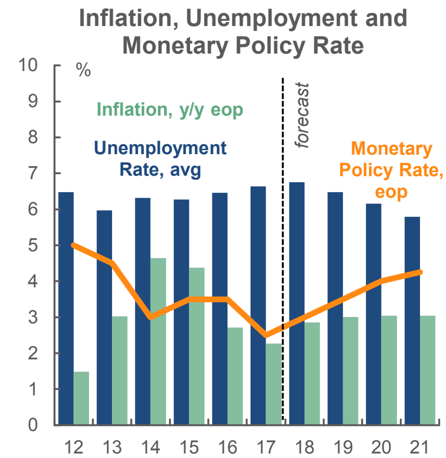
POLITICAL PANORAMA: A CAREFUL BUT DECIDED GOVERNMENT

We have seen little change on the political front. The Government continued with its plan to: take actions to unleash investment (severely contained in previous years by terms of trade, institutional challenges, and lack of confidence); achieve a wide consensus with the opposition for long-term reforms, and; re-orient public finances towards more sustainable levels. So far, results have not been evident, but many actions show they are moving in that direction in a very decided way. For example, political support for a corporate tax cut was impossible to get, and was replaced by a simplification of the tax reform to be proposed in short order. Some limited fissures in the Government coalition have been looming, but negative consequences for themselves and the President's leadership should be enough to avoid more noise. The most relevant center-left opposition seems open-minded to negotiate, trying to avoid political costs of crippling actions.

MAIN RISKS: TERMS OF TRADE AND POLITICAL AGREEMENTS ARE THE KEY

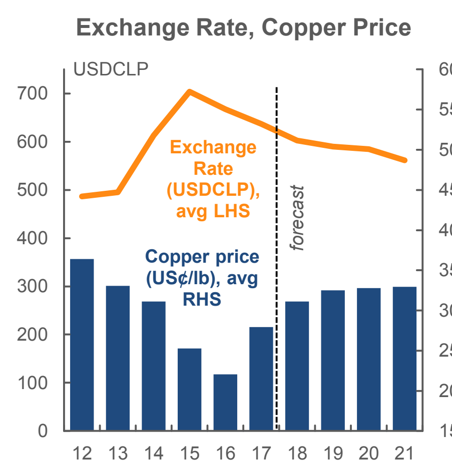
Main risks for the Chilean economy remain the same: from abroad, changes in terms of trade are, by far, the most important. An escalation in trade uncertainty could lead to declines in metals prices despite the strong fundamentals, as has been observed in recent days. Other risks, like restrictions to international commerce, could be serious, but over a longer term. As said, risks coming from changes in Fed policy seem very limited if kept within sensible limits and should not have a major impact on Chile's terms of trade. On the domestic front, the main risks concern the Government's ability to deliver on its mandate and improve public finances.

Chart 3



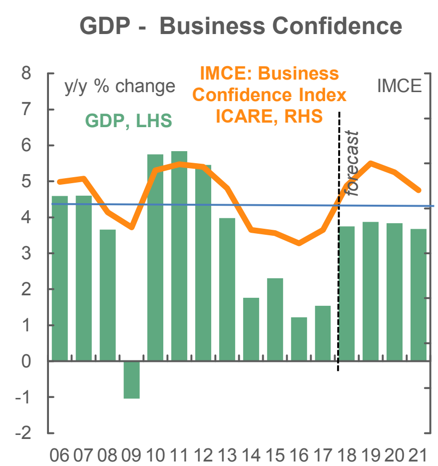
Sources: Scotiabank Economics, INE, Banco Central de Chile.

Chart 4



Sources: Scotiabank Economics, Reuters Eikon.

Chart 5



Sources: Scotiabank Economics, Banco Central de Chile, IMCE: ICARE-UAI.