Latin America Capital Flows

- **Robust capital flows; resilience to low growth; China/Mexico stress.**
- **Continuous rebalancing of investment portfolios; Southern Cone revival.**
- **Uneven monetary policy in Developing Americas; North-South divide.**
- **Currency stabilization; smooth alignment to commodity price shifts.**
- **Intensifying election-related uncertainty; leadership renewal in context.**

Emerging markets are in fashion once again. Growth and interest rate differentials remain a key magnet to global portfolio investors in search of higher-yielding Latin American assets in a world of excessively low interest rates. The ultra-stimulating monetary policies in credit-intensive advanced economies (such as the US, the UK and certain jurisdictions in Europe) continue to direct capital flows to core economies in the developing Americas. The persistence of global liquidity excesses is preventing a more rigorous approach to intra-regional credit risk differentiation in Latin America in a context of below-potential regional economic growth. The voluminous capital flight suffered by China, as measured in the sharp decline in central bank reserves (down US$1 trillion between July 2014 and January 2017) was taken with utmost indifference by dedicated emerging-market investors. Even the elevated financial market stress in Mexico as a result of the US presidential elections has been gradually unwound, proving incentives for opportunistic trading activity.

Global investors remain in active portfolio rebalancing of their exposure to emerging markets in general and to Latin American assets in particular. It is quite telling that exposure to China's corporate bond markets has been declining, triggered by fears of excess leverage in selected sectors of the economy (real estate in focus) at a time when the Chinese central bank lost a sizeable amount of international reserves. However, the core sovereign issuers in Latin America remain relatively immune to the escalating capital flight in China, which seems to be relatively well engineered by supply/demand market forces. Within the developing Americas, the return of Brazil and Argentina as core players in both primary and secondary debt markets accelerated a process of intra-regional rebalancing which alleviated investors' exposure to Mexico and increased holdings of Southern Cone credits in the hemisphere. Looking ahead, Latin America will have a more balanced presence in emerging markets at large despite the lingering risks affecting Mexico as a result of potential policy shifts in the USA.

Interest rate differentials remain a primary factor swaying capital flows to emerging markets. Policy shifts in the USA remain a factor of potential stress. Although the "Fed fear" factor has somewhat dissipated as there is better clarity of US policy developments, yield differentials between local government bonds and US treasury assets might increase in relevance in the coming months providing, at times, bouts of market volatility within the high-yield debt segments. The continuous development of local-currency government securities continues to

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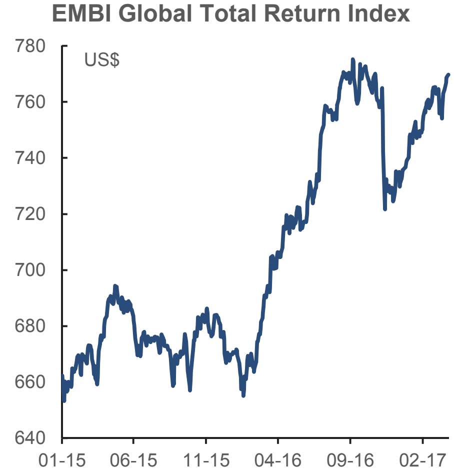
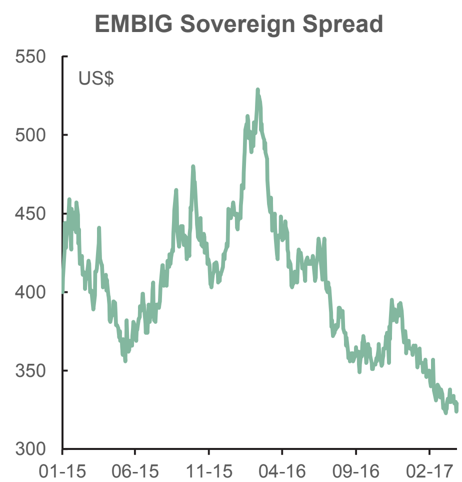
Chart 1



Sources: Scotiabank Economics, JP Morgan.

Chart 2



Sources: Scotiabank Economics, JP Morgan.

direct portfolio flows to selected countries in the Western Hemisphere. Mexico, with large-scale participation of foreign portfolio investors, remains the pre-eminent core jurisdiction in Latin American debt markets. In this regard, monetary policy developments (and the ensuing inflation context) are critical to keep the interest rate premium as a key magnet of capital inflows. There is evidence of a divergent trend in monetary policy dynamics between the North (USA and Mexico) and the South (Brazil, Colombia and Chile). The stark contrast between rising central bank rates in Mexico—which helped stabilize Mexican currency market stress—and steady rate declines in Brazil is proof of this divide between Northern and Southern markets.

Latin American exchange rates have enjoyed a phase of steady consolidation over the past four months. Nevertheless, the regional currency environment might be subject to sporadic volatility swings through the remainder of the year, primarily influenced by the direction of the US dollar (USD) versus its peer major currencies and unforeseen shifts in US monetary policy. However, the complete unwinding of the sharp currency weakness suffered by the Mexican peso (MXN) following the completion of US presidential elections is indicative of the strong support of foreign portfolio investors as well as the country's highly attractive interest rate differentials. Bullish financial market sentiment to the Brazilian real (BRL) remains in place, despite the activation of an aggressive monetary easing cycle by the central bank. The normalization of copper price trends has stabilized trading activity in both the Peruvian sol (PEN) and Chilean peso (CLP), yet volatile changes in crude oil prices might keep the Colombian peso (COP) on the defensive in the months to come.

The Latin American region initiates a period of electoral intensity leading to leadership renewal in the core economies. The imminent election in the state of Mexico will provide a clear hint of electoral sentiment towards the current leadership and potential demands from society ahead of next year's presidential vote scheduled for July 2018. At times, US-Mexico bilateral relations might fuel volatile market-moving events. As for other members of the Pacific Alliance, presidential elections will take place in Chile (November 2017) whereas congressional and presidential elections are scheduled for March and May 2018, respectively. Other core economies within the region with scheduled elections include: Argentina's congressional elections (October 2017), Venezuela's presidential elections (April 2018) and Brazil's general elections (October 2018).

Brazil

- **Slow economic recovery in motion; active disinflation is under way.**
- **Improved global perception of Brazilian sovereign credit risk.**
- **The Brazilian real (BRL) remains the world's best performing currency.**
- **Deeper fiscal consolidation is critical to improve economic outlook.**
- **Leadership renewal in sight; elections scheduled for October 2018.**

Business confidence indicators show signs of improvement in the first two months of the year. The inflation and monetary outlook is also improving. Following two years of deep recession, the economy will post positive growth in 2017. We expect that real GDP will expand by 0.5% before accelerating to 2–2.5% in 2018. The ongoing correction of deep macroeconomic (fiscal and external) imbalances will facilitate a slow and gradual recovery. The economic legacy of the previous administration which led to the presidential impeachment last August included a 12% unemployment rate and a 7.4% contraction of real GDP over the past seven quarters.

The central bank has adopted a pro-growth monetary policy strategy. The administered policy interest rate has been reduced by 200 bps to 12.25% over the past four months. Market participants discount further aggressive rate cuts to close this year at 9.5%. Strongly aided by a sharp exchange rate appreciation and a prolonged recession, the headline inflation rate sharply declined to 4.8% y/y (February 2017) from 10.7% y/y (January 2016). A prolonged economic recession together with a distortive interest rate environment provoked a swift reduction in credit activity. Total credit declined to 49% of GDP in 2016 from 54% in 2015 in line with the acute economic contraction.

Brazil's creditworthiness has materially improved, yet local markets remain vulnerable to potential volatility associated with unexpected shifts in monetary policy conditions in the USA. Market metrics in credit default swaps (CDS) imply a sharp reduction in the cost of insurance to hold USD-denominated Brazilian debt assets. In fact, the five-year CDS contract declined to 220 basis points (bps) from 500 bps over the past 14 months. This robust market performance is in stark contrast to the position of international credit rating agencies, all of which maintain a "negative outlook" on their Brazilian sovereign country debt ratings. In this regard, sustained progress on fiscal consolidation and credit quality improvement will be at the core of investor sentiment in the year ahead.

The combination of favourable domestic and external factors led to sustained appreciation of the Brazilian currency which gained 33% against the US dollar (USD) since January 2016. The reversal of the terms of trade shock in the wake of a deep economic recession and favourable financial market conditions in core emerging-market economies fuelled a bullish tone into the BRL. A robust international reserve position (central bank reserves of US$375 billion) coupled with sizeable foreign direct investment flows (US$85 billion in the last 12 months) reasserted the positive exchange rate direction.

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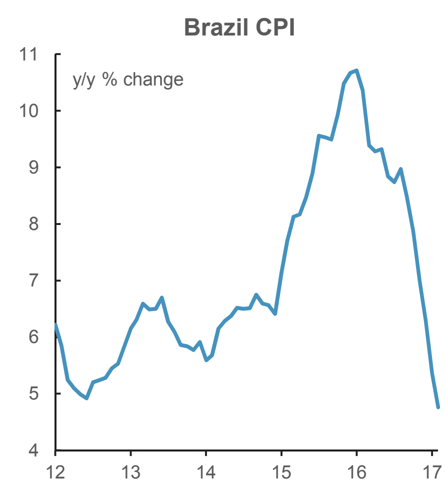
Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, IBGE.

The process of structural fiscal reform is advancing, yet the fiscal emergency remains in place. The approval of public sector budget cuts coupled with advances in pension system reform is a major step in the right direction. The consolidated public sector deficit remains in gradual adjustment, reaching 8.5% of GDP (January 2017), a positive advance from the near 11% of GDP recorded in January 2016. At the core of such improvement is the sharp reduction in the debt service burden (now at 6.1% of GDP). On a positive note, the external sector adjustment continues to advance with the current account deficit currently at 1.3% of GDP.

The administration of President Michel Temer is focused on introducing the needed policy changes to restart an economy after a deep recession. Meanwhile, the campaign process leading to the October 2018 presidential elections will increasingly become the dominant event shaping the domestic political environment. Meanwhile, Brazil is setting a unique and powerful precedent to address—and prevent—serious public sector misconduct and corruption. The ongoing improvement in the quality of the judiciary cohabiting with a pro-democracy local press will help improve public sector governance in the next political cycle, despite the severe institutional shock caused by the Lava Jato corruption affair.

Mexico

HIGH SUSPENSE AND SHARP CONTRASTS

- **Heightened uncertainty about possible changes to US trade policy is curbing investment and weakening the outlook for economic growth.**
- **There are sharp contrasts among different sectors: some contracting dramatically (oil production, heavy construction) and some expanding rapidly (communications, financial services, some manufacturing).**
- **Inflation is rapidly rising due to the increased fuel prices implemented by the government.**
- **To manage inflationary expectations, Banco de Mexico is acting swiftly to increase interest rates.**

For an economy with real growth potential of 4% y/y, a forecast of 1.4% for the present year looks grim and even weak. The situation is not as grim as the headline growth number suggests, as there are sharp contrasts in economic activity among sectors and regions within Mexico. Some sectors are experiencing challenges and pulling GDP growth lower, but many other sectors and regions are thriving.

It has been a rough start of the year for the Mexican economy. The Mexican peso has been on a roller coaster ride, reacting mainly to comments made by the new administration in the US. First, comments made by President Trump on his inauguration speech sent the peso through the roof, reaching close to 22 MXN/USD and losing close to 6%. Then a more temperate and constructive set of comments by Wilbur Ross and Peter Navarro paved the way for a sharp strengthening of more than 14% on the Mexican peso, reaching levels below 19 MXN/USD (chart 1). This more positive climate in the market had led us to an improved forecast for the Mexican peso.

This wide volatility is a reflection of the heightened uncertainty generated by the possible changes in the trading policy of the United States. Much is at stake for the North American economy and for the many firms that have developed competitive advantages by building deep trade relationships and supply chains across the three countries. According to anecdotal information, the uncertainty surrounding US trade policy has led many firms to put new investment plans on hold, while ongoing investments continue. In addition, public spending on physical investment is contracting due to the fiscal consolidation. As a result, we are expecting a contraction in total investment during the current year. There are some already visible signs of this effect: the building component of the construction industry that had been previously growing at high rates, contracted 1.0% real y/y in January; and banking credit to the construction industry also contracted by 1.5% real y/y in the same month. Another concerning sign is the unprecedented drop in consumer confidence during January (lowest on record), and then the tepid recovery of February (second lowest on record), which could suggest a slowdown in the consumption rhythm.

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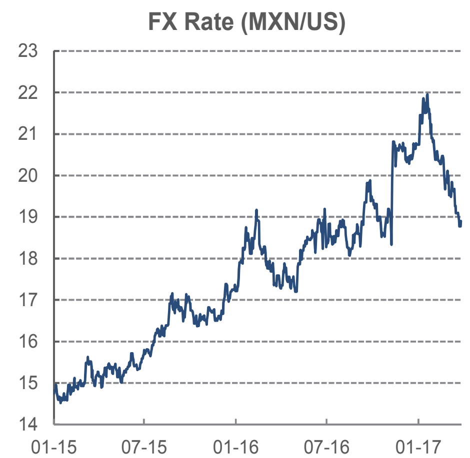
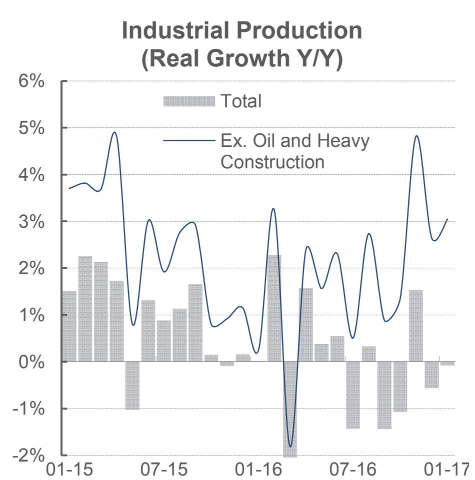
Chart 1



Sources: Scotiabank Economics, Banco de Mexico

Chart 2



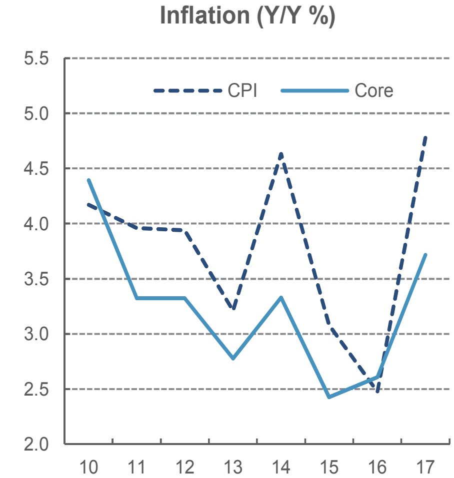
Sources: Scotiabank Economics, INEGI.

There are, however, sharp contrasts in the economy. Industrial activity, on the one hand, contracted 0.1% real y/y in January, but was heavily influenced by downturns in oil extraction (-11.9% real y/y) and heavy works construction (-11.1% real y/y). On the other hand, manufacturing activity grew 4.3% real y/y in January, with outstanding performance in sectors such as basic metal industries (+10.2% real y/y) and machinery and equipment (+12.1% real y/y). Excluding oil extraction and heavy construction from the total industry, the rest of industrial activities grew 3.1% real y/y, as can be seen in chart 2. Different indicators suggest a strong internal market: job creation was very positive in February (+154 k), retail sales grew 4.9% real y/y in January and automobile sales grew 6.5% real y/y in February.

Inflation is on the rise and has reached levels not seen in the last seven years, with the Consumer Price Index reaching 5.29% y/y in the first half of March and the core component reaching 4.32% y/y (chart 3). This unusual rebound is mainly explained by the beginning of the liberalization process of fuel prices and the pass-through effect from the accumulated depreciation of the currency. Even though it is expected that this inflationary increase will be temporary, there is a serious risk of second order effects that could generate an undesirable inertia in inflation dynamics. To prevent this, Banco de Mexico has been acting on the monetary policy by rapidly increasing the reference interest rates, hiking 325 basis points since December 2015, and it is expected that it will continue tightening the monetary policy another 100 basis points during the rest of 2017.

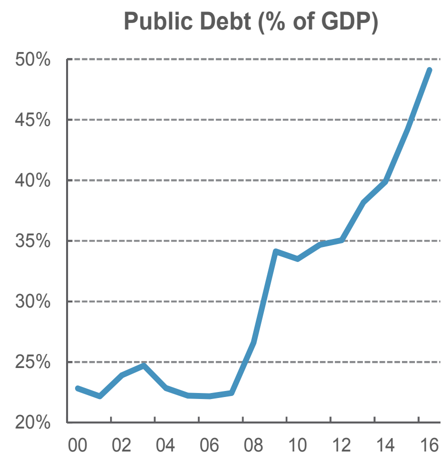
Another matter of concern is the upward trend of public debt (chart 4). There have been many different warnings about the weakening of the fiscal discipline, from the International Monetary Fund and the international rating agencies to many private sector analysts. The federal government has taken different actions to reach the official deficit targets, which have been met. Much of the improvement in the budgetary situation is explained to a large degree by unusual revenues, such as the operational surplus of Banco de Mexico. Total public spending keeps growing as a percentage of GDP, and this could spell trouble in the future. More decisive action to curb the spending side of the fiscal policy appears to be required in order to strengthen the macroeconomic fundamentals of the country.

Chart 3



Sources: Scotiabank Economics, INEGI.

Chart 4



Sources: Scotiabank Economics, Ministry of Finance.

On this framework, we are anticipating for 2017 a significant slowdown of the total real GDP growth to 1.4%, mainly affected by a 2.6% contraction in total investment, while private consumption is expected to grow 1.9%. The Pemex reorganization is ongoing, leading to decreased oil production. Weaker construction activity is compounding this impact, leading to an expected contraction of 0.2% in industrial production. The services sector is expected to be less affected by the uncertainty and grow 2.4%. Total inflation is forecast to reach 5.9% while core inflation is expected to jump to 4.9%. The Mexican peso is expected to show high volatility during the year, ending close to 21.3 MXN/USD, but it is worth noting that there are many possible outcomes for the exchange rate.

In summary, 2017 appears to be a complicated year for the Mexican economy, which is expected to underperform. On the other hand, the medium- and long-term outlook for Mexico remains positive, and once all the headwinds affecting the immediate horizon start to dissipate, the economy should start gathering momentum and performance will improve.

Colombia

- **The Colombian economy is still performing below its potential.**
- **Colombia benefits from a sharp increase in global risk appetite.**
- **The central bank has adopted a pro-growth monetary stance.**
- **The structural fiscal adjustment remains a key macroeconomic priority.**
- **The electoral cycle will shape the near-term political environment.**

The ongoing correction of the twin (fiscal and current account) deficits is being accompanied by a slower pace of economic activity. Real GDP increased by just 2% in 2016. Looking ahead, a similar rate of economic growth is projected for this year. The necessary fiscal adjustment under way is at the core of the reduction in economic activity with lower contribution from government spending. Weak employment conditions (jobless rate at 11.7% in January 2017) have also eroded consumer confidence during this period of macroeconomic adjustment. Long-term private-sector investment plans may also be delayed ahead of the elections in 2018. It is worth mentioning that the adverse weather shock (torrential rains and mudslides) which caused severe social distress in the Mocoa area (south west of the country) at the beginning of April will be a focus of fiscal relief and reconstruction activity in the months to come.

Colombia is benefiting from a sharp increase in global risk appetite (with an ensuing boost into high-yielding assets) in the wake of the presidential elections in the USA. Market pricing implies a gradual increase in the administered monetary policy rate by the US Federal Reserve, alleviating a potential risk of disruptive contagion waves in the hemisphere. However, given the intensified presence of foreign holdings in local debt markets, Colombia may receive the negative effects of unforeseen changes in emerging market sentiment through the remainder of the year. On the domestic front, investors have welcomed the disinflation trends which led the central bank to adopt a bias towards monetary easing to support growth prospects. The Colombian banking sector remains well capitalized and rigorously supervised. Domestic credit activity remains tied to the economic cycle.

The Colombian peso (COP) has reached a stabilization phase following a recovery phase since mid-November (see chart 1). The primary factors shaping the value of the Colombian currency remain the following: 1) the direction of crude oil prices, 2) the degree of global risk aversion towards emerging markets, and 3) the prospects of monetary policy normalization in the USA with the ensuing impact on the value of the USD vis-à-vis its major peer currencies. Irrespective of the Colombian leadership's strategy to diversify economic structures away from the energy (primarily crude oil) sector, Colombia remains strongly influenced by the direction of energy prices; indeed, the sharp increase in the benchmark WTI price (up 25% since mid-November) was a supporting factor for the local currency in recent months.

The central bank is in monetary stimulus mode. A clear disinflation process has been in place since August 2016, with the rate of consumer price inflation reaching 5.2% y/y in February, down from 9% y/y in July 2016. Lower currency

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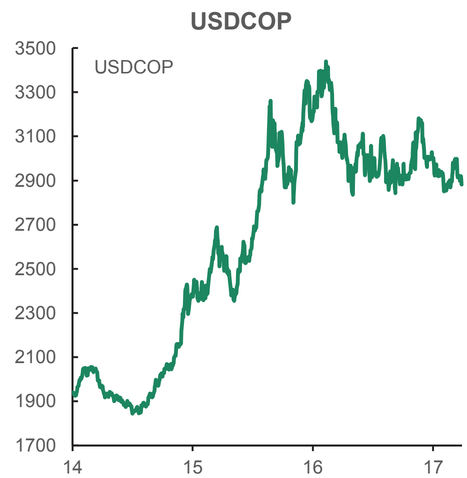
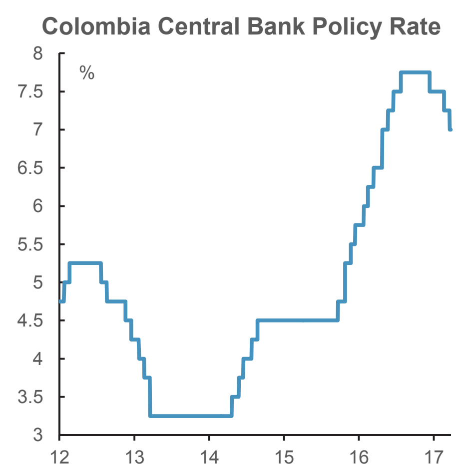


Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Banco Central de la Republica de Colombia.

market volatility in the context of recovering terms of trade and food price adjustments reinforced this phase of price stabilization over the past few months. The central bank, which maintains its 3% ± 1% inflation target, reacted in an orthodox manner by adopting a gradual monetary easing bias at a time when economic activity shows persistent evidence of deceleration. The central bank reference rate has been reduced by 50 basis points (bps) to 7.25% over the past three months (see chart 2).

The Colombian economy is making firm advancements in tackling the structural rigidities which led the general government deficit to increase from 2.3% to 4.0% of GDP over the past three years. The combined effect of depleted oil-linked revenue (from 3.3% of GDP to virtually nil) and rising debt service costs (2.9% of GDP) triggered a swift tax reform which received congressional approval at the end of 2016. Looking ahead, this structural reform aims at increasing non-oil revenue by 1.4% of GDP and reducing government expenditures by 0.8% of GDP over the next five years.

Congressional elections, scheduled for March 2018, will be followed by presidential elections two months later. Colombia remains a strategic economic partner and military ally of the USA. As such, the administration of President Santos will continue to receive the diplomatic support of the Trump administration through direct and indirect (IMF assistance) means. As per regional integration with peer economies, the four-member Pacific Alliance initiative will help Colombia implement a trade diversification strategy in the hemisphere. At times, trade, migration and security issues connected with the escalating Venezuelan crisis might provoke situations of bilateral friction.

Peru

- **Adverse weather-related ENSO (El Niño Southern Oscillation) shocks.**
- **Delays in infrastructure projects reduce growth expectations.**
- **Reconstruction efforts to impact fiscal consolidation and boost growth.**
- **Exchange rate stable despite modest ENSO-linked inflationary impact.**

There are three major events impacting the economy in 2017. Two are negative: El Niño, and the political and legal issues surrounding infrastructure investment projects, and one is positive: an increase in fiscal spending.

Since these events are ongoing, their impact on growth is hard to gauge, but will be significant. We are lowering our GDP growth forecast for 2017 from 3.4% to 2.9%, based on the combined impact of the three events, although this may change as the events evolve. What is not impacting growth quite yet, but is a very important positive backdrop, is the sharp improvement in terms of trade.

EL NIÑO

The 2017 El Niño, and the rains, flooding and mudslides it has brought, is one of the four worst ENSO climate events in the last hundred years, together with those in 1925, 1982–83 and 1997–98. The social impact in terms of the number of people affected, houses destroyed, infrastructure damaged, is similar to past mega-Niño. However, the impact on GDP growth will be much weaker. GDP growth was -0.4% in 1998 and -10% in 1983. In contrast, there will not be a recession in 2017, although we'd expect El Niño events to shave off, ceteris paribus, about 0.6 percentage point from growth. There are a number of reasons why the impact of this Niño is mild compared to the past. Unlike the past, the current Niño is an ocean -surface, rather than deep-sea, phenomenon. As a result, there has not been a drought in the south, which is what severely damaged agriculture in the past. Nor have anchovy schools disappeared. In addition, the country, and the world, is healthier. The 1998 Niño occurred in the midst of the Asia crisis. The 1983 Niño occurred during the LatAm debt crisis. The current Niño occurs when the world economy is improving, metal prices are rising, and the country has ample resources for emergency and reconstruction spending (which we quantify in subsequent paragraphs), something that did not exist in the past.

The greatest impact of El Niño will be in construction, with possibly double-digit declines for March and April. On the plus side, there is likely to be an important rebound over a longer horizon, once reconstruction begins in earnest.

Although the impact on mining output has, so far, been minor, this may change given the severe disruption in the transportation of ore, both by train and truck, from the Central Andes to port. Both Volcan and Chinalco have declared force majeure as a result. Most mining companies continue producing near normal levels and stocking up the ore they cannot transport, but there is a limit to this before companies run out of stockpiling capacity.

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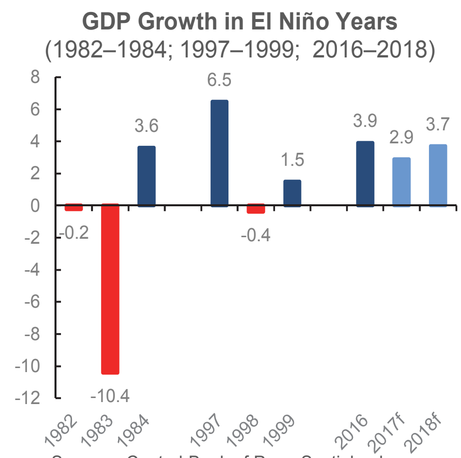
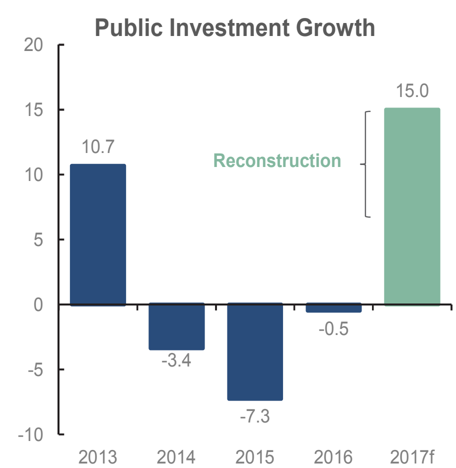


Sources: Central Bank of Peru, Scotiabank Economics Peru.

Chart 2



Sources: Central Bank of Peru, Scotiabank Economics Peru.

Flooding has had a material, albeit relatively minor, impact on agro industrial exports, in part because it is mostly offseason. If communications are not restored promptly, however, the impact could be greater.

As for fishmeal production, anchovy schools have been detected within fishing range. Barring any change in this by the late-April fishing season, fishmeal GDP growth should be positive, unlike past Niño events when fishing GDP declined sharply.

The impact on retail and manufacturing for the domestic market should be strongly negative in March–April, but rebound afterwards. Some supply chains have been disrupted, although this will be compensated by the need to replenish destroyed household supplies and retail inventories. The main risk is that small businesses have been affected, with an impact on employment. Although the damage is contained to localities with a relatively small weight in the economy, we expect the aggregate wealth effect to reduce consumption growth from 3.4% to 3.1%.

INFRASTRUCTURE INVESTMENT PROJECTS

When the Kuzcynski administration came into power in 2017, our expectation was that growth in 2017–2018 would be driven by the large infrastructure projects tendered as Public Private Partnerships (PPP) in 2013–14. However, many of these projects are now facing legal and political issues, some linked to irregularities in government procurement programs (the gas pipeline and Chavimochic) and others to controversial tender conditions. We now believe that spending in many of the important infrastructure projects will be delayed until 2019. All in all, we expect growth to be lower by 0.8pp as a result, although part of this was already in our original forecasts.

FISCAL STIMULUS, AND NOW EMERGENCY SPENDING AND RECONSTRUCTION, MEASURES

The delay in PPP infrastructure investment leaves fiscal spending as the main driver of growth. On March 9, just days before the worst of El Niño hit Lima and the northern coast, the government announced fiscal stimulus measures. Among these was an additional USD 1.3bn in fiscal spending. Part of these resources has since been redirected towards disaster relief and reconstruction. Most of the spending will be in roads, schools, irrigation, housing, water & sewage, and security. The government will also expedite to late March about USD 2.7bn in funds for regional and local governments that are normally transferred in June. In all, the government targets 15% growth in public investment in 2017, up from their 5% previously. We believe this target is achievable. This would add 0.3pp to GDP, which is not enough to compensate for the combined impact of El Niño and delays in infrastructure investment.

The combination of effects, then, amount to the following. Our original forecast (which included a 0.6pp loss due to infrastructure spending delays) was 3.4%. Our new forecast of 2.9% accounts for a loss of 0.6pp due to El Niño, a further 0.2pp loss due to infrastructure delays, and a 0.3pp increase due to greater fiscal spending.

STABLE EXCHANGE RATE ENVIRONMENT AMIDST TEMPORARY ENSO-LINKED INFLATIONARY PRESSURES

Transportation disruptions for agricultural goods will impact inflation temporarily. We expect inflation in March to reach 1%, MoM, taking 12-month inflation to near 3.7%. However, eventually agricultural prices will return to their normal levels, so we see no need to alter our year-end forecast of 3.1%. The Central Bank also expects inflation to rise in March, but then return to its 1% to 3% target range by year-end. Julio Velarde, the president of the CB has stated that it will be discussing whether or not to reduce its reference rate in future months. This is new, and in line with its decision to reduce reserve requirements for soles deposits again in April, from 6% to 5%.

It is telling that El Niño has had no impact on the PEN FX market, on country risk or on bond rates. This suggests that financial markets expect Peru's economy to absorb the El Niño shock without too much trouble, and without affecting stability. Increased government spending should drive the fiscal deficit up, but keep it within a manageable level of 3%. The government plans to finance spending mostly with savings and one-off revenue sources. However, they may be underestimating the impact of El Niño on revenue, and we would not be surprised to see the government increasing debt as well.

The PEN has strengthened more than we expected this year, already reaching our end-year level of 3.25. Fundamentals for the PEN continue to improve. Peru's current account surplus in 4Q16, and monthly trade surpluses, together with metal prices, have surprised to the upside. Exports volumes may suffer due to El Niño in March-April, but this will be compensated by higher than expected metal prices.

Chile

GLOOMY 2017, A GLIMMER OF HOPE FOR 2018

The Chilean economy grew 1.6% last year, the lowest pace of expansion since the recession of 2009 (-1%). Growth was led by services sectors, like personal services, financial, commerce, transportation and communication, while major contraction came from mining, business services and manufacturing (each sector represents around one third of GDP). Over the last three years, the growth rate has not reached 2.5%, while the long-term growth is estimated around 3%. For the current year, our GDP growth forecast was trimmed to 1.8% because trend indicators in the last quarter of 2016 were much weaker than expected and the economy entered 2017 with a negative tone; indeed, some specific factors are going to negatively impact economic activity (the most important being the long-lasting strike in the biggest copper mine, with more than one and half month loss in output). For the second half, we expect acceleration, due to both statistical and economic factors, some of which are likely to be become more pronounced in 2018. All in all, the balance of risks remains on the downside for the first half of the year, while it looks neutral for the second.

For the next year, the base case for GDP growth is a lukewarm recovery to 2.4%. However, there are factors that could help to instill a faster rhythm. Recovery of business confidence could come from a change in the political scenario towards a more market-friendly policy mix. This factor could ease the implementation of reforms that have been approved in the last years (tax, education, labour, among the most arguable and concerning for growth) and even facilitating other critical reforms, like specific actions to increase productivity in following years and improve the pension fund management system. Besides, there are some subtle economic conditions that help to tilt risks to the optimistic side. Productivity gaps in some sectors have been accumulating during a long time, though not at a very fast rate because investment has been contracting for three years, but enough to look like a rather deflationary factor in the short term. At the same time, inventories have been slashed for three years in a row suggesting that a change in business confidence might spark an accelerated re-building of them. As a backdrop, and not without risks (especially those related with China can't be put aside), the terms of trade situation (exports vs. imports) has been mildly improving, which has empirically proved to be positive for the Chilean economy, not just for trade balance dynamics.

SLUGGISH DEMAND

On the demand side, the outlook remains very similar to that of January for investment, with a 1.1% growth. Our view is favoured by a weaker basis for comparison, considering that investment has been contracting for three years in a row. Now, investment is the most supportive factor linked to energy and infrastructure sectors. A further recovery could be reached in 2018 (3.6%). Regarding consumption, the picture has not changed as much either, though the ongoing weakening of the labour market pushed us to trim our estimated growth rate to 2.3% for the current year and 2.9% for the next. Although the unemployment rate has not climbed dramatically in 2016, some deterioration is

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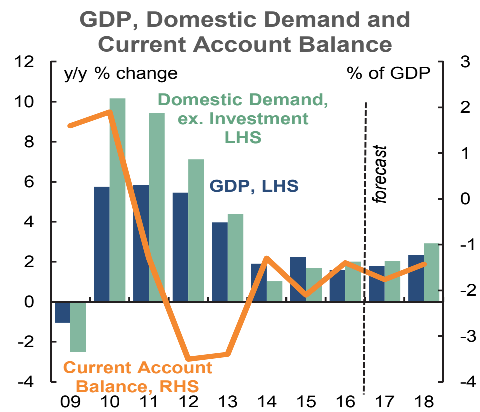
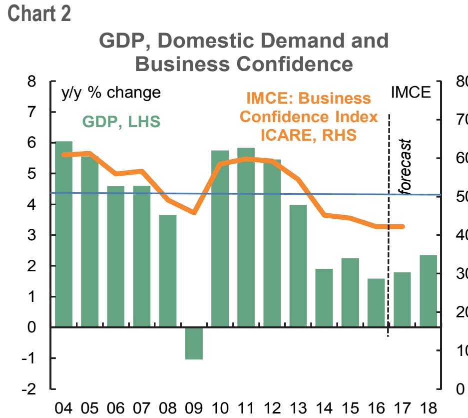
Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



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

Chart 3

Sources: Scotiabank Economics, Banco Central de Chile.

factored in for the next two years. In the meantime, payroll growth and wages are slowing with the ensuing weakening of household consumption. However, self-employment activity has somewhat offset part of that weakness. Indeed, investment reacts more keenly than consumption to changes in financial and economic conditions. As for our view on the contribution of government spending to economic activity, the budgeted growth of 2.7% seems reasonable, even in an electoral year (please note that presidential elections are scheduled for November 2017).

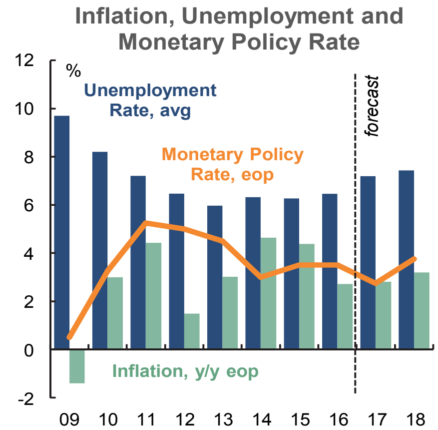
TAMED INFLATION, MONETARY POLICY ALMOST AT LIMIT, HARMLESS EXCHANGE RATE

Productive gaps, slowing salary adjustments, a relatively stable exchange rate and inflation indexing schemes are factors enough to project an inflation rate of 2.8% in 2017, similar to that of 2016 (2.7%). However, estimated oil price hikes and other commodities plus a more reflationary monetary policy should help the headline inflation rate to pick up to 3.2% in 2018. Indeed, the Central Bank increased the monetary policy stimuli in the first quarter (two 25bp cuts, to leave the monetary policy rate at 3%); looking ahead, we expect one more reduction in May or June. Nevertheless, there is not much more room for additional cuts and the effect of reflationary policies does not seem the most decisive to get some recovery of activity. On the other side, a rate hike at the very end of the current year, though is not our base case, should be in the cards if some change in expectations takes place over the next months. Regarding the exchange rate (CLP/USD), we do not expect very dramatic deviations in coming quarters, though a relatively wide range similar to that started in August should prevail, between 640 and 680. The most critical factors for the value of the peso will be copper prices and the USD international value.

ELECTIONS ENTERING HOT SEASON

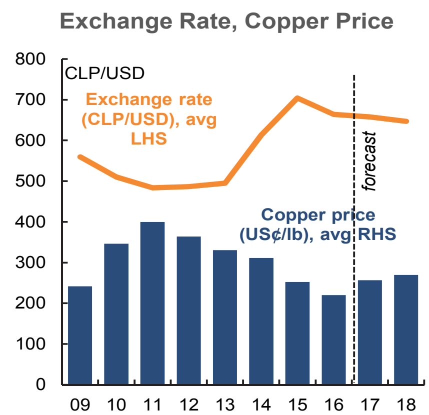
Partial Congress elections and the first round of presidential will take place on November 19th (the run-off vote of the Presidential election—a very likely occurrence—would be on December 17th). So far, the highest probability is for a race between former President Sebastián Piñera (center-right and very pro-market) and, the ruling coalition, Senator Alejandro Guillier (a social democratic sociologist and journalist). Other candidates in both sectors are far behind them (including former center-left President, Ricardo Lagos, who had been in the run since September). Mr. Piñera keeps an advantage over Mr. Guillier, whose campaign has been losing some steam lately. Nothing will be quite clear before mid-year because the ability of each coalition to be well-aligned behind its candidate will be critical. Summing up, the political environment conveys a high political risk, though not necessarily in a negative sense, but its potential effect on economic variables looks higher than usual. Anyway, beyond the result of the election, the ability of forces to get agreement to improve the quality of public policies will be critical in coming years.

Chart 4



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

Chart 5



Sources: Scotiabank Economics, Reuters Eikon.