Mexico

CHANGING COURSE

- **Mexico's elections result granted a lot of political power to AMLO and his movement, and people's expectations for the new government are sky-high. Changing course is the prevailing message of the winning group, and the macroeconomic picture will be heavily dependent on public policy definitions that will take place over the remainder of the year.**

The message from the ballot boxes is crystal-clear: Mexico wants a change. After a very unfriendly electoral process where rhetoric was plagued with populist promises from every candidate, Andrés Manuel López Obrador (AMLO) emerged as the undisputed winner, receiving the strongest support from the electorate since the old days when the PRI reigned the supreme and only political party, some 40 years ago. His political movement, MORENA (Movement for National Regeneration), was granted the absolute majority in Congress, which will give them total control of the federal budget; and the majority in 18 out of 32 local congresses, which puts them very close to having the qualified majority to change the Constitution. Mexico's people believed the promises made by AMLO and his movement, and granted them a strong political power to change the course of the country. The promise was simple and appealing: by eliminating corruption, the economy will thrive, employment will flourish and there will be money to spend on many social programs that will close the gap between the wealthy and the poor. Expectations are through the roof for the new government that now faces the gargantuan challenge of delivering on their promises in the real world, where reality is never as simple as that of the political campaigns.

We are now in a long transition period where the current government is gradually fading out while the future new government is in the spotlight. Good to know, the transition is being as soft as it could have been. In this period prior to Inauguration day on December 1st, the future government is working very hard to accommodate the campaign promises into the realm of what is possible. And they are really struggling. Many messages from the new government are the right ones: macroeconomic stability will be preserved, fiscal discipline will be a priority, public spending will be limited to prevent public debt from growing and Banco de Mexico's autonomy will be respected. But there are many other messages that are controversial to say the least and could produce a lot of trouble in our economy. Which ones should be listened to and incorporated in our projections?

Many of the expressed ideas and comments could suggest the new government will embrace a different paradigm for public policy, returning to an interventionist State that heavily participates in and influences economic matters, significantly changing course for the country. On frequent statements, the now President Elect blames the neo-liberalism for many of the country's shortcomings. It remains to be seen how difficult changing course will be, from a mere realignment of public spending but within fiscal responsibility or all the way to a more populist government.

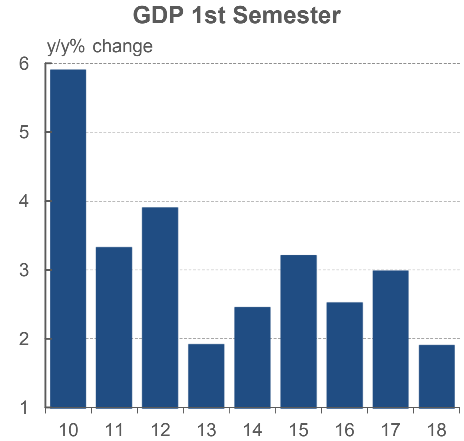
CONTACTS

Mario Correa, Director Estudios Economicos
52.55.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

Mexico	2017	2018f	2019f	2020f
Real GDP (annual % change)	2.0	1.8	2.1	2.4
CPI (y/y %, eop)	6.8	5.1	4.1	3.8
Central bank policy rate (%, eop)	7.25	8.00	8.00	7.50
Mexican peso (USDMXN, eop)	19.66	20.07	20.40	20.69

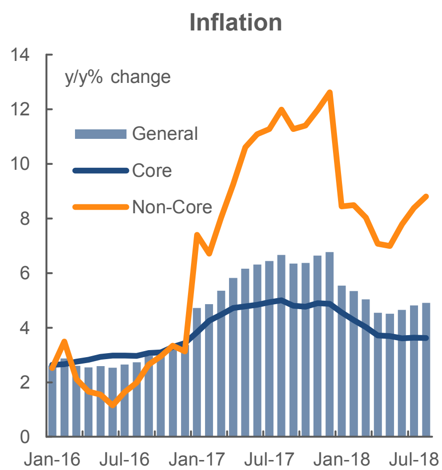
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, INEGI.

Chart 2



Sources: Scotiabank Economics, INEGI.

A few days ago, there were some unfortunate comments from the President Elect about Mexico being bankrupt, and warning that if something goes wrong with inflation and the macroeconomic stability, it will not be the fault of the President, but it will be on external circumstances or on Banco de Mexico's financial policy. Financial markets did not take that comment seriously because we all know Mexico's macroeconomic and financial conditions are pretty sound. Those comments could be the sign that reality is slowly sinking in, that the new government is realizing that available resources are scarce and the economic landscape is difficult to change. So, the federal Government budget to be presented to Congress no later than December 15th will provide the clues to really see what the new government will do and what promises will have priority. Until that happens, there is still some uncertainty affecting the public's expectations, even though we think that fiscal discipline and total respect for the macroeconomic stability will prevail.

Some positive developments have dissipated part of the prevailing uncertainty. The recently reached US-Mexico-Canada Agreement (USMCA) will keep the free trade in North America, even though it could have some negative impacts on regional competitiveness on certain industries, such as the automotive. Many new chapters could be positive for trade and growth in the three countries, but it is not clear as yet that economic prospects will improve dramatically from this event, mainly because we already had a functioning free trade agreement. Worth noting, mid-term elections in the US could affect the agreement. Another positive event to reduce some uncertainty was the appointing of Jonathan Heath to occupy a seat on the Banco de Mexico board as deputy-governor next December. Mr. Heath is a well-known economist with the necessary experience and, most of all, a clear independence reputation that will add to Banco de Mexico autonomy.

Turning to recent dynamics of the Mexican economy, we see a lackluster picture in the economic activity with GDP growing 1.9% real y/y in the first half of 2018 (the lowest since 2010 for such a period), although some marked contrasts are observed. On the positive side, services sector remains growing at healthy rates (+4.4% real y/y in July) with outstanding performance of retail trade (+7.1% real y/y), transportation (+5.6% real y/y) and financial services (+5.1% real y/y). Unemployment rate has been below 3.5% since last November and repetitive anecdotal information from our business clients refers to problems filling their vacancies, which suggests a very strong labor market. Our exports and imports are booming due to higher oil prices and to strong economic activity in our main trading partners. Financial activity keeps growing, with banking credit to the private sector expanding 6.0% real y/y in August. On the negative side, industrial output remains weak (+1.3% real y/y in July) with a persistent contraction in oil extraction that keeps mining activity on negative territory (-7.0% real y/y). Private consumption on the domestic market is decelerating and growing at weak rates (+1.6% real y/y in June) and fixed investment also weakening (+1.4% real y/y in June). Within banking credit, that devoted to consumption is decelerating, growing only 1.2% real y/y in August.

One of the most relevant concerns is inflation. After reaching 6.77% in 2017 (a level not seen since 2001), inflation was expected to rapidly descend as the temporary shocks of the previous year disappeared, but there have been some ugly surprises and inflation stopped descending in May (at 4.51% y/y) and rebounded to 5.02% y/y in September, pressured mainly by energy prices and some other shocks. With some heavy seasonal impacts in the months to come, and due to the recent methodology change in the National Consumer Price Index, we are expecting inflation to keep rising to a level slightly above 5% by the end of the year, and then descend to 4.1% by the end of 2019. One possible concern is the tight labor market, where there are frequent wage negotiations above 5%, which could produce some inflationary pressures in months to come.

Banco de Mexico has been decisively acting on the monetary policy, increasing several times the overnight rate to reach the current level of 7.75%, which represents a clear ex-ante real interest rate in restrictive territory, necessary to keep inflationary expectations well anchored. We were expecting the monetary reference rate to reach 8.5% by 1Q-2019; but now that the NAFTA uncertainty has dissipated, Banco de Mexico could have more time to remain on the sidelines. We are now expecting one more hike at the end of this year, to reach 8.0%; and then to remain on hold through all 2019.

The exchange rate is expected to remain sensitive to an increasingly complicated global financial environment, and then we still believe it will present volatility and end 2018 close to 20.07 pesos per US dollar and close to 20.40 pesos per US dollar by the end of 2019.

Economic activity will be somehow constrained by uncertainty. On the investment side, apart from the natural effect that heightened caution would have on businesses, a significant delay on public infrastructure spending is highly likely. Every time there is a change in administration, the learning curve of the new officials naturally produces a delay of public spending that affects total investment dynamics. On this occasion, the delay could be more accentuated, since a larger number of changes in the ranks of public servants is anticipated. On the one hand, there is a new group coming to power and many substitutions are expected; but on the other hand, the intended limit to public servants wages will most likely push the more talented to leave, while producing some negative selection that will imply a steeper learning curve for the new comers. In this environment, total investment is expected to contract throughout 2019, and private consumption is expected to decelerate as caution prevails among consumers. It could be argued that the intended new social programs will provide income to certain individuals, thus boosting consumption; but it is not clear yet if this incentive would not be at the expense of the middle class.

Mexico is passing through moments of important definitions. The new government is talking about the 4th transformation of Mexico while blaming the neo-liberalism as the root cause of many of the Nation's problems. High expectations from the people rose from campaign promises, and the new government should be very careful in the right mix of public policy to deliver while keeping in touch with reality, which along with market's discipline, will be the most relevant counter weight to prevent some unfortunate turn in the course of the country. The macroeconomic picture of the next couple of years will heavily depend on the public policy in the process of being defined.

Brazil

FISCAL ISSUES SHOULD TAKE CENTER STAGE AFTER THE ELECTION

- **Brazil's fiscal challenges are serious, and its politics does not seem conducive to a new reformist government with a legislative mandate taking over.**
- **External risks seem contained, outside of the pressure that tighter global financial conditions could exert on domestic financial markets, and through these to household, corporate and government balance sheets.**
- **The BCB should kick-off an aggressive monetary tightening cycle. How aggressive will depend on its ability to "get ahead of mounting inflationary pressures".**
- **We expect the gradual deterioration of macro-financial variables to continue, but the bottom line is Brazil looks like a train headed down the wrong track, but without any clear potential catalyst to trigger a derailing.**
- **Our base case and BRL forecasts envision the kick-off of the rate hike cycle, combined with the high yields already in place in the long end of the yield curve, triggering a hunt for yield behavior and boosting the BRL. We see the BRL's rebound as relatively short-lived, with the rally cut short by anticipated lack of progress on reforms.**

BRAZIL'S BALANCE OF RISKS DOES NOT LOOK PRETTY

Brazil faces important challenges regarding its fiscal situation, and we believe there is room for additional deterioration due to an expected fairly steep BCB tightening cycle, which should push interest rates materially higher, in a country where the average maturity of public debt is relatively short—thus meaning quick resets to higher rates. In addition, the new governments that seem the most likely to emerge victorious from Presidential elections held this month (first round was on October 7th, and Haddad and Bolsonary face a run-off on the 28th) seem unlikely to either be "reformist", or have a strong-enough legislative mandate to successfully pass much-needed fiscal and social security changes.

To some degree, Brazil reminds us of the film "The Good, the Bad and the Ugly":

The good:

- Relatively low dependence on foreign funding.
- FX reserve liquidity still very strong.
- Despite the ongoing, and in our view likely to continue, deterioration of the fiscal situation, we fail to see a potential near-term catalyst for more serious trouble. We don't see Brazil being caught up in the same degree of negative sentiment as Turkey or Argentina.

CONTACTS

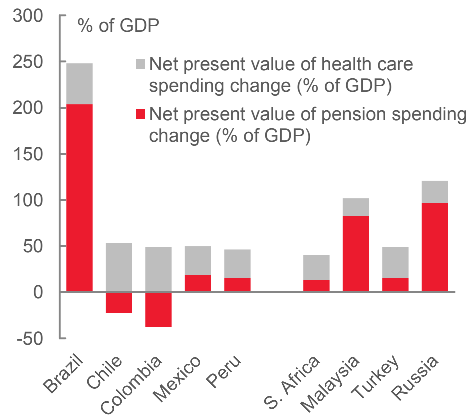
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Brazil	2017	2018f	2019f	2020f
Real GDP (annual % change)	1.0	1.3	1.8	2.1
CPI (y/y %, eop)	3.0	4.7	5.1	4.6
Central bank policy rate (%, eop)	7.00	7.25	9.75	10.00
Brazilian real (USDBRL, eop)	3.31	3.75	4.60	3.89

Source: Scotiabank Economics.

Chart 1

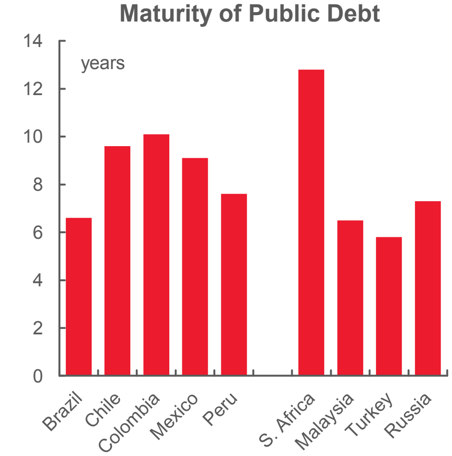
Net Present Value of Social Security Spending Change 2015-50



Sources: Scotiabank Economics, IMF.

Chart 2

Average Term to Maturity of Public Debt



Sources: Scotiabank Economics, IMF.

- Near term, we could even see a bounce in the BRL, as the steepening of the yield curve, and the BCB's expected hike cycle (if validated), can likely spark carry trade behavior, especially as global markets find their footing.

The bad and the ugly:

- The fiscal deficit is wide, and will require strong political will and power to solve.
- High debt burden, combined with structural high interest rates and a relatively short maturity is a bad cocktail.
- Is BCB already behind the curve? Suggesting higher terminal rate?
- Private sector also leveraged—potential spillover to public debt.
- Difficulty seeing reform scenario.

BRAZIL'S FISCAL SITUATION LOOKS INCREASINGLY SHAKY

Over the past couple of years, we have seen repeated disappointment over the Brazilian government's failure to reform the country's pension system, pummeling the prices of Brazilian assets, as well as the country's credit ratings which fell from BBB in 2011, to BB- currently (S&Ps). Focus on the failure of addressing the country's large unfunded pension liabilities is justified, but is only part of the country's problems. As the chart on page one shows, unfunded pension and healthcare spending liabilities in Brazil dwarf those of the LATAM investment grade universe, as well as those of other large EMs outside the region. Partly due to the cost of these liabilities (annual pension spending by the Brazilian government currently amounts to 9.1% of GDP, expected to climb to 16.8% of GDP by 2050), Brazil's fiscal situation looks increasingly weak. Gross public debt of the general government is rapidly approaching 90% of GDP, and this year's fiscal deficit is expected to be close to 8% of GDP. In addition, with the BCB expected to enter an aggressive monetary policy tightening cycle, and with the government's public debt having a relatively short average maturity (about 6 years), financing costs should add to the financing pressures the government already faces.

It's also worth noting that Brazil has a relatively shallow pool of domestic pension savings, which serve as a "buyer of last resort", and thus also appear to lead to more stable foreign investment. The lack of large stable domestic savings, combined with a weak fiscal situation could explain the low foreign ownership of Brazilian debt. Moreover, the composition of Brazil's public debt is not ideal, with a relatively small share being "fixed rate", and large near-term roll-overs (at a time of rising local and global rates), which presents a potential source of weakness in volatile markets:

Lack of a buyer of last resort, and sub-optimal debt composition are risks

Country	Pension assets (US$mn)	Gross public debt	Pension Assets / Gross Public Debt
Greece	1,254	$365,067	0%
India	23,472	$1,832,930	1%
Indonesia	17,034	$293,586	6%
Brazil	231,592	$1,725,763	13%
Poland	36,930	$269,697	14%
Turkey	35,216	$241,949	15%
Mexico	145,819	$622,668	23%
Russia	87,038	$266,345	33%
Colombia	64,578	$152,787	42%
Peru	41,177	$54,897	75%
S. Africa	146,148	$183,986	79%
Chile	174,479	$65,363	267%

Sources: Scotiabank, OECD, IMF.

Federal Government debt composition	% of total
Fixed rate	32
Inflation linked	29
Floating rate	29
FX linked	3
% maturing in the next 12 months	19

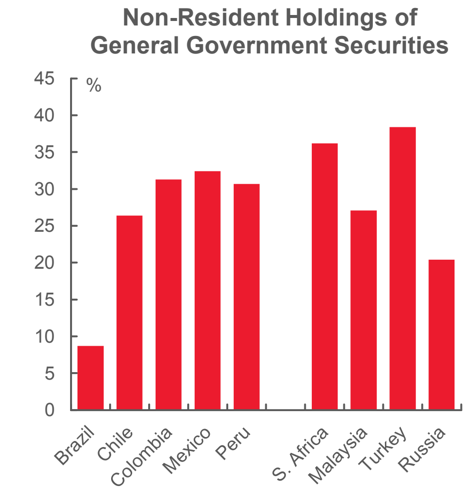
Sources: Scotiabank, Brazilian FinMin.

THE EXTERNAL SIDE OF THE EQUATION LOOKS BETTER:

However, not all aspects of Brazil's balance sheet are weak. The stronger points on Brazil's financial situation are robust FX reserve liquidity (1.55X optimum reserves, compared with 0.64 for S. Africa, 0.86 for China, 0.82 for Chile, 1.26 for Colombia, 1.07 for Mexico, and 2.74 for Peru), and a relatively small share of non-resident holdings of total government debt (see chart on this page). This suggests that Brazil's risks are more linked to domestic risks (i.e. failure to address pensions and fiscal imbalances, as well as the risk the BCB fails to get ahead of inflation, driving up interest rates), or externally linked due to rising global rates pushing up domestic interest rates—and thus debt service costs.

At the present time, we don't see a potential catalyst for a full blown crisis / hard landing. Rather, we see a continued run down the wrong path, which will lead to a continued gradual deterioration in macro-financial variables.

Chart 3

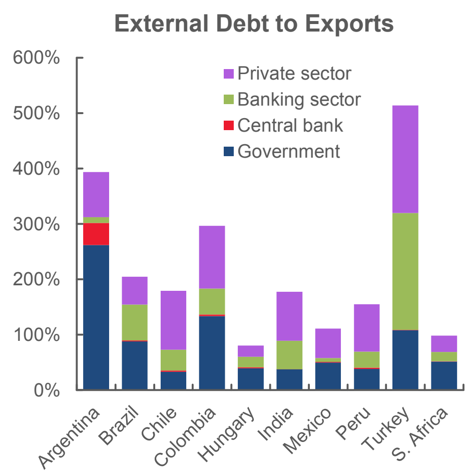


Sources: Scotiabank Economics, IMF.

WILL THE BCB STAY AHEAD OF INFLATION? THAT WILL BE THE KEY FOR THE TERMINAL RATE

Consensus and rates markets both expect the BCB to wait until after the elections before kicking off its rate hike cycle, during which it is expected to deliver close to 400bps of hikes over the next 12-months (388bps according to the DI-rate curve). Even though 400bps of hikes qualify as a steep cycle in most countries, it's worth bearing in mind that Brazil's "real neutral rates" are somewhere around 4.0–4.5% and, with consensus inflation sitting at 4.20% by the end of 2019, those 400bps of hikes take real rates into "moderately tight" territory, but only if inflation stays under control. If inflation moves to the top half of the range, we see risks that the tightening cycle could be steeper than expected by markets at the moment. Although we don't see this scenario of an even deeper cycle as a "base case" at this stage, we see three potential catalysts that could trigger this:

Chart 4



Sources: Scotiabank Economics, World Bank, UNCTAD.

- The first risk is that CPI inflation is trending higher (IPCA has risen about 130bps this year), manufacturing PPI stands at 15.1%—up over 1,000bps since January, and deteriorating!!, FGV IGPM inflation is now north of 10% (a composite of retail and wholesale prices, as well as construction costs), which points towards inflation already deteriorating.
- A second risk is that fiscal settings are ultra-loose (the fiscal deficit is expected to be around 8% in 2018), meaning the BCB may have to compensate with tighter monetary policy settings.
- A third risk is the BRL. Brazil has a relatively high FX-inflation pass-through, of 20–30%. If the new government fails to deliver reforms, market disappointment should drive a weaker BRL.

Hence, those 400bps of hikes that DI rates are pricing are only a lot if the BCB does indeed manage to get ahead of inflation expectations, and the fiscal ship is successfully tightened. For the time being, we'd argue that risks to our base case are towards tightening needing to be deeper than what we and consensus expect.

POLITICS DOESN'T SEEM CONDUCIVE TO REFORM

Although these still seems like a tough elections to call, the strong showing by "right leaning populist" Jair Bolsonaro in the first round (46%) suggests he has a strong kick-off point for the 2 weeks of second round campaign we now face. Lula heir-apparent Fernando Haddad (30%), may benefit from a consolidation of the more left leaning vote behind him. We expect both to tack to the center, in order to target the moderate vote. Bolsonaro has been somewhat unclear in terms of his economic agenda, but has spoken about potentially pursuing a more gradual pension reform than the current version being proposed. However, given the split of Congress / the Senate, which saw an emergence of non-traditional parties, and a robust showing by the left, we struggle to find a scenario where he could find a reformist mandate, even with post-election coalition building (the PSDB-PMDB failed to approve it back when they were a fairly harmonious coalition that had the PT on its knees). On the other hand, if Haddad were to emerge victorious, the PT has long opposed social spending cuts, as well as pension reform. In our view, it's hard to envision meaningful reforms being passed, without a severe financial pressure scenario pushing politicians to take bold steps.

WITH ALL THESE RISKS, WE REVISED OUR BRL AND SELIC RATE FORECASTS:

If inflation succumbs to PPI / fiscal pressures, and starts moving higher, while the BCB fails to get ahead of the curve, we could see the BCB's hike pipeline be even more aggressive. Although the election is extremely tough to call at this stage, we fail to see a likely scenario where a reformist with a mandate to execute change takes over. However, we think the kick-off of the BCB tightening cycle will trigger a BRL rebound, mostly chasing higher yields. We see that rally lasting a couple of months only, as reform disappointment, and fiscal concerns are likely to derail sentiment.

Colombia

COLOMBIA'S NEW GOVERNMENT SEEMS TO BE PREPARING FOR A TAX SYSTEM OVERHAUL

- **BanRep remains on hold, but we expect it to start hiking late-2018/ early-2019, as prices in some non-tradable elements in the core-CPI basket are trending higher, at the same time as foreign holdings of TES are dropping and the spread of BanRep's rate over the Fed is rapidly eroding.**
- **The big surprise from the central bank came from the announcement of a new FX reserve accumulation program through the options mechanism. The objective of the program is to boost reserves ahead of a potential reduction in the country's available resources through the IMF's FCL. No target size was announced, and we expect dollar accumulation to take place at times when COP is strengthening.**
- **On the fiscal front, the government has suggested it has plans to push for a fiscal reform, both to strengthen the country's financial position, but also to support an increase in potential growth. At this stage, it appears the government would like to reduce exemptions on VAT, and redistribute some income tax burden away from corporations.**

GROWTH GAINING MOMENTUM, CONVERGING TO POTENTIAL

After growth bottomed in 3Q2016 (at 0.6% y/y), we've seen it gradually accelerating to just under 3.0% y/y last quarter. We have for some time argued that Colombia's potential growth rate is somewhere between 3.0% and 3.5%. At the moment, although growth remains slightly sub-potential (2.8%), recent data seems to suggest that during Q3, we are likely to see growth print slightly above 3%, now that industrial production, which had been lagging, is picking up steam (coming in above 3% this summer). Our base case is that towards the end of 2018, growth will sit in the 3.0%–3.5% range, before settling down around 3.5% for the coming couple of years.

The Duque government has a fairly ambitious agenda to accelerate investment which includes, among other measures, reducing the tax burden on corporates (which currently pay around 80% of total income tax receipts), towards a stronger contribution by VAT (eliminating exemptions), and personal income tax. If the reform succeeds, we'd expect an upswing in investment, which has been slowing the past couple of years (from around 24% of GDP back in 2014, to around 22% last year). However, we don't expect higher investment to materialize until late in our forecast horizon, even if the tax reform gets implemented in the short term.

BANREP SHIFTS TACK—BUT ON FX, NOT RATES

As expected, [BanRep left its policy rate unchanged on September 28th], as headline inflation remained near the central bank's target range, at 3.1%. However, the bank did acknowledge that the components of the CPI basket that are showing upward momentum are non-tradable goods, which would argue in

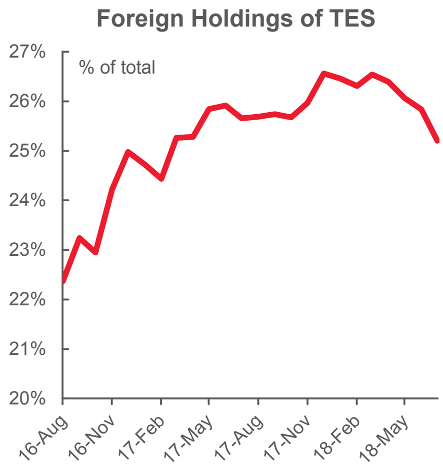
CONTACTS

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

Colombia	2017	2018f	2019f	2020f
Real GDP (annual % change)	1.8	2.5	3.5	3.6
CPI (y/y %, eop)	4.1	3.4	3.6	3.6
Central bank policy rate (%, eop)	4.75	4.50	5.50	5.50
Colombian peso (USDCOP, eop)	2,986	3,080	3,055	3,065

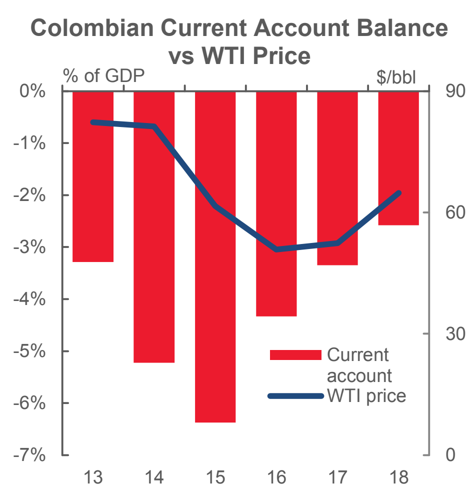
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Colombian Ministry of Finance.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

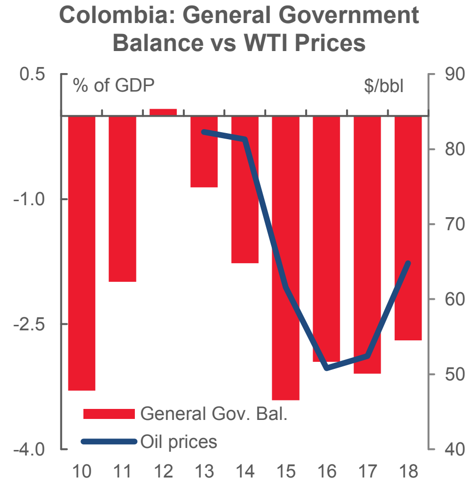
favor of mounting pressures (a large share of the disinflationary forces came from non-core items such as foodstuff, and FX-linked prices). BanRep is also comfortable with inflation expectations sitting at 3.2% for 2018, and 3.3% for 2019, although it's worth remembering these embed expectations for 90bps of hikes over the next 12 months, and 150bps over the next 2 years. The reasons behind the expected hike cycle by BanRep are likely more external than domestic. Colombian inflation is behaving well, but for a country with a current account that can be vulnerable (and its deficit is still relatively wide, despite its improvement alongside oil prices), and which already has foreign holdings of domestic debt dropping, keeping an eye on the spread between its policy rate and the Fed's seems wise. Note that the government has now formally acknowledged a drop in the country's "potential growth rate" from 4.8% back in 2012, to 3.5% in its 2018 estimate. This suggests that although the economy is still operating slightly below potential, it's now very close to it.

The big surprise in BanRep's statement came on the FX front. BanRep stated that with a potential reduction of the resources the country has available from the IMF's FCL (Flexible Credit Line, which offers the country access to about US$11.4bn) in 2020, the board decided to boost the stock of its FX reserves. The board and said it will not target any specific level, but kicked off with an initial auction worth US$400mn. Our sense is the reason no target was announced was that the central bank is comfortable with USD/COP at current levels, and does not want to trigger too much peso weakness, as this could result in pressure on the inflation front. Hence, we expect the central bank to accumulate reserves when the peso is strengthening. At the moment, Colombia's stock of FX reserves are 1.26X their "optimum level", according to the IMF's ARA metric—which is sound, but not spectacular.

Our Colombian rate forecast has the hike cycle kicking off a couple of months before consensus, but we have a shallower tightening cycle altogether. This is because we are expecting that BanRep will stay ahead of inflation, and be mindful of the Fed. If the cycle is delayed, we would expect a higher terminal rate—closer in line with what the local interest rate swap curve is pricing.

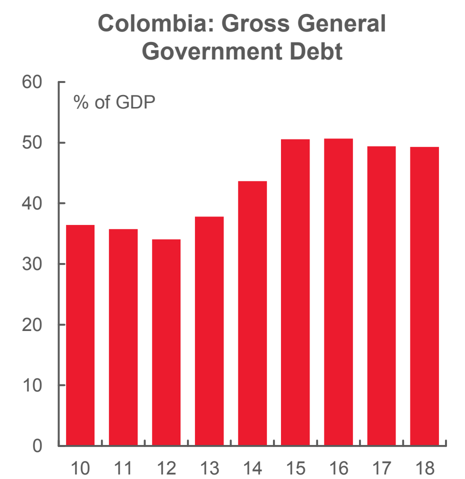
In terms of currency moves, USD/COP has been quite stable for the past 2.5 years, mostly moving sideways in a 2,800–3,150 range since early 2016. We expect that pattern to hold, although we have some moderate near-term weakening of the peso, which we mostly see resulting from the yield disadvantage that COP offers relative to other LATAM currencies, such as BRL and MXN. As the tightening cycle in Colombia gains traction, we see USD/COP stabilizing around its fair value of 3,000, resuming a mild depreciation pattern into 2020.

Chart 3



Sources: Scotiabank Economics, IMF, Bloomberg.

Chart 4



Sources: Scotiabank Economics, IMF.

FISCAL REFORM 1.0 FAILED, WHAT TO EXPECT FROM ATTEMPT 2.0?

The results from the last attempt at fiscal reform were underwhelming, failing to reduce dependence on oil-related revenues and help get fiscal dynamics back on an improving trend. Accordingly, Moody's sounded some warnings on Colombia's fiscal situation towards the end of September, although we don't think a downgrade is a near-term risk—and we also don't think it would be justified by the country's current fundamental metrics. There have recently been signals from the government that suggest a more ambitious fiscal reform could be pursued, as Duque has been talking about the need for a more competitive and "just" tax system, while at the same time FinMin officials seem to be on a tax education campaign.

Even though we have seen an improvement on the deficit front, as in the current account, the vast majority of it was due to the rebound in oil prices. Overall, the country remains too dependent on oil price dynamics. The recent meetings held by FinMin Carrasquilla and his team to discuss the country's tax structure suggest that plans for a deeper overhaul are in place. The overhaul of the tax system and the consolidation of public finances are also at the heart of the government's push to bring potential growth back to their previous highs, while their presentations suggest that a combination of security, poor infrastructure, and "crowding out" is hurting the country's growth prospects. There has been discussion by the new government about the cost that the gap-filled structure of the country's VAT has on overall collection, and also on the negative effects the tax structure could be having on investment. Our take is that two priorities on the tax reform will be: 1) reducing exemptions in VAT, and 2) re-distributing the burden of income tax away from corporations:

- Here, the government addressed the problems that the current VAT structure has, both in terms of relatively low collection, but also on the positive spillovers it could have on the collection of other taxes—if addressed. The government also stressed that the current basket of exempted and 0-rate goods is overwhelmingly benefiting higher-income households (at about a 3:1 ratio).

- The government also appears to be in a lobby offensive, seeking to rebalance the burden of income tax receipts away from corporations (which in Colombia account for 80.9% of income tax receipts vs countries such as Mexico where it is 52.2%, Brazil 64.2%, and the OECD average 32.6%), towards more personal income tax collection—which currently represents a very low share.

If this stab at tax reform is successful, we would expect several positive results: 1) a more attractive tax environment for corporate investment, 2) a stronger fiscal stance which is less reliant on oil, and 3) a less distortive overall tax structure in the country. At this stage, it's hard to handicap the odds for the government's success in this campaign.

Peru

THE DIFFICULT PATH OF GETTING BACK TO BUSINESS AS USUAL

- **Mild increase in our 2018 GDP growth forecast from 3.5% to 3.7%.**
- **Raising our year-end FX forecast for the PEN from 3.22 to 3.26.**
- **Volatility in monthly GDP growth figures distorts true picture.**
- **Political tension has revived, but metal price trends are more important.**
- **Inflation is contained and macro balances remain robust.**

Lately, Peru's FX rate seems more stable than GDP growth. Year-over-year GDP growth has slowed rather dramatically to a 2.0%–2.5% range in the June–August period, after tallying 7.8% in April and 6.5% in May. The reasons behind the sharp slowdown are somewhat of a mixed bag. Second quarter figures were an overstatement as they compared with a low base due to last year's El Niño. In addition, since June, resource sectors—especially mining and fishing—have declined for reasons mostly short-term in nature (temporarily low ore grades, and an off-fishing season). As a result, neither second quarter nor more recent growth figures adequately reflect the actual underlying growth trend. Perhaps the best indicator would be non-resource GDP growth, which is more linked to domestic demand, and which rose 3.3% in June and 3.9% in July. There has been, however, one worrisome change recently, namely, a sharp decrease in government investment in July–August. This may continue. Furthermore, political tension between Congress and the Executive has revived, which raises the question of how much it may affect growth. Although demand growth is fairly robust, and the business community has largely given signs of going back to a business-as-usual mode, there is also a sense that politics is getting in the way of public sector investment, and weighing down on the private sector to some extent.

It's not easy to fit the unpredictability of politics into our growth equation. We've long said that our 2018 GDP forecast of 3.5% had upside to it, but that upside has narrowed, given the low growth of recent months. We are raising our forecast only mildly, to 3.7%, to account for the upside, but this is still below consensus and government forecasts which are in the vicinity of 4.0%. We are maintaining our 2019 GDP growth forecast of 4.0%. We would have lowered our forecast due to political risk, and key metal prices underperforming expectations, if not for the recent announcement by Anglo American that it will go ahead with its USD 5bn Quellaveco copper mine investment. This compensates for the greater uncertainty that we see for 2019.

The brighter side is that, if you ignore politics and metal markets (if only that were possible) nearly all economic indicators are actually quite positive. Both fiscal and external accounts have been surpassing expectations, inflation has stayed well within the bounds of the Central Bank target range, and the PEN has continued to be the most stable currency in the region. The fiscal deficit has come down from

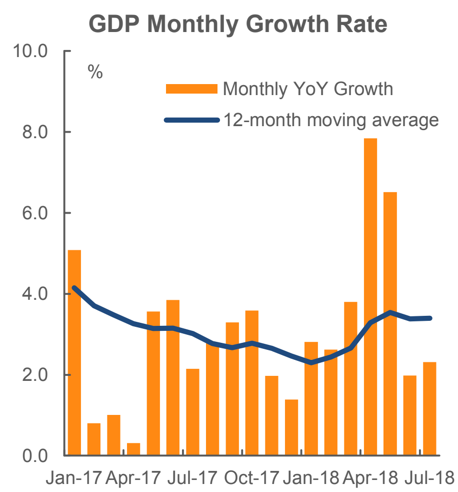
CONTACTS

Guillermo Arbe, Gerente Principal Estudios Economicos
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

Peru	2017	2018f	2019f	2020f
Real GDP (annual % change)	2.5	3.7	4.0	4.1
CPI (y/y %, eop)	1.4	2.0	2.5	2.5
Central bank policy rate (%, eop)	3.25	2.75	3.25	4.00
Peruvian sol (USDPEN, eop)	3.24	3.26	3.22	3.20

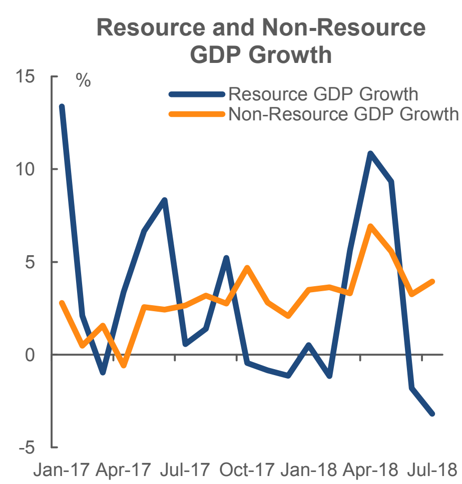
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, INEI.

Chart 2

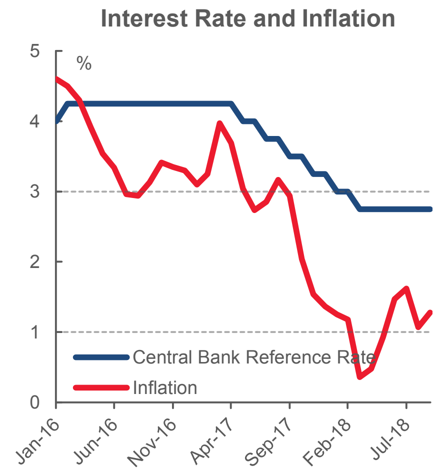


Sources: Scotiabank Economics, Central Bank of Peru.

3.2% of GDP at the turn of the year, to 2.1% in July. Importantly, the improvement is more from greater revenue—from both mining and domestic demand sales tax—than from low fiscal spending, which has also occurred. It will be a task for the government to spend enough to bring the deficit up to 3.0% by year-end. We hold to our 2018 2.8% full-year deficit forecast, but the risk is to the downside.

We also see no need to change our inflation forecast of 2.0% for the year. Yearly inflation to September came in at 1.2%, but should rise moderately henceforth. Monthly inflation will stay low in future months, but will temporarily compare with negative inflation in 2017. With inflation contained within its target range and GDP growth moderate, we continue to expect the Central Bank to not raise its reference rate, currently at 2.75%, until 2Q2019. The hardest price to forecast is the PEN/USD, since it has been driven by the USD, somewhat volatile in itself, and by speculation on how the trade war might affect metal markets, rather than by Peru's external accounts fundamentals per se. Even though we expect the market to correct from current levels of S/ 3.30–S/ 3.31, our forecast of 3.22 seems increasingly difficult to achieve. We are, therefore, raising our year-end forecast to 3.26.

Chart 3



Sources: Scotiabank Economics, Central Bank of Peru, INEI.

Chile

EXPERIENCING SOME HEADWINDS: GROWTH WILL DISAPPOINT CONSENSUS THE SECOND HALF OF 2018

- **Deterioration of some foreign conditions continued in the last months, with copper price falling below 280 US¢/lb. The US-China trade conflict has intensified which, together with the cyclical stage of the US economy and its differences with other developed economies has led to a global appreciation of the dollar and a fall in commodity prices.**
- **A surprising GDP growth of 5.3% yoy during the second quarter fed some exuberance for long-term growth. Domestic demand grew above expectations, reflecting a greater expansion of private consumption (mostly durable goods), an increase in inventory accumulation, and more dynamic investment in machinery and equipment.**
- **We foresee a deceleration to 3% yoy during Q3, consistent with a GDP growth for 2018 of 3.9%, below both consensus (4%) and the Central Bank baseline scenario (4.25%). The main drivers for good but not exuberant GDP growth during the second part of the year will come from deceleration of private consumption (particularly durable goods) and slow recovery in investment. Inflation expectations for the current year have increased due to volatile components, but are still well anchored at 3%. Central Bank will likely announce an increase of 25 bp to the MPR at the December meeting.**
- **Though domestic political conditions are stable, weakness in parliamentary support loomed again due to the tax reform. Government difficulties in accomplishing the main structural reforms might increase during the next months.**

MACRO UPDATE: WEAKER GROWTH DURING THE SECOND SEMESTER

Headwinds have continued or deepened in the last three months. Terms of trade worsened, and some domestic conditions seemed to lose some steam (like Government expectation of wide support for critical reforms). However, as said in July, there is a prevalent set of conditions that can help in avoiding extremely negative effects: (1) Government's commitment to fostering domestic investment; (2) fiscal consolidation; (3) sustainable external accounts and economic-institutional stability.

Not surprisingly, the GDP growth in Q2 continued accelerating, but data already available for Q3 are showing deceleration. The labor market is posting a weaker-than-expected recovery, which will affect the dynamism of consumption during the second part of the year. Consensus and economic authorities will be disappointed during the second part of the year, which might cause a slight reversal in consumer and business confidence.

On the inflationary front, the exchange rate upsurge and higher oil price inched up inflation expectations for the current and next year, but the market remains very

CONTACTS

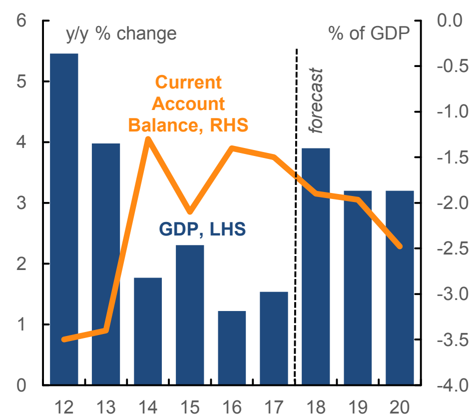
Benjamin Sierra, Manager Economista Mercado Financieros
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chile	2017	2018f	2019f	2020f
Real GDP (annual % change)	1.5	3.9	3.2	3.2
CPI (y/y %, eop)	2.3	3.2	3.0	3.0
Central bank policy rate (%, eop)	2.50	2.75	3.75	4.00
Chilean peso (USDCLP, eop)	615	650	650	640

Source: Scotiabank Economics.

Chart 1

GDP and Current Account Balance



Sources: Scotiabank Economics, Banco Central de Chile.

conscious that causes are related to highly volatile items, while core inflation is evolving as expected. The Central Bank estimates that the current monetary stimulus is less necessary and will begin reducing it in the coming months with the next move likely at the December meeting. Finally, a very prudent and coordinated fiscal policy is expected to help avoid pressures due to rapid increases in the MPR. The 2019 budget report expects a 3.2% expansion in public expenditure (3.6% for current spending and 1.2% for public investment), the lowest since 2011 and below the GDP growth forecasted by the authorities for 2019. To be discussed in coming weeks, the reaction of the private sector was mostly positive.

Long term rates have retaken a smooth uptrend recently. There are many factors behind this: likely boosted in part by higher inflation expectations, by the Central Bank's less dovish speech, and by higher external interest rates. Though an uptrend seems the most likely scenario in coming months, a dramatic upsurge is not expected, though volatility will likely persist. One critical factor will be the exchange rate, whose wide trading range was remarkable in last two months. Our baseline scenario is a USDCLP around 650 by the end of 2018 and 2019.

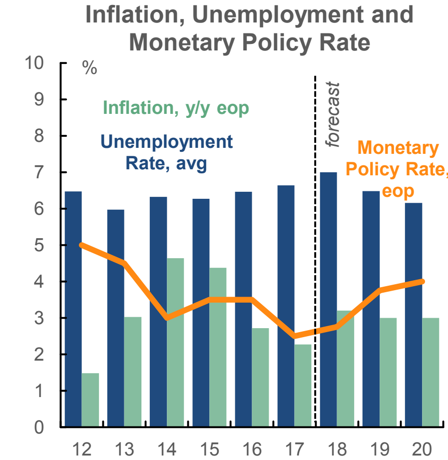
POLITICAL PANORAMA: STILL FEW CHANGES

Politically, everything points to more difficulty to get the minimal support required to accomplish critical improvements and modernization, like that related to the tax framework, the pension system or labor regulations. On the other side, the opposition has intended to achieve some cohesion as a response to specific matters but has not been able to go much further, suggesting they still are not well organized and some wounds have not healed yet. If the Government were able to tap that, some critical reforms could go faster and better. There were some less-negative-than-expected reviews regarding the 2019 budget. The Government maintained its decision to accomplish as much as possible through non-legislative methods, but it is not quite clear how far this can go. As said, in politics time is limited and when some foreign conditions are becoming riskier, time is a critical variable.

MAIN RISKS

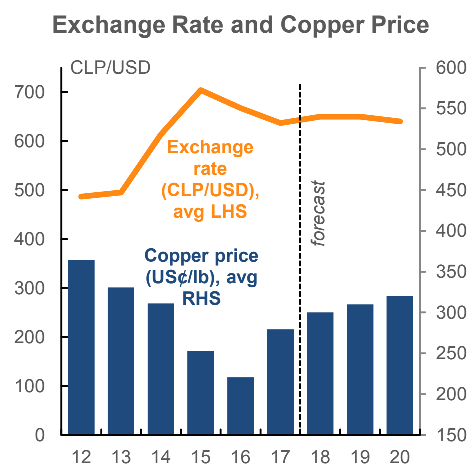
Despite variables having changed intensity, the structure of risks for the Chilean economy has not changed. Copper price, which affects not just the fiscal budget or the exchange rate, but is a keystone for private expectation, seems to have reached the bottom but it is still below the level reached in mid-2018. Expectations for the copper price are critical in the current stage of the cycle, because of its influential effect on investment decisions. Regional risk remains high, especially that from South America's large 'Atlantic' countries—Brazil and Argentina—which is not devastating but not positive either for the outlook. Another positive factor is the declining but still significant popularity of the President. These elements should be kept the sight in coming months to analyze risks.

Chart 2



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

Chart 3



Sources: Scotiabank Economics, Reuters Eikon