Global Economy

Be Careful with Year-End Cheerfulness
World growth will only be marginally better in 2013. Prospect of a quick resolution of the fiscal cliff in the U.S. appears exaggerated. And we doubt that investors will remain unworried about the waiting game in Spain for much longer

Brazil

The Elusive Quest for Growth
GDP disappointed in the third quarter and growth in 2012 and 2013 is bound to be weaker. More stimuli may follow, including lower interest rates

Argentina

November Rain
The government is facing tough political challenges, while U.S. court rulings favorable to the holdouts have increased the likelihood of a technical default. The economy is still far from making a solid rebound

Mexico

Reforms Advance
Growth disappointed in the 3Q12, while inflation continues to fall. We revised our scenario for 2013, and now expect lower inflation, no rate moves, and a stronger exchange-rate appreciation

Chile

Growth Surprises Once Again
External risks, under control inflation, and a widening current account deficit will likely prevent interest rate hikes

Peru

“Mine” Your Own Business
As uncertainty over mining is left behind, economic growth is back at higher speed

Colombia

Just a Cyclical Slowdown
While consumption has been losing steam, investment spending remains healthy

Commodities

Increased Supply and Mixed Performance
Stabilizing growth in China and geopolitical risks also affected commodity prices

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The Elusive Quest for Growth

As the end of the year approaches, there is some positive news in the global landscape. Although not accelerating, the world economy is at least stabilizing. Markets seem eager to join in the year-end celebrations.

We still see volatility on the horizon. The risk of a fiscal cliff in the U.S. continues to linger. And we doubt that investors will remain calm about Spain for much longer, without intervention by the European Central Bank.

Commodity prices have taken diverging paths. While a better-than-expected crop generated lower agricultural prices, energy prices have benefited from worsening geopolitics and metals have been sustained by a firmer outlook for China.

The Brazilian economy disappointed yet again. Investment spending is just not recovering as expected. In response, we will probably see a new round of policy stimulus, including interest-rate cuts and a weaker-than-expected exchange rate.

Elsewhere in Latin America, the scenario remains positive. Mexico’s reform agenda finally made progress, with the approval of a new labor-market bill that is expected to generate greater optimism about advances on other fronts. Chile and Peru’s economies remain on a fast track. Robust fundamentals continue to boost investment in Colombia, despite the cyclical slowdown in credit and manufacturing.

In Argentina, however, challenges continue to mount. Lower grain prices, protests against the government, and a possible new technical default are fresh additions to an already-cloudy outlook.

Hope you enjoy,
Ilan Goldfajn and Macro Team
Global economy

Be Careful with Year-End Cheerfulness

World growth will only be marginally better in 2013. Prospect of a quick resolution of the fiscal cliff in the U.S. appears exaggerated. And we doubt that investors will remain unworried about the waiting game in Spain for much longer.

Financial markets appear eager to join in the end-of-the-year celebrations. The stabilization of the global economy and positive activity data in the U.S. and China provide support. However, we see the world growth at 3.0% in 2013, only marginally better than the 2.9% of this year. Not a slowdown, but definitely a low-growth environment.

We also fear that the chances of some bumps ahead are higher than markets are factoring in. Despite some optimism after the election, the risk of the fiscal cliff lingers on in the U.S. And we doubt that investors will remain calm with Spain much longer if the country doesn’t becomes eligible for the European Central Bank (ECB) bond-buying program.

Central banks have been in an ultra-active mode in the past year, won’t they give a further push and counterbalance any risk? Some will try, but alas, central banks in the developed world are at their limits. We are skeptical about the stimulating capacity of monetary policy ahead and see fiscal policy – balancing necessary adjustments without too much damage to activity – as the main game in town.

Finally, we are lowering our price forecasts for agriculture commodities because of lower-than-expected prices in November and a better supply outlook. As a consequence, we now expect the Itaú Commodity Index (ICI) to increase only 13.7% in 2012 (previously 19.2%).

Europe

Official creditors approved the disbursement of €44 billion ($57 billion) to Greece. The deal solves the country’s cash needs in the short term. However, the government debt remains unsustainable. Without a definitive solution for its debt problem – which depends on the currently politically unacceptable official loans haircut – Greece will occasionally return to the spotlight.

Spain continues to access bond markets at reasonable volume and cost. In November the treasury issued €8.6 billion at an average yield of 4.6%. As long as this situation persists, the government of Mariano Rajoy will probably keep suggesting that the country is ready to request aid from the ESM, but say it doesn’t need it and not ask for it.

The Spanish government points out that foreign investors returned to Spain after the ECB launched its new bond-buying program (called Outright Monetary Transactions – OMT). Indeed, preliminary data show that the share of sovereign debt held by nonresidents increased 2.3 percentage points in September.

However, in our view, this equilibrium is not sustainable and at some point the pressure will return. The fiscal adjustment, deleveraging and rebalancing of the Spanish economy to tradable sectors remain challenging. Giving the uncertainties and without actual ECB interventions, we don’t believe that foreign investors will keep increasing their holdings. Without their flow, domestic institutions are unlikely to absorb the €120 billion of bonds Spain will need to issue next year.

Therefore, as Spain moves into 2013 without being eligible for the ECB’s OMT, we could see sovereign yields trending up. But it might take some bond-auction failure to finally trigger an aid request.

France gained the media spotlight in the past month. An IMF paper and a special country report in The Economist warned about the country’s bleak prospects. Moody’s downgraded France’s government bonds’ rating by one notch to Aa1 from Aaa.
The French economy in fact shows weakness. Unit labor cost increased significantly and the external current account turned negative in the past decade (see graph). And the French government spends 56% of GDP, more than any other country in the euro area.

However the country has time to adjust and President Hollande started to address some of these problems. Last month he announced €20 billion in tax rebates (1% of GDP) to firms so they can increase their competitiveness. And despite adopting some flagship campaign promises – like the 75% tax rate for income above €1 million – the socialist government has broadly maintained its fiscal targets.

It is true that a lot more needs to be done. The fiscal consolidation so far focuses on increasing revenues, which depend on rosy growth assumptions, and doesn't attack the size of the government. The country's impetus for structural reforms also appears limited by various taboo areas (the 35-hour work week is an example). In any case, France has more a medium- to long-term problem to deal with, rather than facing an immediate collapse.

GDP in the euro area declined 0.05% seasonally adjusted in 3Q12, in line with our 0% forecast. One-off factors – VAT increase in September and statistical issues with working days and seasonal adjustment during the European summer – provided a brief relief to output. We foresee the recession intensifying again in 4Q12, with GDP dropping 0.25%.

Looking into next year, we see some downside risks to our forecast. Purchasing managers’ indexes available to November show little sign of recovery and are compatible with GDP contracting around 0.4% per quarter (see graph.) This contrasts with our baseline scenario, in which output is already flat in the 1Q13 and turns slightly positive afterwards. If leading indicators don’t improve soon, we might need to lower our forecasts again.

Given the weak economic outlook, we expect the ECB to cut its main rate by 0.25% to 0.50% in the 1Q13.

U.S.

Economic indicators in the U.S. surprised on the positive side to October. Hence GDP growth in 3Q12 was revised to a 2.7% seasonally adjusted annual rate, from 2.0% in the advance estimate. The revision lifted our growth estimate to 2.2% from 2.1% in 2012. We don't, however, believe that the better trend would persist, as most of the gains appeared to be transitory, stemming from higher inventory accumulation and exports.
More recently, hurricane Sandy has been distorting the activity data. Our surprise index has started to trend down as more economic indicators missed the consensus forecast (see graph). Most data releases should continue to be negatively distorted until year-end, as energy supply remained significantly below normal levels during the first half of November. Only high-frequency weekly economic data - like initial jobless claims - should start to rebound in the coming month.

Nevertheless we had already discounted the impacts of the storm. Our economic outlook remains the same, with GDP expanding 1.8% in 2013.

Fiscal policy – not monetary – is the main game in town

Market participants vigorously discuss the next steps by the U.S. Fed. We do expect the FOMC to move in December and next year. However, the latest round of stimulus – the open-ended quantitative easing from September – had only short-lived effects. We don't believe that next time will be different. With the fiscal cliff still unresolved, fiscal policy is by far more important at the moment.

Hopes for a quick resolution of the fiscal cliff increased as Congressional leaders publicly expressed their aim to reach a deal before the year-end. However the Republicans rejected the first proposal by President Obama, indicating that two parties are still far apart.

A middle ground on many contentious political interests still must be negotiated. Republican leaders say they would support raising revenues only through closing loopholes and limiting deductions, not raising tax rates. Obama claims that a balanced fiscal adjustment should include higher tax rates for the upper-income households. Republican leaders also demand that any increase in revenues should come together with Social Security and Health Care reforms. These entitlements reforms would impact disproportionately the low- and middle-income households, leaning against the balanced fiscal adjustment proposed by President Obama.

We continue to expect a hard-fought compromise deal to be reached only in 1Q13, avoiding retroactively the full impact of the fiscal cliff. The political uncertainty should remain a source of volatility for financial markets.

Monetary policy is not a game-changer, but the Fed will keep trying to further stimulate the economy with balance-sheet and communication policies. The last FOMC minutes revealed that they should announce the replacement of Operation Twist with Open-Ended Treasury Purchases in their next meeting on December 12.

The FOMC is also likely to replace calendar-based guidance with an outcome-based forward guidance for the Fed Funds rate. But we see its implementation only in 1H13, because the committee is sorting out some practical issues. Moreover we think the Fed will opt for a qualitative outcome-based forward guidance rather than quantitative targets. Setting explicit thresholds for inflation or the unemployment rate would reduce future policy flexibility more than the Fed appears to accept.

China

October data reinforced the growth-stabilization trend. Industrial production was 9.6% higher than one year ago, an improvement from the 9.2% pace in September. Investment, pushed by infrastructure, and consumption remained firm. Nominal fixed-asset investments were up 22.2% yoy in October, similar to the previous month. Infrastructure growth went up to 23.9% from 23.4% and retail sales
picked up to 14.5% from 14.2%. Inflation slowed to 1.7% from 1.9%, and should remain below 3% in the next few months.

The new Chinese leadership was unveiled in November. Xi Jinping emerged as the new leader and consolidated his position. He succeeded Hu Jintao both as General Secretary of the Communist Party and Chairman of the Central Military Commission, posts usually occupied by the main Chinese Leader. Note that, similarly to arrangements in the past, Hu Jintao could have stayed on as the military chairman for a couple more years. The fact that Xi Jinping has already assumed this position helps to solidify his political power. The perception is reinforced because the Politburo Standing Committee, the highest governing body, has been shrunk from 9 to 7 members, with most of them politically close to Xi.

Looking forward, the transition process should proceed smoothly without disruption of economic policies in the short term. Some of the new leaders already belonged to the party's political core. Additionally, the current transition was in the Communist Party but not in the government. Hence, we do not expect major policy changes, at least until the new leaders take their government positions in March of next year.

With activity data broadly in line with our scenario and a well-coordinated political transition, we maintain our GDP growth forecast of 7.6% in 2012 and 7.7% in 2013.

Japan

Japanese economic growth continues decelerating. The economy contracted 0.9% in the third quarter, worse than our -0.5% forecast. Net exports contributed -0.7 percentage points, reflecting the sluggish external demand and hurt by political dispute with China in September. With weak corporate sentiment, capital expenditure declined 3.2% in the quarter. Personal consumption fell 0.5% qoq, compared with a drop of 0.1% in the second quarter, because of the end of the eco-car subsidies in September. On the positive side, public-sector demand provided some support, with government spending and public fixed investment contributing together 0.2 percentage points.

After two consecutive months of additional easing, the Bank of Japan (BoJ) stayed on hold in November, as expected. However, the political pressure on the BoJ to take bolder monetary action in the next meetings could rise substantially.

In November, Prime Minister Yoshihiko Noda dissolved the Lower House and called elections for December 16. The earlier election was a demanded by the opposition parties, in order to pass a bill to allow the issuance of deficit-covering bonds for the remaining of this fiscal year. Shinzo Abe, the main opposition leader and frontrunner to lead a new administration after elections, has called for bolder monetary action and more government intervention in the BoJ decisions.

Notwithstanding the recent additional stimuli and the possibility of more to come, we expect the weakness in activity to persist. We see GDP contracting 0.1% in the fourth quarter, down from our previous forecast of a 0.1% expansion. We revised our GDP forecast to 1.6% from 2.0% in 2012, mainly reflecting the fourth-quarter revision and the weaker-than-expected third quarter. For 2013, we lowered the output expansion to 0.4% from 0.7% in 2013, due to carry-over effects.

Commodities

After falling 4.2% in October, commodity prices remained flat in November, but with a mixed performance across different groups.

Agricultural prices fell 2.4%, driven by better supply outlook. Soybean had the sharpest decline, with the upward revision to the crop's production in the U.S. and favorable weather conditions in Brazil and Argentina. We still expect low inventories to lead to a price recovery in December. But the rebound will be smaller than we previously expected. We revised our price forecast for the end of the year to
1500 cents per bushel from 1750. For next year, prices should remain relatively high until exports from South America resume by the end of the first quarter.

Despite better supply prospects, the violence in the Gaza Strip kept oil prices firm in November. Following the cease-fire, we expect tension over Iran’s nuclear program to return to the media and sustain high prices, offsetting sector fundamentals and worries about the fiscal cliff in the U.S. We maintain our forecast of crude price (Brent) at $112 by the end of 2012 and at $115 by the end of 2013.

Base metal prices rebounded mildly, rising 4.0% in November. Supply prospects for copper improved, but growth stabilization in China pushed prices up. China’s stockpiling of aluminum and zinc also contributed to the movement.

Finally, we are revising down our year-end forecasts for the ICI. We now expect an increase of 13.7% in 2012 (previously +19.2%) and a decline of 4.1% in 2013 (previously -7.7%).

**Forecasts: World Economy**

<table>
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<th></th>
<th>2007</th>
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<th>2010</th>
<th>2011</th>
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<td>79.6</td>
<td>81.9</td>
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Source: Central Banks, IMF, Haver and Itaú.
* The DXY is a leading benchmark for the international value of the U.S. dollar, measuring its performance against a basket of currencies that includes the euro, yen, pound, Canadian dollar, Swiss franc and Swedish krona.

**Brazil**

The Elusive Quest for Growth

*GDP disappointed in the third quarter and growth in 2012 and 2013 is bound to be weaker. More stimuli may follow, including lower interest rates*

We have reduced our forecasts for GDP growth to 0.9% from 1.5% in 2012 and to 3.2% from 4.0% in 2013. The negative surprise with GDP in 3Q12 and the expectation of slower expansion in capital expenditures have affected forecasts for growth this year and next. In a scenario of weak economic activity, we believe that the government will opt for lower interest rates and a weaker exchange rate to stimulate growth. We incorporated a 100-bp cut in the benchmark Selic interest rate in 2013 (ending the year at 6.25% vs. 7.25% in our previous call). Our year-end forecast for the exchange rate for 2012 was revised to 2.10 reais per U.S dollar and for 2013 moved to 2.15 (from 2.02 previously). We raised our estimate for the consumer price index (IPCA) for 2013 to 5.5% from 5.3%, considering a weaker currency and an increase in fuel prices, despite weaker activity. We revised our forecast for the trade surplus in 2012 to $19.5 billion from $20.5 billion, and to $20 billion from $18 billion in 2013, with the current-account deficit at 2.2% of GDP (from 2.3% previously) in the next year. We revised our forecast for the primary budget surplus to 2.3% of GDP from 2.4% in 2012 and to 2.1% of GDP from 2.2% in 2013.

Investment does not take off and GDP forecasts drop

GDP grew by only 0.6% qoq/sa in the third quarter, at half the pace that was expected. Previously it was the industrial sector which was not growing, now the service sector is the disappointing one.
Private consumption remains solid, but the retreat in investments was sharper than expected, and exports and government spending were also weak.

With a disappointing third quarter and an outlook for tepid growth in the fourth, total growth in 2012 will be lower. The rebound which could have fostered more optimism, boosting business confidence, did not happen as expected. Worries about the future remain, leading to lower investments – and that will affect growth in 2013.

More stimuli are bound to be announced. In addition to more tax breaks, lower interest rates and a weaker exchange rate may be part of the toolbox in 2013, as was the case this year. Such stimuli may help the economy, but reducing domestic uncertainties in order to take advantage of incentives to growth is crucial, particularly in a still very uncertain world.

In the credit market, new consumer loans fell by 1.9% mom/sa in real terms in October, while new corporate loans retreated by 2.0%. Interest rates and spreads declined. Seasonally adjusted delinquency rates for loans more than 90 days past due are stubbornly stable at high levels. But the performance of new loans continues to suggest a drop in future delinquency.

Outstanding loans rose more strongly during the month (1.4%). Earmarked credit, particularly housing and farm credit, continues to take the spotlight. State-owned banks continue to increase their market share. Favorable conditions in the labor market and the expectation of lower delinquency suggest moderate credit expansion in the next few months.

Given the current outlook for economic activity, we cut our forecasts for GDP growth in 2012 and 2013. The expansion in 2012 was directly impacted by the weaker result in the third quarter. Signs for the fourth quarter already point to a more moderate expansion. We therefore lowered our forecast for GDP growth in 2012 to 0.9% from 1.5%.

The statistical carryover to 2013 GDP is declining. A more moderate expansion in the economy in 3Q12 and the pace expected for 4Q12 reduce the outlook for 2013. Furthermore, we believe that this uncertainty about the domestic rebound will have negative consequences for investment decisions. Therefore, we also reduced our forecast for GDP growth in 2013 to 3.2% from 4.0%, already taking into account the additional stimuli.

**A weaker currency, but high FDI**

After another quarter trading in the range of 2.01 to 2.05 reais per U.S. dollar, the exchange rate broke the dynamic of low volatility in November and reached over 2.11. Behind this move, there was an increase in global uncertainty, intensified by technical movements that are triggered when the exchange rate breaks certain levels. However, in contrast to what we have seen previously, the Central Bank acted in the market only at levels above 2.10 reais per dollar. Given weakness in growth and economic policy signals toward raising competitiveness through a weaker exchange rate, we revised our year-end estimates for...
the exchange rate to 2.10 reais per dollar in 2012 and to 2.15 in 2013, from 2.02 in both years.

In October, foreign direct investments (FDI) hit $7.7 billion, topping the most bullish of expectations. The current-account deficit, on the other hand, widened to $5.4 billion, due to a smaller trade surplus, more profit and dividend remittances and greater spending on international travel. For other flows, we continue to observe robust borrowing abroad and an outflow from the local stock market. We maintain our FDI forecast at $63 billion in 2012. Trade balance stood below our forecast in November. As a result, we revised downwards our projection to $19.5 billion from $20.5 billion in 2012.

A weaker exchange rate and lower economic growth impacted our forecasts for the trade and current account balances. Our call for the trade surplus in 2013 climbed to $20 billion from $18 billion, and our estimate for the current-account gap in 2013 slid to 2.2% of GDP from 2.3%.

**Falling fiscal performance**

Budget trends and outlook have changed little last month. Tax collection still loses steam, as activity remains sluggish and the impact of tax cuts begins to show. Moreover, federal spending is moving in high gear, at a pace of 6% from year-ago levels in the six months to October. The current speed of government spending exceeds estimates of potential GDP growth, which confirms an expansionary fiscal policy stance on the expenditure side.

The public sector's trailing twelve-month balance continues to downtrend. In October, it reached the lowest level since the end of 2011 (around 2.2% of GDP). Monthly budget results point to an increasing risk that the government will have to resort to deductibles on top of the 25.6 billion reais projected in the last budget review. For this year, spending on the PAC (infrastructure) program may deduct up to 0.9% of GDP from the 3.1% primary surplus target. We forecast a primary budget surplus of 2.3% of GDP for 2012 (previous forecast: 2.4%). Our estimate still counts on a temporary improvement in fiscal performance in the fourth quarter.

For 2013, we are revising down our primary surplus projection to 2.1% of GDP, from 2.2%. Signs of a slower than expected recovery, imply a less pronounced rebound in cyclical revenues (i.e., those strongly influenced by activity). A weaker tax collection reduces the room for future tax cuts, and limits somewhat the expansion of public spending (especially investment). According to our estimates, if the government maintains the fiscal target written in the 2013 Budget Law Guidelines (LDO) - allowing fiscal deductions of up to 1.0% of GDP in PAC expenses – there will be little room for additional stimulus. In this case, the decision to make is: more tax breaks or more public investment?

**A weaker exchange rate and future fuel price increases maintain inflation high in 2013**

We maintain our IPCA forecast at 5.5% in 2012. Current data indicate that the slowdown in food prices and the decline in agricultural prices have run their course. December data should already show more pressure on food prices at the retail level and a pickup in producer prices for agricultural items. According to our forecasts, market-set prices will rise by 6.2%, while regulated prices will increase by 3.4%. Among market-set prices, we expect gains of 4.3% for tradable goods and 7.9% for non-tradable goods.

We raised our forecast for the IPCA in 2013 to 5.5% from 5.3%. Even with the downward revision to our growth forecasts and more benign commodity prices, we anticipate high inflation due to a weaker currency and a possible 5% hike in gasoline prices next year, with a 0.2 p.p. impact on the IPCA.
We revised downward our forecast for the general price index (IGP-M) in 2012 to 7.5% from 7.9%, due to the postponement of fuel-price increases to next year. As a result, we revised upward our forecast for IGP-M in 2013 to 4.8% from 4.2%. We also took into account in this forecast the BRL depreciating to 2.15 at the end of 2013.

Interest rates: a change in direction, given headwinds to growth

The monetary policy committee (Copom) maintained the benchmark interest rate unchanged at 7.25% p.a. in its November meeting. The decision was unanimous and in line with our view and market expectations. The statement that accompanied the decision was the same as the one released in the previous meeting, in which the Copom indicated that the Selic rate will be stable for a “sufficiently prolonged” period (we dubbed it “flying at a cruise level”).

The signal shows confidence in a lower equilibrium real-interest rate, but also that current rates maintain economic stimuli. But we believe the cruise level of interest rates will be changed. There are now more headwinds to economic growth. We expect the Selic rate to go down again in March, with a 50-bp cut, and another cut of the same magnitude in the following meeting. Therefore, we expect the Selic rate to end 2013 at 6.25% (from 7.25% previously).

Forecasts: Brazil

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<th>Economic Activity</th>
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<th>2011</th>
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Source: IMF, IBGE, BCB, Haver and Itaú

(For our monthly Brazil forecasts, click here.)
Argentina

November Rain

The government is facing tough political challenges, while U.S. court rulings favorable to the holdouts have increased the likelihood of a technical default. The economy is still far from making a solid rebound.

We have revised our GDP forecast for 2013 downward, to 2.0% from 2.5%. We expect Argentina’s trade balance to record surpluses of $12.0 billion in 2012 and $10.0 billion in 2013, and we anticipate drops in international reserves of at least $1.0 billion by the end of this year and $1.4 billion in 2013 (flat in with our previous 2013 scenario). We expect the exchange rate to depreciate at a 15% annual pace this year and by 17% in 2013, reaching 4.95 pesos to the dollar by the end of 2012 and 5.80 by the end of 2013. We forecast that inflation will continue to rise, to 25% by the end of 2012 and to 28% by the end of next year. The interest rate will likely hit 17% in December 2012 (down from 18% previously) and 21% by the end of 2013 (from 24%). We forecast fiscal deficits of 2.6% of GDP this year and 2.7% of GDP in 2013.

The odds of a new sovereign default have increased due to adverse rulings in U.S. court proceedings regarding violations of the pari passu clause in international bonds. Argentina appealed and won a temporary suspension of the injunctions.

On pots and pans

November was the most difficult political month President Kirchner has yet undergone. On November 8, thousands of Argentines (mostly middle class) took to the streets banging pots and pans to protest against the government, complaining of rising inflation, high crime rates, corruption, foreign exchange controls and a lack of media freedom. Twelve days later, Kirchner faced a national general strike organized by dissident unions demanding increases in pensions and in the minimum wage subject to income tax. One day later, on November 21, U.S. district judge Thomas Griesa ordered Argentina to deposit US$ 1.3 billion in an escrow account before December 15 to guarantee payments to holdouts. In the second week of December, President Kirchner will face another test when the judicial shelter constraining the implementation of the new media legislation expires and the government may intervene in media groups. Such an intervention could generate another counter-reaction against the incumbent.

There are three new elements in the Argentine political landscape: growing social discontent, presidential weakness and an incipient struggle for the presidential succession. President Kirchner is now seen by Argentine society as a weak leader. That image undermines a political system that is characterized by the dominant role of the executive. The sooner-than-expected introduction of her re-election ambitions onto the political agenda overshadowed the 2013 mid-term elections, and some potential presidential candidates from the Peronist party are emerging. The key issue for political analysts is “governance” (to have control of what happens in the country). President Kirchner may become a lame duck.

Public debt: dancing with wolves

At the end of October, the New York Court of Appeals ruled that Argentina discriminated against bondholders who refused to take part in the massive debt restructurings in 2005 and 2010. On November 20, a U.S. district court ordered Argentina to deposit US$ 1.3 billion in an escrow account by December 15 in order to guarantee payment in full to these holdouts. The decision affected the Bank of New York and other intermediary institutions, so Argentina was inhibited from servicing the restructured debt without paying the holdouts. Finally, the judge lifted the stay (temporary suspension of the decision) on his past ruling, arguing that Argentina has threatened to disobey the court on many occasions – meaning that from December 15 onward, Argentina could not make any payment to the owners of the restructured debt without also paying the holdouts. Argentina appealed the district court ruling, and at the end of November it got a reintroduction of the stay from the Court of Appeals. A
group of holders of restructured bonds filed in support of Argentina. The court set an agenda for receiving statements, proposals and discharges from the parties in the coming months. A hearing will be conducted on February 27, when the court is expected to decide how to continue the process and on the status of the stay. The reintroduction of the stay greatly reduced the risk of a default in the very near term.

The restructured bonds have a clause that compels Argentina to extend any better deal with holdouts to holders of restructured bonds. Thus, if Argentina pays the holdouts in full, it can bring the debt back to pre-default levels. So it seems that the only way to settle the impasse is through a ruling that would force holdouts to receive payments as if they had entered the restructuring. In fact, the government may take the legal steps to reopen the exchange offering.

If the Court of Appeals confirms the ruling of the U.S. district court, the government may try to avoid payments to the holdouts and at the same time continue servicing the exchanged debt by switching the jurisdiction of the bonds (probably to Argentina itself). That move could also trigger the CDS, as it may constitute a technical default.

**Higher risks lead to slower growth in 2013**

The IGA, a GDP proxy estimated by the consultant firm OJF, dropped by 0.3% mom/sa in October. The index is now down 0.4% from one year ago. The Argentine economy is thus far from making a solid rebound from the slump of the second quarter. Construction activity and real estate were the worst-performing sectors.

The unemployment rate edged up to 7.6% in the third quarter of 2012 (from 7.2% in 3Q11), reaching its highest level since 2Q10. The rise in unemployment was most significant in the industrial belt in and around the Buenos Aires metropolitan area (where it rose to 8.4% from 7.8% one year ago). Consumer confidence, as gauged by Universidad Di Tella, remains low. The index fell by 1.7% in November from the previous month and is now down 24.7% from a year ago.

We expect GDP growth to reach 0.5% in 2012. For 2013, we have revised our growth forecast downward, to 2.0% from 2.5%, due to increased uncertainty, weaker growth and exchange rate in Brazil, and lower grain prices (relative to our previous forecast). In addition, slower agricultural output growth in 2013 due to heavy rains remains a significant downside risk factor.

**Inflation continues to outpace interest rates and currency depreciation**

Annual inflation increased again in October, to 24.62%, from 24.3% in September. Inflation continued rising in spite of lower growth. We forecast inflation rates of 25% at the end of this year (vs. 22.8% in 2011) and 28% at the end of 2013. Inflation expectations for the next 12 months returned to 30% (median value) in November, according to a survey conducted by Universidad Di Tella.

The average Badlar rate hit 15.3% in November, up from 14.9% in October. Credit growth in pesos continued to outpace the growth of domestic deposits, due to the new regulations aimed at fostering loans and substitution of U.S.-dollar trade lines for peso loans. Recently, the Central Bank lowered bank capital requirements for loans to the public sector. Provinces lost access to international capital markets due to the high risk premium and are relying increasingly on domestic banks, putting more pressure on interest rates. We expect the reduction in bank liquidity to continue next year, so interest rates will likely continue rising. However, we now expect the Badlar rate to reach 17% by the end of 2012 (down from our previous forecast of 18%) and 21% by the end of 2013.
We still expect the exchange rate to depreciate by 15% by the end of 2012, to 4.95 pesos to the dollar. For 2013, the dollar will likely reach 5.80 pesos by the end of the year (i.e., a 17% depreciation of the peso), so real exchange-rate appreciation will continue. The government will likely continue dealing with the overvalued peso with controls on dollar purchases, adding upward pressure on the parallel markets for dollars.

**International reserves under pressure**

The trade surplus continued to decline slightly in October. The annual surplus reached $12.5 billion (three-month moving average on a seasonally-adjusted basis), down from $13.3 billion in September. Exports fell by 7.6% year over year (+3.9% mom/sa). Exports to Brazil increased by 10% year over year, due to a sharp recovery in shipments of cars and auto parts (+20%). Imports remained almost flat from last year (-1.0% mom/sa). Growth in purchases of capital goods (+2% year over year) and auto parts (+8%) were offset by a decline in industrial inputs, vehicles and fuels. For 2012, we maintain our forecast for a trade surplus of $12 billion. Due to a new scenario of flat grain prices for 2013, we anticipate less export growth. However, lower 2013 GDP growth will mean lower imports as well, so we are maintaining our forecast for a 2013 trade surplus of $10 billion.

We think that international reserves may fall by $1.0 billion by year-end, under the assumption that Argentina does not have (or does not want) to deposit the money related to the payment of the holdouts this year. For 2013, we now expect a $1.4 billion drop in reserves due to a lower current account balance.

**Government maintaining an expansive fiscal policy**

The federal public sector’s overall fiscal balance recorded a deficit of 2.6 billion pesos in September (compared with a deficit of 1.9 billion pesos one year ago). The 12-month rolling result now stands at a deficit of 41.5 billion pesos, or 2.1% of GDP (1.7% of GDP in December 2011). Primary expenditures growth decelerated markedly, to 18.3% year over year (28.3% in August), mainly due to the drop in current and capital transfers to provinces. This year to date, transfers to the provinces have grown by only 5.9% year over year, well below the inflation rate. This has increased financial tensions in many provinces. Governors are in an uncomfortable situation, having difficulty financing their budgets amid growing social discontent. Also, current revenues increased by only 18.4% year over year (28.9% in August). Because expenditures keep growing faster than tax collections (29% year over year vs. 26.1% year over year), we expect the fiscal deficit to reach 2.6% of GDP in 2012. For 2013, we see the fiscal deficit at 2.7% of GDP.

The government announced an increase in electricity and gas tariffs for the metropolitan area of Buenos Aires. Residential, commercial and industrial consumers will face a new fixed charge in their bills. This decision does not constitute a change in the governmental subsidy policy for energy consumption and will not have a significant impact on inflation. The measure actually implies a greater involvement of the government in the management of the utility companies. The new revenues will not go to the companies, but instead will be channeled to a public-sector-run energy development fund of up to 2 billion pesos per year. The fund will be used to finance the expansion of the electricity grid and the gas system. A few days after the tariff announcement, President Kirchner announced that “new” natural gas production (output from newly discovered fields) will be priced at US$ 7.5 per million BTU at the wellhead, compared with the US$ 1.76 average reported by YPF in the past two quarters. “New” natural gas could include gas discoveries from both conventional and unconventional sources. “Old” gas would continue to be priced at the current depressed levels. The government will cover the difference in the prices. The new value is aimed at making the development of natural gas shale resources viable and to combat the decline in natural gas production.
Risks to our scenario

Our scenario assumes that the government can carry on its current set of policies (loose macro policies, slow exchange-rate devaluation and foreign-exchange controls) for another year and once again postpone adjustments.

During 2013, therefore, the economy is likely to get even more imbalanced. The real exchange rate will likely appreciate further. Inflation will probably increase, while growth stays subdued. Controls on exchange-rate purchases coupled with negative real interest rates could leave Argentines without good saving options.

The government may respond with further intervention – by implementing a multiple exchange-rate regime, for example. However, such intervention would put the economy in even worse shape, even as the risks involved in the government’s strategy are already increasing: a new sovereign default is now a real possibility, which could trigger a new round of economic uncertainty; social discontent is on the rise; and the Peronist party is starting to turn against President Kirchner. The government’s position seems likely to weaken as October elections approach.

Adjustments will have to come at some point, and the longer it takes, the more painful they will be (that is, with higher exchange-rate depreciation and tighter fiscal and monetary policies). These adjustments will cost the government some popularity, and its popularity is already too low. More political turmoil may be in the offing.

Forecasts: Argentina

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<tr>
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Source: Central Bank, IMF, INDEC, Haver and Itaú.

Mexico

Reforms Advance

*Growth disappointed in the 3Q12, while inflation continues to fall. We revised our scenario for 2013, and now expect lower inflation, no rate moves, and a stronger exchange-rate appreciation*

Although the economy slowed in the third quarter, we left our growth forecasts, for both this year and the next, unchanged. However, because we expect lower international grain prices and further exchange-rate appreciation (to 12.0 pesos to the dollar in 2013) than in our previous scenario, we now see inflation ending 2013 at 3.6% (vs. 3.8% in our previous scenario). This scenario will provide room for the central bank to postpone interest rate hikes, and we now expect unchanged rates throughout 2013.
The Mexican congress approved the labor reform bill, which should favor productivity growth. In addition, the approval of the bill confirms that Mexico’s two main parties can find common ground to pass the necessary tax and energy reforms next year.

Mexican President Enrique Peña Nieto took office over the weekend. In his inaugural speech on December 1, Peña Nieto emphatically stressed the need for stronger economic growth. The new president went on to say that he will seek to increase competition in the telecommunication and television segments, improve education by linking teacher’s salaries to performance, and zero the budget deficit next year.

GDP slows down in the third quarter

Mexico’s GDP reached 3.3% year over year in 3Q12. Seasonally-adjusted, GDP grew an annualized 1.8% from the previous quarter, slowing from 3.3% in the second quarter and 5.4% in 1Q12. The IGAE (monthly GDP proxy) fell 0.02% from August to September, following a 0.3% drop in the previous month.

Although the demand-side breakdown has yet to be released, high-frequency indicators suggest that consumption remains strong, while exports and investment are weak.

Retail sales increased 3.4% qoq/saar during 3Q12. Moreover, reports from retailers on "El Buen Fin" (the Mexican version of "Black Friday") indicate that consumption remains strong in the current quarter. In addition to this transitory effect, consumption in Mexico continues to benefit from a robust labor market and credit growth.

Meanwhile, manufacturing exports contracted 9.7% qoq/saar in October, as both auto and non-auto exports performed poorly. Capital goods import data suggest that investment is growing slowly.

The weak GDP growth in 3Q12 would initially lead us to reduce our GDP forecast for the year. However, given the upward growth revision for the first half of the year, we still expect the economy to expand 3.8% in 2012.

For 2013, we expect a moderate slowdown, to 3.3%. However, because exports correlate strongly with GDP growth, their weakness adds downside risk to our growth forecast for next year.

Inflation sustains the downward trend

Inflation came in at 0.79% in the first half of November, again led by a seasonal price increase in energy (+7.04%), while non-processed food prices continued to fall (-0.33%). Core prices posted a moderate 0.18% increase.

As a result, annual inflation fell, to 4.36% from 4.55%, in the second half of October, led by a drop in non-core inflation, to 7.22% (vs. 7.87% previously). Core inflation fell 7 bps, to 3.50%. Within the core, goods inflation rebounded to 5.29% and service inflation fell to 2.01%, the lower bound of the target range.

Inflation in Mexico is retreating, but remains above the target range due to high inflation on non-core food items (13.41%). Because high inflation on non-processed food has led to higher prices for processed food, inflation on core goods has also been high. However, there is no sign of demand-side inflationary pressure, as underscored by the low service inflation level.
We expect inflation to continue to fall over the next few months. Our year-end forecast stands at 4.2%.

For 2013, we now expect inflation to end the year at 3.6% (vs. 3.8% in our previous scenario), consistent with our new scenario for grain prices and the exchange rate (discussed below).

**Strong portfolio flows**

The current account posted a $3.6 billion deficit in 3Q12, reducing the four-quarter rolling result to a low and easily-financed $5.1 billion deficit (about 0.45% of GDP).

In the financial account, the spotlight remains on the portfolio flows. In 3Q12, foreign portfolio investment came in at an impressive $24.1 billion, led by investment in domestic bonds. Over the last four quarters, foreign portfolio investment soared to $64.8 billion. Meanwhile, foreign direct investment remains below pre-crisis levels, at $18 billion accumulated over the last four quarters. Mexican direct investment abroad was even higher, at $18.5 billion.

Strong portfolio flows and greater optimism toward reforms will likely lead to a greater exchange-rate appreciation than we expected. We now see the peso ending 2013 at 12.0 to the dollar (vs. 12.5 in our previous scenario), from 13.0 this year.

**Unchanged rates for longer**

The Mexican central bank left the reference rate unchanged in its November monetary policy decision. Although the board continues to suggest that it will raise rates if the upcoming numbers fail to confirm the downward trend in inflation, board members now seem much more comfortable with the inflation outlook.

While we expect the central bank to sustain a hiking bias as long inflation remains above the upper bound of the target range, we still don’t see the board delivering hikes anytime soon. After all, in our scenario, inflation gradually returns to the target range.

However, in our previous scenarios, we expected rate hikes to take place in the second half of 2013, so that the central bank would start bringing monetary conditions down to less expansionary levels. The inflation scenario now seems comfortable enough to allow the central bank to wait longer before starting to withdraw stimulus. As a result, we currently see the reference rate at 4.5% throughout 2013.

**Mexican congress passes the labor reform**

The Mexican congress approved the labor reform, following a dispute between the lower house and the Senate that risked “freezing” the bill. Under the new rules, companies will be able to hire workers on a trial basis, or by the hour, which was not allowed until now. The reform also regulates outsourcing, which was previously carried out under unclear rules. When a case of unfair dismissal is taken to the courts, there will be a limit on the compensation a worker receives during the trial.

An inflexible labor market is an often-cited reason for Mexico’s low productivity growth. Economic formalization is likely to increase with the new reform, boosting productivity.

The approval of the labor reform bill is also positive because it shows that the PRI and the PAN can work together in congress to approve the necessary tax and energy reforms, which will likely be sent to congress for approval next year.

Mexican President Enrique Peña Nieto took office over the weekend. In his inaugural speech on December 1, Peña Nieto emphatically stressed the need for stronger economic growth. The new president went on to say that he will seek to increase competition in the telecommunication and television segment and improve education by linking teacher’s salaries to performance.
In addition, Peña Nieto pledged to send a zero-deficit 2013 budget to congress (from around 0.5% of GDP this year, excluding PEMEX investments).

Peña Nieto appointed Luis Videgaray as the new Finance Minister. Videgaray, who coordinated Peña Nieto’s presidential campaign and was one of the leaders of the transition team, is an economist with a solid academic background and experience in the public sector. He replaces José Meade, who will remain in the new administration as Minister of Foreign Affairs.

Also over the weekend, Peña Nieto and leaders of the country’s three largest political parties signed the “Pact for Mexico.” The document is an agreement between the political forces to increase competition in all sectors of the economy, with a special focus on telecommunication and energy. In the energy sector, oil exploration would remain a state monopoly, while monopolies in other types of activities within the energy sector (such as refining) would be terminated.

### Forecasts: Mexico

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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<td>Per Capita GDP - USD</td>
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</table>

### Inflation

| CPI - % | 3.8 | 6.5 | 3.6 | 4.4 | 3.8 | 4.2 | 3.6 |

### Interest Rate

| Monetary Policy Rate - eop - % | - | 8.25 | 4.50 | 4.50 | 4.50 | 4.50 |

### Balance of Payments

| MXN / USD - eop | 10.87 | 13.54 | 13.06 | 12.36 | 13.99 | 13.00 | 12.00 |
| Trade Balance - USD bn | -10.1 | -17.3 | -4.7 | -3.0 | -1.5 | 0.0 | -1.0 |
| Current Account - % GDP | -1.2 | -1.6 | -0.6 | -0.2 | -0.8 | -0.5 | -1.0 |
| Foreign Direct Investment - % GDP | 3.1 | 2.5 | 1.8 | 2.0 | 1.8 | 1.7 | 2.0 |
| International Reserves - USD bn | 78.0 | 85.4 | 90.8 | 113.6 | 142.5 | 165.0 | 190.0 |

### Public Finances

| Nominal Balance - % GDP | 0.0 | -0.1 | -2.3 | -2.8 | -2.5 | -2.5 | -2.5 |
| Net Public Debt - % GDP | 14.9 | 18.2 | 29.0 | 30.6 | 32.2 | 32.2 | 32.6 |

Source: Central Bank, IMF, INEGI, Haver and Itaú.

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**Chile**

**Growth Surprises Once Again**

*External risks, under control inflation, and a widening current account deficit will likely prevent interest rate hikes*

Chile’s economy strengthened significantly during the 3Q12, led by investment. We now see growth at 5.5% this year and 4.9% in 2013, up from 5.2% and 4.7%, respectively, in our previous scenario. Inflation surprised for the second consecutive month. Although we raised our 2012 inflation forecast to a still-low 2.3%, we continue to expect inflation to be at 3.0% in 2013. Lower copper prices and strong domestic demand continue to widen the current-account deficit. The exchange-rate will likely end the year at 470 pesos to the dollar, and reach 460 by the end of 2013. In our view, a stronger appreciation would trigger intervention. We do not expect rate hikes at least until the end of 2013.

**An even stronger economy**

Chile’s GDP figures were recently revised upward. GDP rose 5.7% in 3Q12, relative to both 2Q11 and 2Q12 (annualized). Previously released IMACEC (monthly GDP) data indicated a 5.4% year-over-year gain.
The demand-side breakdown shows a 6.4% yoy increase in private consumption (from 5.4% in 2Q12) and a 13.3% jump in gross fixed-capital formation (9.0% in 2Q12). As a result, domestic demand, excluding change in inventories, gained 7.7% from the year before. Exports of goods and services fell 3.4%, while imports rose 2.5%.

As a result, the Chilean economy has been even more dynamic than suggested by past data, driven by strong domestic demand. Furthermore, the recent GDP number underscores the economy's resilience to the global downturn. The ongoing rapid growth in real labor income supports consumers, while investment has proven hardly sensitive to short-term copper price swings.

We expect a 5.5% growth rate this year, up from 5.2% in our previous scenario. In 2013, we expect the economy to grow 4.9% (vs. 4.7% previously).

**Inflation surprises on the upside**

Chile's inflation was higher than expected in October, at 0.6% month over month, led by a 2.2% increase in food prices. This marks the second consecutive surprise following months of lower-than-expected readings. However, due to base effects, inflation rose only slightly on a year-over-year basis, to 2.9% (vs. 2.8% in September). Thus, inflation is still running below the center of the target.

Inflation, excluding food and energy, remains extremely low, at 0% mom and 1.9% yoy. Service prices rose 0.5% relative to September, suggesting some pressure from the tight labor market, but rose a comfortable 3.0% on an annual basis.

We continue to expect annual inflation to fall sharply over the next few months, driven by base effects. However, we now see inflation ending the year at 2.3% (from 2.1% previously). For 2013, we expect a tighter output gap than in our previous scenario; however, given that lower grain prices are likely to offset demand-side inflationary pressures, we maintain our 3.0% forecast for next year.

**Current account deficit continues to widen**

Strong domestic demand and lower copper prices continue to pressure the balance of payments. The current account deficit reached $4.8 billion in 3Q12, widening the four-quarter rolling deficit, to $7.6 billion (around 3% of GDP) from $5.8 billion in 2Q12. The downward trend of the current account deficit is attributable to a lower trade balance. In fact, the trade surplus narrowed further in October, and is now at $4.1 billion on a 12-month rolling basis. Sequentially, the trade balance is already close to zero.

The deficit has not been financed solely through direct investment. Although foreign direct investment reached $24 billion in the last four quarters, Chilean direct investments abroad have also been strong, implying a net direct investment of $5.1 billion in the period.

We expect a current account deficit of 3.3% of GDP this year. For 2013, we now expect the deficit to reach 4.0% of GDP (from 3.3% in our previous scenario).

The exchange-rate will likely end the year at 470 pesos to the dollar, and be at 460 by the end of 2013. In our view, a stronger appreciation would trigger intervention.
Will the Central Bank sustain the neutral bias?

In November, the central bank once again left the reference rate unchanged at 5.0%. The minutes of the decision revealed that board members considered leaving rates unchanged to be the only relevant option. Overall, the board seemed slightly more upbeat on the global economy, mostly due to China, and more worried about the fast pace of internal demand growth. However, the bias remains neutral: external risks and low inflation limit the room for interest rate hikes, while strong internal demand constrains cuts.

Although this decision took place before the upward revision in 3Q12 GDP, we still don’t see the central bank hiking rates until at least the end of 2013. Inflation and inflation expectations remain under control, while external risks are high. The central bank is also clearly worried about the higher current account deficits. Higher rates risk increasing capital inflows. In the minutes, two board members mentioned that the current scenario might require greater fiscal and monetary policy coordination.

While a tighter fiscal stance may be the best policy to cool demand in the current scenario (if needed), it is hard to make a case for a meaningful fiscal contraction in Chile. After all, the government already runs a prudent policy, and the pressure for higher social spending (on education, for example) has been high. A solution to this “policy dilemma” might be the use of macro-prudential tools.

Forecasts: Chile

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012F</th>
<th>2013F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>5.2</td>
<td>3.3</td>
<td>-1.0</td>
<td>6.1</td>
<td>6.0</td>
<td>5.5</td>
<td>4.9</td>
</tr>
<tr>
<td>Nominal GDP - USD bn</td>
<td>173.1</td>
<td>179.6</td>
<td>173.0</td>
<td>216.3</td>
<td>248.5</td>
<td>262</td>
<td>302</td>
</tr>
<tr>
<td>Population</td>
<td>16.6</td>
<td>16.8</td>
<td>17.0</td>
<td>17.2</td>
<td>17.4</td>
<td>17.6</td>
<td>17.8</td>
</tr>
<tr>
<td>Per Capita GDP - USD</td>
<td>10,436</td>
<td>10,723</td>
<td>10,185</td>
<td>12,585</td>
<td>14,285</td>
<td>14,865</td>
<td>16,917</td>
</tr>
<tr>
<td>Unemployment Rate - year avg</td>
<td>7.0</td>
<td>7.8</td>
<td>9.6</td>
<td>8.3</td>
<td>7.2</td>
<td>6.5</td>
<td>6.7</td>
</tr>
</tbody>
</table>

| Inflation | CPI - % | 7.8 | 7.1 | -1.5 | 3.0 | 4.4 | 2.3 | 3.0 |
| Interest Rate | Monetary Policy Rate - eop - % | 6.00 | 8.25 | 0.50 | 3.25 | 5.25 | 5.00 | 5.00 |

| Balance of Payments | CLP / USD - eop | 496 | 629 | 506 | 468 | 521 | 470 | 460 |
| Trade Balance - USD bn | 24.1 | 6.1 | 15.4 | 15.3 | 10.8 | 3.8 | 1.0 |
| Current Account - % GDP | 4.1 | -3.2 | 2.0 | 1.5 | -1.3 | -3.3 | -4.0 |
| Foreign Direct Investment - % GDP | 7.3 | 8.6 | 7.5 | 7.1 | 7.0 | 8.5 | 7.0 |
| International Reserves - USD bn | 16.9 | 23.2 | 25.4 | 27.9 | 42.0 | 41.0 | 43.0 |

| Public Finances | Nominal Balance - % GDP | 8.2 | 4.7 | -4.3 | -0.3 | 1.5 | 0.7 | 0.7 |
| Net Public Debt - % GDP | -12.8 | -22.6 | -12.0 | -7.8 | -10.7 | -10.6 | -10.5 |

Source: Central Bank, IMF, INE, Haver and Itaú.

Peru

“Mine” Your Own Business

As uncertainty over mining is left behind, economic growth is back at higher speed

Growth has been stronger than expected, business confidence is on the rise and mining projects are boosting construction. We revised our GDP growth forecast to 6.5% this year (from 6.1%) and to 6.2% for 2013 (from 6.0%). The Central Bank has been acting to moderate foreign borrowing, but solid growth momentum and a favorable long-term outlook will continue to draw resources to the country. We now expect the exchange rate to appreciate to 2.50 soles per dollar by the end of 2013 (from 2.60).
Activity

Peru’s economic growth continues to outpace its regional peers. In the third quarter, as robust local demand offset weakening exports, GDP gained 6.5% from one year earlier. Private investment grew an impressive 16%, up from 14% in the second quarter. Public investment also soared (23%). Exports felt the impact of poor global demand and declined by 0.9%. Private consumption, which has been decelerating moderately, reached 5.8% in Q3.

The outlook for investment is likely to remain positive. Business confidence, whose movements lead those of private investment (see graph), is up again after a period of decline. Opposition against the Conga mining project had forced the consortium that runs the project to suspend it. However, what could have turned into a spiral of harsh confrontations and canceled projects elsewhere didn’t. On the contrary: other mining projects around the country are moving forward at high speed.

Energy and Mines Minister Jorge Merino has recently said that he expects the country to attract more than 10 billion dollars to the mining sector next year. He added that the government has been speeding up the process of issuing permissions to new investments.

These projects, which are now boosting construction activity, will afterwards foster mining exports and other related activities, such as manufacturing and services.

This renewed optimism about mining activity led us to raise our GDP growth forecast to 6.5% this year (6.1% previously) and 6.2% in 2013 (6.0% before).

Capital flows, credit and the FX rate

While the economy expands, inflation fell but remained above-target and credit has grown slightly faster than the 15% rate considered sustainable by the Central Bank. To contain credit growth and inflation pressures, the Central Bank has opted for macroprudential measures instead of hiking rates. A conventional rate-tightening cycle would play against the goals of moderating foreign borrowing and reducing the pressure on the exchange-rate.

That is why the Central Bank has maintained the policy rate at 4.25% and increased the reserve requirement ratio four times this year (see graph). In addition, the official bank regulator has proposed to increase capital requirements to certain types of credit, especially those denominated in foreign currency. Therefore, while we expect the policy rate to remain at 4.25% until the end of 2013, more macroprudential measures to contain credit growth are likely.

Yet that would still fall short of preventing further appreciation of the currency. The positive growth momentum and favorable outlook for the country are likely to continue bringing in foreign capital. We now expect the sol to appreciate to 2.50 per dollar by the end of 2013, from 2.60 earlier.
Colombia

Just a Cyclical Slowdown

_While consumption has been losing steam, investment spending remains healthy_

Latest activity numbers have came out on the weak side and the slowdown in credit concessions gives comfort to our view that consumption is indeed decelerating. Still, looking beyond the current credit cycle, we believe that the fundamentals of the Colombian economy remain solid and that reflects in the positive trend for investment growth.

We have slightly cut our forecasts for GDP growth to 4.3% this year (from 4.4%) and to 4.2% in 2013 (from 4.5%). The government continues to push for economic reforms (e.g. tax reforms), improving the country’s long-term outlook. We have also reduced our inflation forecasts to 3.0% by the end of this year (from 3.2%) and to 3.1% by the end of 2013 (from 3.3%).

The Central Bank cut the policy rate, but indicated that the economy needs no further stimulus. We believe the policy rate will remain at 4.5% until the end of 2013.

Another disappointment in growth

Both retail sales and manufacturing have disappointed market estimates in the last few months. In September, manufacturing declined by 1.3% from one year ago, while retail sales were up by 2.3%. The FX appreciation and weak global growth have weighed on manufacturing, but the slowdown in consumption has also played a role.

Consumer credit has decelerated substantially, in line with the lost of steam of retail sales (see graph). These numbers hint at lower consumption growth in the third-quarter GDP, which will be out on December 20.

The perspective that consumption and manufacturing will grow less in coming quarters led us to adjust our GDP growth forecast for this year to 4.3% (from 4.4%) and to 4.2% in 2013 (from 4.5%).

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The perspective that consumption and manufacturing will grow less in coming quarters led us to adjust our GDP growth forecast for this year to 4.3% (from 4.4%) and to 4.2% in 2013 (from 4.5%).
That said, investment keeps growing at a fast pace. In the second quarter, investment grew a solid 6.6% seasonally-adjusted from the first quarter, and preliminary indicators for the third quarter, such as construction licenses, hint that the investment cycle remains positive.

In all, the latest activity numbers have came out on the weak side and the slowdown in credit concessions gives comfort to our view that consumption is indeed decelerating. Still, looking beyond the current credit cycle, we believe that the fundamentals of the Colombian economy remain solid and that reflects in the positive trend for investment growth.

Lower growth will reduce pressure on prices. We have revised our inflation forecast to 3.0% by the end of this year (from 3.2%) and to 3.1% by the end of 2013 (from 3.3%).

**Another surprising rate cut**

In its latest decision, the Central Bank cut the policy rate to 4.50% from 4.75%, surprising most analysts surveyed by Bloomberg - including us - that expected a no-move. The statement mentioned that recent indicators, such as industrial production and exports, suggest that growth has been decelerating “slightly more than expected”.

However, members also indicated that the economy needs no further stimulus. The board believes that that the current level of interest rates (4.50%) is consistent with economic growth “close to the capacity of production” and inflation on target. In our view, that suggests that the board is not willing to continue cutting the policy rate in coming meetings.

We believe that the policy rate will remain at 4.50% until the end of 2013.

**Discussions of the tax reform**

In early October, the Finance Ministry sent to Congress a tax reform proposal that reduces non-wage labor costs for companies and creates a progressive income tax for individuals. The main goals are to stimulate job creation and improve the country’s income distribution.

One of the changes being discussed in the Joint-Committee of the Congress refers to the new income tax on individuals.

The new bill states that only individuals earning more than four minimum wages will pay income tax, with a progressive rate that reaches up to 15%. The Joint-Committee proposed to raise the ceiling above 15%, arguing that the exemptions would cause revenues to fall.

Another measure being discussed is cutting the tax on foreigner’s bond profits to 14%, from 33%. Such measure would reduce borrowing costs in the public debt market, but would also increase capital flows and put more pressure for the peso’s appreciation.

**No progress in peace negotiations**

Recent developments have disappointed those who were more optimistic about the peace talks between the government and the guerilla. Members of the FARC blew up two electricity pylons in Reposo, municipality of Campamento, after the group had unilaterally declared a two-month ceasefire.

Earlier, the FARC had already surprised observers by asking for changes in the entire “economic model” during the Oslo meetings.

Despite the FARC’s rhetoric, the group is structurally weaker than before. Drugs production has been falling for years and the guerrilla is financially weaker. That suggests it is still in their best interest not to leave the negotiation table.
Forecasts: Colombia

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012F</th>
<th>2013F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>6.9</td>
<td>3.5</td>
<td>1.7</td>
<td>4.0</td>
<td>5.9</td>
<td>4.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Nominal GDP - USD bn</td>
<td>207.4</td>
<td>244.3</td>
<td>233.8</td>
<td>286.3</td>
<td>333</td>
<td>353</td>
<td>395</td>
</tr>
<tr>
<td>Population</td>
<td>43.9</td>
<td>44.5</td>
<td>45.0</td>
<td>45.5</td>
<td>46.0</td>
<td>46.6</td>
<td>47.2</td>
</tr>
<tr>
<td>Per Capita GDP - USD</td>
<td>4,723</td>
<td>5,496</td>
<td>5,199</td>
<td>6,291</td>
<td>7,236</td>
<td>7,586</td>
<td>8,373</td>
</tr>
<tr>
<td>Unemployment Rate - year avg</td>
<td>11.2</td>
<td>11.3</td>
<td>12.0</td>
<td>11.8</td>
<td>10.8</td>
<td>10.2</td>
<td>9.5</td>
</tr>
</tbody>
</table>

| Inflation | | | | | |
| CPI - %    | 5.7  | 7.7  | 2.0  | 3.2  | 3.7  | 3.0   | 3.1   |

| Interest Rate | | | | | |
| Monetary Policy Rate - eop - % | 9.50 | 9.50 | 3.50 | 3.00 | 4.75 | 4.50  | 4.50  |

| Balance of Payments | | | | | |
| COP / USD - eop | 2015 | 2244 | 2044 | 1914 | 1943 | 1800  | 1800  |
| Trade Balance - USD bn | -2.9 | -2.0 | 0.0  | -0.9 | 2.3  | 1.0   | 0.5   |
| Current Account - % GDP | -2.9 | -2.8 | -2.1 | -3.1 | -3.0 | -2.5  | -2.2  |
| Foreign Direct Investment - % GDP | 4.4  | 4.3  | 3.1  | 2.4  | 4.0  | 4.1   | 3.8   |
| International Reserves - USD bn | 20.9 | 24.0 | 25.4 | 28.5 | 32.3 | 37.0  | 39.0  |

| Public Finances | | | | | |
| Nominal Balance - % GDP | -2.8 | -1.7 | -3.7 | -3.5 | -2.1 | -1.9  | -1.8  |
| Gross Public Debt - % GDP | 32.9 | 33.3 | 35.0 | 35.0 | 33.8 | 33.3  | 32.8  |

Source: Central Bank, DANE, Haver and Itaú.

Commodities

Increased Supply and Mixed Performance

Stabilizing growth in China and geopolitical risks also affected commodity prices

Given lower prices than we expected in November and a better crop-supply outlook, we are revising our year-end forecasts for the Itaú Commodity Index (ICI) downward. We now expect an increase of 13.7% in 2012 (previously 19.2%) and a decline of 4.1% in 2013 (previously -7.7%).

Commodity prices remained flat in November after falling 4.2% in October, with mixed performance across the groups. Agricultural prices fell 2.4% in November, driven by a better supply outlook. Base metal and energy prices rose 4.0% and 1.7%, respectively. Despite better supply prospects for copper and oil, prices were affected by renewed signs of stabilizing growth in China. Oil prices were also affected by increased geopolitical risks in the Middle East.

Agriculture prices fell 2.4% mom in November, extending losses for the third straight month. Prices were negatively affected by improvements in the supply outlook, with higher soybean yield in the U.S. and better weather conditions in South America. Taking these facts into account, we are reducing our 2012 year-end soybean forecast to 1450 cents/bushel (from 1750), and corn forecast to 770 cents/bushel (from 850).

Sugar No. 11 Futures prices have remained between $0.19/lb and $0.20/lb since mid-October. Given the lack of relevant data since our last report, we maintain our view that sugar prices will remain around $0.20/lb throughout 2013.

In the cattle sector, the U.S. placements in feedlots remained weak in October, reinforcing a scenario of lower beef supply (and lower feed-grain demand) in 2013.
Despite expectations of a sizable surplus in the cotton global balance, future prices are expected to increase in 2013. This reflects a relative deficit in cotton to meet requirements for NYB-ICE futures contracts. We expect cotton No. 2 future contracts to reach 77 cents/lb by the end of 2013.

Geopolitical risk led oil prices to rebound in November, even in the context of looser global balance in 4Q12. Following the ceasefire that ended the latest round of violence in the Gaza Strip, we expect the tension over Iran’s nuclear program to return to the media and sustain high prices, offsetting sector fundamentals and worries about the fiscal cliff in the U.S. We continue to forecast crude prices at $112/bbl by the end of 2012 and at $115/bbl by the end of 2013.

Finally, prices for base metals rebounded mildly in November. Besides China’s signs of stabilizing growth, its stockpiling purchase of aluminum and zinc also contributed to the movement. Iron ore spot prices are close to iron ore contract prices for 4Q12 and should remain around current levels of $120/ton for a while. The global copper balance is approaching a surplus, with production increasing and demand growth decelerating.

Weather: better conditions in South America

November was marked by better weather conditions for agricultural production in South America. Above-average rains in Mato Grosso, Mato Grosso do Sul, Goiás and Western Bahia offset lack of rains in October. Meanwhile, lower rain in Argentina and Rio Grande do Sul offset excess rains in the previous month. São Paulo received more rain in November, but still below average. Recent rains in Paraná were not enough to bring precipitation to the seasonal average, but that state, unlike others, received a fair amount of rain in the previous month.

Crop planting is advancing at a reasonable pace, but is still slightly behind schedule. It is important for both soybeans and the corn crop that there is rain when the plant is pollinating and generating the grains, a phase that is expected to take place between the second half of December and January.

Given the current neutral conditions in the Pacific Ocean (no El Niño or La Niña), our best estimate is to expect average rains during this sensitive period. This should lead to crops that are close to current forecasts from USDA and CONAB. However, the standard deviation is high and risks remain.

Agriculture: better supply outlook led to new decline in prices

Agriculture prices fell 2.4% mom in November, extending losses for the third straight month. Prices were negatively affected by improvements in the supply outlook, with higher soybean yield in the U.S. and better weather conditions in South America.

In order to accommodate the better supply outlook and November prices, we are reducing our 2012 year-end soybean forecast to 1500 cents/bushel (from 1750), and corn forecast to 800 cents/bushel (from 850). Given lower global inventories, prices would be heavily affected by another crop loss in South America.

The USDA’s November report (World Agricultural Supply Demand Estimate, or WASDE) revised ending stocks for the three main agricultural commodities (corn, soy and wheat) upward. The largest adjustment was to the soybean balance, increasing the U.S. yield for 2012-13 crop by 3.9%.
The WASDE revised beginning stocks and the U.S. production upward, leading the supply (beginning stocks + production) for the 2012-13 crop year to increase by 1.4%, to 323.6 million tons from 319 million tons. The adjustment to the supply was divided between greater demand (mainly from China) and higher ending stocks. A looser global balance is probably the main reason for the 7% fall in soybean prices in November. The estimate for Brazil was maintained at 81 million tons, within the range of the CONAB (Brazil's food supply agency) 2012-13 forecasts. The estimate for Argentina was also unchanged, at 55 million tons. Both forecasts are consistent with average weather conditions and estimated planted areas.

Corn prices fell 1.0% mom in November to 748 cents/bushel, well above prices before the U.S. drought became a reality (between 600 and 700 cents/bushel). The WASDE made small adjustments to the global balance. Supply for the 2012-13 crop increased by 0.1%, (1.2 million tons), from higher beginning stocks and higher production in the U.S. The adjustment to the supply was divided between higher global demand (0.5 million tons) and higher ending stocks (0.7 million tons). Despite the improvement, ending stocks are low if compared with previous years. The current ending stock estimate (60 million tons) is less than half the average from the last three years. As expected, estimates from Brazil and Argentina were kept at 70 and 28 million tons, respectively.

Finally, the WASDE revised downward the wheat supply for the 2012-13 crop year. However, the downward revision to wheat production was lower than expected and lower than the revision to demand, leading to higher ending stocks for the commodity in both the U.S. and the rest of the world. The estimate for the Brazilian crop (5 million tons) may still not reflect CONAB’s last revision to 4.4 million tons from 5 million tons.

Another risk for global supply is the current condition of winter wheat in the U.S. According to the USDA, only 33% of the U.S. winter wheat was rated good or excellent as of November 23, 20 percentage points below the last-5-years average and the worst condition since tracking of data began in 1985. Under favorable winter climate conditions, quality may improve during the dormancy period (December to February). Nevertheless, this indicator is a risk to the USDA’s current estimate of a 13% increase in the 2012-13 crop compared with the previous season.

**Beef: October data in the U.S. reinforces lower supply scenario in 2013**

High feed-grain costs are leading to lower cattle placements in feedlots. In the U.S., placements in feedlots remained weak in October, down 12.8% yoy according to the USDA. In Brazil, a private study (Rally da Pecuária 2012) has estimated lower-than-
expected cattle placements in feedlots throughout 2012 (6% vs. 18% expected) and a flat number for 2013. A flat number of placements in Brazil suggests a lower beef supply, given the trend of pastureland being converted to crop production and reducing the area available for extensive cattle farming.

The consolidation of low cattle placements in feedlots suggests lower demand for grain feed and a lower beef supply for 2013, and reinforces a scenario of higher cattle and beef prices next year.

**Cotton: stocks and prices to increase in 2013**

The USDA’s November report estimates a loose global balance in the 2012-13 crop year. Even in a scenario of 6% lower global production and 3% greater demand, there is still a sizable surplus, leading to another year of stock increases.

Looking back, cotton prices fell 18% in May and have remained at a lower level since then, averaging 71 cents/lb in November. We expect prices on the benchmark contract quoted on ICE at NY to increase to 77 cents/lb throughout 2013, even with the fundamentals mentioned above. This should happen due to a quality premium on the contract, which specifies delivery of U.S.-grown cotton of exchange-grade quality.

In Brazil, one of the major exporters, the USDA estimates a production decrease of 25.3% and a lower crop than CONAB, which expects the total cotton crop for 2012-13 to range between 1.5 and 1.6 million tons, while the USDA is below the range at 1.4 million tons (we expect 1.5 million tons). CONAB’s average forecast also points to a fall of 23.8% in the cotton planted area, mostly lost to soybeans, a result of the higher margins for producers.

**Metals: prices increasing on Chinese growth stabilization**

The base-metals price index increased about 4.0% in November, partially reversing the strong fall in October. This month, among the base metals, aluminum prices increased 11.0%, zinc 10.7%, lead 8.5%, nickel 9.1% and copper, which had the weakest performance, rose 2.8%. Besides China’s signs of growth stabilization, its stockpiling purchase of aluminum and zinc also contributed to the price increases.

Iron ore spot prices averaged $120.35/ton in November and were up 5.6% compared with the October average, partly affected by strong Chinese imports. At the moment, spot prices are close to iron ore price contracts for the quarter ($122/ton). Iron ore prices are compatible with the current sector fundamentals and are likely to remain at this level for a while.

Copper future prices fell in the beginning of November, but recovered during the second half. However, when comparing the November average with the previous month, we see a sharp decline of about 4.3% due to high prices in the first half of October. The copper balance for August, released in November by the International Copper Study Group (ICSG), highlights a decline in the global deficit,
caused by increases in production amid demand-growth deceleration. Chinese copper imports, a significant part of demand, were up 26% yoy through October, but are decelerating. In this scenario, we expect copper prices to decrease throughout 2013 due to a combination of supply recovery and weak global growth.

**Energy: geopolitical risk offsets looser global balance and worries about the fiscal cliff**

Brent crude prices rebounded to $111/bbl after falling from $115/bbl in mid-October to $105. Despite a looser global supply-demand balance in 4Q12, geopolitical risks and the fiscal cliff in the U.S. are expected to be the main drivers for prices in the short term. We expect the tension over Iran’s nuclear program to return to the media and sustain high prices, offsetting sector fundamentals and worries about the fiscal cliff in the U.S. We continue to forecast crude prices at $112/bbl by the end of 2012 and at $115/bbl by the end of 2013.

The International Energy Agency’s (IEA) last Oil Market Report again revises its forecasts for the global oil balance towards a larger surplus. Global demand for 4Q12 was revised downward again, reflecting the impact of Hurricane Sandy on the U.S. and lower estimates for Europe. Global supply rose by 0.8 mb/d in October compared with the previous month, as greater supply from the Americas and the North Sea offset a slight decline in OPEC production. This decline in supply from OPEC came despite a rebound in imports from Iran, increasing 300 kb/d in October and reversing a downtrend that had been in place since January.

IEA has also released its Annual Energy Outlook. The highlight is the outlook for lower oil-import requirements from the U.S., with rising unconventional oil and biofuel production in an environment of flat demand. IEA estimated production costs for unconventional oil supplies in the range of $40-100/bbl. If oil prices fall much below current levels or transport constraints and cost inflation raise production costs, investment decisions on new projects could be postponed, lowering supply growth.

**Forecasts: Commodities**

<table>
<thead>
<tr>
<th>Commodity Index</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012F</th>
<th>2013F</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CRB Index</strong></td>
<td>19.3</td>
<td>6.2</td>
<td>-14.6</td>
<td>25.1</td>
<td>19.5</td>
<td>-9.4</td>
<td>-0.4</td>
</tr>
<tr>
<td><strong>Itaú Commodity Index (ICI)</strong></td>
<td>30.7</td>
<td>-32.9</td>
<td>44.8</td>
<td>28.4</td>
<td>-17.2</td>
<td>13.7</td>
<td>-4.1</td>
</tr>
<tr>
<td><strong>Itaú Commodity Index (ICI) - avg growth - %</strong></td>
<td>20.0</td>
<td>14.6</td>
<td>-20.8</td>
<td>21.8</td>
<td>25.0</td>
<td>-7.2</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Metals - avg growth - %</strong></td>
<td>37.0</td>
<td>-13.0</td>
<td>-25.3</td>
<td>29.4</td>
<td>12.0</td>
<td>-18.5</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Energy - avg growth - %</strong></td>
<td>9.0</td>
<td>28.6</td>
<td>-39.4</td>
<td>21.0</td>
<td>30.2</td>
<td>-7.4</td>
<td>9.0</td>
</tr>
<tr>
<td><strong>Agricultural - avg growth - %</strong></td>
<td>18.2</td>
<td>25.3</td>
<td>-7.4</td>
<td>19.8</td>
<td>30.0</td>
<td>-1.9</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Bloomberg and Itaú.

**The Itaú Commodity Index is a proprietary index composed of those commodity prices, measured in U.S. dollars and traded in international exchanges that are relevant to Brazilian consumer inflation. Its sub-indexes are Metals, Energy, and Agricultural.**

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