Global Economy
Stronger global growth amid political risks
Global GDP growth is set to accelerate to 3.6% this year from 3.1% in 2016 and manufacturing surveys point to upside risks. The main risks at the moment are policy shifts in the U.S., elections and Brexit in Europe.

LatAm
Economic recovery postponed
Economic activity in the region is not recovering yet. We have reduced our growth forecasts for this year in Brazil, Colombia, Mexico and Peru, but still envisage recovery in some of these economies this year.

Brazil
Falling inflation brings forward the cycle of interest rate cuts
Falling inflation and disappointing economic activity bring forward the cycle of interest rate cuts. We forecast Selic rate at 9.75% in 2017 and at 8.5% in 2018.

Argentina
Ready to go?
Recent economic data suggests the economy came out of the recession in 4Q16. We expect 2.7% GDP growth in 2017 to be followed by 3% expansion in 2018.

Mexico
Aftermath of the “gasolinazo”
The liberalization of gasoline prices will benefit fiscal accounts, but has worsened the near-term inflation outlook and triggered social unrest six months before a crucial regional election that might have a bearing on the result of the presidential and legislative elections in 2018.

Chile
Monetary easing begins
The central bank started a loosening cycle in January amid low growth and falling inflation. Recent activity data supports our call of a 100-bp easing cycle this year.

Peru
Domestic demand still struggling
We have revised our GDP growth forecast down for 2017 as domestic demand has weakened further. Higher terms of trade, nevertheless, would support growth in 2017.

Colombia
Fiscal and external accounts improve, while activity weakens
The Santos administration approved the tax reform and gained fast-track authority to pass legislation related to the peace deal. At the same time, external accounts are improving and inflation is falling.

Commodities
Enjoy the Party, for Now
The short-term outlook may be bullish for commodity prices. Nonetheless, we expect metal and energy prices to decline throughout 2017.

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Stronger global growth, not in LatAm (yet)

Global GDP growth is set to accelerate to 3.6% this year from 3.1% in 2016 and there are upside risks. Global inflation is also on the rise, driven by better commodity prices. With better economic outlook, interest rates are set to rise in developed countries. We now expect the U.S. Fed to deliver 3 hikes in 2017 (from 2) and 4 in 2018. The main risks at the moment are political shifts in the U.S., elections and Brexit in Europe. China also poses risks, but we see a stable growth environment in 1Q17.

In spite of more solid economic growth in developed economies, economic activity in the Latin America is not yet recovering. We have reduced our growth forecasts for this year for Brazil, Colombia, Mexico and Peru. While activity is still disappointing, the balance of payments and fiscal picture are improving in the region. Many governments are implementing fiscal consolidations, in spite of their low popularity. Weak growth and low inflation are allowing central banks in South America to embark on easing cycles. We have reduced our policy-rate forecasts for Brazil and Colombia. On the other hand, we now expect a more-aggressive monetary tightening in Mexico relative to our previous scenario.

In Brazil, economic activity disappointed at the end of 2016. We now expect a moderate recovery in 2017 due to a lower statistical carry over. Inflation ended 2016 lower than expected and will continue to decline in the coming months. In this environment, there is room for frontloading the cycle of interest rate cuts. We expect the Selic rate at 9.75% at the end of 2017 and at 8.5% in 2018. In light of a slightly more favorable external scenario for emerging countries, we now forecast a less intense depreciation of the real. On the fiscal side, reforms will continue in focus this year. We expect the pension reform to be approved in the second quarter of 2017.

Hope you enjoy,
Mario Mesquita and Macro Team
Global Economy

Stronger global growth amid political risks

- Global GDP growth is set to accelerate to 3.6% this year, from 3.1% in 2016. Manufacturing surveys indicate upside risks.
- Global inflation is also on the rise, driven by rising commodity prices. In the U.S., core inflation is stabilizing as the economy nears full employment.
- With a stronger economic outlook, interest rates in developed countries are set to rise. We now expect the U.S. Fed to deliver three rate hikes in 2017 (from two previously) and four in 2018.
- The main current risks are policy shifts in the U.S., elections and Brexit in Europe
- China also poses risks, but we foresee a stable growth environment in 1Q17.

Stronger Economic Outlook

The world economy ended 2016 in good shape. Industrial production was up 2.7% YoY in November and the global Purchaser Manager’s Index reached 54.0 in December – both indexes are at the highest levels since 2014.

We expect global GDP growth to accelerate to 3.6% this year, from 3.1% in 2016. The pick-up is set to occur in both developed and emerging economies (see graph).

Global inflation is also set for a pick-up

Global inflation is also rising. Our GDP weighted index of world inflation is likely to rise to 2.8% in 2017, from 2.4% in 2016 (see graph), helped by better commodity prices. We note that some developed economies, particularly the U.S., are also close to full employment and seeing stabilization in core inflation.

U.S. – Stronger growth, higher rates, but policy-related uncertainty

Growth of the U.S. economy accelerated to 3.0% in annualized terms in 2H16. Consumer and business confidence indicate positive domestic demand momentum, including a significant pick-up in business investment. Global manufacturing surveys are supportive of U.S. export growth.

We raised our 2017 GDP growth forecast to 2.3% from 2.2%, and expect a further a further pick-up to 2.4% in 2018.

Inflation was softer in November, but largely consistent with a gradual stabilization of core measures. The core PCE will likely close 2016 at 1.8%,
compared with 1.4% in 2015, and we expect it to remain at 1.8% by the end of 2017.

**Stronger growth and increased business investment leads to a shift in the outlook risks.** We anticipate a decline in the unemployment rate to 4.3% by 4Q17, 20 bps below the FOMC’s December forecast. We see risks of an even lower unemployment rate, given that business investment may spur stronger payroll growth.

We now forecast three Fed rate hikes in 2017, instead of two, and continue to expect another four hikes in 2018. A more preemptive Fed seems likely to mitigate the risk of a sharper unemployment rate undershooting of the NAIRU over the next few years.

We foresee a moderate policy mix by President Trump, albeit with significant fiscal impulse. We expect a reduction in corporate and individual tax rates coupled with increases in import tariffs on a country-by-country basis.

**However, US policy risks seem to have increased.**

There is uncertainty surrounding the actual measures to be adopted by the new administration. President-elect Trump’s speeches and interviews have so far lacked concrete information about his plans, while his cabinet indications have sent mixed signals about policies.

**President-elect Trump has also upped his protectionist rhetoric.** He has talked down the “border tax adjustment” advocated by House Speaker Paul Ryan, but mentioned 35% taxes on Mexican auto imports. And he has called on companies to invest and create jobs in the U.S., rather than overseas.

Although president-elect Trump has so far refrained from supporting the border tax adjustment, he could change his mind, which we see as the main protectionist risk. With a border tax adjustment, companies would pay zero taxes on export income but a full tax rate on import costs. This has a similar effect to imposing higher import tariffs and lower export tariffs. It can also be seen as a fiscally-induced devaluation of the USD.

We note that the border tax adjustment could raise government revenues. It can be used to partially offset the decline in revenues from the corporate and individual tax rate cuts.

**The long-term benefits are likely to be null or negative.** Traded weighted USD should fully adjust to this new fiscal regime, and US trading partners could raise import tariffs in retaliation, causing negative long-run spillovers from the de-globalization.

Summing up, policy changes are likely coming to the U.S. and risks remain high about what shape they will take.

**Europe – Resilient activity amid political risks**

**Resilient economic indicators in Europe.** The 4Q16 leading indicators improved, as the credit data reflects the positive effect of the ECB’s easing policies. The solid November Industrial Production ex-Construction figure, which rose 1.5% MoM (see graph), also suggests a stronger 4Q16 (0.4%-0.5%).

**Improving financial conditions, slightly expansionary fiscal policy and a milder external drag contribute to stronger growth.** We note that despite the recovery in headline inflation, which reached 1.1% YoY in December, the ECB is likely to retain its accommodative stance for some time. This means that real interest rates are likely to fall, supporting economic activity.

**Some risks have not materialized.** Despite the demise of Italy’s Renzi reformist government, a quick formation of a pro-establishment administration and the EUR 20 billion rescue plan for the Italian banking system should sustain the country’s brittle stability for now.

**Political risks will nonetheless remain at center stage in Europe.** In the UK, Brexit negotiations are expected to begin after the triggering of Article 50 in
March. In our view, political incentives favor a hard Brexit, as the UK wants control of its borders and regulations, which implies leaving the Single Market. The Netherlands will hold general elections in March, and the Eurosceptic party, PVV, continues to rise in the polls.

In France, former PM François Fillon’s reformist policy program, which is also conservative on immigration issues, makes him the favorite to win the election next year. But the Eurosceptic National Front candidate, Marine Le Pen, still has a good chance of winning the elections in 2Q17. Finally, although not our baseline scenario, there is a chance of early elections in Italy.

We raised our GDP forecast for the euro zone to 1.6% from 1.3% in 2017 and left it at 1.6% for 2016; political risks are likely to hurt confidence in 2018, and we anticipate a deceleration of 1.3% for the year.

Japan – Continued growth in 2017

Japan’s National Accounts underwent a general review. As such, 3Q16 GDP growth totaled 1.3% QoQ/ssaar, driven by Net Exports, which contributed 1.3 pp. Consumption and Government Expenditure rose by 1.3% QoQ/ssaar and 1.2% QoQ/ssaar, respectively.

Inflation is finally set to pick up in 2017. Headline inflation rose to 0.5% YoY in November from 0.1%. Though the effect continued to be driven by the recovery in energy prices and the strong increase in food prices, we expect it to pass through to Core CPI, as the BoJ maintains its accommodative policy stance and inflation expectations start to pick up.

We raised our GDP estimates to 1.1% from 0.8% for 2016 and to 1.4% from 1.2% for 2017 due to the methodological review of Japan’s national accounts.

Commodities – Stability in China to sustain higher metal prices, for now

The Itaú Commodity Index (ICI) has risen by 7% since the end of November – agriculture (5%), metals (5%) and energy 9% – as global economic activity keeps up the strong pace. Furthermore, signs that OPEC members are complying with the production cut deal support the view that the global oil market is already with a small deficit, causing Brent prices to increase by 8% since November 30 (the day the deal was announced).

The rise in agricultural commodities was driven by the reversal of earlier declines. We lowered our price forecasts for coffee (stronger Brazilian crop in 2017) and wheat (assuming that the current environment of a lower premium to corn will continue). Besides coffee and wheat, there were no material changes in the supply outlook, as the La Niña anomaly fades and the crop in South America advances under normal conditions.

We expect China’s economy to remain stable in 1Q17, supporting higher metal prices for a few months. We do not expect a supply increase in response to current prices anytime soon.

Oil prices are also set to remain high for some time, as the market assimilates the coordinated supply cut and global indicators show upside risks for an already-improved growth environment.

China – Stable growth environment in 1Q17

Economic growth is set to remain stable in 1Q17. Credit growth has exhibited a solid pace in recent months, suggesting no monetary tightness despite the hawkish rhetoric. Investment will continue to be supported by higher corporate profits (on a weaker currency and higher producer prices) and the still hot property sector (prudential measures to cool-off the sector are expected to affect investment after 2Q17).

Strong economic activity and intervention in the FX market will probably prevent another China shock like the one in early 2016. Last year, China’s challenging policy predicament, which combined loose monetary policy in the face of weak activity, liberalizing financial flows and an exchange rate peg, created expectations of a strong RMB depreciation and generated global financial market stress. But these three factors are now more nuanced. First, the improvement in activity/inflation dynamics has led to a reduced need for loose monetary policy. Second, one of the sources of capital outflows (unwinding of carry trade liabilities) has declined, and the government is tightening capital controls – contrary to last year when it was liberalizing financial flows. Finally, after depreciating 6.2% year to date vs. the CFETS basket (the new focus of FX policy), the currency seems less overvalued than in 2015.

We forecast GDP growth of 6.7% for 2016, 6.3% for 2017 and 5.8% for 2018.
Beyond the 1Q17, we expect the ICI to decline to 8% below its current level by the end of 2017. The two main culprits are the expected slowdown in China in 2H17 (which will impact metal prices in particular) and a supply response from U.S. shale producers that could partially offset the cartel’s cuts.

Forecasts: World Economy

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<td>Fed Funds - %</td>
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<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.5</td>
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<tr>
<td>USD/EUR - eop</td>
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<td>1.32</td>
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<td>1.09</td>
<td>1.05</td>
<td>1.01</td>
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<tr>
<td>YEN/USD - eop</td>
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<td>DXY Index* - eop</td>
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<td>98.7</td>
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<td>105.5</td>
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Source: IMF, Bloomberg 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.
LatAm

Economic recovery postponed

- Economic activity in the region is not recovering yet, so we have reduced our growth forecasts for this year in Brazil, Colombia, Mexico and Peru.

- While facing low popularity and weak growth, many governments are taking measures to improve fiscal accounts.

- Weak growth and low inflation are allowing central banks in South America to embark on easing cycles. We have reduced our policy-rate forecasts for Brazil and Colombia. On the other hand, we now expect a more-aggressive monetary tightening in Mexico relative to our previous scenario.

Activity is still sluggish…

In spite of more solid economic growth in developed economies, economic activity in the region is not yet recovering. In Brazil, recent data point to another sequential GDP contraction in 4Q16 (which would be the eighth consecutive quarterly GDP drop). In Chile and Colombia, activity is still losing momentum and growth has been very low relative to the historical standards. Peru – the fastest growing economy in the region – also lost momentum in 4Q16. This was mostly a result of a temporary fiscal drag (as the government slashed expenditures to comply with the fiscal target set for 2016), but it is also true that private demand has yet to react to the improved confidence levels since the new Peruvian government was elected. On the other hand, in Mexico, growth has been resilient so far (at around 2.0% year over year, which seems in line with potential): manufacturing exports are starting to recover in line with the better U.S. ISM manufacturing numbers, while private consumption is still solid. Finally, in Argentina the IGA (a GDP proxy estimated by the private sector) suggests that the economy came out of recession in 4Q16.

We have reduced our growth forecasts for this year for Brazil, Colombia, Mexico and Peru. The activity numbers for 4Q16 GDP in Brazil point to a less favorable carryover for 2017. In Colombia, the approved fiscal reform strengthens the country’s fundamentals, but at the cost of higher short-term inflation and a further decrease in real wages. President-elect Trump’s rhetoric on manufacturers operating in Mexico remains harsh. Although our base-case scenario is one with no meaningful changes in U.S. trade policies, rising uncertainty on this matter will likely affect investment in Mexico by more than we were previously expecting. In Peru, even though we still believe that there will be a recovery of domestic demand (in particular of private investment), the rebound would not be strong enough to more than offset the deceleration of mining production.

For 2018, we expect growth to strengthen, fueled mainly by the performance of the Brazilian economy

…but the balance of payments and fiscal picture are improving

While activity is still disappointing, the balance of payments is improving. The current-account deficits of Peru and Colombia (which have been wide) continue to narrow. In Mexico, the more recent trade-balance figures also suggest lower external imbalances. In Chile and Brazil, current-account deficits remain low. However, the current-account deficit in Argentina (at almost 3% of GDP) is wide, especially considering the weak internal demand and the reliance on portfolio flows for funding.

Narrower current account deficits

Source: Haver, Itau
In addition, many governments are implementing fiscal consolidation, in spite of their low popularity. Gasoline price hikes in Mexico and the tax reform in Colombia are the latest examples. Even in Peru, where there is fiscal space that the government was planning to use, a VAT cut was far more modest than promised during the presidential election campaign, and it was conditioned on VAT revenues reaching an improbable threshold. While Argentina’s government is not in a rush to reduce the fiscal deficit, the outcome of the amnesty for undeclared assets has been much better than expected (around USD 100 billion has already been declared), allowing the government to comply with its fiscal targets.

Exchange rates are helping inflation in South America

South American currencies started the year with a good performance, following a solid performance during 2016. On the other hand, the Mexican peso continued to weaken as risks related to U.S. trade policies increased. We have updated our estimates of equilibrium exchange rates for Latin America. Considering the level of terms of trade today, we found that the BRL, CLP and PEN are close to fair value, whereas the COP seems to be overvalued and the MXN undervalued. If we consider the average terms of trade over the last 20 years, the MXN may be even more undervalued, and the CLP is overvalued compared with medium-term fundamentals. The Argentine peso is also overvalued, but this is largely because we assume in this exercise that the sustainable current account deficit is the average value of the past 20 years – in the case of Argentina, this is very low. If Argentina’s current access to international financing is indeed a new equilibrium, the fair value of the currency would be stronger than we estimate in this exercise.

In an environment of weak growth and well-behaved exchange rates, inflation is edging lower in most Latin American countries, although it ended 2016 below the target center only in Chile. In fact, our Itaú Inflationary Surprise Index marked -0.38 in December, which is fairly stable from the -0.37 registered in November. The index’s downward momentum was mostly because of Brazil, though recent downside inflation surprises in Colombia and Chile were also recorded. On the opposite side, Mexico and Peru have been undergoing stronger inflationary pressures recently, largely fueled by currency depreciation in the former and by one-off factors in the latter.

However, we note that inflation expectations for 2017 recently worsened in Argentina, Colombia, Mexico and Peru. Within this group, only in Peru expectations sit below the upper bound around the central bank’s target. Mexico is the country where the outlook for inflation is deteriorating the most. The further weakening of the Mexican peso following the US election and higher gasoline prices are the most to blame, but other factors (such as the minimum wage increase) will also contribute to worsen inflation dynamics this year. Finally, in Colombia the VAT hikes associated with the tax reform will likely keep inflation high during 2017 (although lower than last year’s figure). On the other hand, inflation expectations continue to improve in Brazil and Chile.

Interest rates will likely fall further in South America and rise in Mexico

Central banks facing weak growth and falling inflation are embarking on easing cycles. In Brazil, the central bank increased the pace of rate cuts (to 75 bps). Colombia’s central bank started to slash interest rates sooner than we and the market were expecting. In Chile, the central bank started an easing cycle this month. On the other hand, the recent deterioration of inflation expectations in Argentina led the central bank to pause the easing cycle starting in the first week of December. In Peru, where growth is stronger and inflation has surprised on the upside, the central bank remains on hold. Finally, in Mexico the central bank...
increased the interest rate by 50 bps in December, which was more than the market was expecting. While in previous decisions the central bank of Mexico was, in our view, acting mostly to shield the Mexican peso, its actions now seem to have been focused on the evolution of inflation and inflation expectations (which deteriorated markedly), although the Fed’s interest-rate decisions will likely continue to play an important role.

We now expect lower interest rates (relatively to our previous scenario) for this year in Brazil (9.75%) and Colombia (5.5%). In Mexico, we expect more tightening (an additional 125 bps) than before. In Chile, we still see a 100-bp easing cycle (more than the 50-bp cycle that the market is expecting and that the central bank signaled in its last monetary policy report): recent activity and inflation data are consistent with larger interest-rate cuts. We see further rate cuts in Argentina, even though we do not expect the central bank to meet the inflation target for this year (12%-17%). Finally, Peru’s central bank is expected to remain on hold.

<table>
<thead>
<tr>
<th>Country</th>
<th>Average current account deficit in the last 20 years</th>
<th>Equilibrium exchange rate</th>
<th>Appreciation (-) / Depreciation (+) needed to achieve the average current account deficit**</th>
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<tr>
<td></td>
<td>Terms of trade today*</td>
<td>Avg. terms of trade in the last 20 years</td>
<td>Terms of trade today</td>
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<tr>
<td>Brazil</td>
<td>2.10%</td>
<td>3.25</td>
<td>3.30</td>
</tr>
<tr>
<td>Colombia</td>
<td>2.60%</td>
<td>3400</td>
<td>3395</td>
</tr>
<tr>
<td>Chile</td>
<td>0.80%</td>
<td>663</td>
<td>798</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.60%</td>
<td>15.7</td>
<td>14.6</td>
</tr>
<tr>
<td>Peru</td>
<td>2.80%</td>
<td>3.20</td>
<td>3.27</td>
</tr>
<tr>
<td>Argentina***</td>
<td>0.00%</td>
<td>20.4</td>
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Brazil

Falling inflation brings forward the cycle of interest rate cuts

- Economic activity in Brazil was disappointing in the final stretch of the year, but the demand fundamentals remain stable. We have lowered our estimate of 2017 growth to 1% (from 1.5%) because of the statistical carryover, but we maintain our forecast of 4% growth for 2018.

- We expect Social Security reforms to be approved in the second quarter of 2017.

- We have revised our year-end exchange rate forecasts to BRL 3.50 per dollar for both 2017 and 2018.

- Inflation continues to fall. We now expect the IPCA to be 4.7% in 2017 and 4.0% in 2018.

- The central bank has increased the pace of interest rate cuts. We are forecasting Selic rates of 9.75% in 2017 and 8.5% in 2018.

Lower growth and interest rates this year

Economic activity in Brazil was disappointing in the final stretch of the year. This has translated to a worse statistical inheritance for 2017. However, the demand fundamentals remain stable at the margin. The inventory cycle, improving commodity prices and monetary policy loosening should allow for moderate growth this year (1%), but we are not likely to see a more robust recovery until 2018 (4%).

In 2017, the spotlight will remain on fiscal reforms. The Lower House of Congress will likely approve the proposed Social Security reforms, which are critical for achieving future compliance with the spending cap, by the end of the second quarter.

With a slightly more favorable external scenario for emerging-market countries, we now expect less intense BRL depreciation. We are now forecasting year-end exchange rates of BRL 3.50 to the dollar for both 2017 and 2018.

Inflation ended 2016 lower than expected and will likely continue to fall over the months ahead. The composition of the Extended National Consumer Price Index (IPCA) remains benign, with various components retreating, including service prices. We have lowered our IPCA inflation forecasts to 4.7% for this year and to 4.0% from 4.2% for 2018.

Falling inflation has created an opportunity to front-load the monetary easing cycle. At its January meeting, the central bank reduced the Selic benchmark rate of interest by 0.75 percentage points (pp). We are forecasting two additional cuts of this magnitude at the February and April meetings. The Selic rate is likely to reach 9.75% by the end of 2017 and 8.5% by the end of 2018.

We have lowered our 2017 GDP forecast to 1.0%

Industrial activity data have been disappointing recently. In November we saw a tepid 0.2% rise in industrial output, after a 1.2% decline in October. This was a disappointing outcome relative to our forecasts and market expectations. Although preliminary indicators are pointing to an increase in December, this is unlikely to offset the previous month’s letdown.

According to the Monthly Services Survey (PMS-IBGE), real service sector revenues remained essentially stable (0.1%) in November, after a significant 2.3% drop in October. Retail sales surprised positively in November, but initial indicators suggest that they dropped back sharply in December.
In our opinion, this pattern occurred because people made their year-end purchases earlier (a Black Friday effect that has not yet been satisfactorily captured by seasonal adjustment algorithms).

**Business confidence fell in December.** Over the final month of the year, confidence fell in three of the four main sectors of economic activity. Industrial inventories worsened at the margin. Demand remained stable and above installed capacity utilization (Nuci), but excessive inventories were back on the rise. The inventory adjustment cycle is therefore likely to last a little longer than expected, in which case industrial output will rise more slowly. However, given our previous observations of the automotive sector, we expect to see inventories stop falling in the months ahead, which would support an economic recovery.

**GDP likely to fall again in 4Q16.** Industrial output was not the only disappointment in 4Q16, as other sectors also failed to perform as expected. We estimate that GDP will fall by 0.6% in the fourth quarter of 2016 compared with the preceding quarter, after seasonal adjustment (we had previously forecast that GDP would remain stable). All else being equal, the statistical inheritance for 2017 would then deteriorate to -0.8% from -0.4%. Despite weaker data at the margin, however, demand fundamentals remain stable. More specifically, commodity prices (which, on average, are likely to rise in 2017 compared with 2016) and ongoing monetary policy easing may support moderate growth in 2017. We have therefore lowered our 2017 GDP forecast to 1.0% (from 1.5%), incorporating the less favorable statistical carryover.

Negative surprise from the formal labor market. In November, a net of 117,000 formal jobs were destroyed (according to figures from CAGED). Stripping out seasonal effects, we estimate a contraction of 128,000 jobs (spread fairly evenly across all sectors). We expect job destruction to ease in the coming months as the downturn in economic activity attenuates.
Unemployment remains high. The national unemployment rate rose to 11.9% in November. With seasonal effects stripped out, unemployment registered its 24\textsuperscript{th} consecutive monthly increase, climbing to 12.3% from 12.1%. As economic activity is growing more slowly than we expected, we are now forecasting an unemployment rate of 13.2% for the end of 2017, up from 12.2% previously. In 2018 we expect a small drop in unemployment, to 12.9%, given the lag in the job market’s reaction to economic activity.

Economic activity still affecting the labor market

Fiscal: spotlight remains on reforms in 2017

Throughout 2017, the spotlight will remain on the approval and implementation of fiscal reforms. This will be the first year that the new public spending cap is in effect. In December of last year, the Senate approved and the President sanctioned a constitutional amendment limiting primary federal expenditure growth to the previous year’s inflation rate for the next ten years. The amendment will reverse the 20-year trend of uninterrupted real increases in primary federal expenditure, gradually correcting the fiscal imbalance as the economy returns to growth.\footnote{See Macro Vision: \textit{FAQs: The Spending Cap (PEC 241)}}

The Lower House will debate Social Security reforms – which will be critical for future compliance with the spending cap – during the first half of this year. Social Security expenditure represented 40\% of the federal government’s total primary expenditure (8.0\% of GDP) in 2016 and is poised to increase in real terms over the coming years as the population ages. The proposed reform would better align the federal budget with Brazil’s demographic trends, setting a minimum retirement age of 65 and unifying the rules on access to Social Security benefits for men and women, public-sector and private-sector workers, and urban and rural residents.\footnote{See Macro Vision: \textit{FAQs: Social Security Reform (PEC 287)}}

Without a reform, Social Security would make the spending cap unviable

In the Brazilian states that are in the most precarious financial situations, such as Rio de Janeiro, Rio Grande do Sul and Minas Gerais, fiscal reform will be addressed through a fiscal recovery regime. Under the regime, the states will have a grace period of up to three years on debt repayments to the federal government. In exchange, their legislative assemblies will have to approve adjustments to control spending and increase revenues, in order to correct their structural imbalances.\footnote{See Macro Vision: \textit{Brazilian states in crisis: diagnosis and solutions}}

We believe that the fiscal reforms and progress on state-level adjustments are critical for stabilizing Brazil’s medium-term public debt. We forecast a

\begin{center}
\begin{tabular}{c|c|c|c|c|c}
\hline
Year & 2016 & 2020 & 2025 \\
\hline
Social Security expenditure & 40\% & 50\% & 65\% \\
\hline
\end{tabular}
\end{center}
return to primary surpluses only in 2020, but a return to
growth and a structural decline in interest rates
following the adoption of reforms could slow the pace
of annual public debt growth significantly. More
specifically, we believe that public debt will remain
stable at around 80% of GDP from 2018 on.

We have raised our forecast for the 2016 primary
deficit to 2.6% of GDP (BRL 160 billion) from 2.4%
of GDP (BRL 150 billion). We revised our estimate
to incorporate a BRL 5 billion increase in payments from
previous fiscal years (“restos a pagar”) in December of
last year and a BRL 5 billion transfer to municipal
governments linked to fines levied under the foreign
asset repatriation program, which we had not
previously included in this account. With this, the
primary result is now likely to be only slightly ahead of
the annual target of -2.6% of GDP (BRL -164 billion).

We have maintained our forecast for a primary
deficit of 2.2% of GDP (BRL 142 billion) in 2017, in
line with the government target. We have included
the BRL 10 billion raised under the new tax
regularization program, which is likely to offset an
equivalent revenue shortfall resulting from our
worsening growth forecasts. Meeting the year’s
primary result target will mean realizing BRL 60 billion
in extraordinary revenues, which we expect to come
from the tax regularization program, an extension of
the asset repatriation program, energy auctions,
infrastructure concessions and taxes raised from IPOs.

| Fulfillment of the 2017 primary target depends on 60 BRL bln in extraordinary revenues |
|---------------------------------|---------------------------------|
| Total (BRL bln) | 60 |
| Concessions and asset sales | 20 |
| Energy auctions | 17 |
| Repatriation of funds abroad | 13 |
| Tax regularization program | 10 |

Source: Itaú

For 2018, we expect a primary deficit of 1.6% of
GDP (BRL 116 billion). This forecast takes into
account the second year of the spending cap and BRL
35 billion (0.5% of GDP) in extraordinary revenues,
which is compatible with a gradual reversal of Brazil’s
fiscal imbalance.

Less intense BRL depreciation

The exchange rate ended 2016 at BRL 3.25 to the
dollar. The external environment has become more
favorable for emerging-market economies, with rising
commodity prices and a drop in risk aversion (which
had risen because of the U.S. elections in November),
which helps explain why the USD has lost strength
against other currencies, including the BRL.

We have lowered our exchange-rate forecasts to
3.50 BRL per dollar at the end of 2017 (previously
3.60) and 3.50 BRL per dollar at the end of 2018
(previously 3.70). We are forecasting a slightly more
favorable external scenario for emerging-market
economies than we had previously. Even so, as U.S.
interest rates increase (however gradually) throughout
the year and commodity prices drop from their current
levels, the BRL is likely to depreciate from current
levels. Our scenario assumes the approval of the
Social Security reforms. This currency trend is in line
with a scenario of a slight increase in current account
deficits, at levels that will not compromise external
sustainability.

In 2016, the trade surplus reached USD 48 billion, the highest level in the historical series (since 1992). Exports fell slightly from 2015 levels (USD 185 billion in 2016, compared with USD 191 billion in 2015), but a sharp decline in imports (to USD 138 billion from USD 171 billion) on the back of weak activity guaranteed a largely positive outcome. Despite the trade surplus, we again saw a significant reduction in Brazil’s trade flow, which fell to USD 323 billion from USD 363 billion.

The current account deficit continued to retreat in 2016. The 12-month current account deficit shrunk to 1.1% of GDP in November, compared with 3.3% at the end of 2015. The improvement was widespread, driven by successive trade surpluses and lower service and income deficits. However, the current account deficit stabilized at the margin. The annualized three-month moving average, with seasonal effects stripped out, has been hovering around a USD 20-25 billion deficit since September of last year.

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4 As reported by the MDIC.
The trade surplus hits an all-time high

![The trade surplus hits an all-time high](chart)

Source: MDIC, Itaú

On the financing side, direct investment in the country amounted to 4.4% of GDP, enough to fully cover the current account deficit and thus reducing dependency on more volatile financing sources. However, foreign investment in portfolios (fixed-income and the stock market) continued to show outflows (1% of GDP over the 12 months through November).

For the coming years, we forecast a slight increase in the current account deficit, but not enough to compromise external sustainability. We forecast trade surpluses of USD 46 billion in 2017 and USD 37 billion in 2018. We forecast a USD 30 billion current account deficit in 2017 (previously USD 29 billion) and USD 43 billion deficit in 2018.

Lower inflation forecasts for 2017 and 2018

The IPCA rose 0.30% in December, slightly below our estimates and median market expectations. As a result, after posting a 10.7% increase in 2015, the index ended last year up just 6.3% – well below what was expected just a few months ago and within the inflation target tolerance range. Market prices rose by 6.6% last year (compared with 8.5% in 2015), contributing 5.0 pp to inflation over that period (down from 6.6 pp in 2015). Regulated prices rose by 5.5% last year (compared with 18.1% in 2015), contributing 1.3 pp to inflation over that period (down from 4.1 pp in 2015).

Our IPCA inflation forecast for 2017 has been lowered to 4.7% from 4.8%. The effects of lower inflationary inertia and the downward revision in our exchange-rate scenario more than offset the impact of unexpected upward pressure on prices in the public transportation and telephony sectors. According to our forecasts, inflation will continue to fall in the months ahead compared with the same period of last year, despite a seasonal first-quarter increase. In the last-12-month metric we are forecasting that inflation will fall steadily, to 5.5% in January, 5.1% in March, 4.5% in June and 4.3% in September – and we note that disinflation is likely to trigger a welcome debate about a possible reduction in the inflation target.

On a disaggregated basis, we are forecasting a 4.4% rise in market prices and a 5.6% increase in regulated prices for 2017. Looking at market prices, we have reduced our forecast for home food price inflation to 3.7% from 4.0% (compared with 9.4% in 2016) based on our revised exchange-rate scenario, while maintaining the outlook that the world’s largest agricultural producers will enjoy bumper harvests as they reap the benefit of favorable weather conditions. In the other segments, we are forecasting a 5.3% increase in service prices (compared with 6.5% in 2016) and a 3.4% increase in industrial prices (compared with 4.8% in 2016). The labor market and real estate sector will continue to face adverse conditions; along with a reduced inertial effect from past inflation and smaller increases in the minimum salary, this is likely to have a moderating effect on salary and rent costs, contributing to a further decline in service inflation this year. Looking at regulated prices, we are forecasting price increases of 1% for gasoline, 5% for drugs, 5% for fixed-line telephony, 7% for urban bus transportation, 8% for electricity and 11% for health plans.

Our 2018 inflation forecast has fallen to 4.0% from 4.2%. On a disaggregated basis, we are now forecasting a 3.9% rise in market prices and a 4.5% increase in regulated prices in 2018. The full-year inflation forecast was lowered to reflect the revision of our exchange-rate scenario and the outlook for a slower labor market recovery. As noted above, if there are occasions when inflation comes in below the center of the target range this year, it may create an opportunity to discuss reducing the inflation target for the years ahead.

The main inflation-scenario risk factors are external scenario uncertainties and domestic political issues. Despite the markets’ apparent tranquility at the beginning of the year, greater
uncertainty abroad could trigger an increase in risk premiums, which in turn may result in further exchange-rate depreciation. In fiscal terms, any further difficulties moving ahead with the necessary reforms and adjustments could put additional pressure on risk premiums and exchange rates and create an opening for alternative fiscal measures, with a greater focus on tax hikes. So far, however, the signs have been positive for the fiscal reform effort.

The high level of idle capacity in the economy may help to push inflation down further. Although this indicator is subject to uncertainty and errors of measurement, the output gap (the difference between potential GDP and actual GDP) appears to be negative, which could lead to faster market price disinflation over the next few months, particularly in areas that are more sensitive to the economic cycle, like industrial products and services. The inflation surprises in recent months already suggest that there is a more widespread disinflation process underway across exactly these components. This means that progress on fiscal reforms could further improve the outlook for inflation, either through exchange rate and inflation expectations, or via a gradual switch from expansionary to neutral or even contractionary fiscal policies.

More solidly grounded expectations reinforce the scenario of falling inflation. According to the central bank’s Focus survey, median inflation expectations for 2016 retreated again last month, from 4.9% to 4.8%, which is close to the inflation target. In turn, median expectations for 2018 and beyond remain solidly around the target (4.5%), reflecting economic agents’ increasing conviction that the central bank will take steps to ensure that the IPCA will indeed converge over a timeline that will allow monetary policy to have a greater effect.

Monetary policy: lower interest rates in 2017

At its January monetary policy meeting, the central bank decided to make another interest rate cut, this time of 75 bps, bringing the Selic rate to 13.00%, in line with our expectations. In its statement and the meeting minutes, the committee signaled the possibility of at least one more 75-bp cut in February, but did not commit to delivering it. This strategy is justified, in our view, because inflation is falling faster – and more broadly – than expected and activity is failing to meet expectations in an environment where inflation expectations are anchored. The central bank also indicated that this movement is consistent with a front-loading of the monetary easing cycle but not, in principle, with a change in the total budget for monetary loosening.

In our view, rising unemployment will continue to help bring down inflation, and given no further uncertainty abroad, this should allow the central bank to maintain a faster pace of monetary policy easing over the next several meetings. We expect two additional 75-bp cuts at the February and April meetings.

We have lowered our year-end Selic rate forecast for 2017 to 9.75% (previously 10%), as the inflationary scenario is more benign than we anticipated.

Looking at 2018, we believe that the continued downward trend in inflation and high levels of unemployment are consistent with further interest rate cuts. We expect a Selic rate of 8.50% at the end of 2018.
## Forecast: Brazil

### Economic Activity

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<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>7.5</td>
<td>4.0</td>
<td>1.9</td>
<td>3.0</td>
<td>0.5</td>
<td>-3.8</td>
<td>-3.4</td>
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<tr>
<td>Nominal GDP - BRL bn</td>
<td>3,886</td>
<td>4,376</td>
<td>4,815</td>
<td>5,332</td>
<td>5,779</td>
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<td>6,256</td>
<td>6,585</td>
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<tr>
<td>Nominal GDP - USD bn</td>
<td>2,208</td>
<td>2,612</td>
<td>2,463</td>
<td>2,468</td>
<td>2,455</td>
<td>1,802</td>
<td>1,794</td>
<td>1,951</td>
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<td>Population (millions)</td>
<td>195.5</td>
<td>197.4</td>
<td>199.2</td>
<td>201.0</td>
<td>202.8</td>
<td>204.5</td>
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<td>Per Capita GDP - USD</td>
<td>11,292</td>
<td>13,234</td>
<td>12,362</td>
<td>12,278</td>
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<td>8,811</td>
<td>8,707</td>
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### Inflation

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<tbody>
<tr>
<td>IPCA - %</td>
<td>5.9</td>
<td>6.5</td>
<td>5.8</td>
<td>5.9</td>
<td>6.4</td>
<td>10.7</td>
<td>6.3</td>
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<td>IGP-M - %</td>
<td>11.3</td>
<td>5.1</td>
<td>7.8</td>
<td>5.5</td>
<td>3.7</td>
<td>10.5</td>
<td>7.2</td>
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### Interest Rate

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<tbody>
<tr>
<td>Selic - eop - %</td>
<td>10.75</td>
<td>11.00</td>
<td>7.25</td>
<td>10.00</td>
<td>11.75</td>
<td>14.25</td>
<td>13.75</td>
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### Balance of Payments

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<tbody>
<tr>
<td>BRL/USD - eop</td>
<td>1.66</td>
<td>1.87</td>
<td>2.05</td>
<td>2.36</td>
<td>2.66</td>
<td>3.96</td>
<td>3.26</td>
<td>3.50</td>
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<tr>
<td>Trade Balance - USD bn</td>
<td>20</td>
<td>30</td>
<td>19</td>
<td>2</td>
<td>-4</td>
<td>20</td>
<td>48</td>
<td>46</td>
<td>37</td>
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<tr>
<td>Current Account - % GDP</td>
<td>-3.4</td>
<td>-2.9</td>
<td>-3.0</td>
<td>-3.0</td>
<td>-4.2</td>
<td>-3.3</td>
<td>-1.3</td>
<td>-1.5</td>
<td>-2.1</td>
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<tr>
<td>Direct Investment (liabilities) - % GDP</td>
<td>4.0</td>
<td>3.9</td>
<td>3.5</td>
<td>2.8</td>
<td>3.9</td>
<td>4.2</td>
<td>4.3</td>
<td>3.6</td>
<td>3.5</td>
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<tr>
<td>International Reserves - USD bn</td>
<td>289</td>
<td>352</td>
<td>379</td>
<td>376</td>
<td>374</td>
<td>369</td>
<td>372</td>
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### Public Finances

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<tbody>
<tr>
<td>Primary Balance - % GDP</td>
<td>2.6</td>
<td>2.9</td>
<td>2.2</td>
<td>1.7</td>
<td>-0.6</td>
<td>-1.9</td>
<td>-2.6</td>
<td>-2.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>Nominal Balance - % GDP</td>
<td>2.4</td>
<td>-2.5</td>
<td>-2.3</td>
<td>-3.0</td>
<td>-6.0</td>
<td>-10.2</td>
<td>-9.8</td>
<td>-9.0</td>
<td>-8.0</td>
</tr>
<tr>
<td>Gross Public Debt - % GDP</td>
<td>51.8</td>
<td>51.3</td>
<td>53.7</td>
<td>51.5</td>
<td>56.3</td>
<td>65.5</td>
<td>70.5</td>
<td>76.2</td>
<td>78.6</td>
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<tr>
<td>Net Public Debt - % GDP</td>
<td>38.0</td>
<td>34.5</td>
<td>32.3</td>
<td>30.6</td>
<td>33.1</td>
<td>36.0</td>
<td>47.2</td>
<td>52.7</td>
<td>56.8</td>
</tr>
</tbody>
</table>

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC
Argentina

Ready to go?

- The economy appears to have emerged from recession in 4Q16, after a necessary adjustment in relative prices. We expect 2.7% GDP growth in 2017 to be followed by 3% expansion in 2018.
- Inflation posted a marked deceleration to below 20% (annualized) in 2H16. However, meeting the central bank’s target for 2017 (12%-17%) will be challenging and highly dependent on the outcome of the coming wage negotiations.
- The central bank set a new seven-day reference rate (Repo rate) of 24.75%, unchanged from the 35-day reference rate that was maintained in December 2016. We expect gradual monetary easing ahead.
- We expect a fairly stable bilateral ARS-USD real exchange rate in 2017 and 2018, relative to end-2016. Uncertainties in the external environment will, in our view, mitigate the impact of net USD inflows.
- Positive tax amnesty surprises, which include a declaration of assets of USD 100 billion so far and fiscal revenue of 1.3% of GDP. Extraordinary revenues will likely allow the government to more than comply with the primary deficit target for 2016 (4.8% of GDP) and improve the outlook for 2017.
- President Mauricio Macri’s approval rating remains high and attention is beginning to turn to the midterm elections.

Recession at an end

Different indicators suggest the beginning of a recovery in 4Q16. The IGA (a GDP proxy estimated by private consulting firm OJF) grew 0.3% in October and 0.4% in November. The coincident indicators for December, such as consumer confidence, retail sales, cement deliveries, car production and credit in real terms show a continued recovery. Real wages improved somewhat following the inflation deceleration in 2H16, recovering part of the loss registered in 2016 (estimated at -5.7% yoy). An extra bonus, pension increases and higher social subsidies apparently helped to nudge demand at the end of last year.

We anticipate a recovery to 2.7% in 2017, following a 2.4% GDP contraction in 2016. A pick-up in activity will be driven by a recovery in real wages and investment as well as access to capital markets and market-friendly policies.

A round of wage moderation will be key to consolidating disinflation

Inflation decelerated in 2H16 to an annualized figure of 19.1%, from 75% in the first six months of the year. The high inflation seen in 1H16 reflected the impact of the necessary changes in relative prices (currency depreciation and tariff hikes). Inflation fell to 1.2% mom in the City of Buenos Aires in December (down from 2% in November), bringing the annual rate to 41% and matching our forecast for 2016. Inflation in the Greater Buenos Aires Area (according to the index published by INDEC, the official statistic agency) also came in at 1.2% for the month. Disinflation was led by a credible monetary policy, recession and a more stable currency.

The central bank inflation target range (12%-17%) for 2017 is nevertheless still ambitious, in our view. Inflation expectations (at 21% according to the latest central bank survey) also came in above the upper limit of the band. A new round of annual wage negotiations will start at the end of 1Q17. The government of the Province of Buenos Aires has already reached an agreement with some public workers’ unions for an 18% salary adjustment. The deal sets a good precedent, as the
wage increase is much closer to the forward looking target than to past inflation, but is still limited in terms of scope. Key negotiations with teachers will likely start in February, before the beginning of the new school year. The more the new agreements internalize the inflation target or inflation expectations (instead of past inflation), the better the inflation outlook will be. We expect inflation to fall to 22% in 2017. Despite an expected moderation in wages, prices are likely to continue to be pressured by a new round of energy tariff hikes and currency depreciation.

### Disinflation

![Graph showing disinflation](source: Government of Buenos Aires City)

### New monetary policy framework

As previously announced, the central bank began to use the center of the seven-day repo rate range as the monetary policy instrument in 2017. The monetary authority left its new reference rate (7-day repo rate) at 24.75% in the first weeks of January (unchanged from the 35-day Lebac rate – the previous policy rate - that had prevailed since the first week of December). The deterioration of inflation expectations for 2017 has made the central bank more cautious about monetary easing. We expect the reference rate to reach 20% before the end of December 2017 as inflation and inflation expectations resume a downward trend.

The multilateral real exchange rate strengthened by 4.6% in 2016; appreciation against the USD was 9.0%. The nominal exchange rate depreciated by 22%, to 15.85 ARS/USD at YE16. The exchange rate hit 16 ARS/USD in mid-December (our forecast for YE16), but a surge of capital inflows at the end of the month slightly strengthened the ARS. The inflows were mostly to pay penalties related to the tax amnesty and to purchase local-currency bonds. The latter was encouraged by Argentina’s removal of the last remnant of capital controls, which imposed a minimum term (120 days) for foreign capital flows. The decision allows ARS bonds to enter well-known international bond indices, increasing the demand for these assets. This trend toward appreciation will, in our view, likely be mitigated by uncertainties surrounding the external scenario and higher interest rates in the U.S. We expect the exchange rate to hit 19.2 ARS/USD by December 2017, implying a fairly stable bilateral rate in real terms.

### Peso strengthened

![Graph showing peso strengthening](source: BCRA)
We now project that the current account deficit will reach 2.8% of GDP in 2016 (vs. 2.1% in our previous scenario). The deterioration in the travel account offset the improvement in the trade balance. The accumulation of reserves also exceeded our expectations. Gross reserves increased by USD 13.3 billion, to USD 38.8 billion, throughout 2016. Although the central bank has not intervened in the market since mid-July, it purchased USD 7.5 billion directly from the treasury and USD 0.7 billion through the tax amnesty program. Reserves net of the central bank’s foreign currency obligations also recovered last year, to USD 12.0 billion from zero in December 2015. We adjusted our forecast for international reserves in 2017 to USD 43.8 billion (from USD 38.8 before) based on our expectation that the treasury will continue to finance the deficit mostly in the international markets and selling dollars directly to the central bank (instead of going through the exchange rate market). The ARS is likely to remain strong as internal demand recovers and interest payments abroad increase; we therefore expect a current account deficit of 3.5% of GDP (vs. 2.8% in our previous scenario) in 2017.

Rebuilding reserves

Source: BCRA, IMF

Tax amnesty result exceeds expectations

Total declared assets had already reached USD 100 billion (18% of GDP) at the end of 2016, significantly surpassing the most optimistic market expectations (between USD 40 billion and USD 60 billion) and the threshold (USD 20 billion) set by the then Minister of Treasury & Finance, Alfonso Prat-Gay, as a reasonable goal just a few months ago. As a result, the treasury has already collected penalties totaling 1.3% of GDP, significantly boosting the tax collection in December, which will likely allow the government to more than comply with the primary deficit target of 4.8% of GDP for 2016. The deadline to declare assets (mostly held abroad) expires in March. However, the penalty for assets declared this year is now 15%, unless the assets are brought to Argentina and allocated to specific treasury bonds or designated investment projects. The funds declared this year are therefore more likely to result in capital inflows.

We now expect a primary deficit of 4.5% of GDP in 2016 (down from 4.8% in our previous scenario) and a nominal deficit of 4.7% of GDP. For 2017, we expect a 4.7% primary deficit, from 5% previously. Primary expenditures fell by 8.6% yoy in real terms in the first eleven months of 2016 (mostly due to the reduction in energy subsidies), but the impact was partially offset by a 12.8% contraction in revenues due to tax cuts and a weak economy. The government confirmed it will seek a primary deficit target for 2017, at 4.2% of GDP, implying a gradual consolidation path. Because more offshore assets are expected to be declared, we adjusted our primary deficit forecast to 4.7% of GDP, from 5% previously.

Pending fiscal consolidation

Source: Ministry of Economy

The ministry of finance plans to tap domestic and international markets to finance both the primary deficit targeted for this year and the USD 28.0 billion debt service (principal and interest, mostly on bonds, excluding public agency holdings). The program
encompasses bank loans and bond issuance of USD 30.0 billion, among other sources of finance. The government has already signed a USD 6.0 billion 18-month repo bond with a group of international banks at a cost of 3.8% per year, and has sold USD 7.0 billion in bonds in the international market.

One year in office

President Macri’s approval rating remains high (55%) despite some loss of popularity in 2016 – a year of harsh adjustments and recession. More than seventy bills were negotiated with the opposition and passed, the most controversial of which was the income tax reform. Although the approved bill had a larger fiscal cost than originally planned, it was mostly offset by the elimination of VAT benefits on the use of debit cards.

Macri reshuffled the cabinet in December 2016, ousting the Minister of Treasury and Finance, Alfonso Prat-Gay, and splitting his functions into two new Ministries. Nicolás Dujovne was appointed Minister of the Treasury and Luis Caputo was appointed Minister of Finance. Dujovne, a former private consultant, has experience in both the private and public sectors (particularly in fiscal affairs). Caputo led the team that negotiated with the holdouts and issued bonds in the international markets. The change signals the government’s commitment to improving coordination and reinforces the path of gradual fiscal consolidation.

In his initial public remarks, Minister Dujovne outlines a reform agenda focused on increasing formal employment, improving fiscal institutions, and optimizing expenditures. The government is analyzing initiatives that include a reduction in payroll taxes, a fiscal responsibility law and the creation of a new public credit office.

Argentines will vote in October to renew half of the house of representatives and a third of the senators. The congress will likely continue to have no majority party leader. The incumbent party has few seats at stake, so it is unlikely to lose representation, but it is also unlikely to increase it significantly. The most important outcome to monitor is the Province of Buenos Aires, currently governed by Frente Cambiemos (Macri’s coalition with radicals). A victory for Macri would put him in a good position for a presidential reelection in 2019, while a defeat could give some impetus to dissident Peronists.

Scenario for 2018

We expect the economy to consolidate growth in 2018 (we forecast 3%) based on a further recovery of real wages, looser monetary policy and the benefits of business-friendly economic policies. Inflation is likely to continue to decelerate, to 16%, as moderate wage negotiations this year contribute to lower inflationary inertia, allowing for lower nominal interest rates. We see the repo rate at 16% by December 2018. We expect a stable bilateral real exchange rate of 21.9 ARS/USD, relative to YE17. We anticipate some fiscal consolidation, bringing the primary deficit to 3.8% of GDP. The current account deficit will likely deteriorate to 3.7% of GDP as higher imports accompany activity.
## Forecast: Argentina

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<td>Real GDP growth - %</td>
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<td>2.4</td>
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<tr>
<td>Nominal GDP - USD bn</td>
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<td>579.6</td>
<td>611.0</td>
<td>563.9</td>
<td>630.4</td>
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<td>Population (millions)</td>
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<td>41.7</td>
<td>42.2</td>
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<td>43.6</td>
<td>44.0</td>
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<td>13,888</td>
<td>14,478</td>
<td>13,215</td>
<td>14,616</td>
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<td>7.1</td>
<td>7.3</td>
<td>6.5</td>
<td>9.0</td>
<td>8.5</td>
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<tr>
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<td>25.6</td>
<td>26.6</td>
<td>38.0</td>
<td>26.9</td>
<td>41.0</td>
<td>22.0</td>
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<td>BADLAR - eop - %</td>
<td>17.19</td>
<td>15.44</td>
<td>21.63</td>
<td>20.38</td>
<td>27.25</td>
<td>19.88</td>
<td>16.00</td>
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<td>Lebac 35 days - eop - %</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>33.00</td>
<td>24.75</td>
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<td>Repo rate 7 days - eop - %</td>
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<td>-</td>
<td>-</td>
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<td>-</td>
<td>24.75</td>
<td>20.00</td>
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<td>ARS / USD - eop</td>
<td>4.30</td>
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<td>6.52</td>
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<td>13.01</td>
<td>15.85</td>
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<td>Current Account - % GDP</td>
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<td>-0.2</td>
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<td>-2.7</td>
<td>-2.8</td>
<td>-3.5</td>
<td>-3.7</td>
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<td>Foreign Direct Investment - % GDP</td>
<td>1.9</td>
<td>2.4</td>
<td>1.4</td>
<td>0.8</td>
<td>1.6</td>
<td>1.1</td>
<td>1.7</td>
<td>2.4</td>
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<td>International Reserves - USD bn</td>
<td>46.4</td>
<td>43.3</td>
<td>30.5</td>
<td>31.4</td>
<td>25.6</td>
<td>38.8</td>
<td>43.8</td>
<td>47.0</td>
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<tr>
<td>Primary Balance - % GDP</td>
<td>-0.8</td>
<td>-1.2</td>
<td>-2.4</td>
<td>-3.7</td>
<td>-5.0</td>
<td>-4.5</td>
<td>-4.7</td>
<td>-3.8</td>
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<tr>
<td>Nominal Balance - % GDP</td>
<td>-1.4</td>
<td>-2.1</td>
<td>-2.0</td>
<td>-2.7</td>
<td>-4.8</td>
<td>-4.7</td>
<td>-5.5</td>
<td>-4.5</td>
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<tr>
<td>Gross Public Debt - % GDP</td>
<td>38.7</td>
<td>40.2</td>
<td>43.3</td>
<td>44.4</td>
<td>53.6</td>
<td>51.6</td>
<td>54.4</td>
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Source: IMF, Bloomberg, BCRA, Haver and Itaú
**Mexico**

**Aftermath of the “gasolinazo”**

- The hike and announced liberalization of gasoline prices will benefit fiscal accounts, but has worsened the near-term inflation outlook and triggered social unrest six months before a crucial regional election that might have a bearing on the result of the presidential and legislative elections (due in 2018).

- We have increased our inflation forecast for 2017 (to 4.6%, from 3.9%). Exchange-rate pass-through and the liberalization of gasoline prices will be the drivers of consumer prices in 2017.

- We have revised our exchange rate forecast for 2017 upward (to 20.5, from 19.5), as the risk of more protectionist policies in the U.S. has intensified.

- Inflation should eat through real wages and tighter macroeconomic policies will hurt consumers. This, added to growing uncertainty over protectionism, will weigh negatively on growth in 2017. We have revised our GDP growth forecast downward (to 1.6%, from 1.8%).

- Given the deterioration of the inflation outlook, we believe that the Central Bank will tighten monetary policy more aggressively than we previously anticipated. We expect Banxico to hike 50 bps in February, and then follow the Fed (3x 25 bps), taking the reference rate up to 7% in 2017.

**Liberalization of gasoline prices backfires**

The liberalization of gasoline prices implies fiscal relief, at the expense of higher inflation and social and political backlash. In late December, the Ministry of Finance decided to frontload the adjustment of gasoline prices by announcing a 15% average increase that would take place on the first day of 2017. Different maximum prices were set in 83 regions, based on specific market conditions. Maximum prices will be eliminated according to a liberalization calendar, announced previously by the Energy Regulatory Commission (CRE), between March and December. Importantly, according to the government, maximum regional gasoline prices are already supposed to reflect market prices. By the end of this year gasoline prices will be fully market determined.

The main goal of liberalizing gasoline prices is to safeguard fiscal revenues. According to the government, keeping the gasoline subsidies would have cost MXN 200 billion (1% of GDP) per year. Coupled with another sizable dividend from Banxico (1.2% of GDP in 2016) from exchange gains on reserves, the liberalization of prices makes it easier for the government to achieve the 0.4% of GDP primary surplus target in 2017 and thus prevent a rating downgrade. Higher oil prices will help too.

Nevertheless, fiscal accounts deteriorated in the last months of 2016. We note that the 12-month fiscal deficit widened from MXN 369.5 billion (around 1.9% of GDP) in October to MXN 400.8 billion (2.1% of GDP) in November, while net public debt climbed from 46.8% of GDP to 48.5% of GDP during the same period (mainly as a result of sharp peso depreciation, which increased the local-currency value of foreign debt). We expect an annual fiscal deficit of 2.7% of GDP in 2016, as lower revenues from the oil hedge (USD 2.7 billion in 2016 vs. USD 6.3 billion in 2015, 0.3 pp of GDP difference in peso terms) and the back-loading of public-debt interest payments will widen the deficit in the last month of the year. Likewise, we believe that net public net debt ended 2016 at 49.2% of GDP, considering that the federal government purchased the pension liabilities of the National Electricity Company (CFE) for MXN 160 billion (0.8% of GDP) in December.

However, liberalizing gasoline prices worsened the inflation outlook further. Headline inflation ended 2016 at a moderate 3.4%, within the Central Bank’s target range, but the beginning of 2017 has featured multiple shocks on inflation. In addition to the “gasolinazo,” there has been a 15% rise in the liquefied petroleum gas price, a 10% hike in the minimum wage, a 15% increase in the tortilla price (an important staple), higher local taxes in 14 of Mexico’s 31 states, higher electricity prices and a further weakening of the exchange rate (over rising risk that President Trump will pursue protectionist policies). As a result, we have increased our inflation forecast for 2017 (to 4.6%, from 3.9%).

Considering the temporary nature of the abovementioned shocks and assuming that Banxico manages to prevent significant second-round effects, we believe that inflation will moderate to 3.3% in 2018.
Inflation expectations increasing

Another negative spillover of the “gasolinazo” is the social and political backlash. Social unrest began as street protests and degenerated into the looting of 370 retail stores across 9 of Mexico’s 31 states (according to The National Association of Supermarkets and Department Stores, ANTAD); something that will likely affect activity in January. Moreover, the radical-left political leader, Andrés Manuel López Obrador (AMLO), capitalized on the unrest by blaming the government’s energy reform for the increase in gasoline prices. Importantly, after the tax reform – which came into force in 2014 – President Peña Nieto made a public promise not increase taxes further. The point is that gasoline prices have increased because the government is no longer subsidizing them. And semantics aside, most citizens probably do not care about the difference between the elimination of a subsidy and a tax increase.

The regional elections, due in June 2017, could show which party has the better chance of winning the presidential election in 2018. According to Reforma’s poll, President Peña Nieto’s popularity fell from 24% in December 2016 to 12% in January 2017, right after the “gasolinazo”, setting a new historical low. Crucially, the regional elections will include the most populous state in the country, the State of Mexico (PRI’s historical stronghold, where President Peña Nieto was the Governor between 2005 and 2011). We believe that an alliance between the PAN (right) and PRD (left), as they successfully implemented in the 2016 regional elections (with a net gain of five states over the ruling party PRI), would have a high chance of winning the State of Mexico and thus gain traction for 2018.

However, if the PRD allies with the anti-establishment Morena (AMLO’s party) at some point in the presidential race, the perception of political risk in Mexico is set to increase.

Peso weakness keeps pressuring the central bank

Peso depreciation and the possibility of second-round effects are keeping Banxico under pressure. After depreciating 19% in 2016, the Mexican peso depreciated further in the first days of January, over concerns that the next U.S. administration might disrupt FDI inflows into Mexico and adopt more-protectionist trade policies. Against this backdrop, the Foreign Exchange Commission (formed by the Central Bank and the Ministry of Finance) sold USD 2 billion in the spot market without meaningful impact on the currency. In its statement about the decision, the FX Commission mentioned that it acted to mitigate volatility, rather than to defend a specific exchange-rate level. Nevertheless, the statement stressed that the government’s main approach to anchoring the value of the currency will be the “preservation of solid economic fundamentals.” This, in our view, means that macroeconomic policies (monetary and fiscal) will likely be tightened further, and that the government will remain committed to implementing structural reforms.

We have revised our exchange rate forecast for 2017 upward (to 20.5, from 19.5), as the risk of more protectionist policies in the U.S. has intensified. With uncertainty over protectionism gradually dissipating, we expect a moderate appreciation (to 19.5) in 2018.
Our take is that Banxico is more worried about the occurrence of simultaneous shocks, which could derail inflation expectations (and thus produce second-round effects on inflation). Therefore, we believe that the Central Bank will tighten monetary policy more aggressively than we were previously expecting. We expect Banxico to hike 50 bps in the next meeting, and then follow the Fed (3 hikes of 25 bps before the end of this year), taking the reference rate up to 7% in 2017. With lower inflation and a better-behaved currency next year, there would be some room for easing (we expect two 25-bp rate cuts).

**Activity is slowing down**

Mexico’s economic activity slowed down in the beginning of 4Q16. The monthly GDP proxy (IGAE) expanded by 1.2% year over year in October, leaving the 3-month moving-average growth rate at 1.9% year over year (the same as in 3Q16). At the margin, GDP gained a weak 0.2% from the previous month, with the quarter-over-quarter annualized growth rate (qoq/saar) decreasing from 4.2% in 3Q16 to 2.8% in October.

Manufacturing exports are firming up, while consumption seems to be weakening. Manufacturing output advanced 0.7% month over month (the highest print in fifteen months), which is consistent with the pick-up of manufacturing exports (11.4% qoq/saar) reported in November’s trade balance. On the consumption side, the monthly private consumption indicator expanded at a modest 1.8% year over year in October, pulling the three-month moving-average growth rate down to 3.3% year over year (from 3.5% in September). At the margin, private consumption stood flat from September. Also, fiscal consolidation (mostly through Pemex) continues to weigh negatively on mining production and non-residential construction.

We still expect GDP growth of 2.1% in 2016, but have revised our forecast for 2017 downward (to 1.6%, from 1.8%). Tighter fiscal and monetary policies, as well as lower real wages (mainly because of higher inflation) and uncertainty over protectionism, will weigh negatively on economic growth. A buffer, however, is that if protectionism doesn’t materialize, manufacturing exports will likely benefit from stronger growth in the U.S. For 2018, we expect a moderate pick-up to 2.1%, assuming that bilateral relations with the U.S. are not disrupted significantly, in spite of some protectionism.

### Forecast: Mexico

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<tr>
<td>Real GDP growth - %</td>
<td>4.0</td>
<td>4.0</td>
<td>1.4</td>
<td>2.3</td>
<td>2.6</td>
<td>2.1</td>
<td>1.6</td>
<td>2.1</td>
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<tr>
<td>Nominal GDP - USD bn</td>
<td>1,119</td>
<td>1,223</td>
<td>1,264</td>
<td>1,270</td>
<td>1,103</td>
<td>967</td>
<td>1,005</td>
<td>1,110</td>
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<td>Population (millions)</td>
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<td>117.1</td>
<td>118.4</td>
<td>119.7</td>
<td>121.0</td>
<td>122.3</td>
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<td>Per Capita GDP - USD</td>
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<td>10,676</td>
<td>10,811</td>
<td>9,116</td>
<td>7,908</td>
<td>8,138</td>
<td>8,903</td>
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<td>Unemployment Rate - year avg</td>
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<td>4.9</td>
<td>4.8</td>
<td>4.4</td>
<td>3.9</td>
<td>4.3</td>
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<tr>
<td>CPI - %</td>
<td>3.8</td>
<td>3.6</td>
<td>4.0</td>
<td>4.1</td>
<td>2.1</td>
<td>3.4</td>
<td>4.6</td>
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### Interest Rate

| Monetary Policy Rate - eop - % | 4.50 | 4.50 | 3.50 | 3.00 | 3.25 | 5.75 | 7.00 | 6.50 |

### Balance of Payments

| MXN / USD - eop | 13.9 | 13.0 | 13.1 | 14.7 | 17.4 | 20.7 | 20.5 | 19.5 |
| Trade Balance - USD bn | -1.4 | 0.0 | -1.2 | -3.1 | -14.6 | -15.0 | -9.0 | -8.0 |
| Current Account - % GDP | -1.2 | -1.4 | -2.5 | -2.0 | -2.9 | -2.8 | -2.4 | -2.3 |
| Foreign Direct Investment - % GDP | 2.1  | 1.7  | 3.7  | 2.1  | 2.8  | 2.7  | 2.9  | 2.7  |
| International Reserves - USD bn | 142.5| 163.6| 176.6| 193.0| 176.4| 176.5| 165.0| 160.0|

### Public Finances

| Nominal Balance - % GDP | -2.4 | -2.6 | -2.3 | -3.2 | -3.5 | -2.7 | -2.4 | -2.1 |
| Net Public Debt - % GDP | 33.3 | 34.3 | 36.9 | 40.3 | 45.0 | 49.2 | 48.7 | 48.4 |

Source: IMF, Bloomberg, INEGI, Banxico, Haver and Itaú
Chile

Monetary easing begins

• In 2018, Chile will have posted five consecutive years of low growth, following the end of the commodities boom cycle and subdued private sentiment.

• A more stable currency has led to faster-than-expected disinflation. The inflation index will move towards the bottom of the 2%-4% target range this year, before returning to the 3% target in 2018.

• The central bank started a loosening cycle in January amid low growth and falling inflation. Recent activity and inflation data supports our call of a 100-bp easing cycle this year.

• Fitch placed Chile’s sovereign rating in negative watch due to concerns that weak growth has led to a worsening in fiscal dynamics.

• Uncertainty is set to persist this year as surprise presidential candidate, Alejandro Guillier, consolidates his position at the top of the electoral polls, alongside former President Sebastián Piñera.

Disappointing activity

Non-mining activity continues to weaken, dampening expectations of a recovery. The IMACEC monthly GDP proxy increased 0.8% year over year in November, after a 0.4% contraction in October. The weak reading came in spite of the growth recovery in mining, to 2.2% year over year (from -7.1% previously), while non-mining activity was weighed down by manufacturing.

The fourth quarter is set to be the weakest of the year. Activity in the quarter ending in November expanded by 0.6% (vs. +1.6% in 3Q16) – the lowest rate since October 2009. Mining declined by 2.8% (vs. -0.8% in 3Q16), while non-mining activity posted a modest increase of 0.9% (vs. +1.8% in 3Q16). Activity also contracted at the margin.

After a weak end to 2016, growth is likely to remain subdued going into 2017. The impact of supply-side shocks (reduced fishing output, which has affected manufacturing production, as well as mining disruptions) are expected to ease going forward, but still-low confidence could cause the low-growth scenario to persist despite the recent increase in copper prices.

Business confidence according to Icare ended 2016 near the historical lows, at 41.5 (50 = neutral), from 42.9 one year ago, while consumer confidence registered an uptick at the end of the year (to 40.1) but completed three years in negative territory.

Unemployment remains low, however the composition of employment growth continues to indicate a less robust labor market. The recent improvement in waged employment was largely related to jobs without contracts, suggesting that companies are employing workers on a temporary – rather than permanent – basis, as the economic outlook is further evaluated.

Alongside low confidence levels and growing uncertainties surrounding the upcoming presidential elections, the latest data puts a downward bias on our 1.5% GDP estimate for 2016 as well as on the 2% recovery expected for this year. Despite the expected pick-up to 2.5% in 2018, the Chilean economy would register a fifth year of below-potential growth.
Inflation on a downward trend

In December, inflation delivered the third downside surprise in the last four months of 2016, as price pressures eased amid weak activity and a stable exchange rate. Tradable goods have led the disinflation in recent months, while inflation of non-tradables has stabilized.

![Graph showing Tradable inflation falls](image)

Annual inflation came in at 2.7%, from 2.9% in the previous month and 4.4% in 2015. This is the lowest reading since November 2013. Tradable inflation dipped below the lower end of the target range, at 1.7% (vs. 2.2% previously). Meanwhile, non-tradable inflation remained near the upper limit of the target range, at 4.0% (vs. 3.9% previously). Core inflation (excluding food and energy prices) came in at 2.8% (vs. 3.0% previously) – the lowest reading since March 2014. Service inflation within the core index, which better reflects domestic inflationary pressures, was broadly stable at 4%, in line with non-tradable inflation. Our diffusion index continues to moderate, mainly due to the tradable goods component, but the non-tradable component is also moderating.

We expect inflation to remain within the lower half of the central bank’s 2%-4% target throughout 2017. Inflation would end this year at 2.8% and near the 3% target by yearend 2018.

Rate cut

Although the central bank kept the policy rate at 3.5% in December, one board member voted for a 25-bp rate cut. This is the first split decision since September 2015, when the board held the policy rate at 3.0% before initiating its short tightening cycle the following month. According to the minutes of the meeting, the board believes that additional monetary stimulus is necessary. The latest Central Bank Inflation Report assumes a monetary policy path similar to the one implied by asset prices and surveys at the time that the forecasts were elaborated, which indicate a cycle of only 50 bps.

In line with this, the central bank cut its monetary policy rate by 25 basis points to 3.25% in its January meeting. The decision followed disappointing November activity and inflation ending 2016 below expectations. The press release announcing the decision retained the same loosening bias, supporting the expectation of more easing ahead.

We expect the central bank to implement a second 25bp cut in the quarter. However, given the expectations of weak growth and inflation set to hover around 2% for a significant part of 2017, we anticipate further monetary easing. We see the policy rate ending 2017 at 2.5%, implying a cycle of 100 bps. A partial removal of the monetary stimulus would take place later in 2018 (we see the policy rate ending next year at 3.25%), as activity picks up and inflation gradually returns to the center of the target range.

Following Rodrigo Vergara’s departure, Rosanna Costa was appointed as board member. Ms Costa will be the second woman to serve as board member of the central bank of Chile. Previously, she was head of the Budget Office at the Ministry of Finance during the Piñera administration (2010-2014) and until now was the deputy director of local think tank Libertad y Desarrollo, linked to the political right. Ms Costa will serve the remaining three years of former President Vergara’s appointment, until December 2018.

Strong trade surplus in 2016

The trade balance saw a significant improvement at the end of the year. In 4Q16, exports posted the best performance since the quarter ending in August 2011, expanding by 6.5% from last year after falling 2.1% in 3Q16. According to our seasonally-adjusted series, the trade balance picked up to USD 5.3 billion (annualized) in 4Q16, at the margin, marking an improvement from...
the USD 3.7 billion recorded in 3Q16, supported by higher copper prices. The full-year trade surplus therefore came in at USD 4.6 billion, above the USD 3.5 billion recorded in 2015. The mining balance (mostly copper exports and oil imports) inched downward relative to 2015, while the non-mining balance deficit narrowed, leading the improvement in the headline figure.

The strong trade figures suggest that the current-account balance deficit for 2016 would come in at 1.7% of GDP, lower than previously anticipated. Soft internal demand growth and the recent recovery in copper prices will help to keep the current account deficit at a moderate level in 2017 (1.8%) and 2018 (1.9%).

The CLP performed well at the end of 2016 (670 CLP/USD), but depreciation is expected ahead. Lower rates in Chile and rate hikes in the U.S. would lead to a weaker CLP/USD by the end of this year (685) and the next (695).

**Downgraded fiscal outlook**

Fitch Ratings confirmed Chile’s Long-Term Foreign and Local Currency Issuer Default Ratings at ‘A+’ and ‘AA-’, respectively, but revised the outlook to negative from stable. According to the rating agency, the revision reflects prolonged economic weakness, which has contributed to a relatively rapid deterioration in the sovereign balance sheet. While Chile’s sovereign balance sheet continues to be its key strength relative to its peers, it has experienced the fastest erosion of any sovereign in the ‘A’ category, according to the agency. Fitch projects a general government gross debt of 21.4% of GDP by the end of 2016 – double the level registered in 2011, when Chile was upgraded to ‘A+’. Debt could surpass 30% by 2019, still well below the ‘A’ median of around 50%, but converging with the ‘A’ median as a share of revenue given the narrower revenue base.

**Political outsider makes strides**

Alejandro Guillier, an independent left-leaning senator, is leading in a head-to-head contest against ex-president Sebastian Piñera, according to the latest CERC-MORI public opinion survey. The Chilean presidential election will take place in November. The survey has Guillier winning a potential runoff election by 5 points against Piñera. In the first round, the survey showed that Guillier would obtain 19% of the vote, while Piñera would get 23%, not enough to prevent a runoff. Guillier has gained traction as establishment politicians face the backlash of public frustration with corruption scandals and an underwhelming economic performance. There is limited information on Guillier’s views on the economy or a potential government program, and this element of surprise could mean lingering uncertainties going forward (partly reflected in the low business confidence levels). Surveys by other pollsters confirm that the two candidates are consolidating their advantage over the pack. A generalized drop in the number of undecided voters will help reduce the uncertainty going forward.
## Economic Activity

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<td><strong>Real GDP growth - %</strong></td>
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<td>5.5</td>
<td>4.0</td>
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<td><strong>CPI - %</strong></td>
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<td>5.25</td>
<td>5.00</td>
<td>4.50</td>
<td>3.00</td>
<td>3.50</td>
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<tr>
<td><strong>CLP / USD - eop</strong></td>
<td>520</td>
<td>479</td>
<td>525</td>
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<td><strong>Trade Balance - USD bn</strong></td>
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<td>2.3</td>
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<td><strong>Current Account - % GDP</strong></td>
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<td>9.3</td>
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<td><strong>Nominal Balance - % GDP</strong></td>
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<td>-0.6</td>
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<td><strong>Net Public Debt - % GDP</strong></td>
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Source: IMF, Bloomberg, BCCh, INE, Haver and Itaú
Peru

Domestic demand still struggling

- We have revised our GDP growth forecast down for 2017 (to 3.8%, from 4.0%) as domestic demand has weakened further, amid softer labor market conditions and a moderation of business and consumer confidence. Higher terms of trade, nevertheless, should support growth in 2017.

- Rising treasury yields exert exchange-rate depreciation pressure, but the increase of metal prices and the narrowing of the current-account deficit provide relief. We see the real exchange rate broadly stable from current levels.

- We continue expecting inflation at 2.7% in 2017, down from 3.2% in 2016. Disinflation would come from the absence of El Niño supply-side effects and a relatively stable exchange rate. The VAT cut (from 18% to 17%) could be significant too, but the government might backtrack with the proposal.

- The central bank will likely maintain the reference rate at 4.25% throughout 2017. For 2018, we do not expect a change in the policy rate either, as inflation should be close to the target and GDP growth near potential.

Activity hindered by domestic demand

GDP accelerated in 2016, led by metallic mining exports, but domestic demand probably weakened in 4Q16. The GDP proxy expanded 3.6% year over year in November, boosted by metallic mining output (20.1% year over year) and the second fishing season. The latter caused a temporary upsurge in manufacturing output (2.9% year over year, from -3.3% in October) by pushing primary manufacturing growth to a double-digit rate (from nil previously) through the processing of fishmeal and fish oil (among Peru’s top five exports).

Taken together, natural resource sectors (metallic mining, hydrocarbons, fishing, agriculture, and primary manufacturing) expanded at a strong 12.3% year over year in November. Conversely, non-natural resource sectors, which reflect domestic demand, barely grew (1.2% year over year), with the three-month moving average growth rate slowing down to 1.2% year over year (from 1.9% in October).

Two factors could explain a slowdown of domestic demand in 4Q16; namely, a one-off fiscal drag and the deterioration of labor market conditions. Central government expenditures were slashed by 18.5% year over year in 4Q16, in order the meet the fiscal deficit target set for 2016, taking a heavy toll on construction activity. In fact, construction posted its sharpest contraction on record in October (16.5% year over year) and fell by 8.7% in November. Even though this fiscal drag was temporary, we note that the deterioration of labor market conditions, in contrast, could have a more lasting negative effect on domestic demand. In December, the unemployment rate stood at 6.2%, 0.6 pp above the rate recorded in the same month of last year. Formal employment contracted by 0.2% year-over-year in 4Q16, after expanding 0.8% in 3Q16, and the growth of nominal wages slowed down to a still-strong 5.1% year over year (from 6.2%) during the same period.

Given that domestic demand is taking longer to recover, with weaker labor market conditions and a moderation of business and consumer confidence, we have revised down our GDP growth forecast for 2017 (to 3.8%, from 4.0%). Still, we estimate that GDP growth in 2016 was 3.9%, a bit above our previous forecast (3.8%), marking an acceleration with respect to 2015 (when the economy expanded 3.3%). Looking ahead, higher terms of trade (mainly metal prices) will act as a buffer in 2017. For 2018, we expect GDP growth to pick up to 4%.
Consumer confidence fell

Source: BCRP, Apoyo, Itaú

Structural reforms to help long-term growth

The 90-day fast-track authority to implement structural reforms, granted by Congress to the president, expired in late December. Thus, the government was able to approve an ambitious set of structural reforms, which will now enter the implementation phase. The overarching goal of the reforms is to decrease the size of the informal sector within the economy and thus increase productivity.

The economic reforms are focused on deregulation and tax cuts. On the investment deregulation front, we highlight the recent creation of the “Social Advance Payment Fund,” which will basically provide upfront payments to local communities that are affected by extractive industries (such as metallic mining and energy). This tackles a structural problem, which in the past has blocked a number of large investment projects (Minas Conga, Tía Mira, among others). Other important measures include the decentralization of the National Investment Promotion Agency (Proinversión), with an eye on capacity building at the regional and local government levels; the broadening of the “Public Works In Lieu of Taxes” mechanism, a facility that allows firms to pay taxes by investing in infrastructure; the demise of the bureaucratic National System of Public Investment (SNIP); and the “Special Project for Access to Property for Prioritized Investment Projects (APIP)” coupled with changes in the Property Expropriation Law, which aim at speeding up infrastructure projects.

On the tax front, it seems that the government will backtrack on its proposal to lower the value-added tax, which is actually a good signal for fiscal discipline. As per the legislative decree approved, the reduction of the VAT (from 18% to 17%) – which has an estimated fiscal cost of 0.5 pp of GDP – will be conditioned to an increase of net VAT collections by 1.2 pp of GDP, by mid-2017. In our view, this is highly unlikely, as net VAT collections reached 7.2% of GDP (the threshold to cut VAT) only once over the past 15 years. Thus, the apparent decision to omit the VAT cut from the reform plan, coupled with the fact that the slashing of government expenditures in 4Q16 brought the annual fiscal deficit to 2.7% of GDP (below the 3% target for 2016, according to preliminary data), suggests that the government is committed to preserving fiscal stability.

An ambitious inflation target

The Peruvian sol is unlikely to weaken much further, in our view. The U.S. election affected the Peruvian currency, but higher metal prices were a buffer. The sol appreciated 1.6% in 2016, in contrast with the 15% depreciation observed in 2015. Export-led growth and lower risk premium (due to the outcome of the presidential elections in Peru) helped. We expect the exchange rate to depreciate a bit, reaching PEN 3.45/USD in 2017 (from 3.36 by the end of 2016). Rising treasury yields exert depreciation pressure, but the increase of metal prices and the narrowing of the current-account deficit provide relief. For 2018, we forecast a moderate appreciation (to 3.40).

We expect inflation at 2.7% in 2017, with food inflation moderating over the course of the year (peaking in 1Q17 as drought conditions affect food supply). Food prices are crucial because they have a weight of 38% in the CPI basket. We expect core inflation to move down, against the backdrop of limited demand-side pressure and a pretty stable exchange rate. The evolution of inflation expectations will also help, as they now stand within the target range for all surveyed years (2017 and 2018). For 2018, we forecast an inflation rate of 2.5%.

The Central Bank of Peru (BCRP) decided to maintain the reference rate at 4.25% in December, amid higher inflation forecasts. The 4Q16 inflation report, published in the inter-meeting period, had already shown an increase in the inflation forecasts for 2016 and 2017. Also importantly, the BCRP cut foreign-
currency reserve requirements in January – lowering the marginal rate from 70% to 48% – as a preemptive move to cushion the rise of U.S. Treasury yields in Peru’s partially dollarized financial system.

The statement announcing the latest decision has two significant changes; namely, a less-benign inflation outlook and an acknowledgement of weaker growth. First, it mentions that inflation will probably converge back to the target range by mid-2017 (rather than decrease to 2% by the end of 2017, as it read previously). In other words, this means the board believes that inflation will stay above 3% (upper bound of the target range) for six more months, probably as a consequence of drought conditions that would affect food prices in 1Q17 (more intensely than expected in the 4Q16 inflation report). On the other hand, the statement now acknowledges that GDP growth slowed down in 4Q16.

We do not believe that the lowering of reserve requirements signals the beginning of an easing cycle, and still expect the BCRP to maintain the policy rate at 4.25% throughout 2017. The monthly monetary-policy statement still had an explicit tightening bias (which was introduced in August 2015, right before the BCRP hiked rates between 3Q15 and 1Q16). Moreover, inflation ended 2016 at 3.2%, above the Central Bank’s target range for a third consecutive year. Some politicians and academics are criticizing the credibility of the BCRP, and asking for an increase in the inflation target (from 2% to 3%) in order to have more space to support the economy. However, we believe that such a change is unlikely. For 2018, we do not expect a change in the policy rate either, as inflation would be close to the target and GDP growth near potential (a 4.25% policy rate is within the range considered neutral by the Central Bank).

### Forecast: Peru

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<tbody>
<tr>
<td>Real GDP growth - %</td>
<td>6.5</td>
<td>6.0</td>
<td>5.8</td>
<td>2.4</td>
<td>3.3</td>
<td>3.9</td>
<td>3.8</td>
<td>4.0</td>
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<tr>
<td>Nominal GDP - USD bn</td>
<td>169</td>
<td>189</td>
<td>198</td>
<td>203</td>
<td>192</td>
<td>195</td>
<td>206</td>
<td>219</td>
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<tr>
<td>Population (millions)</td>
<td>29.8</td>
<td>30.1</td>
<td>30.5</td>
<td>30.8</td>
<td>31.1</td>
<td>31.5</td>
<td>31.8</td>
<td>32.2</td>
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<td>Per Capita GDP - USD</td>
<td>5,675</td>
<td>6,288</td>
<td>6,489</td>
<td>6,592</td>
<td>6,178</td>
<td>6,191</td>
<td>6,487</td>
<td>6,821</td>
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<tr>
<td>Unemployment Rate - year avg</td>
<td>7.7</td>
<td>7.0</td>
<td>5.9</td>
<td>6.0</td>
<td>6.4</td>
<td>6.7</td>
<td>6.5</td>
<td>6.3</td>
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</table>

### Inflation

| CPI - %                    | 4.7  | 2.6  | 2.9  | 3.2  | 4.4  | 3.2   | 2.7   | 2.5   |

### Interest Rate

| Monetary Policy Rate - eop - % | 4.25 | 4.25 | 4.00 | 3.50 | 3.75 | 4.25  | 4.25  | 4.25  |

### Balance of Payments

| PEN / USD - eop             | 2.70 | 2.57 | 2.79 | 2.98 | 3.41 | 3.36  | 3.45  | 3.40  |
| Trade Balance - USD bn      | 9.2  | 6.4  | 0.5  | -1.5 | -3.1 | 0.7   | 1.5   | 1.4   |
| Current Account - % GDP     | -1.9 | -2.7 | -4.3 | -4.0 | -4.8 | -3.3  | -3.1  | -3.0  |
| Foreign Direct Investment - % GDP | 4.5  | 6.2  | 4.6  | 3.9  | 4.1  | 3.1   | 3.1   | 3.0   |
| International Reserves - USD bn | 48.8 | 64.0 | 65.7 | 62.3 | 61.5 | 61.7  | 62.0  | 62.5  |

### Public Finances

| NFPS Nominal Balance - % GDP | 2.0  | 2.3  | 0.9  | -0.3 | -2.1 | -2.7  | -2.6  | -2.4  |
| NFPS Debt - % GDP            | 22.1 | 20.4 | 19.6 | 20.1 | 23.3 | 24.9  | 25.9  | 26.4  |

Source: IMF, INEI, BCRP, Itaú
Colombia Fiscal and external accounts improve, while activity weakens

- The end of 2016 was positive for the Santos administration, which achieved approval of the tax reform and gained fast-track authority to pass legislation related to the peace deal. At the same time, external accounts are improving and inflation is falling. As a result, the rating agency Standard & Poor’s decided to maintain Colombia’s rating at BBB, although a negative outlook is still in place.

- However, activity continues to disappoint as the Colombian economy adjusts to the terms-of-trade shock.

- The shocks that drove inflation to record highs are unwinding. This, along with weak activity, a rapidly narrowing current-account deficit and a stable currency, allows the monetary easing cycle to continue this year and the next.

A diluted tax reform is passed

Legislators passed a modified tax-reform bill after various discussions in the two houses of congress. The bill has undergone changes from the initial version submitted in October, but succeeds in raising revenue to partially make up for the loss of oil revenue and will help compliance with the fiscal rule.

The reform will likely have a one-off inflation impact. The sales tax rate will increase to 19% on February 1, 2017, from 16%. During the discussion of the bill, some politicians vied for a gradual or smaller increase, at a time when consumers have been hit hard by high inflation and interest rates. As part of the negotiation process, it was agreed that 1 pp out of the total 3 pp added revenue will be reallocated to finance social expenses. Moreover, congress reduced the VAT rate for some goods allocated in the low-income basket (bicycles, lower-end mobile phones etc.) from 16% to 5%.

Corporate taxes will be lowered, but there will be no increase in the personal income-tax base. The concessions made on the personal income-tax front have led to fewer cuts to corporate income-tax rates. The tax rate will be 33% in 2019 (it is currently between 34% and 40%, with the top rate previously expected to reach 43% in 2018), one percentage point above that proposed in the original project. Meanwhile, from 2017, corporates will be able to use the VAT from capital goods purchases as tax credit (an investment incentive).

By 2022, the expected additional tax revenue will be around 1 percentage point less than planned in the initial proposal. Nevertheless, the reform is a move in the right direction and would help hold off fiscal concerns for the time being. This reform will likely ease the rating-downgrade risk in the short term (Colombia currently holds a rating one notch above the minimum investment-grade level). In fact, S&P reaffirmed Colombia’s rating at BBB but maintained a negative watch following the approval of the tax reform, while Fitch would visit the country later in the year before pronouncing itself on a revised outlook. In the medium term, either an expenditure adjustment or further reform will be necessary to ensure fiscal sustainability.

Soft patch in activity endures

Activity indicators bounced back in November, but continue to point at a weak final quarter of 2016. Non-durable retail and manufacturing activity (excluding oil refining) remain sluggish, and the labor market continues to loosen.

Manufacturing activity slowed down from 3Q16. Oil refining continues to pull up activity, but less so than earlier in the year as the Cartagena refinery completes a
full year in operation. Additionally, roughly half of the categories recording contractions, reflecting the fragility of manufacturing activity. In the moving quarter manufacturing expanded 1.9%, below 3Q16’s 2.2%.

**Meanwhile, consumption-related activity’s rebound was due to durable goods, with the non-durable component still contracting.** In the moving quarter, retail sales picked up to 1.0%, from -2.0% in 3Q16. Once vehicles are excluded, retail sales were nearly flat from last year. Looking ahead, pessimistic consumers will weigh down retail growth. Think-tank Fedesarrollo’s consumer confidence measure spent all of 2016 in pessimistic territory, hinting at still-weak consumption in the coming months.

**Activity remains weak**

With the Colombian economy slowing down, we expect job creation to continue to be dominated by low-quality occupations. Additionally, labor-market participation has been systematically lower compared with 2015, as discouraged workers are leaving the labor force. So, the labor market continues to show signs of weakness even though the unemployment rate is near historical lows.

We expect GDP to have increased 1.8% last year, from 3.1% in 2015, as the slowdown following the terms-of-trade deterioration consolidates. Higher oil prices, the positive effect of the 4G PPP investments and lower interest rates will lead to a gradual recovery. However, we now expect a more modest activity improvement this year (2.3% vs. 2.5% previously). The short-term negative impact of the tax reform on consumption will also limit growth. For 2018, we expect a 2.8% GDP growth rate.

**External imbalances moderating**

Colombia’s current account for 3Q16 confirms that the country’s vulnerability to external shocks is diminishing. The rolling four-quarter deficit moderated to USD 13.7 billion (5.0% of GDP), from USD 18.9 billion as of 2Q16 (6.5% of GDP). Our own seasonal adjustment shows that the current-account deficit is even lower at the margin, at 4.5% of GDP (4.6% in 2Q16) – the smallest deficit since 1Q14.

**Narrowing current account deficit**

The narrowing of the trade deficit led the improvement in the quarter. The balance of goods and services recorded a smaller USD 15.1 billion deficit in the four-quarter period ending in 3Q16 (USD 18.5 billion in 2015). Meanwhile, the income deficit has stabilized around USD 3.9 billion as oil prices show some recovery, benefiting oil companies operating in Colombia, although it is still below the USD 5.5 billion recorded in 2015.

Despite foreign direct investment disappointing in the quarter, the rolling four-quarter figure remained stable. The one-off flow earlier in the year, related to the privatization of Isagen, supported the investment inflow. However, net direct investment (USD 9.0 billion accumulated in four quarters) was insufficient to fully fund the current-account deficit. Foreign portfolio inflows continued to moderate (to USD 6.2 billion) after reaching record highs in 2014 (USD 18.7 billion) when the weight of Colombian peso-denominated debt in one of the popular emerging market bond indexes was increased.
The ongoing narrowing of the current-account deficit is a positive development for the Colombian economy. We expect the current-account deficit to have narrowed to 4.4% of GDP in 2016, from 6.5% in 2015. As oil prices stabilize above levels recorded in 2016, the current account will likely continue to improve ahead. We expect the CAD to come in at 3.6% in 2017 and 3.0% next year.

The Colombian peso performed favorably recently, helped by the latest surge in oil prices as well as a moderation of domestic risks given the approval of key reforms at the turn of the year. After closing last year at around 3,000 to the dollar, we see the Colombian peso at 3,080 by the end of this year (somewhat stronger than our previous 3,225 forecast). Further depreciation, to 3,175 to the dollar, would occur in 2018.

Inflation ends 2016 on a downward trajectory

Disinflation proceeded in December, but inflation has been above the central bank’s target range for nearly two full years. Food price inflation (7.22%) remains the key contributor to the still-high headline print (5.75%). The moderation of tradable inflation continues (5.31% vs. 5.74% in November), while non-tradable inflation was broadly stable at 4.85%. Inflation excluding food prices inched down to 5.14%. Moreover, our diffusion index indicates that inflationary pressures continue to moderate.

The approval of the tax reform will likely have a temporary impact on consumer prices going forward. Even so, we expect the disinflationary process to continue this year as the impacts from previous supply shocks (exchange-rate depreciation and El Niño) fade and activity remains weak. Although inflation has been falling even faster than we were expecting, we now see inflation above the target range also this year, at 4.3% (above our previous 4.0% estimate), due to the VAT hike. In 2018, inflation would reenter the target range, ending at 3.5%.

Room to lower contractionary stance

The minutes of the December monetary policy meeting, when the central bank surprised the market with a 25-bp cut, show that the majority of the board believes that the conditions are sufficient to reduce the contractionary policy stance. This group acknowledges that the policy rate is high compared with historical standards and to the neutral rate. The decision to take the policy rate to 7.5% was by a 4-3 majority.

The board considers that Colombia’s vulnerability to external shocks has diminished, and they see headline disinflation unfolding faster than expected. Additionally, 2016 growth is likely to fall to the bottom half of the 1.5%-2.5% forecast range, and the widening output gap going forward will further support the disinflation process. The majority of the board also noted the lower risk of a steep exchange-rate depreciation, because of the recent stabilization of oil prices. Finally, this group prefers to not fall behind the curve, considering the lagged effect that monetary policy has on inflation and domestic demand.

With inflation set to continue to moderate and activity indicators remaining weak, we expect the central bank to cut the policy rate by a further 25 basis points in January, to 7.25%. This will be the first meeting led by Juan José Echavarría. In spite of the recent VAT hike, the new central bank governor recently mentioned the target of bringing inflation to within the range in 2017. So, although we think the central bank will proceed cautiously with rate cuts, we now see the policy rate ending this year at 5.5% (6.0% in our previous scenario). In 2018, we see the policy rate reaching 4.5%, as inflation gradually returns to the 3% target.
## Forecast: Colombia

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<tr>
<td>Nominal GDP - USD bn</td>
<td>336</td>
<td>370</td>
<td>380</td>
<td>378</td>
<td>293</td>
<td>280</td>
<td>300</td>
<td>310</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>46.0</td>
<td>46.6</td>
<td>47.1</td>
<td>47.7</td>
<td>48.2</td>
<td>48.8</td>
<td>49.3</td>
<td>49.9</td>
</tr>
<tr>
<td>Per Capita GDP - USD</td>
<td>7,287</td>
<td>7,939</td>
<td>8,065</td>
<td>7,940</td>
<td>6,069</td>
<td>5,735</td>
<td>6,075</td>
<td>6,214</td>
</tr>
<tr>
<td>Unemployment Rate - year avg</td>
<td>10.8</td>
<td>10.4</td>
<td>9.6</td>
<td>9.1</td>
<td>8.9</td>
<td>9.2</td>
<td>8.8</td>
<td>8.5</td>
</tr>
</tbody>
</table>

| Inflation | | | | | | | | |
| CPI - % | 3.7 | 2.4 | 1.9 | 3.7 | 6.8 | 5.8 | 4.3 | 3.5 |

| Interest Rate | | | | | | | | |
| Monetary Policy Rate - eop - % | 4.75 | 4.25 | 3.25 | 4.5 | 5.75 | 7.50 | 5.50 | 4.50 |

| Balance of Payments | | | | | | | | |
| COP / USD - eop | 1,939 | 1,767 | 1,930 | 2,377 | 3,175 | 3,002 | 3,080 | 3,175 |
| Trade Balance - USD bn | 5.4 | 4.0 | 2.2 | -6.3 | -15.9 | -12.0 | -8.0 | -7.5 |
| Current Account - % GDP | -2.9 | -3.0 | -3.3 | -5.2 | -6.5 | -4.4 | -3.6 | -3.0 |
| Foreign Direct Investment - % GDP | 4.4 | 4.1 | 4.3 | 4.3 | 4.1 | 3.8 | 3.4 | 3.2 |
| International Reserves - USD bn | 32.3 | 37.5 | 43.6 | 47.3 | 46.7 | 46.7 | 47.7 | 48.6 |

| Public Finances | | | | | | | | |
| Nominal Central Govt Balance - % GDP | -2.8 | -2.3 | -2.3 | -2.4 | -3.0 | -4.0 | -3.3 | -2.9 |
| Central Govt Gross Public Debt - % GDP | 36.5 | 34.5 | 37.1 | 40.6 | 45.1 | 46.0 | 46.3 | 46.3 |

Source: IMF, Bloomberg, Dane, Banrep, Haver and Itaú
Commodities

Enjoy the party, for now

• Commodity prices have continued to rise since late November, driven by strong global economic indicators and signs that OPEC members are complying with the deal to cut production.

• The short-term outlook may be bullish for commodity prices, given that China’s economy is likely to remain stable in 1Q17 and that the oil market may still fully adjust to the supply cut.

• Nonetheless, we expect metal and energy prices to decline throughout 2017, due to slowdown in China (particularly in metal-intensive sectors) and stronger supply.

The Itaú Commodity Index (ICI) has risen by 7% since the end of November, driven by increases in its three components – agriculture (5%), metals (5%) and energy (9%) – as global economic activity sustains a strong pace. Moreover, signs that OPEC members are complying with the deal to cut production supports the view that global oil balance shifted to a small deficit, causing Brent prices to increase by 8% since November 30 (the day the deal was announced).

Looking forward, we expect the ICI to decline by 8% in 2017. The two major drivers are the expected slowdown in China in 2H17 (which particularly affects metal prices) and a supply response from U.S. shale producers that could partially offset the cartel’s cut.

Nonetheless, both factors are likely to take some time to affect prices, and the short term may remain constructive. China’s economy is set to remain positive in 1Q17, and a few months may be needed to see the supply reaction from U.S. shale producers. Short-term prices may therefore continue to be driven by a tight market and, even after the decline, we forecast prices well above the lows registered in early 2016.

Agricultural commodities continue to trade sideways, given that the major increases since the end of November (corn, wheat and sugar) were driven by the reversal of earlier declines. We lowered our price forecasts for coffee (stronger Brazilian crop in 2017) and wheat (recognizing that the current environment of lower premium to corn will continue). Besides coffee and wheat, there were no material changes in the supply outlook, as the La Niña anomaly fades and the crops in South America advance under normal conditions.
**Metals: Prices to decline in 2017 on demand slowdown and stronger supply**

The ICI Metals has risen by 7.4% year to date, even after a 40% increase in 2016, on both demand and supply surprises. Global demand was stronger than expected, particularly in China, as the government shifted its focus to the short term and metal-intensive sectors accelerated (see chart). Supply was also surprising, with improved rationality from larger producers and capacity cuts in China.

However, Chinese demand growth is not sustainable. There are some signs that China’s growth in 2016 was well above its potential, and therefore not sustainable; these include excessive credit growth, an uptrend in non-food inflation, and rising house prices until September. These factors forced the government to act in 3Q16 (macro-prudential measures to cool down house prices), and will certainly become more of an issue in 2H17 after the political transition is more established.

We also expect supply increases in 2017, from both big producers and non-traditional players, in response to the current higher-price scenario (vs. the average for 2016).

We forecast a 16.5% YoY decline in the ICI Metals. In particular, we see iron ore prices falling to USD 55/mt by the end of the year.

**Commodities vs. USD: A rare break in correlation**

The negative correlation between the USD and commodity prices was broken in 2H16 (see chart), when commodity prices rose at the same time that the USD was appreciating against other currencies.

There is an economic reason for the two causality sides of the correlation. On the one hand (USD → commodities), a strong USD shifts both producer’s supply and consumer’s demand curve, leading to lower equilibrium prices in USD. On the other hand (commodities → USD), higher commodity prices raise the current account surpluses of emerging economies (that are net commodity exporters, on aggregate), leading their currencies to appreciate.

Demand- and supply-related surprises are responsible for the divergence. We can model commodity prices as a function of the USD (changes vs. other currencies not caused by commodity prices), global demand and supply. Despite a stronger USD, global demand rose throughout 2016 (beating expectations), and several supply shocks are bullish for prices (OPEC deal, capacity cuts in China, higher supply discipline among iron ore producers, etc.).

Past data (following chart) shows three periods with a similar break: between ’92 and ’94, between ’99 and 2000, and in 2005. Global growth was accelerating during the latter two periods.
USD vs. commodities over a long period: correlation breaks are rare

Oil: OPEC’s compliance, U.S. shale & global economy to drive prices

Brent prices have remained at around USD 55/bbl since the end of November, while WTI prices rose by USD 1.5/bbl to USD 52/bbl over the same period. The increase in prices was a reaction to the agreement announced by OPEC on November 30.

Oil: Sharp gains following announcement of formal OPEC agreement

Supply cuts seems to be advancing in line with OPEC’s announcement on November 30. Non-OPEC members agreed to cut an additional 0.6 mbd on December 9, as signaled by OPEC a few days earlier. The participants of the coordinated cut seem to be complying with the deal, which is in our view enough to lead to a small deficit in the global market in 1Q17.

OPEC agreement will lead to lower inventories in 1Q17

Looking forward, we see three drivers for prices. Besides the global macroeconomic outlook, the market will react swiftly to signs of (non-)compliance with the deal and the pace of investments in U.S. shale.

We maintain our YE17 Brent forecast of USD 54/bbl (WTI: USD 52/bbl), a level that would allow for an additional response by U.S. producers to partly offset the measures taken by the cartel.

Grains: Favorable weather & strong demand

Corn, soybean and wheat prices have risen by 6%, 1% and 12%, respectively, since late November. Nonetheless, corn and wheat have traded within a narrow range since mid-September, while soybean prices have trended upward over the same period.
Prices remain well behaved due to an absence of supply shocks – crops in South America are performing close to expectations, and strong external demand in the U.S. has prevented surpluses in the country to lead to lower prices.

**Grains/Soybeans: Low volatility since mid-september**

We lowered our YE17 wheat price forecast to USD 4.4/bushel from USD 4.7 due to our expectation of a lower premium to corn this year.

**Our scenario for these three commodities is close to current levels until year-end.** Our YE17 forecasts are:

- Corn: USD 3.6/bushel
- Soybeans: USD 10/bushel
- Wheat: USD 4.4/bushel

Our scenario assumes that *La Niña* will fade throughout 1Q17 and will be followed by neutral weather. The anomaly would therefore end before affecting the next crop in the Northern Hemisphere or the winter corn crop in Brazil.

**Sugar/Coffee: Lower coffee prices on stronger estimates for Brazil’s crop**

International contracts for raw sugar and coffee have risen since the end of 2016, partially reversing earlier losses. Sugar prices have risen by 5%, to USD 0.2052/lb, while coffee prices have risen by 9% over the same period, to USD 1.49/lb.

Notwithstanding the recent increase, we lowered our YE17 coffee price forecast to USD 1.55/lb (from USD 1.70), following upward revisions of Brazil’s 2017 crop estimates.

**We expect sugar prices to average USD 0.215/lb in 2017.** We estimate a deficit of 3.6 million tons in the 2016-17 crop year (after a deficit of 10 million in 2015-16), followed by two consecutive years of surpluses that lead to lower prices in 2018.
Forecast: Commodities

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<td>avg growth - %</td>
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<td>ICI - Inflation **</td>
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<td>yoy - %</td>
<td>-6.8</td>
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<td>-4.8</td>
<td>6.6</td>
<td>-2.5</td>
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</table>

Source: Bloomberg Itaú.

* The Itaú Commodity Index is a proprietary index composed of commodity prices, measured in U.S. dollars and traded on international exchanges, which are relevant to global production. Its sub-indexes are Metals, Energy and Agriculture.

** The ICI-Inflation Index is a proprietary index composed of commodity prices, measured in U.S. dollars and traded on international exchanges, which are relevant to inflation in Brazil (IPCA). Its sub-indexes are Food, Industrials and Energy.
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