Strictly Macro

Monetary Policy in LatAm: The Road Back to Neutral

March 29, 2017

TABLE OF CONTENTS

Macro Overview……………………………………………………………………………………………………1

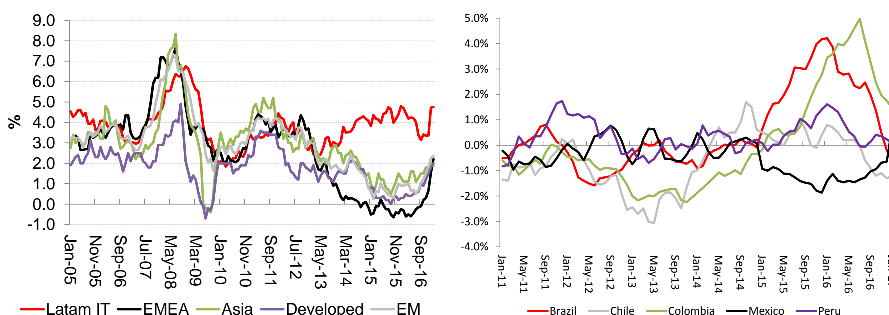
ARGENTINA: Central Bank to stay on hold for longer…..…..…………………………………………...……..…………..6
BRAZIL: Time to Reap the Benefits of Regained Credibility...9
CHILE: Monetary Easing: Ready for More?.........……………………………………………………………….....................12
COMOLBIA: How “Gradual” Will the Cycle Be?................…………………………………………………….................15
MEXICO: MXN Recovery Removes Hiking Pressure from Banxico…...……………………….……..…………...................18
PERU: Wait and See Mode…………………... ..…………………………………………………………..............................21
URUGUAY: Inflation Falls, Driven by UYU Strength…………………………………………………………………………..24

LatAm inflation: Getting back to normal

Since the beginning of 2016, LatAm inflation has been showing convergence with the rest of emerging markets, following the pressure on currencies and thus tradable prices from a terms of trade shock that began in 2Q 2014, coupled with food price inflation in some countries. This convergence is partly due to the pickup in inflation in the rest of emerging markets, as energy prices start to exert upward pressure, and partly due to the downturn in inflation in countries like Brazil and Colombia, the re-anchoring in Peru, and the faster than expected deceleration in Chile. The only economy in the region where inflation has increased recently has been Mexico, as prices have been under strain due to the MXN depreciation and more recently due to the adjustment in gasoline prices at the beginning of 2017. Some nascent signs of second-round effects are present, in our view, though more information will be needed to determine the persistence of inflation there.

From the beginning of 2015 and for most of 2016, inflation remained above the upper bound of central bank targets in Brazil, Colombia, Peru, and to a lesser extent Chile, while in the same period the effects of structural reforms in Mexico kept inflation below target for several months. However, when dissected by components, the process of re-centering of inflation in the region has been far from uniform. In **Brazil**, the FX adjustment coupled with a food price shock pushed tradable prices upward from 6.4% y/y in September 2015 to a peak of 10% in August 2016, before descending to 4.8% in February 2017. Perhaps more noteworthy has been the behavior of non-tradable prices; after a prolonged period hovering at an elevated 8% in annual terms – from 2014 until 3Q 2016 – they fell recently to 4.7% y/y as of February, as the effects of monetary policy and the economic cycle on services inflation have finally taken hold.

Inflation, a story of convergence (except Mexico)



Left-hand chart shows the median annual inflation per region (LatAm: Brazil, Chile, Colombia, Mexico and Peru; EMEA: Bulgaria, Croatia, Czech Republic, Hungary, Israel, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and South Africa; Asia: China, India, Malaysia, Philippines, Singapore, South Korea and Thailand). Right-hand chart shows the deviation of headline inflation (annual) over the upper bound of the Central Bank target. Sources: Central Banks, Bloomberg, and Santander.

Brendan Hurley
Macro, Rates & FX Strategy
Economist, Colombia
bhurley@santander.us
1 (212) 350-0733

Nicolas Kohn*
Macro, Rates & FX Strategy
nicolas.kohn@santandergcb.com
(44) 207 756-6633

Martin Mansur*
Economist, Argentina
cmansur@santanderrio.com.ar
(54)11 4341-1096

Luciano Sobral*
Economist, Brazil
lsobral@santander.com.br
(55) 11 3553-3753

Juan Pablo Cabrera*
Economist, Chile
jcabrera@santander.cl
(56) 2 2320-3778

David Franco*
Economist, Mexico
dafranco@santander.com.mx
(52) 55 5257-8170

Tatiana Pinheiro*
Economist, Peru
tatiana.pinheiro@santander.com.br
(55) 11 3012-5179

Marcela Bensión*
Economist, Uruguay
mbension@santander.com.uy
(59) 8 1747-6905

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE “IMPORTANT DISCLOSURES” SECTION OF THIS REPORT.
U.S. investors’ inquiries should be directed to Santander Investment at (212) 350-0707.
* Employed by a non-US affiliate of Santander Investment Securities Inc. and is not registered/qualified as a research analyst under FINRA rules.

For both **Chile** and **Colombia,** their disinflation cycle has been heavily affected by the tradable component of their CPI baskets, something that was not seen in **Peru**. In **Chile**, the more than 2-pp decline in tradable inflation between mid-2016 and 4Q 2016 was a determining factor in inflation returning to the Central Bank's target quickly in 2016. In **Colombia**, after the fast ascent from 2.0% y/y in December 2014 to a peak of 7.9% in June 2016, tradable prices have declined more than 2 pp since then. In addition, the dissipation of a weather-related food shock has removed nearly 3 pp from headline inflation since its peak in July 2016. The story of **Mexico** shows that, after reaching the lowest tradable inflation since July 2006, tradable prices increased from 2.2% in January 2016 to 6.3% y/y in February, constituting the main driving force for inflation on a combination of a (contained) FX pass-through and, more importantly, the adjustment in regulated prices. In the same period, non-tradable prices have so far been well contained, rising by only 1.2 pp to stand at 3.4% as of February.

The disinflation cycle and expectations

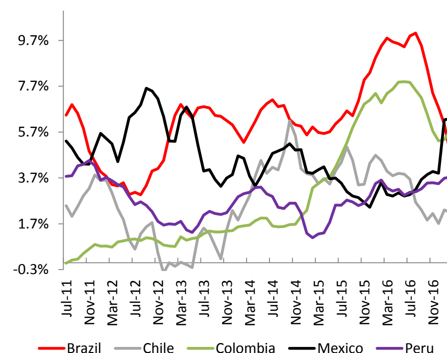
The turnaround in inflation has favored a gradual re-anchoring in inflation expectations, but not without challenges for LatAm central banks, especially for those that plan to embark on easing cycles – and indeed the picture on expectations is far from homogeneous. At the beginning of 4Q 2016, the market expected Brazil, Chile, Mexico, and Peru to see inflation within their target bands in 2017 (see table at right), but the latest developments have excluded Mexico from the list, while Colombia is still expected to miss the target this year, which is in line with our view. Not until 2018 do surveys show a much higher and homogeneous degree of confidence that inflation will be back at target. In the case of Argentina, survey-based expectations suggest that BCRA is likely to miss its 12-17% and 8-12% targets in 2017 and 2018; however, the disinflation cycle is expected to continue ahead. In contrast to our December edition of *Strictly Macro*, our inflation forecasts show dynamics similar to survey-based ones, as we expect inflation to remain out of the target range in Argentina, Colombia, and Mexico in 2017 but to return to target in 2018 in the latter two.

Activity: A less gloomy external scenario supporting domestic recoveries

Since the publication of our December *Strictly Macro*, uncertainty over the potential course of U.S. policy and a more challenging external scenario for LatAm has receded somewhat. Indeed, the perception of a coordinated global growth pickup seems to have gained momentum for the time being. In the context of receding external woes, our GDP forecasts continue to contemplate a mild acceleration in GDP growth across the region, except in Mexico. We expect southern countries like Argentina and Brazil to return to positive growth by 1Q 2017 – as supported by high frequency activity indicators – but with unchanged year-end forecasts of 3.0% and 0.7%, respectively. In the Andean countries, weather conditions have posed a short-term challenge and represent downward risks to growth in Peru, while growth has continued to lose momentum in Chile and Colombia. In the former, the strike at La Escondida mine, coupled with the 0.4% q/q drop in 4Q 2016 GDP, risks sending the country into a (temporary) technical recession; thus, while our forecast for full year growth remains at 2.0% vs. 1.6% in 2016, downside risks prevail. In Colombia our 2.2% forecast for growth has balanced risks: on the downside a continued deterioration in household spending, while on the upside execution of the government's infrastructure initiatives. In Mexico, worries about the potential impact of U.S. trade and economic policies, along with a drop-off in government consumption, represent downside risks, while the manufacturing sector represents upside risks. All in all, we continue to forecast a further deceleration in GDP growth to 1.7% in 2017 from 2.3% last year in Mexico.

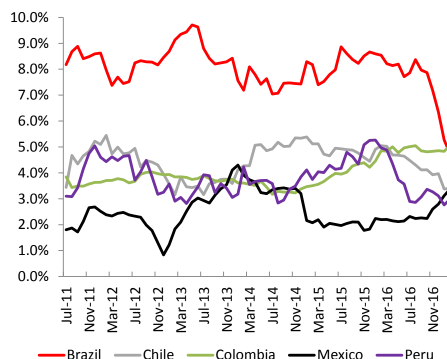
Our GDP forecasts suggest that growth will be below potential throughout the region in 2017, implying a lack of pressure on inflation from internal demand. In 2018, we see output gaps throughout the region closing as growth accelerates, thus increasing on the margin demand-driven price pressure. Nonetheless, we and the market are not concerned, and for 2018 we expect continued convergence of inflation to target, implying little risk to the conduct of monetary policy. So while continued inflation convergence seems likely in most of LatAm in 2017, given improving growth dynamics and the room for non-tradable inflation to exert upward pressure, it will be important to keep an eye on possible price shocks going into 2018, which could change the outlook for monetary policy.

Tradable inflation – a mixed picture



Annual changes in tradable prices. Sources: Bureau of Statistics, central banks, and Santander.

Non-tradable inflation – strong reaction in Brazil



Annual changes in non-tradable prices. Sources: Bureau of Statistics, central banks, and Santander.

Re-anchoring expectations (with exceptions)

	Oct-2016		Latest	
	2017	2018	2017	2018
Argentina	19.70	14.80	20.80	14.90
Brazil	5.00	4.50	4.12	4.50
Chile	3.00		3.00	3.00
Colombia	4.19	3.50	4.41	3.50
Mexico	3.53	3.40	5.40	3.80
Peru	2.75	2.60	3.00	2.90

Inflation expectations for December 2017 and 2018. Latest shows the February survey of expectations in Argentina and Mexico, the March edition for Brazil, Chile, and Colombia, and the January edition for Peru. Sources: Central banks and Santander.

Monetary policy: The road to neutral

In this context of normalizing inflation, policy makers and market participants have been shifting their attention to neutral rates and central bank policy in the face of diminished inflation risks. To get a sense of the neutral policy rate in each country, we adopt a historical perspective and consider the realized real policy rate, or the rate of return an investor would receive after inflation in a given year if she kept her money in an overnight interest-bearing bank account. While these historical averages do not constitute neutral rates per say, as the 2000-2016 period includes growth regimes that were above, below, and at-potential, they provide a useful practical benchmark to compare current policy stances. We find that for the 2000-2016 period, the average realized real overnight rate was 6.3% in Brazil, 1.3% in Colombia, 1.5% in Mexico, and 0.6% in Chile.

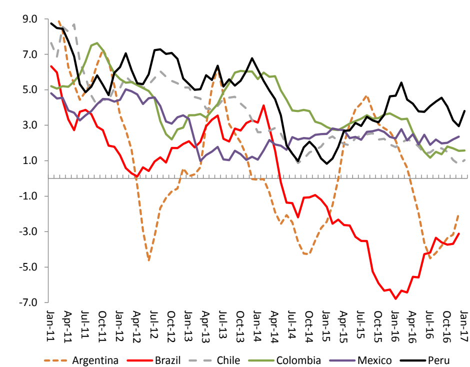
How do current real policy rate settings compare to their historical averages and what should we expect going forward for the real policy rate? To determine this, we compare our historical *realized* measure to the current ex ante real policy rate, or nominal policy rate deflated by one-year inflation expectations. In **Chile**, this measure of ex ante real policy rate stands at 0%, as inflation expectations are now anchored at 3%, the same level as the nominal policy rate. By this measure, the current real policy rate in Chile is slightly below its historical average, which we find appropriate given the deceleration in activity, supressed confidence levels, below-target inflation, and anchored inflation expectations. What is somewhat surprising to us is that the market does not yet contemplate much additional accommodation. Indeed, in 2018, the real policy rate is expected to remain at its current level of 0%, with any additional easing below 0% likely to be quickly reversed. In this sense, the market seems to expect a quick "re-coupling" of growth in Chile to the more rosy global outlook, and indeed our GDP, inflation, and monetary policy forecasts tell the same story.

In **Colombia**, the current real policy rate is well above its historical level at 3.15%, or 1.85 pp above the historical average, and given the challenging growth dynamics, there is room for the policy rate to fall in real terms. Our economics team expects the real policy rate to fall to neutral this year and remain at a neutral policy rate setting in 2018, in line with BanRep's stated goal, but our team acknowledges that once inflation returns credibly to target, there could potentially be room to the downside for their monetary policy forecasts. In the near term, however, the policy rate may stay above neutral a bit longer than the market expects in our view.

In **Mexico**, the last 100 bps of hikes from Banxico have pushed the real policy rate above neutral, to 2.16% vs. the historical average of 1.45%. The move above neutral has corresponded with a sharp increase in inflation and inflation expectations. Market prices reflect an expectation that even as inflation retraces from our 5.2% 2017 forecast to 3.8% in 2018, the nominal policy rate will remain unchanged, resulting in an above-target and increasing real policy rate of 3.6% in 2018. The market expectation of an increasing real policy rate in 2018 stems from the belief that Mexico will be unable to cut rates during a Fed hiking cycle, and likely reflects ongoing concern about the impact of U.S. political, economic, and monetary policy on holders of Mexican assets. However, as the likelihood of abrupt capital flight from Mexico has dissipated, in our view, to the extent that inflation is expected to fall in 2018, Banxico may be less well advised to continue with a restrictive policy rate. This means that either inflation may not retrace as quickly as we expect, or Banxico may find itself with room to reduce rates as early as 2018.

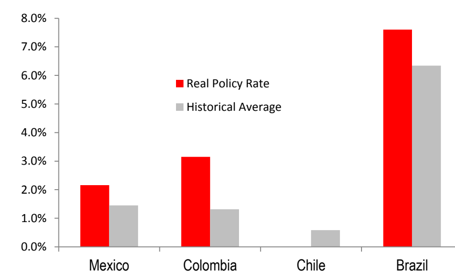
In **Brazil**, the current real policy rate is also restrictive, at 7.6% vs. an average realized real rate of 6.3% in the 2000-2016 period. By 2018, market pricing expects the real policy rate to average 4.35%, reflecting a cutting cycle in Brazil accompanied by falling inflation. This suggests that real rates will drop below the historical average but remain relatively high. Our economics team has a 4% real policy rate pencilled in for 2018 vs. their estimate of a 5% neutral policy rate. While a 4% real policy rate may seem somewhat high given the depths of the recession that Brazil has suffered, the possibility of a weaker BRL and a more healthy growth rate in 2H 2017 keep us wary about forecasting a deeper accommodation throughout 2018.

Activity indicators



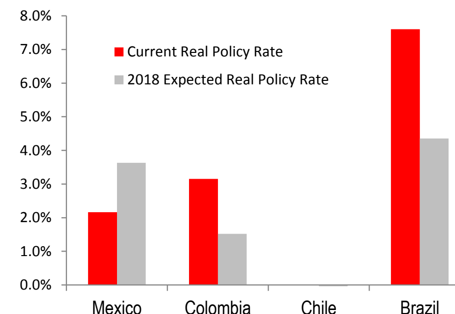
3mo-MA Y/y. Sources: Bureau of Statistics, central banks, and Santander.

Real policy rate vs. historical averages



Sources: Santander, Bloomberg, and Central Banks.

Real policy rate expectations



Sources: Santander, Bloomberg, and Central Banks.

Brendan Hurley
Macro, Rates & FX Strategy
bhurley@santander.us
(212) 350-0733

Nicolas Kohn*
Macro, Rates & FX Strategy
nicolas.kohn@santandergcb.com
(44) 207 756-6633

FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2015	2016F	1Q17	2Q17	3Q17	4Q17	2017F	2018F	Last Review '17	Nom GDP '17
Argentina	**2.6**	**-2.3**	**0.3**	3.6	4.6	3.4	**3.0**	**4.5**	Down	**635**
Brazil	**-3.8**	**-3.6**	-0.8	0.3	1.2	2.1	**0.7**	**3.0**	Down	2,036
Chile	**2.0**	**1.6**	0.5	2.5	2.4	2.6	**2.0**	**2.7**	Down	258
Colombia	**3.1**	**2.0**	1.8	2.1	2.3	2.4	**2.2**	**3.0**	Unchanged	302
Mexico	**2.6**	**2.3**	2.0	0.9	1.9	2.1	**1.7**	**2.2**	Down	1,121
Peru	**3.0**	**3.9**	3.8	4.5	5.0	4.5	**4.5**	**4.9**	Up	195
Uruguay	**0.4**	**1.5**	1.0	1.4	0.3	0.6	**1.8**	**3.5**	Down	58
LatAm-7	-0.2	-0.9	0.5	1.3	2.1	2.4	1.6	3.1		4,605

In %. Year-on-year basis. Nominal GDP in US$ billions. Sources: National central banks, finance ministries, and Santander.

GDP Components	Priv Cons '15	Priv Cons '16	Priv Cons '17	Pub Cons '15	Pub Cons '16	Pub Cons '17	Investment '15	Investment '16	Investment '17	Exports '15	Exports '16	Exports '17	Imports '15	Imports '16	Imports '17
Argentina	3.5	-1.4	3.1	6.8	0.3	3.0	3.8	-5.5	7.7	-0.6	3.7	6.0	5.7	5.4	9.2
Brazil	-3.9	-4.2	0.3	-1.0	-0.6	-0.4	-13.9	-10.2	3.5	6.4	1.9	2.0	-13.9	-10.3	3.3
Chile	1.9	2.8	2.1	5.8	5.1	4.6	-1.5	-0.8	0.3	-1.9	-0.1	1.9	-2.8	-1.6	1.7
Colombia	4.0	2.1	2.0	2.8	1.9	2.5	2.8	-4.5	0.5	-0.6	-0.9	2.2	4.0	-6.1	1.0
Mexico	2.3	2.8	2.4	2.3	1.1	-2.5	4.2	0.4	0.0	10.3	1.2	3.5	8.6	1.1	2.1
Peru	3.4	3.4	3.5	9.8	-0.5	2.0	-0.7	-4.9	3.0	3.5	5.0	3.5	2.5	-2.3	-1.5
Uruguay	-0.5	0.7	1.0	2.2	1.6	1.5	-9.0	1.5	1.2	-0.6	-1.4	1.5	-7.3	-2.9	-0.7
LatAm-7	-0.2	-0.9	1.5	2.0	0.5	0.1	-4.7	-5.7	2.8	5.2	1.8	3.0	-3.1	-4.2	3.3

Annual changes in %. na: Not available. Sources: National central banks, finance ministries, and Santander.

Inflation	Headline CPI (YoY)							Core measure		
	2015*	2016*	Mar-17F	Apr-17F	May-17F	2017F*	2018F*	2016F	2017F	2018F
Argentina	**26.9**	**37.7**	33.4	27.4	24.7	**22.0**	**13.0**	**32.1**	**18.6**	**13.0**
Brazil	**10.7**	**6.3**	4.9	4.8	4.4	**4.8**	**4.5**	**6.2**	**4.8**	**4.5**
Chile	**4.4**	**3.0**	2.7	2.5	2.5	**2.8**	**3.0**	**3.1**	**2.9**	**3.1**
Colombia	**6.8**	**5.8**	4.8	4.6	4.4	**4.3**	**3.3**	**5.1**	**4.4**	**3.4**
Mexico	**2.4**	**3.3**	5.3	5.5	5.6	**5.2**	**3.8**	**3.4**	**4.5**	**3.7**
Peru	**4.4**	**3.2**	3.2	3.3	3.0	**2.8**	**2.5**	**3.0**	**2.5**	**2.5**
Uruguay	**9.4**	**8.1**	6.5	6.5	6.0	**8.2**	**7.8**	**8.2**	**8.5**	**8.5**
LatAm-7	**10.0**	**9.6**	**8.7**	**7.9**	**7.3**	**7.1**	**5.3**	**8.7**	**6.4**	**5.3**

*Year-end levels, YoY. Core measure as per national definitions. Santander estimates denoted by F. Sources: National central banks, finance ministries, and Santander.

Macro Miscellanea			ARS	BRL	CLP	COP	MXN	PEN	UYU
Fiscal balance	% of GDP	2016	-4.5	-10.3	-2.1	-3.9	-3.5	-2.1	-3.5
		2017F	-4.6	-8.9	-2.8	-3.5	-2.6	-2.6	-4.1
		2018F	-4.1	-7.4	-2.7	-2.7	-2.4	-2.8	-3.4
Public debt	% of GDP	2016	25.0	36.0	4.7	44.0	47.3	23.3	32.3
(Net terms in ARS, BRL, CLP)		2017F	25.5	45.9	7.2	46.0	50.5	23.8	39.4
		2018F	27.2	48.6	10.0	47.0	50.2	26.5	33.7
Current account	% of GDP	2016	-2.6	-3.3	-2.0	-4.5	-2.9	-4.4	-2.3
		2017F	-2.6	-1.3	-1.4	-4.0	-2.7	-3.8	-0.8
		2018F	-2.8	-1.8	-2.1	-4.3	-2.4	-3.5	-0.5
Trade balance	US$ bn	2016	2.1	17.7	3.5	-10.0	-14.6	-1.6	-0.3
		2017F	-3.6	47.7	4.9	-10.6	-13.1	-0.2	0.3
		2018F	-4.5	40.7	6.0	-11.1	-12.0	0.2	0.4
External debt	% of GDP	2016	7.6	9.0	6.2	9.2	4.4	6.2	7.5
(Total public and private)		2017F	7.1	12.0	6.5	10.0	3.9	7.0	7.8
		2018F	6.5	12.0	6.4	10.0	3.7	5.0	7.9
Unemployment	% of workforce	2016	-4.5	-10.3	-2.1	-3.9	-3.5	-2.1	-3.5
		2017F	-4.6	-8.9	-2.8	-3.5	-2.6	-2.6	-4.1
		2018F	-4.1	-7.4	-2.7	-2.7	-2.4	-2.8	-3.4

Source: Santander.

MONETARY POLICY MONITOR

	Current	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
ARGENTINA	24.75	24.75	24.00	22.25	20.00	18.50	16.75	15.50	13.50
		0	-75	-175	-225	-150	-175	-125	-200
BRAZIL	12.25	12.25	11.75	10.75	9.75	8.50	8.50	8.50	8.50
		0	-50	-100	-100	-125	0	0	0
CHILE	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50
		0	0	0	0	0	25	25	0
COLOMBIA	7.00	7.00	6.25	6.00	5.75	5.50	5.25	5.00	5.00
		0	-75	-25	-25	-25	-25	-25	0
MEXICO	6.25	6.50	6.75	6.75	6.75	7.00	7.00	7.00	7.00
		25	25	0	0	25	0	0	0
PERU	4.25	4.25	4.25	4.25	4.25	4.25	4.00	4.00	4.00
		0	0	0	0	0	-25	0	0

Central bank reference interest rates. Levels in %, monthly changes in bps. Sources: Central banks and Santander.

- **Easing Argentina, Brazil and Colombia: After accelerating the easing pace at the beginning of the year and delivering 150 bps worth of cuts in 1Q17 in Brazil, we expect the BCB to continue with its easing cycle, sending the Selic rate to 9.75% by 4Q17 and to 8.5% by 1Q18. The BCRA stayed put in Argentina in 1Q17 on the adjustment in regulated prices, but we continue to see an aggressive easing cycle of 475 bps in 2017 and 625 bps in 2018. In Colombia, after BanRep delivered some surprises along the road, we expect it to ease upfront in 2Q17 and to send the policy rate to 5.75% by year-end. We forecast the easing cycle to extend in 2018, with 25 bps cuts in each of the first three quarters.**
- **Mexico, going (less) sideways: After preventive hikes of 325 bps since the end of 2015 and amid expected inflation out of bounds in 2017, the better MXN prospects amid a potentially less disruptive incoming NAFTA renegotiation should pave the way for Banxico to reduce the hiking pace and to deliver two more 25 bps hikes in 1H17 and then stay on hold throughout 2018.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Dec-16	3.25	20.6	670	3100	15.9	3.36	28.8
Mar-17	3.12	18.8	665	3000	15.6	3.25	28.5
Jun-17	3.22	18.0	670	3100	16.0	3.26	29.3
Sep-17	3.36	18.0	679	2900	17.2	3.27	30.8
Dec-17	3.50	18.3	679	3000	19.0	3.40	31.6
Mar-18	3.63	20.0	670	3100	19.4	3.48	32.2
Jun-18	3.72	18.5	665	3300	19.8	3.57	32.8
Sep-18	3.80	18.0	685	3200	20.3	3.65	33.5
Dec-18	3.84	18.0	690	3200	20.7	3.67	34.1

End-of-period levels. Sources: Bloomberg and Santander.

- **After a turbulent start of the year, the outlook for risky assets has improved, and LatAm FX has benefited from a more supportive than expected external scenario.**
- **The strongest case has been that of Mexico after Banxico's intervention program, coupled with (supportive) signals from U.S. government officials on upcoming NAFTA renegotiations provided strong relief and support to the MXN. We now expect the peso to trade at USD/MXN 18.3 by year-end. In Brazil, flows have been highly supportive for the BRL, and the BCB has taken the opportunity to continue unwinding its FX swaps position, which now stands at USD 18.0bn. However, Congressional activity could bring some short-term volatility in the *real*, as the Lower House prepares to discuss the widely expected social security reform.**
- **We expect to see some weakening pressure in the ARS, CLP, PEN, and UYU in the months ahead. In Argentina, fiscal gradualism and the prospect of issuances, coupled with export seasonality, should keep the peso stable up until July. For the COP, although it may be under strain in the short term, we expect it to trade in a relatively stable range and to reach USD/COP 3,000 by 4Q17.**

ARGENTINA

Central Bank to Stay on Hold for Longer

Martin Mansur*
(5411) 4341-1096

Cristian Cancela*
(5411) 4341-1383

- **Although activity indicators indicate GDP has started to expand, the social mood has deteriorated, and labor unions' stance has hardened ahead of wage negotiations.**
- **February inflation (+2.5% m/m) surprised on the upside and will likely push expectations up; we also expect March and April readings to be high on utility rate hikes and the impact of wage increases.**
- **While inflation remains above the desired trend, we think the CB has no room to loosen its grip; neither will it tighten policy given the temporary nature of the shock and to avoid further FX strengthening.**

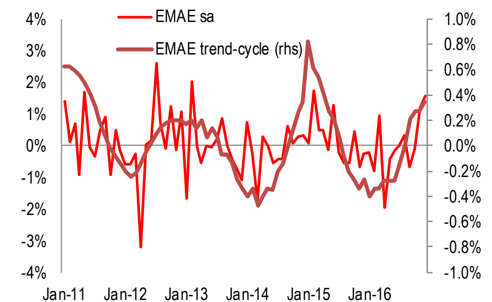
Although the recession is over, social discontent is up

The economic activity growth pickup is gathering pace. The official Monthly Economic Activity Estimator trend component has expanded consistently since September 2016 (at a 0.3% average monthly rate), indicating that the recessionary phase is behind us. However, the recovery is heterogeneous among sectors, with the agricultural production and related sectors pushing ahead, while industry appears to be lagging. We forecast grain output will likely reach a record high 120 million tons (main harvest to start in March-April); farm-related machinery sales expanded 106% during 2016 (+131% y/y in 4Q16). Although still in negative territory, industry's rate of expansion rose to -1.1% y/y in January (from -5.9% y/y in 2H16). We estimate that in 2Q17 we will see GDP growth of 3.6% y/y, to average 3% throughout the year. In the same vein, after reaching a trough in July, employment also is showing signs of recovery. Private jobs in the formal sector expanded 1.1% between July and December (+67,330 jobs) after falling 1.8% between December 2015 and July. Despite the incipient signs of cycle reversal, social discontent has mounted, in part spurred by labor unions' more confrontational stance prior to the wage negotiations season. While the government is trying to contain excessive claims and aims at setting the Central Bank's targets as a guideline for hikes, unions have said they intend to claw back purchasing power lost in the recessionary 2016. Salary negotiations results are one of the key risks for future inflation and hence monetary policy setting. Also, confidence indicators headed downward during the (southern hemisphere) summer. According to Poliarquia, a local pollster, the percentage of people expecting an economic improvement in the near future fell 11 pp to 47% in February, the lowest reading during the current administration. Likewise, the consumer confidence index dropped 8.5% m/m in February, reaching the minimum since May 2014.

Regulated prices and salaries push inflation upward . . .

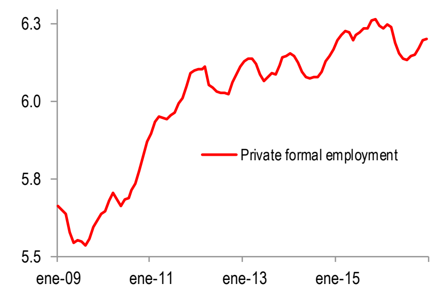
The Central Bank was able to materially lower the inflation rate during 2016, in a context of significant relative price adjustments (peso devaluation in December 2015 and utility rate hikes afterward). While core inflation averaged 3.3% between December 2015 and June 2016, it fell to only 1.7% in 2H16. Following INDEC figures, after posting a record low 1.3% m/m in January, core inflation rose again to 1.8% m/m in February, partly due to the pass-through from electricity price hikes (+47%) that took place that month. Authorities had intended to apply more increases in April, such as gas (+40%), water (+17%), and urban transport (+33%). However, due to concerns regarding affecting real incomes in an electoral year, and because of the impact on inflation, the authorities may be backtracking on some of these increases. Currently there is some uncertainty regarding the final plan for the regulated price hikes mentioned above, which have not been completely rolled out. However, only half of the originally planned hikes may be applied, in our view, and the remainder will probably be postponed until after the October mid-terms. Although we have only scant data to confirm the relation between utility rate hikes and core inflation, approximately 10% of regulated prices inflation is transmitted to core measures. Despite the probable rescheduling of the hikes, we expect higher inflation during March (+2.2% m/m) and April (+2.7% m/m) because of the salary increases taking place during these months. We assume typical seasonality for wage negotiations, which are concentrated mostly in 2Q.The current reference CPI is constructed based on prices in the City of Buenos Aires and outskirts (GBA).

Activity expanding at the margin



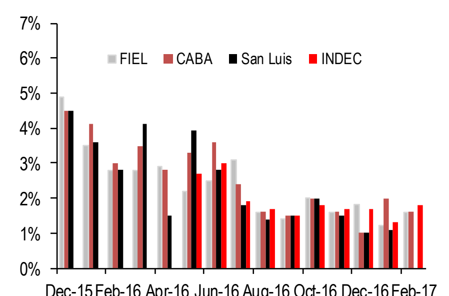
Notes: Economic Activity Monthly Estimator monthly growth. Sources: INDEC and Santander.

Job market, slowly recovering



Notes: Number of jobs in the private formal sector, in million. Sources: Ministry of Labor and Santander.

Core inflation, harder to dampen



Notes: monthly core inflation. Sources: INDEC, FIEL, Province of San Luis, City of Buenos Aires and Santander.

INDEC has said it is working on a new nationally based CPI. We expect regulated prices inflation in areas other than Buenos Aires to be more contained (given that energy price distortions accumulated since the 2002 crisis were not as marked). Although regulated price hikes in the inner provinces may be lower, the weight of items such as electricity, transport, and other regulated services tends to be higher than in the GBA's CPI. Therefore, a nationwide CPI would not necessarily result in significantly lower inflation. A rough comparison between the "broad" CPI put out by the Central Bank (44% Buenos Aires, 34% Cordoba, and 22% San Luis) and the current INDEC GBA CPI results in an average difference in monthly readings of 0.1 pp. Overall, we estimate that in a new national CPI, headline inflation could be up to 1 pp lower than the GBA measure during one year, assuming that utility rate hikes in Buenos Aires double those in the provinces.

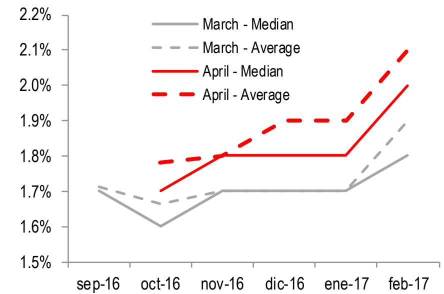
. . . likely prompting the Central Bank to stay on hold for longer

In a context of seasonally high inflation, we think the Central Bank has little room to resume rate cuts in the near term. As details of the utility rate hikes became clear, inflation expectations started to adjust upward. For example, between October and February, expectations for April's monthly inflation increased 0.3 pp to 2% and 0.1 pp to 1.5% for the headline and core measures, respectively (median). Furthermore, February's inflation print (+2.5% m/m vs. the expected +1.8%) surprised on the upside, and the core measure (+1.8% m/m) stood significantly higher than the median forecast (+1.5% m/m), which might lead to a round of higher forecasts in March's poll. As a result, we will likely see rates adjusted by inflation expectations decrease going forward. Although rates adjusted by core inflation expectations remained steady at approximately 4% p.a. in the last three months, if adjusted by headline inflation they have declined to 0.4% p.a. in March, from 1.6% in February. Recall that the real rate, in the words of the Central Bank, needs to be "positive enough" to ensure a disinflationary path, in accordance with the determined targets.

During the last week we have seen the Central Bank actively intervening in the Lebac secondary market to lift Lebac yields that often stand below the rates set in the primary auction (in the last auction, the 35-day Lebac yield was 22.25% p.a.). By this move, we think the Central Bank may be acknowledging the need to marginally tighten monetary policy in the current context of temporary higher inflation. Moreover, we find several distortions that weaken the transmission of monetary policy. Among them, the gross income tax, which is deducted from earnings from banks' passive repo placements (that rate currently stands at 24% p.a.), brings down the effective rate to only about 22.3%. Since only the financial system has access to the repo rate facility (unlike the Lebacs, which can be acquired by virtually any company or individual), this wedge weakens the policy rate's effectiveness. In addition, the low level of financial intermediation (currently, the loan to GDP ratio stands at just 13%) renders the inflation-targeting mechanism weaker. Therefore, the recently launched inflation-targeting regime works best through the expectations and FX channels. In its latest monetary policy statement, the Central Bank suggested that "is ready to act if necessary," which market observers took to mean that it could hike rates if the (so far temporary) inflation spike starts to exceed the bounds (for example, if excessive salary hikes are validated by labor agreements).

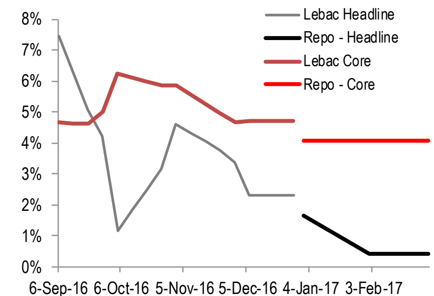
However, we believe there are reasons to think this might be a move of last resort and that the monetary authority will remain on hold as long as inflation remains above the desired level. First, in its latest monetary policy report, the Central Bank affirmed that rate moves will be "parsimonious" and that it will avoid reacting to temporary inflation movements. Second, a rate hike may prompt even more short-term capital coming into the local market, causing further appreciation in an already strong peso. Our REER measure stands 19% stronger than its 1996-2015 average, and many local, mostly industrial clusters are increasingly vocal about the need for a more competitive peso. Therefore, we tend to believe that the Central Bank will only resume rate cuts when the inflationary landscape looks more reassuring. We expect the reflationary process to be temporary, and core readings resume a downward trend starting in May-June. We estimate that the monetary authority will maintain the current average repo rate (at 24.75% p.a.) throughout April and cut it only 25 bps in May, to converge to 20% p.a. by year-end. Note that our expected policy rate path assumes higher rates for longer than anticipated by the market (average of Central Bank's poll of economic forecasters), which stands at 23.8% for the end of April.

Inflation expectations moving up



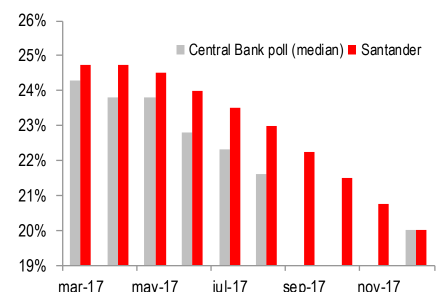
Notes: Median and average headline inflation expectations for March and April (m/m). Sources: Central Bank and Santander.

Real interest rates



Notes: Policy rates adjusted by median inflation expectations (corer and headline measures), annualized. Sources: Central Bank and Santander.

Cutting rates at a slower pace



Notes: Expectations of average 7-day repo rates. Sources: Central Bank and Santander.

ARGENTINA

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		2.3	-2.56	2.6	-2.3	3	4.5
Private Consumption (Δ% y/y)	72.1	4.64	-5.19	3.5	-1.4	3.1	3.8
Public Consumption (Δ% y/y)	13.4	5.32	2.95	6.8	0.3	3	2.1
Investment (Δ% y/y)	19.5	3.91	-7.6	3.8	-5.5	7.7	15.5
Exports (Δ% y/y Local Currency)	19.2	-3.52	-6.98	-0.6	3.7	6	8
Imports (Δ% y/y Local Currency)	24.7	3.88	-11.48	5.7	5.4	9.2	12
GDP (US$ bn)		614.2	567.5	631.89	545.1	634.9	645.4
Monetary and Exchange Rate Indicators							
*CPI Inflation (Dec Cumulative)		10.5	24.9	26.9	37.7	22	13
*CPI core Inflation (Dec Cumulative)		10	24.1	25.7	32.1	18.6	13
US$ Exchange Rate (Average)		5.5	8.1	9.26	14.78	16.59	19.91
Central Bank Reference Rate (eop)		21.6	20.4	33	24.75	20	13.5
Private sector credit (% of GDP)		12.7	12.5	13.8	13.2	15	17.9
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.9	-4.3	-4.6	-4.5	-4.6	-4.1
**Primary Balance, % of GDP		-1.7	-2.7	-4.9	-4.6	-3.9	-3.1
Balance of Payments							
Trade Balance, % of GDP		0.2	0.5	-0.5	0.4	-0.6	-0.7
Current Account, % of GDP		-0.9	-1.4	-2.7	-2.6	-2.6	-2.8
Debt Profile							
Central Bank International Reserves (US$ bn)		30.1	31.4	25.6	38.8	49	52
Total Public Debt (net of public sector holdings, % of GDP)		18.1%	17.6%	16.0%	25.0%	25.5%	27.2%
Of which: Foreign-currency denominated (% of GDP)		18.3	13	13.6	20.3%	21.0%	23.1%
Labor Markets							
Unemployment Rate (% eop)		6.4	6.9	5.9	7.6	7.1	6.5

Sources: Economy Ministry, Central Bank, and Santander estimates.

BRAZIL

TIME TO REAP THE BENEFITS OF REGAINED CREDIBILITY

Luciano Sobral*
(55) 11 3553-3753

- **A conjunction of positive factors has led markets to expect a deep and sustained cycle of monetary policy easing.**
- **We continue to believe that Brazil's Central Bank may end the current cycle with the policy rate at 8.5%.**
- **The main risks, in our view, are linked to the external environment (trajectory of the USD) and to the outcomes of the reform agenda in Brazil.**

In our view, Brazil's Central Bank (BCB) is enjoying a rare benign alignment in the variables most relevant to inflation control and monetary policy conduct. First, the external and political backdrops have been relatively stable (at least compared to the turmoil of the past couple of years), leading to a less volatile and strengthening currency, helping to stabilize prices of tradable goods. BRL/USD realized volatility has been trending down since October 2015 and is now back to the 10-15% range (in annualized terms), and the *real* had a strong first quarter based on rising commodity prices (especially iron ore, Brazil's main export).

Second, the effects of two strong negative supply shocks (in energy and foodstuff prices) finally ceased to influence headline inflation – in the case of foodstuffs, the BCB has said it is now considering excluding the effects of a positive supply shock from the determination of policy rates over the next few months. Twelve-month trailing food inflation fell sharply from 16.8% in August 2016 to 4.3% according to the last reading, subtracting more than 200 bps from headline inflation in the same period.

Third, the deepest recession in the country's history (in terms of real GDP loss) finally dragged down prices of non-tradable goods, such as services: average real wages fell in both 2015 and 2016 (we expect a modest rise – 0.3% – for this year), and we believe the GDP contraction should prevent real gains in the minimum wage (one of the main sources of rigidity in the prices of labor-intensive services) until at least 2018.

Finally, efforts at fiscal consolidation, the structural reform agenda, and regained confidence in the Central Bank (as evidenced by well-anchored inflation expectations) are allowing the BCB to act counter-cyclically, even opening a discussion about a structural decline in the neutral real rate of interest (see our comments below).

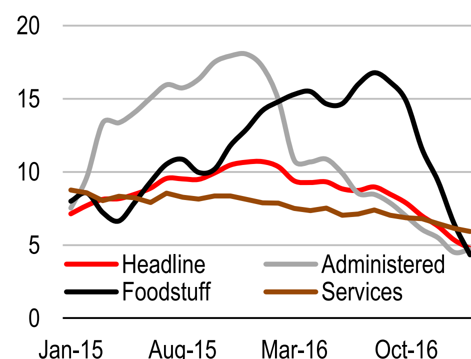
During 1Q 2017, the conjunction of those factors led markets to quickly reassess their expectations of future inflation and the path of interest rates. When we first called a single-digit overnight rate by the end of 2017, last October[1], market consensus for this variable (according to BCB's Focus poll) was at 11%; currently, the frequency distribution is centered at 9%, with a notable skew toward lower rates.

We still believe that this conjunction will last long enough for the BCB to continue cutting the Selic rate to 8.5% by the end of the current cycle, although we do not take the latest wave of optimism at face value. Currently, our main divergence with market consensus is on the trajectory of the BRL: we believe that markets may be extrapolating a short-term trend (a breakdown in the historical correlations between the U.S. dollar value and commodity prices, and broad commodity and iron ore prices) that will eventually revert to the mean and lead to a weaker BRL[2]. This divergence also explains most of the gap between our 2017 CPI inflation forecast (4.8%) and the market consensus (4.12%).

The elusive neutral rate

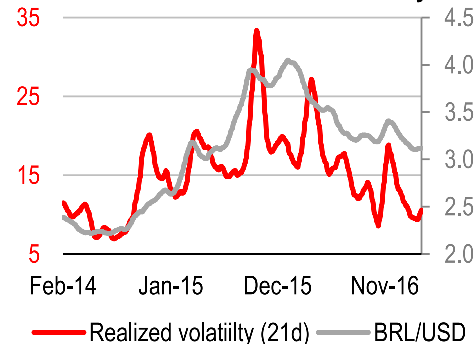
In the minutes of the February monetary policy meeting, the BCB sparked a discussion about the neutral interest rate, stating that the extension of the monetary easing cycle depends, among other factors, on an estimate of the "structural interest rate of the economy." According to the BCB, "this rate depends on factors such as the economy's productivity growth, the perspectives for fiscal policy, the quality of the business and contractual environment, the efficiency of resource allocation through the financial system, and the quality of economic policy."[3] The BCB highlighted the importance of the government's changes in economic policy ("notably the social security reform")

12-month CPI inflation, %



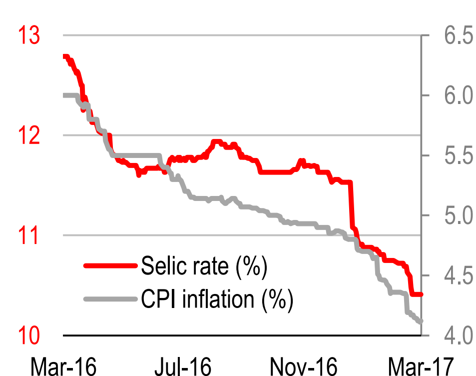
Sources: IBGE, Brazil's Central Bank, and Santander.

BRL/USD level and realized volatility



Notes: 21-day moving averages, annualized volatility in %. Sources: Brazil Central Bank and Santander.

Year-end 2017 market consensus



Notes: Median of BCB's Focus poll. Sources: Brazil Central Bank and Santander.

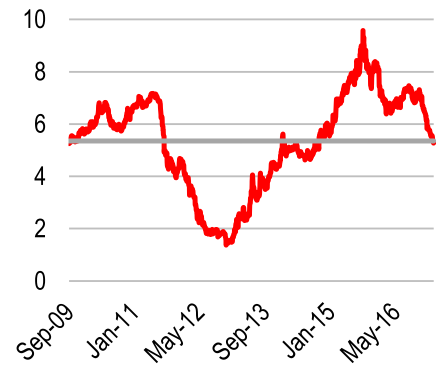
.

[1] For more details, please see our report *On the Way Back to Single-Digit Rates*, October 19, 2016.
[2] For more details, please see our report *Reality Check: Revised but (Still) Out-of-Consensus BRL Forecast*, March 22, 2017.
[3] *Minutes of the 205th Meeting of the Monetary Policy Committee ("Copom") of the Central Bank of Brazil*, February 21 and 22, 2017.

in sustainably reducing the neutral rate. Indeed, among the variables listed, only the perceived quality of economic policy is likely to change in the short term, and market participants tend to see the outcome of the current debate on social security reform in the Lower House as a litmus test of the government's ability to move forward with the structural reform agenda.

There are, in our view, at least two good reasons to be cautious about how estimates of the neutral rate will affect monetary policy in the short term. The first is the nature of such estimates, usually dependent on other non-observable parameters (such as potential GDP and output gap) and subject to a high degree of uncertainty (confidence intervals in the literature are often more than 2 percentage points wide) – thus inadequate to a fine-tuning of monetary policy. The second is that we believe the government's social security reform proposal is still at risk of being watered down in the Congress, to the point that its effect on the expected debt/GDP trajectory is still unknown. Therefore, we favor a conservative estimate (around 5%, close to the observed average during the past decade) for the real neutral rate. We believe the current negative output gap should allow the BCB to go below this level for some time, but, in our main scenario, the economy will be growing at the margin at a 3% annualized rate in 2H 2017, a rate that, if persistent, may soon raise some concerns.

1-year ex ante real rate (%)

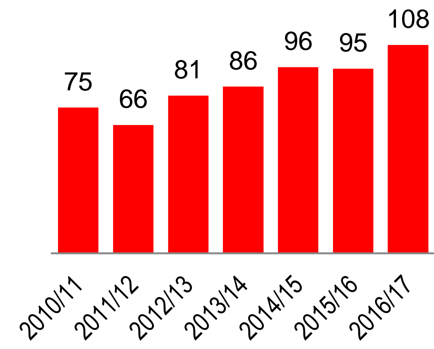


Notes: 1-year market rate deflated by expected 12-month CPI inflation. Sources: Anbima, Brazil's Central Bank, and Santander.

Main risks: politics and the external scenario

As we noted above, part of the optimism in the rates market is explained by a stronger than expected risk appetite for emerging market assets. A favorable external environment has been keeping the Brazilian currency in a strengthening trend and reducing the risk premium across asset classes, thus influencing positively the formation of expectations. In addition to this general trend, Brazil has lately benefited from rising terms of trade, a strong agricultural harvest, and positive expectations concerning the outcome of the government's proposed structural reform agenda.

Brazil, production of soybeans (millions of tons)



Sources: Conab and Santander.

It is impossible to project the timing of a reversal in terms of trade, but, as we observed above, the current conjunction is somewhat unusual – commonly, a strong dollar leads to lower commodity prices, and Brazil's export prices tend to follow broad commodity indices such as the CRB. If markets do not anticipate a structural change and the U.S. dollar remains strong, the typical historical patterns may prevail and trigger a devaluation in the BRL, with the usual pass-through to consumer prices. A strong dollar stemming from higher U.S. interest rates could also raise the risk premium in long rates, potentially leading to more caution regarding the monetary easing process.

As has been the norm, politics is also a risk – specifically, how the current corruption investigations could affect the government's capacity to persuade Congress to vote in favor of reforms. Markets are still confident that deputies and senators will approve a version of the social security reform that will stabilize this kind of spending as a share of GDP at current levels, but such confidence, embedded in asset prices, is still to be tested in a floor vote. Thus, key upcoming events are: the vote on the report of the special committee on social security reform, expected in early April, and, conditional upon approval of reform in the special committee, the first Lower House floor vote on the reform, probably by late May/early June. As the process unfolds, indications of significant weakening of the original proposal also might trigger a revaluation of risk premium and influence future monetary policy decisions.

BRAZIL

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		2.7	0.5	-3.8	-3.6	0.7	3.0
Private Consumption (Δ% y/y)	62.8	2.9	2.3	-3.9	-4.2	0.3	2.5
Public Consumption (Δ% y/y)	20.8	2.2	0.8	-1.0	-0.6	-0.4	1.4
Investment (Δ% y/y)	16.5	6.1	-4.2	-13.9	-10.2	3.5	6.0
Exports (Δ% y/y Local Currency)	11.3	2.1	-1.1	6.4	1.9	2.0	2.5
Imports (Δ% y/y Local Currency)	-11.4	7.6	-1.9	-13.9	-10.3	3.3	2.2
GDP (US$ bn)		2,246	2,416	1,801	1,796	2,014	1,878
Monetary and Exchange Rate Indicators							
IPCA-IBGE Inflation (Dec Cumulative) (%)		5.9	6.4	10.7	6.4	4.8	4.5
IGP-M Inflation (Dec Cumulative) (%)		5.5	3.7	10.5	7.0	5.0	5.0
US$ Exchange Rate (Average)		2.2	2.4	3.3	3.5	3.3	3.7
Central Bank Reference Rate (eop)		10	11.75	14.3	13.8	9.8	8.5
Stock of Credit To Nonfinancial Private Sector (% of GDP)		56.5	58.9	54.5	50.5	48.6	48.7
Fiscal Policy Indicators							
Public Sector Fiscal Balance (harmonized) (% of GDP)		-3.1	-6.0	-10.2	-8.9	-7.4	-6.9
Primary Balance (% of GDP)		1.77	-0.57	-1.85	-2.5	-2.3	-1.3
Balance of Payments							
Trade Balance, % of GDP		2.6	-3.9	1.0	2.7	2.0	2.3
Current Account, % of GDP		-3.04	-4.31	-3.27	-1.30	-1.83	-1.77
Debt Profile							
International Reserves (US$ bn)		358.8	363.6	356.5	365.0	358.7	369.5
Total Public Debt (net of public sector holdings, % of GDP)		30.6	33.1	35.6	45.9	48.6	50.9
Of which: Foreign-currency denominated (% of GDP)		-10.2	-10.3	-10.5	-10.5	-10.0	-9.8
Labor Markets							
Unemployment Rate (% eop)		6.2	6.5	9	12.0	12.0	10.9

Sources: IBGE, MDIC, FIPE, FGV, Central Bank, SEADE, and Santander.

CHILE
MONETARY EASING: READY FOR MORE?

Juan Pablo Cabrera*
(562) 2320-3778

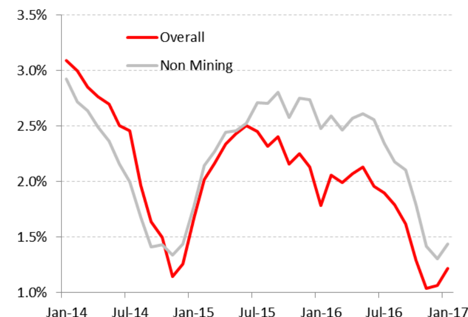
- **BCCh cuts rates to 3% in March, and the market anticipates some additional room for monetary easing.**
- **We expect local news flow to remain dovish, especially on the growth front. We think inflation is likely to remain below 3%, on a stable peso.**
- **Typical Taylor-rule-based estimates suggest to us that 2.50% is a reasonable terminal rate level; will the upcoming IPoM pave the way?**

In March, the Central Bank of Chile (BCCh) cut rates by 25 bps to 3.00%, after a similar move in January. The board also maintained a dovish bias in its communiqué, indicating that further stimulus "could be necessary" in upcoming months. Now market attention is focused on whether the easing cycle will end or continue in upcoming months, and on the terminal level of the cycle.

Growth/inflation balance: Dovish news flow to last a bit longer

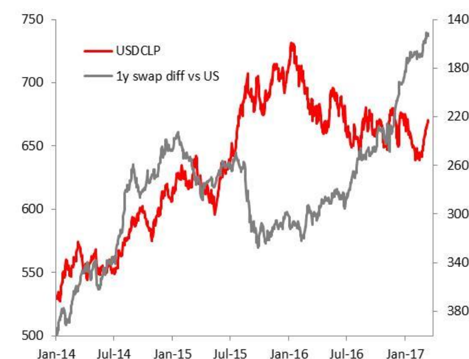
With the turn of the year, the growth outlook has deteriorated noticeably. First, 4Q16 figures were worse than expected, especially in the non-mining sector, suggesting that the soft inertia seen in 2016 will likely continue, in our view. Investment, in turn, continues weak, with private investment remaining stagnant due to still low business confidence, and public investment having begun to suffer late last year in a context of rising fiscal restrictions. In addition, the construction sector is now experiencing the negative phase of the cycle triggered by the tax reform, which applied VAT to new home sales beginning in early 2016: the industry's GDP plunged 4.9% y/y in 4Q16. Non-mining sector exports have started to recover in 4Q16 (+3.8% y/y), mainly due to agricultural products, but this sector accounts for only 15% of GDP. The pillar of growth continues to be private consumption (+2.4% y/y in 4Q16), reflecting a resilient labor market, abundant credit, and increasing tourism inflows.

IMACEC growth by sector



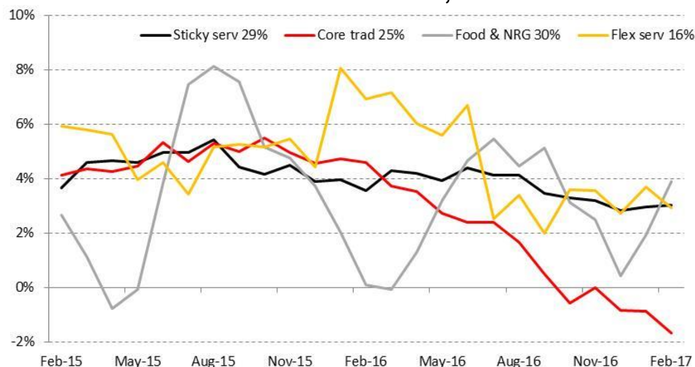
Last six month average of y/y changes. Sources: Central Bank and Santander.

USD/CLP vs. Interest rate differentials



1yr swap rate differential between Chile and U.S. (bops). Differential in inverted scale, right hand side. Sources: Bloomberg and Santander.

CPI inflation: Deflation in core tradables, rebound in food & energy



Last 6 month inflation, annualized, based on seasonally adjusted series. Sources: INE and Santander.

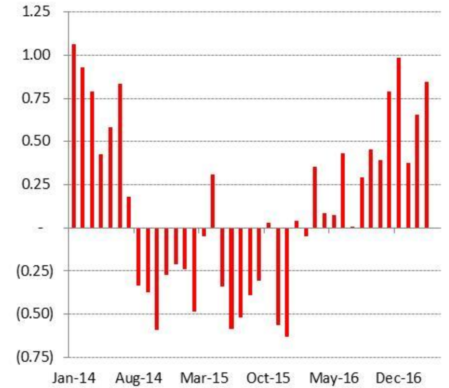
On the inflation front, 70% of the CPI has been behaving favorably in recent months. Sticky services (representing 29% of the index) are showing a very gradual downtrend, at 4.5% y/y, which we expect to continue in tandem with slowing nominal salaries and lower indexation inertia. Inflation for the rest of services (16% of CPI) is running at around 3% annually, while core tradables prices (mainly cars, electronics, and apparel, for 25% of the CPI) are already showing deflation at the margin, owing to the strong peso. Only food and energy prices (for the remaining 30% of the index) are showing an increasing pace of inflation (around 4%), reflecting rising international commodity prices. Summing up, given the continuation of a range-bound FX rate and wide output gap conditions, coupled with a positive year-base effect, we see y/y inflation falling below 2.5% by June/July, picking up modestly in 2H17 to 2.8%.

The upcoming Monetary Policy Report, or IPoM, will be key for the future conduct of monetary policy, as frequently has been the case of late: four of the last five cycles, or mini-cycles, have started in the month immediately following the release of a quarterly IPoM. In the previous IPoM, 2017 GDP growth was estimated at 1.5-2.5%, while forecast CPI stood at 2.9% y/y for both December 2017 and December 2018. In our view, the GDP forecast could be cut by 25 bps, to 1.25-2.25%, as the Escondida strike affecting mining output is likely to push y/y growth below +0.5% y/y in 1Q17, and a significant part of this loss is unlikely to be recovered in following months.

As a result, the current 2% average BCCh estimate for 2017 implies a pace of around 2.5% y/y for the rest of the year, which we believe is too fast for the present state of the real economy. Regarding inflation, BCCh estimates continue to look reasonable to us compared with current market and analyst expectations, so we expect no material changes here.

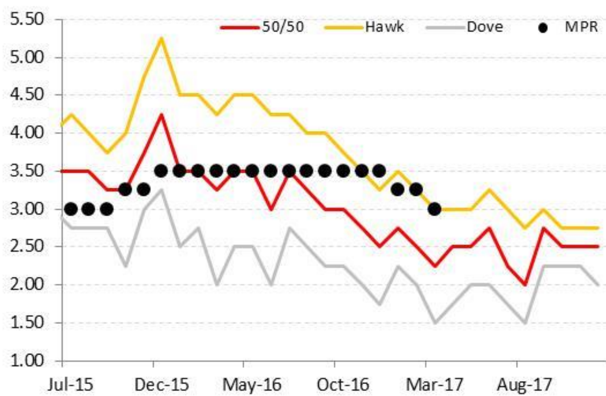
In general, Taylor-rule-based estimates of the theoretical policy rate indicate that there is room for further cuts. Our model suggests that 2.50% would be a reasonable terminal level for this cycle. Supporting this view, note that in July 2015 the BCCh policy rate was also at 3.00%, but in a clearly more hawkish environment: IMACEC growth averaged 2.1% y/y in the previous three months, while expected growth for the following 12 months was estimated at 2.7% (as per the BCCh survey). On the inflation front, in turn, the actual CPI measure averaged 4.2% y/y, and 12-month-ahead expectations were at 3.2%. Now we see no dilemma for the BCCh: vs. July 2015, present IMACEC growth is 90 bps lower, growth expectations are 80 bps lower, present CPI is 150 bps lower, and CPI expectations are 20 bps lower. The balance has tilted to the dovish side, in terms of both hard data and market sentiment, which means that the BCCh has strong reasons to cut rates below 3%, in our view.

MonPol bias vs. model (in p.p.)



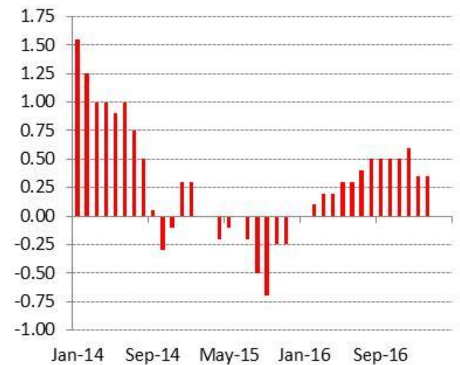
Actual BCCh policy rate minus theoretical interest rate as per our Growth-Inflation Balance Index, equally weighted version. Positive value indicates a contractionary policy bias; negative value indicates the reverse. Sources: Central Bank and Santander.

BCCh Policy Rate (MPR): Actual and theoretical levels (%)



Hawk version refers to a reaction function where the weighting of inflation is 75% and growth 25%; dove version is the reverse. Sources: Central Bank, INE and Santander.

Ex ante BCCh policy rate (%)



Nominal BCCh policy rate minus 12-month-ahead inflation expectations. Sources: BCCh and Santander.

With so many doubts on potential growth since the end of the copper boom, we think the discussion on long-term, or neutral, interest rates in Chile has probably become too abstract in recent years. That said, according to our Growth/Inflation Balance model, the nominal policy rate that coincides with neutral conditions in growth/inflation is around 4.25%. Considering that inflation expectations are well anchored at 3%, that means a real interest rate slightly above 1%, which is reasonable for the average Chile of the last, say, 20 years. But we cannot rule out that the possibility that in upcoming years, Chile could grow in a non-inflationary way with interest rates somewhat lower than that. In any case, we understand that the convergence to neutral levels would take a long time, as currently priced in by the rates market (4% is reached by about 2Q20).

Regarding the opposite direction taken by monetary policy in Chile vs. the U.S., the key element here is FX dynamics, in our view. Rates markets are already pricing in a substantial compression in the interest rate differential (to 140 bps from 300 bps in July 2016, as per the 1yr swap rate), but its correlation to the USD/CLP rate has been sharply erratic and mostly positive since late 2015 (i.e., rates and the USD move in the same direction in Chile, a pattern that tends to prevail in markets trading under the risk-on/risk-off logic). This supports the notion that CLP dynamics will tend to be more dependent on copper prices and relative value vs. other EM pairs in the near future. As a result, the range-bound USD outlook vs. overall EM gives the BCCh an opportunity to cut further, in our view, and if it finally comes, a bit of CLP weakness would be favorable for the real economy and would not jeopardize efforts to control inflation (at least if the USD/CLP rate stays below 685 on average, as per our model).

CHILE

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		4.1	1.9	2.3	1.6	2	2.7
Private Consumption (∆% y/y)	12	4.2	4.4	1.9	2.4	2.1	2.2
Public Consumption (∆% y/y)	65	5.6	2.2	5.8	5.1	4.6	4
Investment (∆% y/y)	28.4	0.4	-6.1	-1.5	-0.8	0.3	2.6
Exports (∆% y/y Local Currency)	39	4.3	0.7	-1.9	-0.1	1.9	3
Imports (∆% y/y Local Currency)	39	2.2	-7.0	-2.8	-1.6	1.7	2.6
GDP (US$ bn)		277	258	241	247	259	270
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		2.9	4.6	4.4	2.7	2.8	3
CPI core Inflation IPCX1 (Dec Cumulative)		2.6	4.6	4.7	3.1	2.9	3.1
US$ Exchange Rate (Average)		525	606	654	678	679	690
Central Bank Reference Rate (eop)		4.5	3.0	3.5	3.5	3	3.5
Private sector credit (% of GDP)		83.2	85.0	88.0	88.2	89.0	89.5
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-0.6	-1.6	-2.1	-3.3	-2.7	-2
**Primary Balance, % of GDP		-0.1	-1.0	-1.4	-2.6	-2.1	-1.4
Balance of Payments							
Trade Balance, % of GDP		0.6	2.5	1.5	2	2.3	1.6
Current Account, % of GDP		-3.7	-1.3	-2	-1.4	-2	-2.1
Debt Profile							
Central Bank International Reserves (US$ bn)		41.1	40.5	38.6	40	40	40
Total Public Debt (gross, % of GDP)		12.1	14.1	16.2	20.6	22.8	23.5
Of which: Foreign-currency denominated (% of GDP)		1.9	2.5	3.2	3.5	4.0	4.5
Labor Markets							
Unemployment Rate (% eop)		6.0	6.4	6.2	6.5	6.4	6.4

Sources: Central Bank, Servicio de Estudios, and Santander.

How "Gradual" Will the Cycle Be?

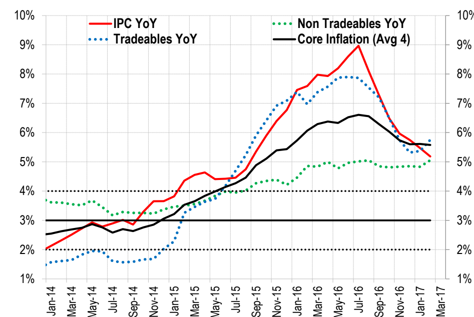
- **Inflation is moving lower; however, we believe BanRep's stated goal of bringing inflation below the top of its target range in 2017 remains in doubt.**
- **With general agreement among the board that a "gradual" cycle of policy rate cuts is necessary, the speed of the cuts will depend on developments in activity and inflation and BanRep's commitment to its inflation goals.**

Brendan Hurley
(212) 350-0733

Inflation: So far not an impediment to a pronounced near-term cutting cycle

Since November 2016, headline inflation has declined to 5.18% from 5.96%, while core inflation has fallen to 5.17% from 5.32%. Core non-tradable inflation actually worsened, moving up from 4.83% to 5.05% y/y. The impressive drop in headline inflation was driven nearly exclusively by the reversion of shocks to food prices, which accounted for 83% of the decrease. Core inflation has not fallen as quickly, and indeed core inflation is now above headline inflation for the first time since 2014. The lack of more progress in core inflation is a result of stagnation in core tradable inflation at the high level of 5.75%, combined with an increase in core non-tradable inflation. Going forward, we expect more relief on tradable prices, but we still see core inflation finishing 2017 at 4.5%, above BanRep's target range. The outlook for core inflation is complicated by two main factors, one temporary and one permanent. First, the tax reform passed in December 2016 increased sales taxes on a large portion of the CPI basket to 19% from 16%. Estimates of this impact on core (ex food) and headline inflation are around 0.3 pp and 0.5 pp, respectively. Second, medium-term factors such as a 7% minimum wage increase in 2017, which affects indexed prices, as well as inertia in the non-tradable basket, continue to exert influence over core inflation. This is evidenced in the non-tradable price index, which includes only a small impact from sales tax increases and has nonetheless stagnated near 5% despite the ongoing deceleration in growth. All in all, inflation is running slightly above BanRep's forecasts and appears unlikely, in our view, to fall back within the top range of BanRep's 2-4% inflation band for the third year in a row. Therefore, we maintain our long-held Dec-2017 forecast of 4.3% y/y, considering that in 2H17 the base effects should turn positive, pushing inflation higher on a y/y basis.

Headline and core CPI

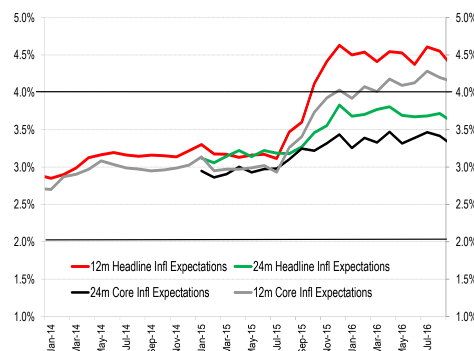


Sources: DANE, BanRep, and Santander.

Monetary policy: The destination is clear but the path less so

BanRep's cutting cycle started earlier than expected, with a 25-bp cut in December 2016, after keeping rates on hold at 7.75% for four months. The minutes of BanRep's February policy meeting made clear the goal of the two cuts that have followed since then: to bring its policy rate lower to arrive "gradually" at a neutral setting. To get a sense of where this neutral real rate is, the third graph to the right shows the level of the real policy rate by deflating the nominal policy rate by 12m inflation expectations. The current real policy rate level of 3.1% implies that the policy rate would need to fall by 160 bps in real terms in order to arrive at its neutral level, which we estimate at 1.5%. The level of 1.5% corresponds to both the median historical realized real policy rate and the average of econometrically derived estimates. If the goal is to arrive at the neutral real rate of 1.5%, by our measure, this would imply 200 bps of cuts in BanRep's nominal policy rate to reach 5.00%, which, using our estimate of inflation in one year, would equate to a real rate of 1.5%.

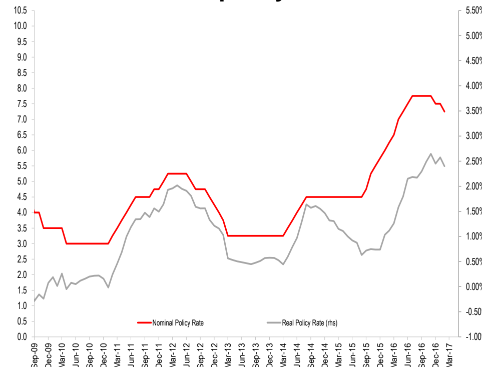
Inflation expectations



Source: BanRep.

If the destination is clear, the path is not as certain, nor are the risks along the way. BanRep has stated that while there is broad agreement on the goal of the current cutting cycle and the need to proceed "gradually," the rhythm of the decrease in real policy rates will be driven by the information and risks observed each month. Indeed, each of BanRep's last four board meetings has been decided in split votes, with members differing between leaving rates unchanged and cutting by 25 bps.

Real and nominal policy rates



Sources: Santander and BanRep

Analysis of recent BanRep discourse seems to suggest that BanRep appears to be looking at three sets of developments as it decides the pace at which to decrease the policy rate toward neutral. These developments are: (1) international risks, (2) the slowing of domestic demand, and (3) the speed of convergence of inflation to target. The board has mentioned on several occasions the presence of **international risks**

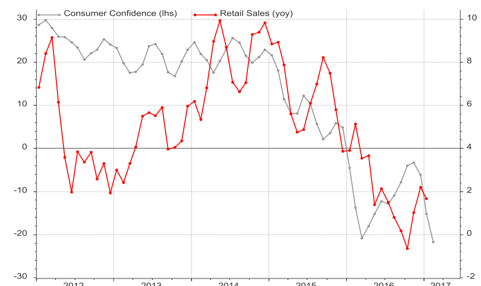
specifically stemming from a possible change in trade policies from the new U.S. administration, such as increases in the FOMC's federal funds rate. However, these risks have not appeared to be of much concern since January, and the current benign market environment would seem to argue that risks have largely abated, in our view. Nonetheless, BanRep did mention "international uncertainty" in its March communique, and, should uncertainty increase again in international markets, and the risk factors associated with rate hikes in the U.S. become an area of focus, we expect the more hawkish members of BanRep will begin use this as a reason to argue in favor of more gradualism in lowering policy rates.

In terms of **domestic demand,** while BanRep does not have an express growth mandate, its goal of price stability is to be pursued with the least damage possible to the near-term growth outlook. Ever since BanRep's November 2016 meeting, when a minority within the board cited a change in the balance of risks between growth and inflation, some members have started to shift their focus toward growth and seem to be willing to risk the 2017 inflation target in order to avoid a deepening slowdown in activity. In addition, the statement from the November meeting suggested that the deceleration in growth had been faster than expected. While the cut that followed in December referenced primarily the drop in inflation and inflation expectations, the focus on growth was again present in January and February, with some members of the board emphasizing the risks of "excessive" deceleration in growth and the possibility of falling into a "negative spiral" of a larger than expected deceleration in the economy. While this may be some exaggeration to make a point, with 2% growth hardly characteristic of a "negative spiral," the outlook for growth in Colombia is not favorable, in our view. We expect that 1Q17 should see a somewhat lower growth rate than the full year as a whole, due to a high base of comparison for industrial production cause by the ramping up of a major refinery in 1Q16, as well as a give-back from higher than normal household consumption in November and December 2016, as local consumers front-loaded spending on durables ahead of sales tax increases. Given these factors, we expect the developments for growth, especially in 1H17, to continue to support a more accommodative monetary stance.

In terms of **inflation,** in December the board characterized inflation as falling "faster than expected" due to the rapid declines in food prices. However, the news so far in 2017 has not been as encouraging, in our view, and BanRep has since walked back that assessment. Convergence of inflation to target is not happening quite as quickly as BanRep envisaged, with headline and core tracking 0.35 pp and 0.20 pp, respectively, above the CB's inflation forecasts. The lack of improvement in headline inflation is largely a result of a slower than forecast convergence in food inflation, while the stickiness in core is perhaps more troubling. Diffusion indices remain elevated, and sticky prices, as measured by core non-tradable prices, remain high. Indeed, BanRep President Echavarria admitted in February that the potential for inflation going below the 4% upper bound by year-end 2017, an important milestone given that BanRep has pledged to do "whatever it takes" to bring inflation below 4% by then, has fallen to nearly 40%. Despite these challenges, because of generous base effects in 2016, we forecast that y/y inflation should continue to fall until June, albeit remaining above BanRep's forecast. We expect this convergence to be reflected in lower inflation expectations, allowing BanRep to continue to cut rates despite the lack of improvement in the medium-term outlook, which ultimately should lead to a third consecutive year of inflation *above* expectations. However, toward 2H17, if inflation continues to run above forecasts, we see upside risk to our forecast of rates falling to 5.75% this year.

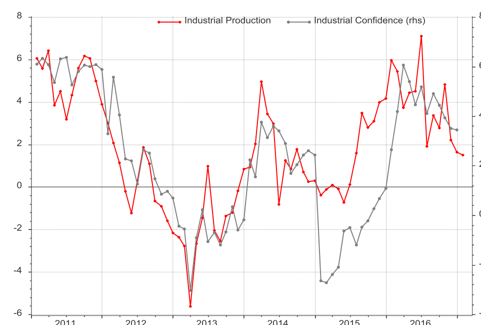
For its part, the market expects slightly more than 175 bps of cuts from the current level of 7.0%, to reach 5.25% in nominal terms. In addition, inflation surveys show that inflation is expected to be at 3.80% in one year's time. Thus, the market anticipates that the real policy rate should reach 1.45%, in line with estimates of neutral. It is worth noting that BanRep is likely to reach this neutral rate despite inflation being forecast to finish 2017 above target. We see more upside than downside risks to our monetary policy forecasts for 2017, given the persistence of above-target inflation; in the medium term, however, we incorporate downside risks, given the potential for rates to go below neutral if the economy fails to reactivate in 2018 and the recent addition of two new members to BanRep's board, Gerardo Hernandez and Jose Antonio Ocampo, who are perceived to be more pro-government and therefore of a more dovish bias.

Retail sales softening . . .



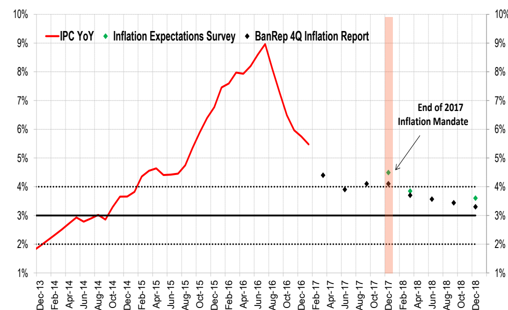
Source: DANE.

. . . along with Industrial production



Source: DANE.

Inflation not expected to reach target in 2017



Source: DANE.

COLOMBIA

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		4.7	4.6	3.1	2.0	2.2	3.0
.0Private Consumption (∆% y/y)	61.1	4.2	4.4	4	2.1	1.8	3.0
Public Consumption (∆% y/y)	16.1	5.8	6.3	2.8	1.9	2.0	2.5
Investment (∆% y/y)	23.7	5.1	11	2.7	-4.5	3.0	3.0
Exports (∆% y/y)	18.9	5.4	-6.7	-0.6	-0.9	1.0	3.0
Imports (∆% y/y)	19.8	4.5	8	4.1	-6.1	2.0	2.0
GDP (US$ bn)		381.8	378	293	279	302	300
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		1.9	3.7	6.8	5.75	4.3	3.3
CPI core Inflation (Dec Cumulative)		2.8	3.3	5.2	5.14	4.5	3.4
US$ Exchange Rate (Average)		1869.3	2400	2740	3050	3000	3200
Central Bank Reference Rate (eop)		3.25	4.5	5.75	7.5	6.00	5.00
Bank lending to the private sector (% chg y/y, Dec)		14	14	12	11	8	12
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.4	-2.4	-3.1	-3.9	-3.5	-2.7
**Primary Balance, % of GDP		-1	-0.5	-0.5	-1.0	-0.5	0.0
Balance of Payments							
Trade Balance (% of GDP)		-0.7	-3	-6.2	-3.7	-3.5	-3.7
Current Account, % of GDP		-3.3	-6.6	-6.4	-4.5	-4.0	-4.3
Debt Profile							
Central Bank International Reserves (US$ bn)		43.6	47	47	47	46	46
Total Public Debt (gross, % of GDP)		31.6	38.3	37	44	46	47
Of which: Foreign-currency denominated (% of GDP)		8.5	11	14	15	16	15
Labor Markets							
Unemployment Rate (year-end, % of EAP)		9.6	9.1	8.9	9.2	10	10

E = Santander estimate. F = Santander forecast. Sources: Finance Ministry, Budget Office, Central Bank, and Santander.

MEXICO

MXN RECOVERY REMOVES HIKING PRESSURE FROM BANXICO

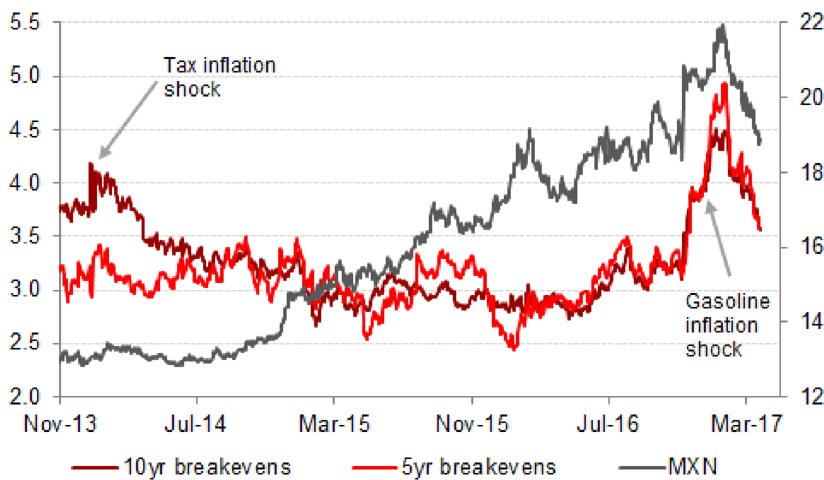
David Franco
(+52) 55 5257-8170

- **Banxico faces a tougher inflation shock and unusual external shocks. This warrants keeping its tightening stance, in our view.**
- **MXN recovery has removed hiking pressure, so we expect Banxico to decelerate its pace of hiking to 25 bps at its March 30 meeting.**
- **With the real policy rate spread vs. Fed at 425 bps, we believe Banxico will stay put at 6.75% in 2H 2017.**

A tougher inflationary shock . . .

The simultaneous supply-side price shock at the turn of the year, led by higher gasoline prices (part of the gradual energy price liberalization scheduled to end in early 2018), in addition to lingering external risks, mainly NAFTA renegotiation, justifies yet more tightening, so we expect Banxico to hike another 50 bps this year, taking its policy rate to 6.75%. Consumer prices rose to 4.9% in February, and we calculate that inflation should peak at 5.6% in May, or the fastest annual pace since the global financial crisis (GFC) (6.5% y/y in Dec-2008). The weaker Mexican peso's impact on imports has amplified the energy shock, and the policy-sensitive core inflation measure is also running at its fastest pace since the GFC (4.3%), fueled by higher goods prices and with some contamination on the steadier services items. Relative to the previous inflationary shock Banxico faced in January 2014 due to higher taxes as part of fiscal reform, the big difference today is the weaker MXN.

Price contamination risks declining due to a stronger MXN . . .



Notes: Market-derived inflation expectations are Mbonos minus Udis. Sources: Bloomberg and Santander.

. . . together with a challenging external backdrop . . .

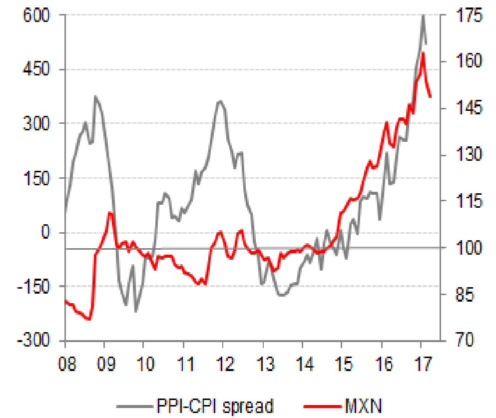
Our conclusions from these two price shocks are as follows:

1. Higher FX pass-through. The PPI-CPI core spread has widened above 600 bps to well above its previous peak during the GFC (chart 1). Producers have more reason to pass higher prices on to consumers currently, as retail sales growth averaged 8% y/y (six months before the shock hit) vs. 1% in 2014.
2. Banxico has continued to tighten preemptively, as inflation risks have coincided with unusual external risks, in sharp contrast to 2014, when the board actually continued easing after inflation risks subsided (chart 2).
3. New taxes in 2014 were a one-off, but energy prices today are still shifting, explaining the use of fiscal revenue to smooth price changes, in our view.

. . . warrant additional rate hikes . . .

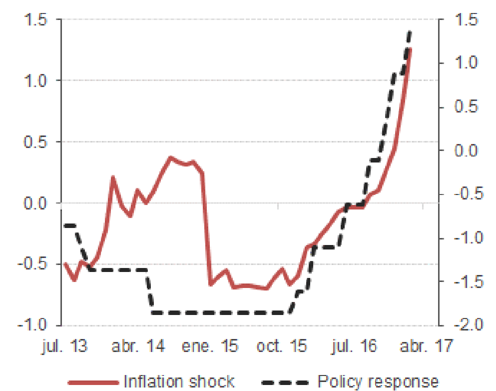
Although Banxico's reaction function is based on the sole mandate of keeping inflation around the 3% target, we believe this target is not yet fully symmetric due to (a) external risks and (b) relatively weak macro fundamentals (low growth and high debt-to-GDP ratio at 50%). In our view, this means the board will be inclined to err on the cautious side and deliver additional hikes instead of pausing the hiking cycle at the current 6.25%. After two additional hikes of 25 bps each, bringing the policy rate to

FX pass-through is up, albeit from low levels



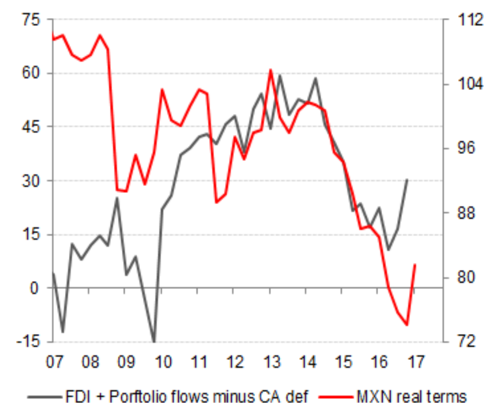
Notes: Inflation spread based on core indices. MXN index 2012 average=100. Sources: Inegi and Santander.

Energy price shock has been more challenging for Banxico . . .



Notes: Inflation shock is core CPI minus Banxico's 3% CPI target. Policy response is Banxico's policy rate minus its average over last decade. Sources: Inegi and Santander.

. . . . particularly amid lingering external negative factors, mainly NAFTA



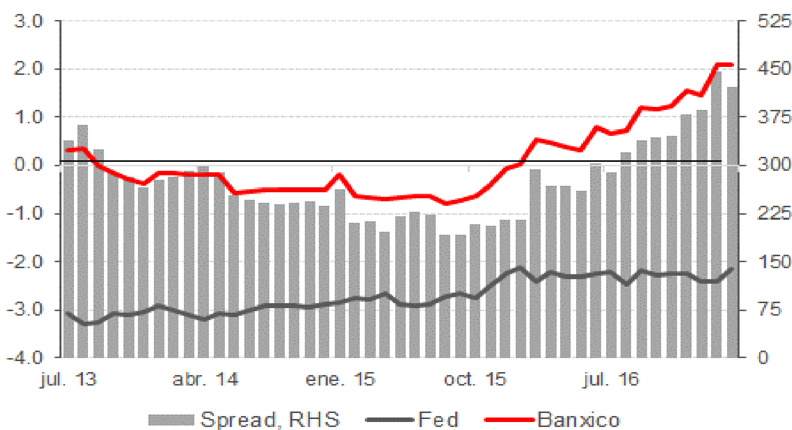
Notes: USD bn, 12m-sum. Sources: Banxico and Santander.

6.75% next June, we believe the board will stay put and assess the impact of 375 bps of cumulative hikes since Dec-15, given two factors all five board members seem to agree on: (i) growth risks are skewed to the downside, and (ii) no domestic-demand price pressures exist. The following developments speak to both factors: growth expectations, short term (2017) and long term (average next 10 yrs) were downgraded to 1.5% and 2.7%, from 2.1% and 3.1% in September; banking credit growth has slowed from 14% to 8% (y/y, real terms); the CA deficit narrowed in 4Q16; fixed investment dynamics remain weak, led by public works (budget cuts); wages are not tracking inflation higher; and confidence levels have plunged.

. . . but pressures to maintain an aggressive 50-bp dose have declined

Overall, relative prices have increased, but mostly reflecting a higher FX pass-through rather than structural (domestically rooted) price pressures. It is therefore essential, in our opinion, for monetary authorities to gauge inflation contamination risks. The two most important, in our view, are the persistence of higher core inflation and longer-term inflation expectations. On the former, we expect March-April biweekly CPI reports to confirm a deceleration in average core inflation to 0.16% 2w/2w from 0.36% in the first four prints of the year. Meanwhile, inflation expectations provide a timely test of recent monetary actions and of the bank's credibility. Market-derived inflation expectations have declined quickly, so remain consistent with a transitory price shock (center chart previous page). Both 5yr and 10yr breakeven rates are already trading below 3.6%, with major support from MXN, not far from their 3.4-3.5% range seen last summer. The consensus of analysts has longer-term inflation outlook stable around 3.5%, also not far from the 3.4% average forecast since 2012. Banxico already has a policy rate in real terms at 2.1% (1yr fwd), or 425 bps above its U.S. counterpart, which is the widest spread since the GFC. As a result, market pricing of additional rate hikes from Banxico has slowed noticeably, to about 50 bps over the next 12 months.

Banxico vs. Fed: real policy rates have widened significantly

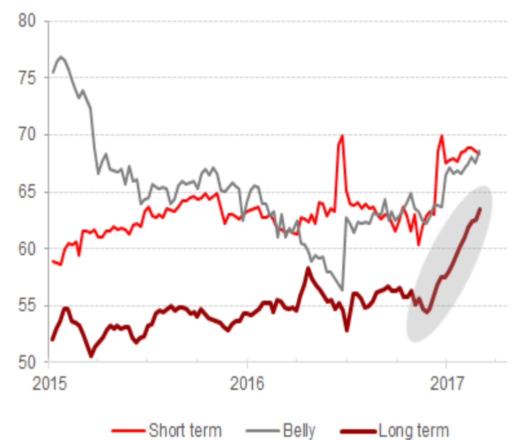


Notes: Deflated using 1yr forward CPI expectations from Banxico and NY Fed surveys. Sources: Bloomberg and Santander.

MXN and the Fed expected to dictate Banxico's terminal rate

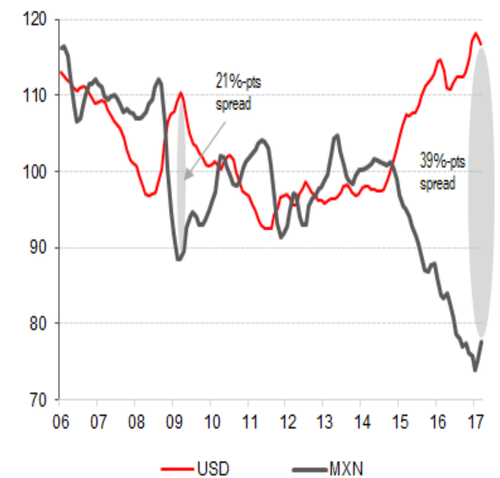
As the energy price shock becomes less centric, a key driver for Banxico's forecast that inflation will converge to its 3% target by end-2018 is a stable, or better yet, stronger MXN. At 18.8, the peso has recovered 14% since its worst level this year but remains cheap in real terms. The MXN-USD spread in real terms has widen by twofold versus worst levels during the GFC (chart 5). Our constructive MXN view (end-2017 forecast is peso at 18.30) assumes NAFTA renegotiation with a regional content focus (i.e., rules of origin to raise U.S. firms' market access, compliance with a legal ruling involving a trade dispute between firms and an upgrade to include e-commerce). Additionally, we believe further improvement in Mexico's idiosyncratic factors is needed to cement MXN recovery. In the meantime, the following factors have also helped to remove a great deal of hiking pressure from Banxico: (1) Gasoline prices have stabilized on lower oil but also due to the fiscal smoothing effort. (2) The USD has stabilized lower too, in our view due to the Fed's "dovish hike" combined with rising concerns about U.S. reforms. (3) Foreign investors have been adding local duration risk since right after the U.S. election. The sponsorship of Mbonos by foreigners reached an all-time high at two thirds of total outstanding, but positions in the longer end of the curve saw the biggest addition and grew by 9 pp vs. January 2016.

Foreigners have added duration despite NAFTA risks



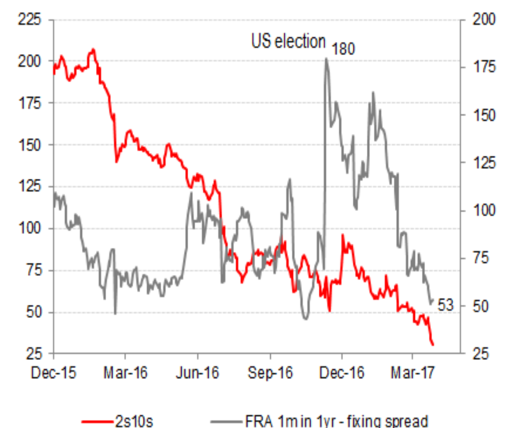
Notes: Mbonos holdings by foreigners as % of total outstanding. Short term are up to 3yrs, Belly is 3-7yrs, Long term is 7-30yrs. Sources: Banxico and Santander.

MXN cheap relative to USD



Notes: Effective FX indices in real terms deflated using CPI. Sources: JPMorgan and Santander.

Market is pricing only 50 bps of Banxico hikes and yield curve is too flat already



Notes: Yield curve or 2s10s spread is based on swap rates. Sources: Bloomberg and Santander.

MEXICO

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		1.4	2.2	2.6	2.3	1.7	2.2
Private Consumption (Δ% y/y)	67.5	2.1	1.8	2.3	2.8	2.4	2.4
Public Consumption (Δ% y/y)	11.1	1.0	2.1	2.3	1.1	-2.5	1.0
Investment (Δ% y/y)	21.5	-1.6	2.9	4.2	0.4	0.0	3.8
Exports (Δ% y/y Local Currency)	33.2	2.4	7.0	10.3	1.2	3.5	4.0
Imports (Δ% y/y Local Currency)	-32.9	2.6	6.0	8.6	1.1	2.1	4.5
GDP (US$ bn)		1262.5	1296.7	1,151	1,045	1,121	1,160
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		4.0	4.1	2.1	3.3	5.2	3.8
CPI core Inflation (Dec Cumulative)		2.8	3.2	2.4	3.4	4.5	3.7
US$ Exchange Rate (Average)		12.8	13.3	15.9	18.7	18.7	19.1
Central Bank Reference Rate (eop)		3.50	3.00	3.25	5.75	6.75	7.00
Bank Lending to the Private Sector (% of GDP)		14.9	15.0	16.2	17.5	18.0	18.5
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.3	-3.2	-3.5	-2.6	-2.4	-2.0
**Primary Balance, % of GDP		-0.4	-1.1	-1.1	-0.1	0.4	0.9
Balance of Payments							
Trade Balance (% of GDP)		-0.1	-0.2	-1.3	-1.3	-1.1	-0.8
Current Account (% of GDP)		-2.5	-2.0	-2.9	-2.7	-2.6	-2.2
Debt Profile							
Central Bank International Reserves (US$ bn)		176.5	193.2	176.7	176.5	178.0	180.0
Total Public Debt (gross, % of GDP)		40.4	43.2	47.3	50.5	50.2	50.0
Of which: Foreign-currency denominated (% of GDP)		10.2	11.9	14.7	15.5	15.2	15.0
Labor Markets							
Unemployment Rate (year-end, % of EAP)		4.9	4.8	4.3	3.7	3.7	3.6

Sources: Economy Ministry, Central Bank, and Santander estimates.

PERU

WAIT AND SEE MODE

Tatiana Pinheiro*
(5511) 3012 5179

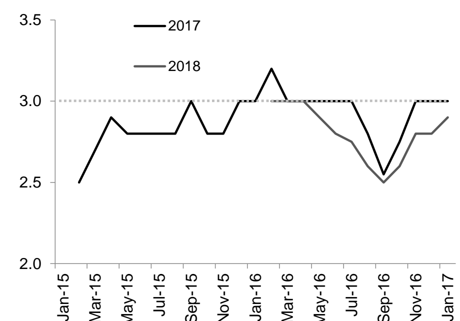
- **The nominal neutral rate has shown notable stability, smoothly declining from 5% to 4% over the last 10 years.**
- **Though the current monetary stance appears tight, if a steeper U.S. yield curve and strong USD and/or inflation remain above the ceiling of the target, we would expect to see the BCRP resuming the monetary tightening cycle.**
- **The economic outlook points to risks to the inflationary scenario – namely supply shocks, economic growth above potential growth, and a loose fiscal policy, among others.**

Monetary policy backdrop

At the March monetary policy meeting, the Central Bank (BCRP) maintained the reference rate unchanged at 4.25% p.a., based on the assumption that consumer price inflation will converge toward the target range this year given that inflation expectations are within the range, as well as expectations of a fading impact of weather on food prices and the narrowing of the nominal fiscal deficit.

As we highlighted in our December *Strictly Macro* report, a steeper U.S. yield curve and strong dollar could force the BCRP to resume the tightening cycle, in our view. We should mention the risk of inflation acceleration that could also trigger a monetary tightening cycle. Given that, the 2017-18 inflation forecasts of the monetary authority in the 2.0-2.5% range seem optimistic. For instance, the weather-related supply shock on food prices could eventually continue to exert upward inflation pressure, which could in turn exert second-order effects on other prices, resulting in an inflation acceleration process.

Inflation Expectations

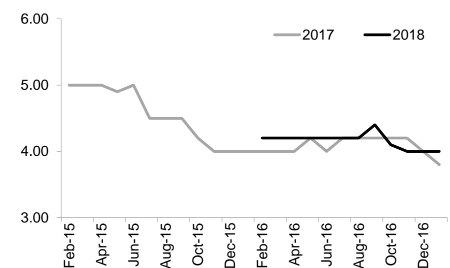


Source: BCRP.

Despite inflation's downward trend since 2015, with inflation having fallen to 3.2% at year-end 2016 from the 4.5% posted at year-end 2015, consumer inflation has run above the official 2% +/-1% target range in the last three years. For now, we are maintaining our 2017 forecast at 2.8%; mainly, we are not seeing secondary effects from the food supply shock on the other prices, and core inflation (excluding food and energy) is still running within the target range, at 2.6% in February.

Economic growth continues expanding. Real growth GDP was 3.9% in 2016, and according to the most recent activity figure, GDP growth as estimated by INEI registered 4.8% y/y in January. This marks the 90th consecutive month of growth in which all sectors (excluding construction) have seen increases. As we expect the country's ongoing corruption scandal to hit GDP growth this year, we are lowering our forecast to 3.8% from our previous 4.5%. However, from a monetary policy perspective, even this lower pace of growth suggests that the output gap will close by year-end. Depending on estimated potential GDP growth, if GDP grows by 3.8%, the output gap would be positive, which would be a source of pressure on the inflation scenario. According to IMF estimates, Peru's potential GDP growth is 3.5%.

GDP Expectations



Source: BCRP.

Regarding fiscal policy, the nominal fiscal balance of the non-financial public sector (NFPS) was under the target in 2016. The fiscal target was a deficit of 3% of GDP, and the nominal fiscal result was a deficit of 2.6% of GDP. However, since the beginning of the year, the nominal fiscal balance has slipped to 2.7% of GDP, which is not in line with the government and BCRP expectations of nominal fiscal deficit narrowing. The government's fiscal consolidation plan calls for the fiscal deficit to moderate to 2.5% of GDP in 2017 and to 2.3% in 2018, scaling back some of its counter-cyclical fiscal policies as the economy continues to heat up. We believe that scaling back government spending will be a tough task, especially with the consensus downward revision of GDP growth. We anticipate a loose fiscal policy this year, with the nominal fiscal deficit at 2.8% of GDP and some reduction in the fiscal deficit to 2.5% of GDP in 2018.

The model for the neutral interest rate

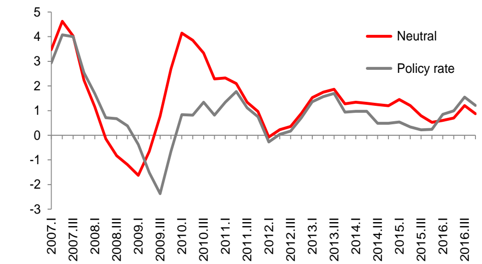
Central banks normally take into consideration both inflation and economic activity when setting interest rates, and even more so if the monetary authority is an inflation targeter, as activity is supposed to have an impact on inflation.

That said, we assume the Peruvian monetary system is an inflation target, and the partial dollarization of the economy does not play an important role in the monetary decision, as we observed in monetary decisions over the last few years. We again ran our version of the Taylor rule for Peru (for details on this model, see our May 2014 *Strictly Macro* report). Our option was for a rather simple one, the dynamic Taylor rule (a recursive estimation that increases the sample using rolling windows) expressed as

$$r_t = r^* + \beta(\pi_t - \pi_t^*) + \theta\tilde{y}_t + \varepsilon_t$$

where r_t is the short term nominal interest rate (here represented by the 1-year interest rate); given the lack of a series for expectations in the months ahead, we employ inflation in 12 months to the date, π_t; π_t^* is the inflation target; $\tilde{y}_t$ is the output gap and ε_t are the residuals, assumed to respect the traditional econometric hypotheses, and r^* is a constant representing the level of the nominal interest rate that would prevail in the absence of both inflation and output gaps (the neutral level).

Real interest rates (% per year)



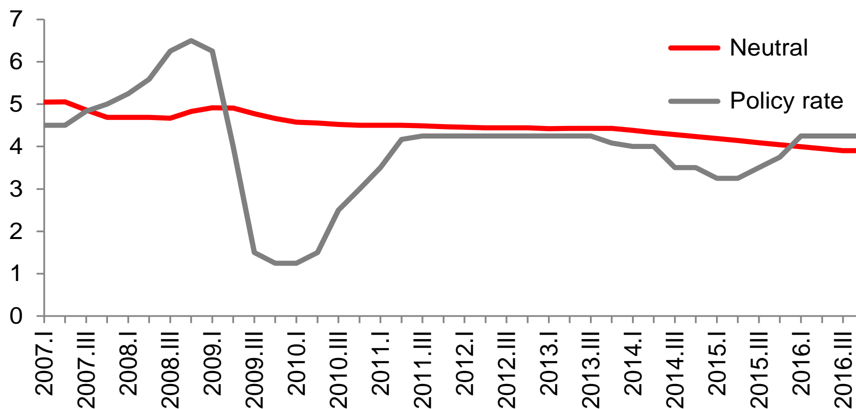
Source: BCRP and Santander estimate.

Data are defined on a quarterly basis, starting in 1Q02, after the BCRP implemented its inflation-targeting regime. The estimations were carried out using GMM, with lagged dependent variables as instruments, so as to solve the inherent problem of endogeneity in the equation above.

The results

First, the nominal neutral rate has been notably stable, smoothly declining from 5% to 4% over the last 10 years. The latest point estimate (4Q 2016) is 4.0% p.a. in nominal terms and 1% in real terms (nominal neutral level discounting the ceiling of the inflation target).

Nominal interest rates (% per year)



Sources: BCRP and Santander.

Therefore, currently the nominal rate is slightly above the neutral level. In addition, since May 2016 the real interest rate has hovered slightly above 1% (reference rate and inflation expectation 12 months ahead), also indicating that the monetary tightening cycle between September 2015 – February 2016 indeed has tightened monetary conditions. This is in contrast to the obvious easing cycle between 2H 2014 and 2015, when the BCRP seems to have adopted a prudently counter-cyclical policy in order to reduce the negative impact of international economic deceleration.

However, with the reference rate now having held steady at 4.25% for 13 consecutive months, it seems to have placed greater weight on activity recently, as inflation is running above the ceiling while consensus is revising downward economic growth expectations. Since February 2016, there have been no indications that the BCRP will implement another round of hikes.

We believe that the most likely scenario is that the reference rate remains unchanged at 4.25%, due to a reduction of foodstuff pressure on inflation. Nevertheless, considering historical decisions by the BCRP, we do not see the monetary authority as biased toward growth rather than inflation. Hence, we do not rule out the risk that the BCRP could resume a tightening cycle if inflation continues running above the ceiling target.

PERU

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		5.8	2.4	3.3	3.9	4.5	4.9
Private Consumption (Δ% y/y)	61.4	5.3	4.1	3.4	3.4	3.5	4
Public Consumption (Δ% y/y)	11.2	6.7	6.4	9.8	-0.5	2	-1
Investment (Δ% y/y)	28.2	11.5	-7.5	-0.7	-4.9	3	5
Exports (Δ% y/y Local Currency)	23.9	-3.1	-4.5	3.5	9.7	5	3.5
Imports (Δ% y/y Local Currency)	24.6	2.1	-5.6	2.5	-2.3	-1.5	-1.5
GDP (US$ bn)		202	204	192	195	210	223
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		2.9	3.2	4.4	3.2	2.8	2.5
WPI Inflation (Dec Cumulative)		1.6	1.5	2.6	1.9	1.5	2
US$ Exchange Rate (Average)		2.7	2.84	3.19	3.356	3.6	3.7
Central Bank Reference Rate (eop)		4	3.5	3.75	4.25	4.25	4
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		0.9	0.3	-2.1	-2.6	-2.8	-2.5
**Primary Balance, % of GDP		2	1.2	-1.9	-1.5	-1.0	-0.5
Balance of Payments							
Trade Balance, % of GDP		0.0%	-1.4%	-1.6%	-0.2%	0.2%	0.4%
Current Account, % of GDP		-4.5	-5	-4.4	-3.8	-3.5	-3
Debt Profile							
Central Bank International Reserves (US$ bn)		65.7	62.4	61.5	61.7	62.9	63
Total Public Debt (gross, % of GDP)		20.0	20.0	23.3	23.8	26.5	26
Of which: Foreign-currency denominated (% of GDP)		8.99	8.74	11.10	10.30	12.0	12.0
Labor Markets							
Unemployment Rate (year-end, % of EAP)		5.9	5.9	6.2	7.0	5.0	4.7

Sources: Economy Ministry, Central Bank, and Santander estimates.

URUGUAY
INFLATION FALLS, DRIVEN BY UYU STRENGTH

Marcela Bensión
598 1747 6905

- **GDP growth prospects improved based on supportive external and regional conditions. We now expect 1.8% y/y growth this year.**
- **Inflation fell to 7.1% y/y as of February, due to peso strength that led to strong appreciation in the RER.**
- **UYU rates remain high, with embedded risk premiums likely signaling potential changes in inflation readings and FX quotes, in our view.**

Improved prospects for 2017 despite continuing imbalances

In recent months, prospects for 2017 have continued to improve, in our view, based on a supportive external context and a stable currency that helped boost household consumption. GDP figures for both 3Q16 and 4Q16 surprised on the upside, due to accelerating household consumption, which grew at an average 0.7% y/y in real terms in 2016, above our 0.4% y/y estimate. All in all, GDP growth averaged 1.5% y/y, in line with our 1.4% y/y expectation, as higher than expected imports offset improved consumption. Leading indicators such as the UCUDAL-SURA consumer confidence index had already anticipated such an outcome, picking up to 48.4 as of February 2017 (near a neutral level of 50) from notably pessimistic levels in May 2016 (40.9). The reasons for the rebound in household consumption are: (i) a stronger peso that allowed for a rebound in sales of durable imported goods, such as automobiles and home appliances; and (ii) wage increases were higher than expected in response to pressure from labor unions as inflation rose in May 2016. Nominal wages increased an average 11.4% y/y in 2016, resulting in real wage increases of 1.6% y/y, slightly above our 1.4% y/y estimate for labor productivity gains. As a result, we were not surprised to see a decline in employment, which fell 0.2%. Still, the salary bill – that is, the combination of wage and employment levels – increased 1.3%, boosting consumption.

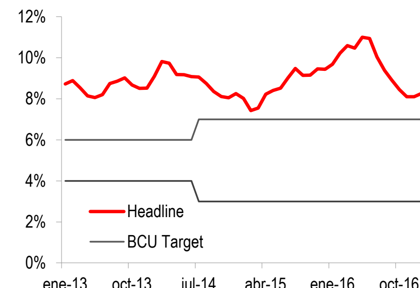
For 2017, we expect real wages to increase 2.3% in y/y real terms – driven by high rigid nominal wages and declining inflation – while employment could recover slightly (+0.2% y/y), driven by improved activity prospects, resulting in a further 2.6% y/y increase in the salary bill. As a result, we expect private consumption to increase 1% y/y in real terms, with GDP accelerating to 1.8% y/y, an upward revision from our previous 1.0% estimate. Downward bias on consumption and activity levels includes fiscal tightening expected since January 2017 – mostly based on higher personal income tax on mid- to high-income households – and high labor costs that will likely continue to jeopardize job creation, in our view.

Inflation declined in recent months on the back of a stronger peso . . .

Despite the activity rebound, domestic price inflation fell considerably during 2H16, due to a stronger peso. After peaking at 11% y/y in May 2016, inflation closed the year at 8.1% y/y and declined further to 7.1% y/y as of February 2017, nearing the 3-7% official target range. Our estimates point to a low 5.2% y/y increase in tradable goods, as the U.S. dollar fell 10.3% y/y against the peso as of February. Other key inflation drivers, such as wages and administered prices, decelerated only marginally since May 2016. Wages decelerated from 11.8% y/y at that time to 9.9% y/y as of January 2017, while administered prices softened from 10.2% y/y to 8.2% y/y as of February. As a result, non-tradable inflation – as per own estimates – remains high at 9% y/y, indicating that inflation readings are highly dependent on FX quotes.

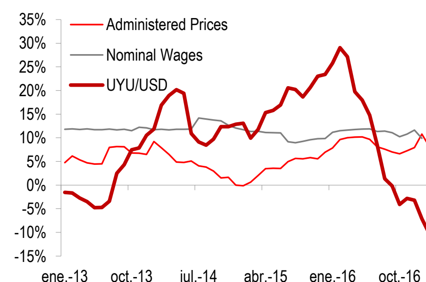
While declining inflation and a stronger peso appear positive for consumers and the monetary authority, they pose a series of risks from a macroeconomic perspective. First, they reaffirm the vulnerability of inflation readings to potential peso weakening. In a context of higher U.S. rates, declining FDI and financial capital inflows, and a tighter fiscal stance, we see little reason for currency appreciation to persist at current levels. In our view, the peso appears to be more strongly influenced by currency appreciation in neighbors Brazil and Argentina than by domestic factors. Second, a strong peso undermines exports, as the country's real exchange rate (RER) strengthens. According to own estimates, as of February 2017, the RER against the U.S. was 20% overvalued compared to average levels since 1994 (proxy of neutral levels). This is substantially higher than the near 6% overvaluation of the Brazilian

Inflation fell to 7.1% y/y . . .



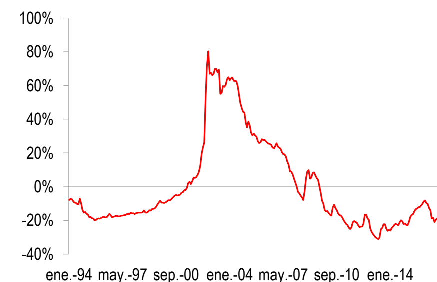
% CPI change, monthly data, y/y as of February. Sources: INE and Santander.

. . . due to peso strength



Main inflation drivers. % change, monthly data, y/y. Wages as of January, FX and administered prices as of February. Sources: INE and BCU.

RER remains strong, weighing negatively on the external sector



RER Uruguay-US. Monthly data gap against average level since 1994. A negative gap indicates that Uruguay has become more expensive in real terms. Source: Santander.

real and the 3% undervaluation of the Chilean peso. In the region, the Uruguayan RER is comparable only to Argentina, which presents a similar 24% overvaluation, according to own estimates. A similar situation occurred during the 1990s, ending in fierce FX overshooting between 1999 and 2002. While we are not expecting such a negative outcome this time – considering sounder economic fundamentals, such as flexible FX regimes, reinforced financial supervision, and social networks, among others – we believe strong RER appreciation exposes the country to sharp currency depreciation under unexpected adverse shocks.

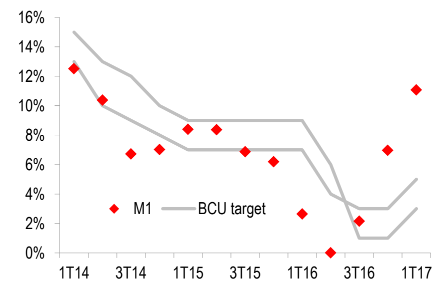
That said, we cannot dismiss the potential for sustained currency appreciation in 2017 in the absence of negative shocks from the external or local economy, particularly under the influence of a stronger ARS and BRL. Under such a base case scenario, we believe there is a strong possibility that inflation could meet the official target for the first time in more than six years, nearing 6% y/y levels in upcoming months. Under our expectation of a UYU/USD 31.5 quote as of year-end – that is, a 9.9% y/y rise – inflation readings should close 2017 at 8.2% y/y, similar to the 2016 reading. However, average inflation is likely to stand at 7.1% y/y, according to our projections, significantly below the 9.6% y/y level reached in 2016. In our opinion, upside risks include higher than expected peso weakening that, coupled with still high fiscal expenses and wage policies, could ignite inflation, as occurred during 1H16.

. . . But money aggregates are expected to accelerate, with unclear impact on UYU rates

As inflation moderates, the monetary authority starts to lose its grip on money aggregates, officially stated as the intermediate tool to comply with indicative inflation targets. Note that in mid-2013, authorities shifted from a reference rate to a money-aggregates regime. However, this shift did little to improve the country's poor track record in complying with indicative inflation targets, considering its failure to do so since 2010. Nevertheless, the evolution of money aggregates does indicate the higher or lower pressure that the monetary authority exerts on FX quotes by the extent to which the authority meets local currency demand, quite volatile by the way, considering the high dollarization of the economy in which portfolio shifts from local to foreign currency are the norm. For instance, during 1H16, money aggregates decelerated to a 1.3% y/y increase from 6.5% y/y during 2H16, as money demand plummeted amid strong peso depreciation. In 3Q16, money aggregates maintained growth at a 2.2% y/y rate, although money demand had already picked up, which we think likely contributed to intensify peso strengthening pressures as agents sold foreign currency to meet local currency needs. During 4Q16, money aggregates picked up to 7% y/y, and during 1Q17 that growth accelerated, rising to 11% y/y as of mid-March, significantly above the 3-5% y/y range announced in December 2016.

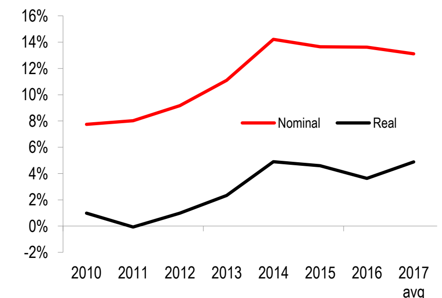
Regarding UYU rates, the current monetary stance still does not appear sufficiently accommodative to bring about a decline in rates, which remain high in both nominal and real terms. Indeed, three-month sovereign yields remain at 13.2% p.a., that is, 4.7% in real terms based on expected annualized six-month inflation as per the monthly Central Bank survey. This is high compared to average 2.5% real yields from 2003 to date and the 3.5-4.0% neutral rates indicated by local researchers (e.g., "La tasa natural de interés: estimación para la economía uruguaya," V. España, 4/2008, or "Aproximaciones empíricas a la tasa natural de interés para la economía uruguaya," C. Brum et al. 9/2010). As a result, market participants appear to perceive as transitory both current peso strength and inflation softening in light of (i) a strong RER, (ii) persistently high inflation in non-tradable goods (amid loose wage and fiscal policies), (iii) a material potential, in our view, for the U.S. Fed to deliver more than two rate hikes this year, and (iv) poor credibility for monetary policy in times of financial distress as occurred during January-February 2016. Under this scenario, risk premiums embedded in UYU rates could remain high, in our opinion.

Money aggregates accelerate . . .



Average quarterly data. % change, y/y. Sources: BCU and Santander.

. . . but UYU rates remain high



3-month tenor Central Bank bills. Real rate based on effective average inflation, except 2017, for which 6-month inflation expectations are considered (monthly BCU survey). Sources: BEVSA, INE, and Santander.

URUGUAY

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		4.6	3.5	0.4	1.5	1.8	3.5
Private Consumption (∆% y/y)	66.0	5.5	3.0	-0.5	0.7	1.0	1.1
Public Consumption (∆% y/y)	13.8	4.9	2.5	2.2	1.6	1.5	1.5
Investment (∆% y/y)	22.9	4.8	0.0	-9.0	1.5	1.2	17.1
Exports (∆% y/y Local Currency)	24.0	-0.1	3.5	-0.6	-1.4	1.5	2.5
Imports (∆% y/y Local Currency)	27.3	2.8	0.8	-7.3	-2.9	-0.7	5.0
GDP (US$ bn)		57.6	57.3	53.4	52.5	58.1	58.7
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		8.5	8.3	9.4	8.1	8.2	7.8
WPI Inflation (Dec Cumulative)		9.2	10.3	10.0	8.1	8.5	8.5
US$ Exchange Rate (Average)		20.5	23.2	27.3	30.1	29.8	32.9
Central Bank Reference Rate (eop)		n/a	n/a	n/a	n/a	n/a	n/a
Monetary Base (∆% y/y)		16.1	10.7	9.5	6.1	8.6	11.7
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.3	-3.5	-3.5	-4.1	-3.4	-3.4
**Primary Balance, % of GDP		0.4	-0.6	0.0	-0.7	0.0	0.3
Balance of Payments							
Trade Balance, % of GDP		-1.4	-0.9	-0.3	0.3	0.4	0.1
Current Account, % of GDP		-2.9	-2.6	-1.2	-0.4	-0.3	-0.6
Debt Profile							
Central Bank International Reserves (US$ bn)		16.3	17.6	15.8	14.2	16.0	20.4
Total Public Debt (gross, % of GDP)		55.3	58.8	61.6	64.6	61.3	63.5
Of which: Foreign-currency denominated (% of GDP)		37.7	44.3	56.3	57.0	57.7	57.8
Labor Markets							
Unemployment Rate (year-end, % of EAP)		6.5	6.6	7.5	7.8	7.9	7.9

Sources: Banco Central de Uruguay, Finance and Economy Ministry, National Statistics Agency (INE), and Santander.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Brendan Hurley	Macro, Rates & FX Strategy – LaAm	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy – LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264
Electronic Media			
Bloomberg	SIEQ <GO>		
Reuters	Pages SISEMA through SISEMZ		

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. (“Santander Investment Bolsa”), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Brendan Hurley, Nicolas Kohn*, Martin Mansur*, Luciano Sobral*, Juan Pablo Cabrera*, David Franco*, Tatiana Pinheiro*, Marcela Bension*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

© 2017 by Santander Investment Securities Inc. All Rights Reserved.