Strictly Macro

Divergence in Interest Rates

July 1, 2019

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To cut, to hike or to hold?

Growth in Latin America has disappointed across the board in 2019, with analysts, including our team, continually revising the region's growth estimates. The cause of the disappointment varies, with some related to lower external demand, public policies, change in government, and lack of business confidence and in some cases high interest rates. With the Fed's change in stance toward the dovish side and opening the door to interest rate cuts in its upcoming July meeting, the discussion in the region has changed to the possibility that the main central banks in the region may follow the Fed's lead and cut their interest rates to provide further support to the economies. While there is room for this in most of the countries in the region, the ideal scenario for any given CB board to pull the trigger depends mainly on domestic factors – for example, in Brazil, pension reform approval is key, while in Argentina, election results are crucial. In the case of Mexico, the board remains concerned about domestic risks, mentioning the risks of further revisions in Pemex and the sovereign rating. In contrast, despite slower growth in Colombia and Peru, inflation above the target is the main limiting factor for the central banks of these countries to lower interest rates, and in effect we think accumulating pressures may lead them in the opposite direction.

Interest rate changes by end of 2020

	Current	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
ARGENTINA	66.93	58.00	48.50	43.87	39.25	34.62	30.00
		-893	-950	-463	-462	-463	-462
BRAZIL	6.50	5.75	5.50	5.50	5.50	5.50	5.50
		-75	-25	0	0	0	0
CHILE	3.00	2.50	2.50	2.25	2.25	2.00	2.00
		-50	0	-25	0	-25	0
COLOMBIA	4.25	4.25	4.50	4.75	4.75	5.00	5.25
		0	25	25	0	25	25
MEXICO	8.25	8.25	8.25	8.00	7.75	7.75	7.75
		0	0	-25	-25	0	0
PERU	2.75	2.75	3.00	3.25	3.25	3.50	3.75
		0	25	25	0	25	25

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

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FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2017	2018	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F	Last Review' 19	Nom GDP '19
Argentina	2.7	-2.5	-5.8	-2.0	1.6	4.4	-0.5	2.3	Unchanged	488
Brazil	1.1	1.1	0.5	1.2	0.4	1.2	0.8	2.0	Down	1,833
Chile	1.5	4.0	1.6	2.3	3.5	3.4	2.7	3.2	Down	305
Colombia	1.4	2.6	2.8	2.9	3.5	3.5	3.2	3.4	Down	323
Mexico	2.1	2.0	1.2	0.3	1.0	1.3	1.0	1.5	Down	1,258
Peru	1.6	4.0	2.3	3.5	4.5	4.6	3.8	3.9	Down	235
Uruguay	2.6	1.6	-0.2	0.3	0.6	2.0	0.5	1.8	Down	58
LatAm-7	**1.7**	**1.4**	**0.4**	**0.9**	**1.4**	**2.1**	**1.2**	**2.2**		**1,202**

In %. Year-on-year basis. Nominal GDP in US$ billions. LatAm 7: Nominal GDP-PPP Weighted Sources: IMF, National central banks, finance ministries, and Santander.

GDP	Priv Cons			Pub Cons			Investment			Exports			Imports		
Components	'17	'18	'19F	'17	'18	'19F	'17	'18	'19F	'17	'18	'19F	'17	'18	'19F
Argentina	3.5	-2.4	-1.8	1.9	-3.3	-3.2	11.3	-1.5	-7.4	0.4	0.0	13.3	14.7	-5.1	-3.6
Brazil	1.4	1.9	1.0	-0.9	0.0	-0.2	-2.5	4.1	2.4	5.2	4.1	1.9	5.0	8.5	2.1
Chile	2.4	4.0	3.4	4.0	2.2	2.4	-1.1	4.7	5.4	-0.9	5.0	2.0	4.7	7.6	3.3
Colombia	2.1	3.6	4.8	3.8	5.6	4.7	-3.2	3.5	4.7	2.5	3.9	2.4	1.2	7.9	13.8
Mexico	3.1	2.2	1.8	1.0	1.4	-3.0	-1.6	0.6	-1.5	3.9	5.7	4.7	6.2	6.2	4.3
Peru	2.6	3.8	3.8	0.5	2.0	2.1	-0.2	4.9	3.0	7.6	2.5	1.5	4.0	3.4	4.2
Uruguay	4.6	1.5	0.5	-0.7	0.8	0.5	-13.0	7.3	1.0	6.9	-4.8	3.0	0.5	-2.0	3.0
LatAm-7	**2.3**	**1.9**	**1.6**	**0.7**	**0.8**	**-0.6**	**-0.7**	**2.5**	**0.6**	**3.9**	**4.0**	**3.9**	**6.0**	**5.9**	**3.4**

Annual changes in %. na: Not available. LatAm 7: Nominal GDP-PPP Weighted Sources: IMF, National central banks, finance ministries, and Santander.

Inflation	Headline CPI (YoY)							Core measure		
	2017*	2018*	Jul-19F	Aug-19F	Sep-19F	2019F*	2020F*	2018	2019F	2020F
Argentina	24.8	47.6	54.2	51.6	45.2	39.0	24.0	47.7	44.0	23.0
Brazil	2.9	3.7	3.2	3.5	3.3	3.9	4.1	2.2	2.9	3.2
Chile	2.3	2..6	2.1	2.2	2.2	2.6	2.9	1.8	2.6	2.7
Colombia	4.1	3.2	3.7	3.6	3.5	3.6	3.9	3.5	3.2	3.0
Mexico	6.8	4.8	3.8	3.6	3.7	3.8	3.6	3.7	3.7	3.5
Peru	1.4	2.2	2.3	2.4	2.4	2.4	2.4	2.4	2.5	2.5
Uruguay	6.6	8.0	7.8	7.8	7.8	8.0	8.0	7.5	7.8	7.5
LatAm-7	**6.5**	**8.6**	**8.5**	**8.4**	**7.6**	**7.3**	**5.8**	**7.6**	**7.4**	**5.3**

*Year-end levels, YoY. Core measure as per national definitions. LatAm7: Nominal GDP-PPP Weighted Sources: Sources: IMF, National central banks, finance ministries, and Santander.

Macro Miscellanea			ARS	BRL	CLP	COP	MXN	PEN	UYU
Fiscal balance	% of GDP	2017	-6.1	-7.8	-2.8	-3.6	-1.1	-3.1	-3.5
		2018	-5.0	-7.1	-1.7	-3.1	-2.1	-2.5	-4.0
		2019F	-4.0	-6.5	-2.0	-2.4	-2.0	-2.3	-4.9
		2020F	-2.8	-5.7	-1.7	-2.2	-2.5	-1.8	-4.6
Public debt	% of GDP	2017	30.9	51.6	14.0	44.8	45.8	24.9	32.0
(Net terms in ARS, BRL, CLP)		2018	53.4	53.8	14.3	48.6	44.8	25.5	32.1
		2019F	52.9	55.2	15.4	50.0	45.3	26.0	39.6
		2020F	50.1	56.4	16.2	52.0	46.0	26.0	40.0
Current account	% of GDP	2017	-4.9	-0.4	-1.5	-3.3	-1.7	-1.2	0.8
		2018	-5.6	-0.8	-3.1	-3.8	-1.8	-1.6	-0.6
		2019F	-2.0	-0.7	-3.5	-4.2	-1.7	-1.8	-1.9
		2020F	-2.4	-1.4	-3.4	-4.5	-1.8	-2.0	-2.2
Trade balance	US$ bn	2017	-8.3	67.0	7.9	-4.6	-11.0	6.7	3.6
		2018	-3.8	58.7	4.7	-5.3	-13.6	7.2	3.5
		2019F	6.6	58.2	3.0	-6.8	-13.3	6.8	2.9
		2020F	5.0	50.8	2.4	-9.1	-14.3	6.7	2.8
Unemployment	% of workforce	2017	7.2	11.8	6.7	8.6	3.4	6.5	7.9
		2018	9.1	11.6	7.0	9.7	3.3	5.7	8.5
		2019F	9.9	10.9	6.8	10.7	3.7	6.5	8.2
		2020F	9.2	9.9	6.7	10.0	3.8	6.5	8.0

Source: Santander.

MONETARY POLICY MONITOR

	Current	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
ARGENTINA	66.93	58.00	48.50	43.87	39.25	34.62	30.00
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BRAZIL	6.50	5.75	5.50	5.50	5.50	5.50	5.50
		-75	-25	0	0	0	0
CHILE	3.00	2.50	2.50	2.25	2.25	2.00	2.00
		-50	0	-25	0	-25	0
COLOMBIA	4.25	4.25	4.50	4.75	4.75	5.00	5.25
		0	25	25	0	25	25
MEXICO	8.25	8.25	8.25	8.00	7.75	7.75	7.75
		0	0	-25	-25	0	0
PERU	2.75	2.75	3.00	3.25	3.25	3.50	3.75
		0	25	25	0	25	25

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

- **<u>Brazil expected to provide further stimuli</u>: Although the BCB deems the current interest level as accommodative, we believe the monetary authority will attempt to provide further support to the economy and cut the Selic rate by 100 bps, in a scenario where structural reforms a working their way through Congress.**
- **<u>Argentina seen as having room to lower interest rates after the elections</u>: High inflation and FX volatility in March prompted the Central Bank to adopt a highly restrictive monetary policy, driving Leliq rates to a maximum of 74.1% on May 2. The stringent monetary policy is not only a response to higher than expected inflation in 1Q19, but also to the need to counter potential dollarization pressures driven by political uncertainty. As a result, we believe there is ample room to adopt a less restrictive stance once the elections are over and provided that inflation starts to decelerate materially.**
- **<u>Mexico expected to hold</u>: In its June communique, Banxico change its tone from hawkish to neutral, stating that the risks to inflation are no longer to the upside. However, we expect Banxico to remain on hold for the rest of the year, as inflation is not falling fast enough to follow Banxico's inflation forecasted path, with the latest inflation number showing even core inflation trending higher.**
- **<u>Divergence in the Andean region</u>: In Colombia, we expect BanRep to hike 100 bps by YE2020, bringing the interest rate to neutral. We believe Peru will hike in 4Q19 as the output gap closes and inflation remains above the target. In contrast, in Chile, after the surprise 50-bps cut in June, we see the Central Bank cutting an additional 75 bps by YE2020 as inflation remains below target and growth is moderating.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Last*	3.86	19.1	679	3192	42.6	3.29	35.3
Sep-19	3.75	19.3	680	3250	49.0	3.36	35.9
Dec-19	**3.90**	**19.8**	**685**	**3300**	**52.0**	**3.37**	**36.2**
Mar-20	4.00	19.8	685	3250	54.0	3.40	36.7
Jun-20	4.10	20.1	690	3300	56.0	3.37	37.1
Sep-20	4.10	20.3	690	3350	58.0	3.39	37.6
Dec-20	**4.10**	**20.5**	**682**	**3400**	**60.0**	**3.40**	**38.0**

End-of-period levels. * June 27 2019 Sources: Bloomberg and Santander.

- **Year to date, LatAm currencies (ex ARS) have appreciated, benefiting in part from a more dovish Fed and relatively stable oil and metals prices. In general, we see more pressures in the FX markets in the coming quarters due to continued concerns about the global economy, likely outweighing the impact on the US dollar from lower interest rates in the US and uncertainty regarding the trade talks between the US and China. Additionally, policy decisions in Brazil and Mexico should continue to have a key influence on asset prices in 2019, in our view. In Argentina, the presidential elections could be an important market mover, in our opinion, while in Chile, Colombia, and Peru, we expect international commodity prices to remain important drivers for FX performance.**

ARGENTINA

CALMER FX HELPS GOVERNMENT IN THE RUN-UP TO PRIMARIES

- **Renewed Central Bank ability to intervene in the currency market has led to lower FX volatility, a key factor explaining the recent improvement in the government's standing in the polls.**
- **The highly restrictive monetary stance also helps avert stronger portfolio dollarization, in our view, and should translate into gradually decreasing inflation in the next few months.**
- **Despite recent improvement in the government's approval ratings, polls are pointing to a tight race against the opposition candidates, which creates substantial uncertainty regarding future fiscal policy.**

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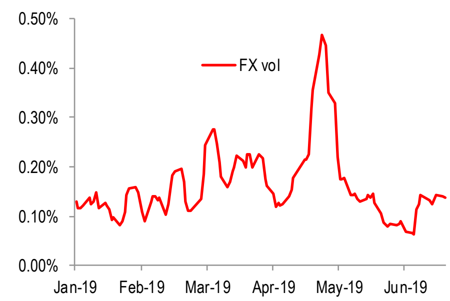
FX and external sector

The decision (in accordance with the IMF) to allow the Central Bank to eventually sell currency within the non-intervention zone was the key factor explaining the sharp reduction in FX volatility since the end of April. Exchange rate volatility declined significantly after the decision was made public. In addition, the selection of Alberto Fernández as a presidential candidate for the Kirchnerist party, and more recently, the selection of Miguel Pichetto as President Macri's running mate, translated into a perception of reduced probability of disruptive political scenarios, helping tame the upward pressure on the peso/dollar exchange rate. Lately, polls have shown a narrower gap in voter preferences for the opposition ticket over the official candidates, also resulting in lower FX volatility (see *Politics* section below). The Central Bank's renewed ability to intervene in the currency market has also helped anchor devaluation expectations, thus incentivizing currency supply growth (until April, the monetary authority's inability to sell currency unless the peso devalued to the level of USDARS 51.45 led to lower liquidity and higher FX volatility). Finally, the portfolio dollarization usual during electoral years is still weaker than expected. Year to April, private sector capital outflow totaled USD 7 bn (below the USD 9 bn observed in the same period of 2018, before the FX shock), and there are no signs of a pickup at the margin. So far, the stringent monetary policy stance (high ex ante real interest rates) has stimulated peso deposit growth, so far deterring investors from swapping into hard currency (see *Monetary policy* section below). Private sector term deposits increased 2.9% m/m in the last 30 days through June 18. We estimate that in an unfavorable scenario, the dollarization coming from the unwinding of peso term deposits could reach approximately USD 4.5-5.0 bn (equivalent to a 20-25% decline in the stock of term deposits). Currently, Central Bank net reserves (at USD ~20 bn, although likely falling in the coming months on bond interest and amortization payments) appear to provide sufficient firepower to tame stronger upward pressure on the exchange rate if the portfolio dollarization trend strengthens in the coming weeks/months. We believe the so-far weak recovery (which has resulted in plummeting imports) and the expected jump in exports should also work in favor of a more serene FX market (again, provided that the perception of a disruptive political scenario remains low). Imports contracted almost 29% y/y during January-May, but we expect them to fall at a slower pace (-12% y/y) for the remainder of the year. However, we believe export growth will likely accelerate to 13% y/y in June-December from the 2.5% annual growth observed year to May (in particular, during May export growth accelerated to +16.5% y/y, mostly due to a strong surge in soybean and corn shipments, thanks to strong production growth after last year's harsh drought).

Monetary policy and inflation

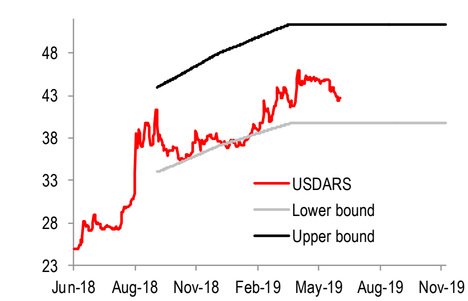
High inflation and FX volatility in March prompted the Central Bank to adopt a highly restrictive monetary policy, driving an increase in Leliq rates to a maximum of 74.07% on May 2. Lately, lower FX volatility has led the monetary authority to adopt a marginally looser stance. However, the ex ante real Leliq rate stands at ~24% in annualized terms, down from the 29.7% observed in April. The stringent monetary policy is not only a response to higher than

Daily exchange rate volatility



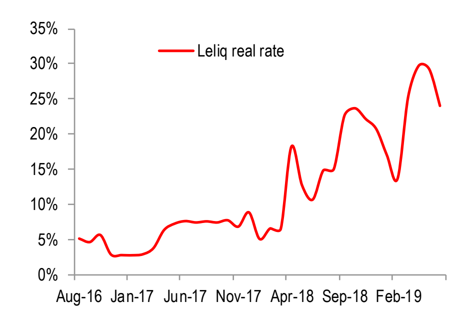
Sources: Bloomberg and Santander.

USD exchange rate and reference zone



Sources: Central Bank, Bloomberg and Santander.

Ex ante real Leliq rate



Sources: Central Bank and Santander.

expected inflation in 1Q19, but also to the need to counter potential dollarization pressures driven by political uncertainty. As a result, we believe there is ample room to adopt a less restrictive stance once the elections are over and provided that inflation starts to decelerate materially, in line with what market expectations are currently suggesting. In the Central Bank's latest survey of economic forecasters, inflation expectations stabilized at around 40% for December 2019. May's CPI print (+3.1% m/m) confirms a gradual deceleration in inflation (from +3.4% m/m in April and +4.7% m/m in March). We expect June inflation to come in at 2.5% m/m, and forecast a gradual reduction to 2.1% m/m in November-December.

Economic activity

After expanding 0.7% between December and February, the seasonally adjusted Monthly Economic Activity Estimator (EMAE) fell 1.4% m/m during March on mounting FX volatility and higher inflation. During April it started to recover again (+0.9% m/m, s.a.), a trend we expect to be sustained at least during 2Q19. The recovery has been mostly driven by farming and related sectors, while most of the other main sectors remain in the red. We currently assume that in a scenario where the perception of future political disruption remains relatively low, activity could continue accelerating in 2H19, leading to only a mild GDP contraction throughout 2019 (we expect GDP to fall 0.5% this year). However, we sense that increased uncertainty in the run-up to the elections could eventually weaken the recovery, leading to a slightly deeper recession in 2019. Going forward, growth is not to be taken for granted, regardless of the results of the elections. Considering the latest GDP data for April, the country has not grown for the last eight years (and is actually contracting in terms of GDP per capita). In our view, a structural reform agenda is crucial to reverse this trend and secure sustainable growth going forward. Reforms in labor regulations, the tax code, and pensions are a prerequisite for stimulating investment and spurring GDP expansion, in our opinion.

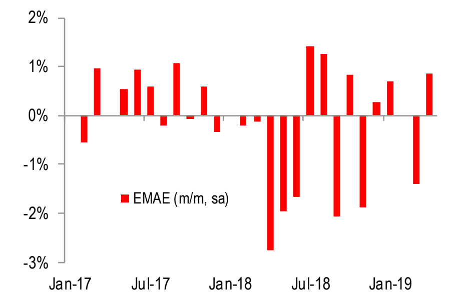
Fiscal accounts

The January-May period confirmed the government's commitment to fiscal consolidation. During this period, public resources increased 43.4% y/y, while primary expenditures grew only 32.9% annually. Revenue is mostly supported by taxes on exports (+391% annually). At the margin, collection of taxes linked to economic activity (income taxes, VAT, and social security) is also improving. All expenditure items grew at a slower pace than inflation in the period (social security, 64% of primary spending, increased 35% y/y). Finally, interest payments increased 126.5% y/y in the period, due to the effect of peso devaluation. As result, the fiscal deficit grew 35.2% annually, although below the inflation level. In the first five months the primary result reached a surplus equivalent to 0.2% of GDP, and we expect it converge to a 0.5% of GDP deficit by year-end. In this scenario, the government would make use of fiscal buffers included in the IMF accord provisions related to additional social and capital spending. In terms of financing needs, the financial program for 2019 is virtually closed: we estimate the government will reach a surplus of approximately USD 2.5 bn that will be drawn on for next year's needs. For 2020, the maturities of bonds in foreign currency will reach USD 6,761 million (we estimate that in the private sector it will reach USD 4,000 million) and the maturity of capital with international organizations is USD 1,775 million.

Politics

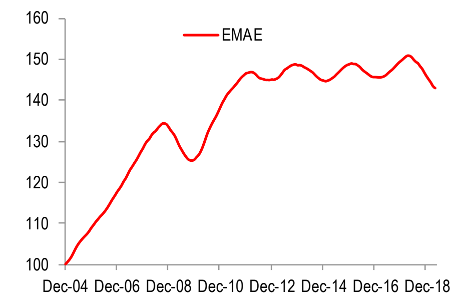
Reduced FX volatility and perception of a modest deceleration in inflation (plus the incipient pickup in activity) has led to a recovery in electoral polling for the government. According to the latest survey (issued on June 21) by Isonomía (a well-known local pollster), the A. Fernández – CFK ticket is polling ahead of Macri-Pichetto by 2 pp (36% vs. 34%). As in previous polls, Roberto Lavagna (the only important political force remaining in the center) is in a distant third place (11% of voting intentions). While the improvement in the economic backdrop has predictably led to a recovery in Macri's approval rating (to 43% in June, up 10 pp from May's survey), we reiterate our view that the contest will likely be quite tight. According to Isonomía's poll of voting intentions for a run-off between A. Fernández and Macri, the former is polling ahead by only 2 pp (43% to 41%).

High GDP growth volatility



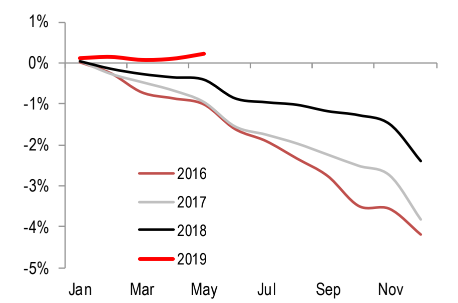
Sources: Indec and Santander.

Stagnant activity



Sources: INDEC and Santander.

Cumulative primary deficit (% of GDP)



Sources: Ministry of Economy, INDEC, and Santander.

ARGENTINA

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		-2.5	2.6	-1.8	2.7	-2.5	-0.5	2.3
Private Consumption (Δ% y/y)	74.1	-4.4	3.5	-1.0	3.5	-2.4	-1.8	2.0
Public Consumption (Δ% y/y)	12.6	2.9	6.8	0.3	1.9	-3.3	-3.2	1.1
Investment (Δ% y/y)	19.5	-6.8	3.8	-4.9	11.3	-1.5	-7.4	6.8
Exports (Δ% y/y Local Currency)	18.8	-7.0	-0.6	5.3	0.4	0.0	13.3	9.0
Imports (Δ% y/y Local Currency)	26.5	-11.5	5.7	5.7	14.7	-5.1	-3.6	9.8
GDP (US$ bn)		563	634	545	643	497	488	507
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)*		40.7	27.2	37.7	24.8	47.6	39.0	24.0
CPI core Inflation (Dec Cumulative)*		37.9	28.2	32.4	21.1	47.7	44.0	23.0
US$ Exchange Rate (Average)		8.1	9.2	14.7	16.6	29.3	44.7	56.2
Central Bank Reference Rate (eop)		26.90	33.00	24.80	28.75	59.25	48.50	30.00
Private sector credit (% of GDP)		12.7	13.7	12.9	14.7	14.8	11.6	12.7
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-5.0	-6.1	-5.9	-6.1	-5.0	-4.0	-2.8
Primary Balance, % of GDP		-3.4	-4.0	-4.3	-3.9	-2.3	-0.5	0.8
Balance of Payments								
Trade Balance		0.4	-0.6	0.3	-1.3	-0.8	1.3	1.0
Current Account, % of GDP		-0.9	-1.5	-2.4	-4.9	-5.6	-2.0	-2.4
Debt Profile								
Central Bank International Reserves (US$ bn)		31.4	25.5	38.7	55.0	65.8	68.3	69.3
Total Public Debt (net of public sector holdings, % of GDP)		18.4	22.8	26.7	30.9	53.4	52.9	50.1
Of which: Foreign-currency denominated (% of GDP)		11.9	15.3	18.2	18.1	40.8	40.2	37.1
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.9	5.8	7.6	7.2	9.1	9.9	9.2

F = Santander forecast. Sources: Economy Ministry, Central Bank, and Santander estimates.
*From 2012-2016 FIEL inflation survey

LOWERING THE BAR

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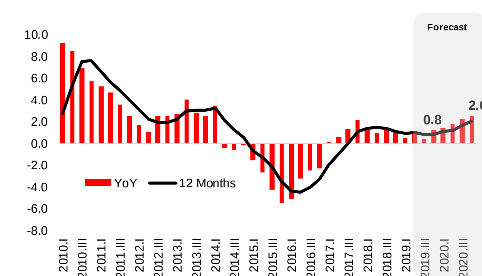
- **In the previous *Strictly Macro* (April 4, 2019), we noted that we did not expect the Brazilian Central Bank (BCB) to provide further monetary stimuli to the economy unless there was substantial progress on the political front or without signs that the recovery continued to be anemic. Lately, we believe both conditions have been met.**
- **On the one hand, activity indicators have failed to bring upbeat news since April. On the other hand, we see an increasing likelihood that the pension system reform bill will be passed by the Lower House before the mid-year congressional break.**
- **We expect the latter development to have a positive impact on the market's perception of the sustainability of Brazilian public debt and to benefit domestic financial asset prices. Hence, the FX rate should be stronger than we initially anticipated, which we think will bring down inflation forecasts over the relevant time horizon for monetary policy – i.e., over the next two years.**
- **At the same time, the lack of sanguine news on the activity front has already led market observers to revise downward their GDP growth forecasts, which we think should also benefit inflation dynamics, thus opening the door for the BCB to trim the base interest rate soon.**
- **On the negative side, the lackluster activity outlook has led us to lower our expectations for the Selic target rate, as well as for the IPCA annual change and GDP growth. On the positive side, we believe the (increasingly) likely approval of pension reform would be a first step toward improving the fiscal balance, with a positive impact on the BRL.**

Be careful what you wish for

As actual readings of price indices and market participants' inflation expectations have signaled a relatively tranquil convergence of inflation toward the targeted levels since earlier this year, there has been significant pressure on the BCB to further ease its monetary grip in order to stimulate the economic recovery. However, the Brazilian monetary authority has not acquiesced to these pleas, for the following reasons, in our view: (i) the BCB has continued to consider that a lack of progress on structural reforms would prevent interest rates from achieving a sustainable lower level; (ii) it has warned that inflation expectations – albeit tame – have been in line with its goals rather than below them; and (iii) it has continued to expect the feeble growth rate to gain momentum soon. Hence, in order for the BCB to trim the Selic target rate, we believe it would need to (i) witness structural reforms working their way through Congress, (ii) see evidence of falling inflation expectations, and (iii) observe frustration with the performance of activity indicators. In our opinion, conditions (i) and (iii) have already been met, and (ii) is on its way. Thus, although the BCB deems the current base interest rate as accommodative, we believe the monetary authority will shortly attempt to stoke the pace of recovery with further cuts in the Selic target rate.

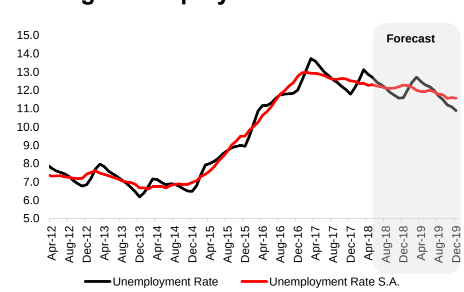
GDP forecast (%)



Sources: IBGE and Santander estimates.

In addition to the improvements in domestic factors, we think the BCB can count on a more favorable external environment, given the signals conveyed by the monetary authorities of developed economies that they also intend to pursue a more accommodative approach toward monetary policy, which is likely to favor BRL strengthening, in our view. Based on this outlook, we now forecast the FX rate to end 2019 at USD/BRL3.90 and 2020 at USD/BRL4.10, vs. our previous forecasts of USD/BRL4.00 and USD/BRL4.30, respectively. Below we discuss the likely impact of these changes on other economic variables.

Still high unemployment rate



Sources: FGV, IBGE and Santander.

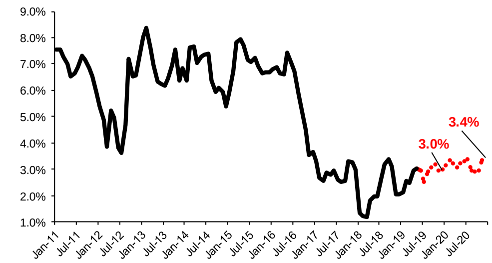
Another downward revision

The performance of the Brazilian economy has been frustrating. Slow growth in the first quarter combined with the poor development of second quarter activity indicators led us to revise our GDP growth forecasts to 0.8% from 1.3% for

2019 and to 2.0% from 2.5% for 2020.

According to the data, business and consumer confidence have not maintained the upward trend that immediately followed the election of President Bolsonaro. Instead, the reverse has happened, with business and consumer confidence falling sharply after market participants realized that fulfilling the political agenda would not be as simple as originally believed. Although we acknowledge that the political scenario has improved considerably of late and that the approval of pension reform is likely – which could boost confidence – the confidence crisis has kept Brazilian economic activity in the same standby mode it has experienced since the truckers' strike in May 2018. Hence, we believe that a solid improvement in economic growth will not be seen until the last quarter of 2019, and that growth in 2020 could be compromised as well.

Core inflation – 3-month moving average S.A.



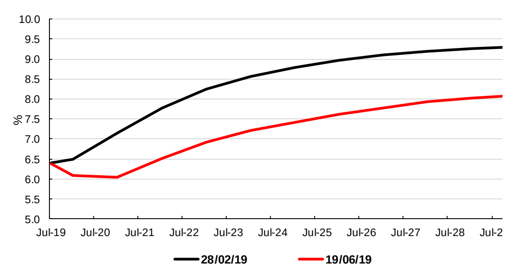
Sources: IBGE and Santander estimates.

Climbing the cliffs in bad weather

As we noted above, Brazilian economic activity has disappointed recently, leading to a rather modest performance for tax revenue – we forecast a nominal increase of 5.3% in 2019 (equivalent to nearly 1.5% in real terms), considerably below the 8.3% expansion in 2018. This deterioration in government revenue explains most of the recent downward revisions in fiscal projections for this year. Nevertheless, it is important to bear in mind that the structural imbalance of Brazilian fiscal policy largely reflects the unsustainable path of non-discretionary expenditures, especially those for social security.

Although uncertainties remain surrounding the potential fiscal savings and timeline for approval of pension reform, most recent developments have been favorable, in our view. After negotiations between Congress and the executive, we expect the pension bill to result in around BRL760 billion in savings over 10 years, which is a little more than 60% of the amount originally proposed by the government. Despite the tight deadline, we believe there is an increasing likelihood that the reform proposal will be approved in the Lower House before the parliamentary recess (i.e., by mid-July). We expect final approval in the Senate in early September.

Interest rate forward curve



Source: BM&F.

We have consistently taken the view that the approval of pension reform is only the first (yet crucial) stage of a broad agenda of measures to adjust Brazilian fiscal policy. The reduction of payroll expenses, revision of tax exemptions, changes in the federative pact, and the concession/privatization program are other examples of important measures to foster fiscal and macroeconomic balance, including more consistent economic growth.

Our baseline scenario considers that these issues will be addressed, albeit gradually. We project that the government's primary fiscal result will return to positive territory in 2023 and show continued increases in the following years, leading the public debt-to-GDP ratio to stabilize in 2025 (at around 82.5%) and decline afterward. Therefore, despite the favorable signs for the progress of structural reforms, we note that completing the fiscal adjustment should take several years, requiring unremitting commitment from the government.

Lowering bars

The disappointing economic recovery and stronger BRL due to the more benign external mood for emerging markets, along with the increasing likelihood of the approval of robust pension reform, led us to revise our 2019 IPCA forecast to 3.9% from 4.0% and our 2020 forecast to 4.1% from 4.5%.

These numbers already include the supply shock effects from the African swine fever (ASF) on protein prices, as described in our report *Inflation – Year of the Pig* (April 30, 2019); otherwise, our 2020 IPCA forecast would be close to 3.7%.

Although our forecast of headline inflation for 2020 is slightly above the IPCA targeted level (4.0%), we expect core inflation to remain subdued and hovering around 3.5% until the end of 2020, reflecting the still high unemployment rate, low wage growth, and negative output gap.

Finally, the aforementioned scenario led us to change our expected path for monetary policy. Market inflation expectations for 2020 should decline in the coming months, in our view, as the ASF price effects will only appear by 1H20, creating the space for monetary easing. We believe that, once pension reform is approved in the first round in the Lower House (per our expectation), the BCB will cut the Selic rate at the following meetings by 25bps, 50bps, and 25bps, then leaving it at 5.50% p.a. until end-2020.

BRAZIL

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		0.5	-3.5	-3.3	1.1	1.1	0.8	2.0
Private Consumption (Δ% y/y)	62.8	2.3	-3.2	-4.3	1.0	1.9	1.0	2.1
Public Consumption (Δ% y/y)	20.8	0.8	-1.4	-0.1	-0.6	0.0	-0.2	0.4
Investment (Δ% y/y)	16.5	-4.2	-13.9	-10.3	-1.8	4.1	2.4	6.2
Exports (Δ% y/y Local Currency)	11.3	-1.1	6.8	1.9	5.2	4.1	1.9	3.4
Imports (Δ% y/y Local Currency)	-11.4	-1.9	-14.2	-10.2	5.0	8.5	2.1	4.9
GDP (US$ bn)		2,455	1,800	1,796	2,053	1,869	1,832	1,826
Monetary and Exchange Rate Indicators								
IPCA-IBGE Inflation (Dec Cumulative) (%)		6.4	10.7	6.3	2.9	3.7	3.9	4.1
IGP-M Inflation (Dec Cumulative) (%)		3.7	10.5	7.2	-0.5	7.5	7.2	4.0
US$ Exchange Rate (Average)		2.35	3.33	3.49	3.19	3.65	3.81	4.00
Central Bank Reference Rate (eop)		11.75	14.25	13.75	7.00	6.50	5.50	5.50
Stock of Credit To Nonfinancial Private Sector (% of GDP)		52.21	53.86	49.72	47.33	47.7	48.9	50.4
Fiscal Policy Indicators								
Public Sector Fiscal Balance (harmonized) (% of GDP)		-6.0	-10.2	-9.0	-7.8	-7.1	-6.5	-5.7
Primary Balance (% of GDP)		-0.6	-1.9	-2.5	-1.7	-1.6	-1.5	-0.6
Balance of Payments								
Trade Balance, % of GDP		-0.2	1.1	2.7	3.3	3.1	3.1	2.7
Current Account, % of GDP		-4.2	-3.3	-1.3	-0.4	-0.8	-0.7	-1.4
Debt Profile								
International Reserves (US$ bn)		374.1	368.7	372.2	382.0	387.0	390.0	392.0
Total Public Debt (net of public sector holdings, % of GDP)		32.6	35.6	46.2	51.6	53.8	55.2	56.4
Of which: Foreign-currency denominated (% of GDP)		-6.8	-11.4	-8.9	-9.4	-11.0	-11.0	-11.0
Labor Markets								
Unemployment Rate (% eop)		6.5	9.0	12.0	11.8	12.3	11.9	10.9

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

CHILE

LIFE AFTER CENTRAL BANK'S BUCKET OF ICE WATER

- **The unexpected 50-bp rate cut by the BCCh put growth at the top of the local economic agenda: we believe 2019 GDP growth consensus is likely to fall below 3%.**
- **All GDP components seem to be softening at the margin, in our view, and non-mining exports suggest that the global "trade war" has already started to take its toll on Chile's growth.**
- **In our view, the absence of FX pass-through is a good reason to anticipate further rate cuts if output gap conditions continue to widen in 2019-2020: the inflationary risks of a weakening CLP appear limited.**

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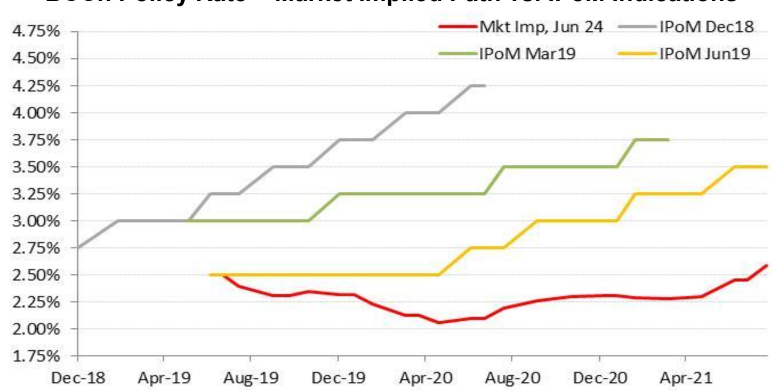
On June 7, the Central Bank (BCCh) surprised the market with a 50-bp rate cut to 2.50%, based on two factors: (i) a "recalibration" of monetary policy, as key parameters have been revised, and (ii) the softening of the real economy, with the balance of risks (local and external) tilting toward the negative side. Resembling the change of tone communicated by major central banks this year, in only six months the BCCh shifted from pledges to hike rates (as indicated by December's IPoM) to easing aggressively, even implying that further cuts could be in the pipeline (as stated in the June report).

The unexpected rate cut triggered another round of downward GDP revisions (recent polls point to sub-3% estimates for 2019), and sent growth to the top of the government's agenda: President Piñera reshuffled his cabinet a week later, in part due to the political need to revamp economic expectations, in a context of falling approval ratings in 1H19 (from 37% in December 2018 to 25% in June 2019, as per the CEP poll dated June 13, 2019).

BCCh Policy Rate – Market Implied Path vs. IPoM Indications

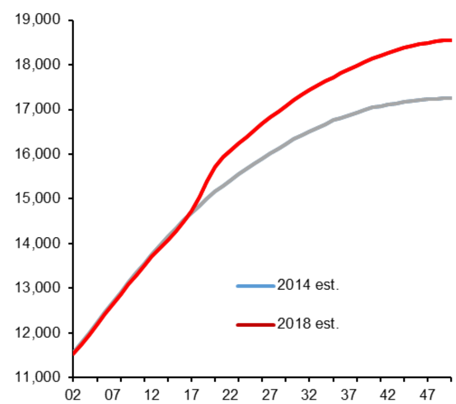


Sources: BCCH and Santander.

The so-called "parameter recalibration" included an increase in the potential GDP growth estimate to 3.4% (+20 bp), due to faster population growth stemming from immigration, and a reduction in the neutral rate of interest (-25 bp to 4.00%, mostly as a result of pressures from developed markets). Coupled with the new CPI methodology released in February, since December the BCCh has faced the "perfect storm" to justify such a drastic change in MonPol guidance: the local economy started to soften just at a time when new studies and data confirmed that the slack was greater than previously thought.

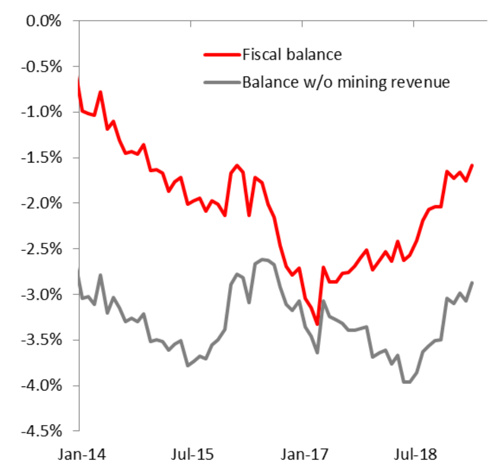
Overall demand conditions indicate that the slowdown is broad across the economy. First, non-mining exports, a good proxy of the external impulse, are now contracting 3% y/y after expanding 15% in mid-2018, suggesting that the cooling of global trade flows has already started to affect Chile, via volumes as well as prices. Second, fiscal policy has been prudent in the recent past, with the overall deficit falling to 1.6% of GDP in April (last-12-month basis), from 2.0% in November. Furthermore, considering that mining revenues are falling

Population growth (2002-2050)



BCCH estimates based on INE projections. Sources: BCCH, INE, and Santander.

Fiscal balance (% of GDP), last 12M

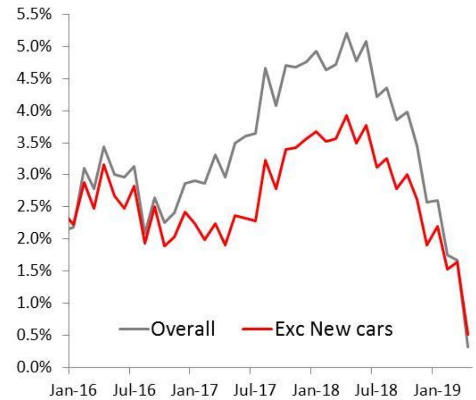


Sources: Dipres and Santander.

due to lower copper prices, the net fiscal impulse has been a negative 0.6% of GDP in recent months. Given these factors, the government has focused on public works to foster domestic demand, but public investment spending has been growing modestly of late: 3% y/y so far this year, vs. 4.5% for overall spending. Regarding private investment, business confidence remains at neutral levels, and the construction sector index is growing by less than 2%, both suggesting that overall investment is expanding, albeit at a modest pace.

Last but not least, private consumption is slowing notably. Overall retail sales grew by a meager 0.3% y/y in the last six months, vs. 4.0% in October. Excluding car sales (where growth came to an abrupt halt after two years of 20%-plus growth), the deceleration is both clear (0.5% y/y in the last six months, vs. 3.0% in October) and broad-based (staples, non-durable goods, and semi-durables are all slowing similarly). Paradoxically, banks' consumer loans are accelerating, to 9% y/y from 6% a year ago, which confirms that tighter financial conditions are not to blame for sluggish consumption in Chile.

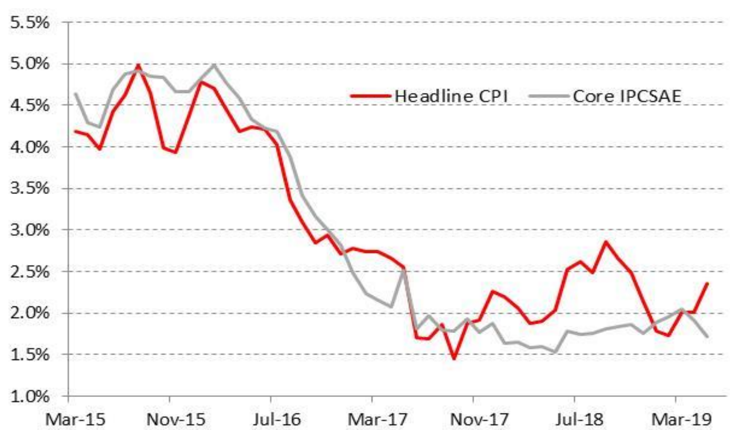
Retail sales (y/y, last 6M)



Sources: INE and Santander.

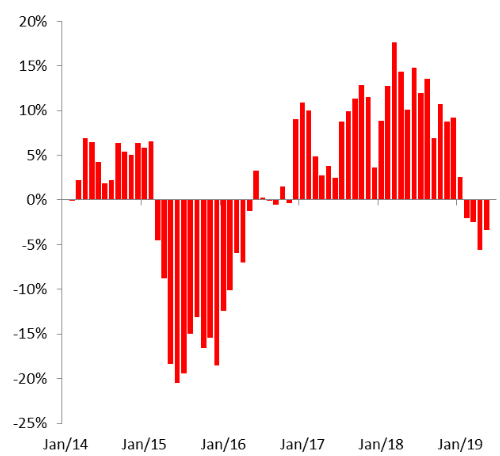
A key point here is the overall effect of immigration on the real economy. On the supply side, the effects are clearly disinflationary: unemployment remains relatively high near 7%, and nominal wage growth is contained at around 5%. But on the demand side, it seems to us that newcomers are adding little to the total amount of retail sales. Assuming meager 1% growth for non-durable retail sales in 2019, we estimate basic consumption in per capita terms could fall by 1.2% this year, which is fairly striking considering that overall economic conditions still look normal.

Inflation y/y – Headline & Core Measures



Sources: INE, Santander.

Non-mining exports (y/y, last 3M)



Sources: BCCh and Santander.

On the inflation side, headline CPI jumped to 2.3% y/y in May, but the core metrics remain low, at 1.7% excluding food and energy. In the latest IPoM projections, the BCCh acknowledges that inflation will remain below target (2.8% and 2.6% by December 2019 for headline and core, respectively), and we share this view. In this regard, we think output gap conditions could worsen somewhat in upcoming quarters, while energy prices (in CLP terms) could be similar to those in 2H18, so y/y inflation here is likely to remain low.

Historically, FX acted as a key driver of inflation, but now pass-through is almost negligible due to the new CPI methodology and more competitive practices in the retail sector. Furthermore, 25% of the CPI is showing a life of its own, with no significant correlation with any of the typical drivers, and a remarkable downward trend (mainly in processed foodstuffs). This creates notably benign conditions for monetary policy: with inflation uncorrelated with FX, the BCCh has strong incentives to cut rates and to bear the risk of a material CLP depreciation, without facing price pressures in the short term.

Inflation & FX cycle

Super core tradables exclude medium-term deflationary items such as apparel, new cars & electronics. Sources: INE and Santander.

Net net, the BCCh has now officially adopted a "neutral bias", but our sense here is that more rate cuts may come (up to 2%) if demand fails to pick up soon and the economy continues to grow below potential with low inflationary pressures. Local macro dynamics and global external conditions (including the recent dovish messages from major central banks) imply no obstacles to more aggressive forms of monetary stimulus.

CHILE

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (∆% y/y)		1.8	2.3	1.3	1.5	4.0	2.6	3.2
Private Consumption (∆% y/y)	65	2.7	2.1	2.2	2.4	4.0	3.4	3.4
Public Consumption (∆% y/y)	14	3.8	4.8	6.3	4.0	2.2	2.4	2.5
Investment (∆% y/y)	21	-4.8	-0.3	-0.7	-1.1	4.7	5.4	4.8
Exports (∆% y/y Local Currency)	30	0.3	-1.7	-0.1	-0.9	5.0	2.0	2.0
Imports (∆% y/y Local Currency)	30	-6.5	-1.1	0.2	4.7	7.6	3.3	2.6
GDP (US$ bn)		261	244	250	277	299	305	323
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.6	4.4	2.7	2.3	2.6	2.6	2.9
CPI core Inflation IPCX1 (Dec Cumulative)		5.1	4.7	2.9	1.9	2.3	2.6	2.7
US$ Exchange Rate (Average)		570	654	677	649	640	682	688
Central Bank Reference Rate (eop)		3.00	3.50	3.50	2.50	2.75	2.50	2.00
Private sector credit (% of GDP)		85.0	88.0	88.2	90.0	88.1	89.5	90.4
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-1.6	-2.1	-2.7	-2.8	-1.7	-2	-1.7
**Primary Balance, % of GDP		-1.0	-1.4	-2.0	-2.0	-0.8	-1.1	-0.8
Balance of Payments								
Trade Balance, % of GDP		2.5	1.4	2.2	2.8	1.6	1.3	1.5
Current Account, % of GDP		-1.7	-2.3	-1.4	-1.5	-3.1	-3.5	-3.4
Debt Profile								
Central Bank International Reserves (US$ bn)		40.5	38.6	40.0	40.0	40.0	40.0	40.0
Total Public Debt (gross, % of GDP)		14.1	16.2	21.5	25.5	23.5	25.6	26.8
Of which: Foreign-currency denominated (% of GDP)		2.5	3.2	3.5	4.0	4.5	4.7	4.8
Labor Markets								
Unemployment Rate (% eop)		6.4	6.2	6.5	6.7	7.0	6.8	6.7

F = Santander forecast Sources: Central Bank, Servicio de Estudios, and Santander.

COLOMBIA

RISK OF A SOVEREIGN DOWNGRADE REMAINS

- **We revised slightly downward our 2019 GDP forecast to 3.2% y/y from 3.3% y/y previously, as growth in 1Q19 surprised to the downside, with investment remaining subdued.**
- **Inflationary pressures are accumulating, with food prices pushing inflation up, to a level above the 3% target. We now estimate that inflation will end at 3.6% in 2019, above our previous estimate of 3.2%.**
- **BanRep sees no space to cut and recognizes temporary pressures on inflation. Although the pace of economic recovery remains a concern, we believe that inflationary pressures may be strong enough to push BanRep to hike by the end of 2019.**
- **The government announced in the Medium Term Fiscal Framework that it will reduce the fiscal deficit to -2.4% of GDP in 2019 despite the additional space given by the Fiscal Committee. Medium-term fiscal consolidation, however, remains a concern.**

Santander Macroeconomics Team

Economic recovery remains modest

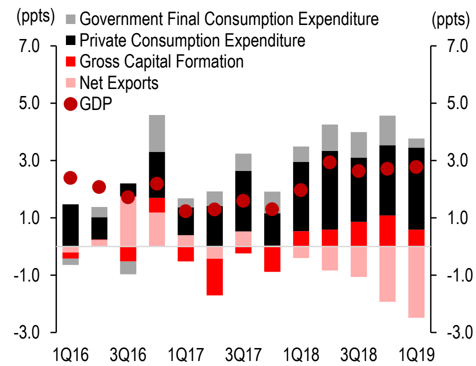
GDP growth surprised to the downside in 1Q19, expanding 2.8% y/y, below consensus at 3.0% and our estimate at 3.2% y/y. On the supply side, the slower than expected growth was explained by construction activity, which contracted 5.6% y/y in 1Q19, subtracting 0.4 ppts from the headline number. Ex construction, all other sectors posted positive growth, with tertiary activities showing the most dynamism and continuing to be the main growth driver. Sequentially, the economy remained flat (0.0% q/q), indicating that the recovery came to a halt after increasing 0.7% q/q on average last year. Again, the main culprit was construction, but we saw some moderation in manufacturing, utilities, public services, and telecommunications. On the demand side, similarly to previous quarters, private consumption continued to be the main driver of growth, contributing 2.9 ppts to annual growth in 1Q19. In contrast, public consumption and investment growth and contribution remain positive but moderated notably in the quarter. Investment figures have disappointed so far this year, as they have failed to overshoot despite the fiscal break given to the corporates. Additionally, exports' drag on growth increased, as imports' 13.7% y/y increase exceeded exports' 3.6% y/y growth in 1Q19.

Finally, note that DANE revised GDP growth for 2018 to 2.6% y/y from 2.7% y/y, also indicating a more modest recovery than initially expected. In all, we still believe the economy will continue with a moderate recovery, yet we are revising slightly downward our growth forecast for 2019 to 3.2% from 3.3% previously, as investment recovery is slower than we initially anticipated. We expect that the recovery will continue next year, driven mainly by private consumption, while the external balance will continue to put pressure on growth. We expect imports to accelerate, in line with the recovery, while exports should remain stable. We expect average oil prices to stabilize and external demand to continue to moderate.

We expect inflation to end at 3.6% in 2019

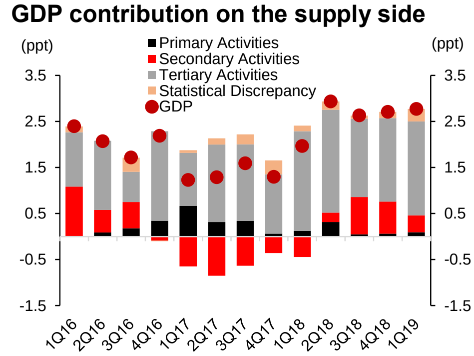
Inflationary pressures are accumulating, with food prices normalizing after remaining historically low last year and with pressures coming from services, possibly in part reflecting higher demand due to the high migration from Venezuela and the economic recovery. In April and May, it was noted that some inflationary pressures were materializing, especially on food prices. In May, headline inflation increased 0.31% m/m, taking annual inflation up to 3.31% from 3.25% in April and 3.18% in December 2018. Food prices alone accounted for one third of the monthly inflation and have consistently been the source of pressure. In effect, food prices are increasing notably, with food annual inflation standing at 4.36% y/y in May, higher than the annual inflation registered in the past two years, which on average remained below 1.0% y/y. Adding to the normalization process for food prices, we think it is likely that food prices may

GDP contribution by component



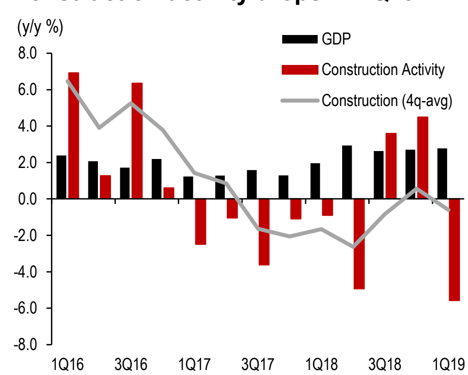
Sources: DANE and Santander

GDP contribution on the supply side



Sources: DANE and Santander.

Construction activity drops in 1Q19



Sources: DANE and Santander.

increase further in the coming months as a result of the closing of the Villavicencio road, a key thoroughfare in terms of food transportation logistics. We estimate that a prolonged closure of the Villavicencio road could add around 0.2% to total inflation.

Additionally, pressures are accumulating in services prices, with rent being the main source of inflation, in addition to utility fare hikes. This reflects, in our view, some demand side pressures coming from stronger demand due to the economic recovery and migration from Venezuela. Finally, we highlight that tradeable inflation, although remaining low, started to pick up in April, suggesting some pass-through effect from FX depreciation, in our view. In all, we consider that inflationary pressures will persist for the remainder of the year and likely in 2020. Thus, we see inflation floating closer to the 4% upper band, and we now see inflation ending at 3.6% and 3.9% in 2019 and 2020, respectively, up from our previous forecasts of 3.2% and 3.0%.

BanRep sees no space to cut and acknowledges inflationary pressures

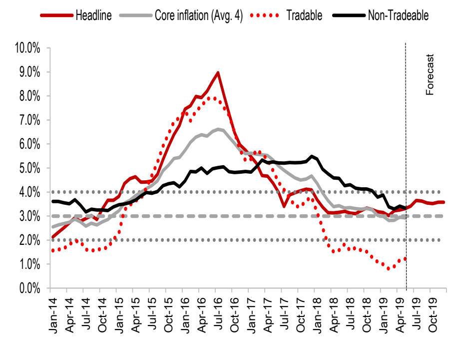
The Central Bank continues with its holding stance and maintains its neutral tone, in our view. In its latest decision, on June 21, the board unanimously kept the policy rate unchanged at 4.25% for the 13th consecutive month (10 consecutive meetings), in line with expectations. In its communique, the Central Bank continued to express concern on the pace of the recovery and noted that GDP was lower than expected. In the press conference, Governor Echavarria mentioned that BanRep's forecast, currently at 3.5% y/y, is under revision; this likely will be revised to the downside, in our view. Despite the concerns on growth, the risks to inflation are increasing to the upside, and although the board noted that core inflation remains slightly below the 3% target, it acknowledges that supply shocks are expected that could push inflation higher in the coming months, although it believes the shocks to be temporary. In general, we believe that risks to inflation are starting to outweigh the risks to growth. In the press conference, Mr. Echavarria confirmed that the board is not discussing cuts despite the possibility of the Fed cutting its interest rate soon and stated that he disagreed with the expectation by some analysts of a cut. Additionally, we note that in May BanRep suspended its international reserve accumulation program that began in September 2018 after the currency approached COP 3,400, its weakest level since 2016. This indicates some concerns about FX depreciation and its impact on inflation, in our view. Thus, while we believe that BanRep will remain on hold for most of the year, we still consider that the next move will be a hike of 25 bps, most likely by end of this year.

Medium-term fiscal consolidation remains a concern

The government presented on June 13 the Medium Term Fiscal Framework, in which it confirmed its goal to decrease the fiscal deficit to -2.4% of GDP in 2019 from -3.1% in 2018, the original target before the Fiscal Rule Committee widened it to -2.7% of GDP to allow some room for the additional fiscal cost of migration from Venezuela. While we think the 2019 target is achievable, concerns remain for 2020 onward, as corporate tax revenues are expected to fall, as set out in the 2018 Financing Law, and costs continue to increase. Moreover, the government's strategy to rely on higher revenue from growth seems risky, in our view, as leading indicators continue to point to a moderate recovery, with growth slightly above 3.0% in 2019 and 2020, below the official forecasts of 3.6% and 4.0%, respectively. On this front, the opinion of the rating agencies remains divided, with Fitch expressing concern about the government's optimistic view and Moody's being more confident on the government's ability to meet its targets. This divergence in view was first expressed on May 24, when Moody's changed Colombia's outlook from negative to stable, and one hour later, Fitch went in the opposite direction and changed its outlook from stable to negative.

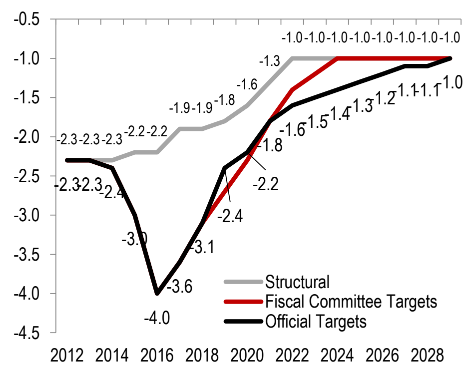
In general, our view is more in line with Fitch's view, as we consider that the 2020 target may be met by selling public assets but take the view that medium-term consolidation still requires additional tax and or structural reforms. We believe that the probability of a downgrade from Fitch is high, as the agency noted one of the reasons to downgrade is the government's failure to implement credible structural reforms, putting some pressure on the government to pursue important reforms such as the pension reform, which thus far has not been on its agenda.

CPI forecast to end 2019 at 3.2%



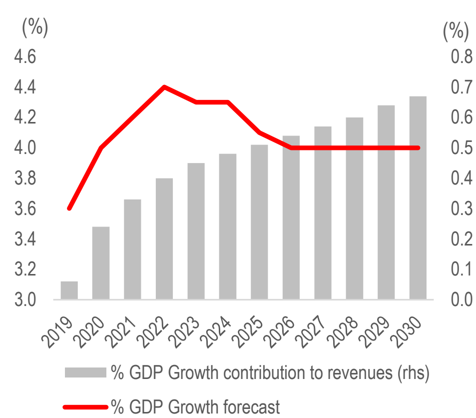
Sources: DANE and Santander.

New fiscal targets



Sources: Ministry of Finance and Santander.

Expected growth and contribution to revenues



Source: Ministry of Finance.

COLOMBIA

	% GDP	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.7	3.0	2.1	1.4	2.6	3.2	3.4
Private Consumption (Δ% y/y)	61.1	4.6	3.1	1.6	2.1	3.6	4.8	5.6
Public Consumption (Δ% y/y)	16.1	4.7	4.9	1.8	3.8	5.6	4.7	6.0
Investment (Δ% y/y)	23.7	11.8	-1.2	-0.2	-3.2	3.5	4.7	6.5
Exports (Δ% y/y)	18.9	-0.3	1.7	-0.2	2.5	3.9	2.4	1.8
Imports (Δ% y/y)	19.8	7.8	-1.1	-3.5	1.2	7.9	13.8	12.2
GDP (US$ bn)		381	293	283	312	330	323	341
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.7	6.8	5.8	4.1	3.2	3.6	3.9
Core inflation (Dec Cumulative)		3.3	5.2	5.1	5.0	3.5	3.2	3.0
US$ Exchange Rate (Average)		2400	2740	3050	2952	2958	3221	3325
Central bank reference Rate (eop)		4.50	5.75	7.50	4.75	4.25	4.50	5.25
Bank lending to the private sector (% chg YoY, Dec)		13.6	14.6	9.2	12.0	4.0	8.0	10.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.4	-3.0	-4.0	-3.6	-3.1	-2.4	-2.2
Primary Balance, % of GDP		-0.2	-0.5	-1.1	-0.8	-0.3	0.6	0.7
Balance of Payments								
Trade Balance (% of GDP)		-3.0	-4.7	-3.3	-1.5	-1.6	-2.0	-2.4
Current Account (% of GDP)		-6.6	-6.4	-4.3	-3.3	-3.8	-4.2	-4.5
Debt Profile								
Central Bank International Reserves (US$ bn)		47.3	46.7	46.7	47.6	48.4	52.0	53.2
Total Public Debt (gross, % of GDP)		38.3	37.0	43.7	44.8	48.6	50.0	52.0
Of which: Foreign-currency denominated (% of GDP)		11.0	14.0	15.5	15.5	16.8	17.0	18.0
Labor Markets								
Unemployment Rate Avg. (year-end,% of EAP)		8.7	8.6	8.7	8.6	9.7	10.7	10.0

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

MEXICO

MEXICO TRAPPED IN STAGFLATION WITH HIGH REAL RATES

- **We now see the Mexican economy growing 1.0% and 1.5% in 2019 and 2020, respectively, down from our previous forecasts of 1.5% and 1.8%.**
- **We anticipate some acceleration of the economy in the second half of the year, but the June 24 IGAE data implies that we will likely need to make a further downward revision in the near future.**
- **The US Fed has already signaled cuts, while Banxico is still trapped by the Ramos Francia critique.**
- **With release of the inflation print on June 24, showing core inflation for the first half of June not only sticky to the downside but trending higher, we believe Banxico has no choice but to maintain a restrictive tone.**

Guillermo Aboumrad*

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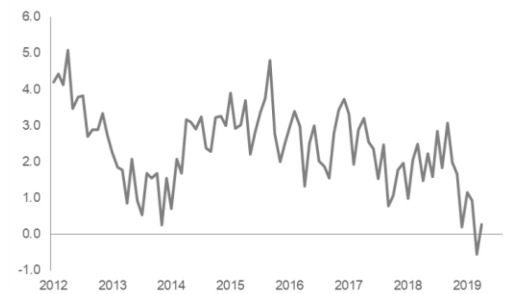
Economic growth is weakening rapidly

We now see the Mexican economy growing 1.0% and 1.5% in 2019 and 2020, respectively, down from our previous forecasts of 1.5% and 1.8%. On June 24, INEGI released the IGAE (monthly GDP proxy) report for the month of April. That report showed that in April, IGAE increased 0.3% vs. the previous year using s.a. data. The increase was a significant change from the result in March, when it fell 0.6%. The decline in March was out of line with the average of 1.0% in the previous two months. Our idea at the time was that the decline could have resulted from a combination of a new lower growth trend for the economy and some issues with the seasonal adjustments made to the data to adjust for the Holy Week effect. We wanted to explore this idea, for which we needed the latest data.

Global Economic Activity Indicator (y/y% S.A.)

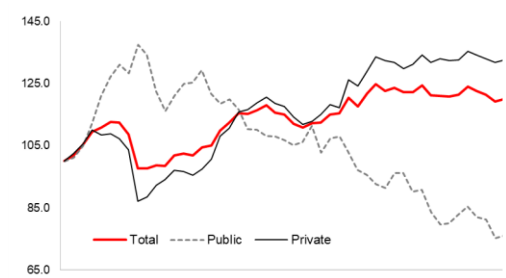


Sources: INEGI and Santander.

The seasonal adjustment for Holy Week clouded the pace of economic deceleration, but nevertheless the economy is on a downward trend. The April IGAE report confirmed this, as the seasonal Holy Week effect seen in March was reversed in April. So, we think it makes sense to compare the average of the first two months of the year with the average of the last two months of data, which is -0.2%, in order to remove the seasonal adjustment and demonstrate that the economy is on a downward trend, and at a rapidly accelerating pace. In April, it was on a downward trend but not as pronounced as the March figures led us to believe. Nevertheless, average IGAE growth for the first four months of the year stands at 0.4%, significantly lower than our forecast of 0.8% for 1H19.

We anticipate some economic acceleration in 2H19, but we think the June 24 IGAE data implies that we will likely need to make a further downward revision in the near future. The breakdown of our forecast for the year considers a GDP growth rate of 0.8% in the first half of the year and 1.2% in the second half (compared to the same periods last year). In our view, although 1Q19 was affected by one-off factors like gasoline shortages, and the whole first half of the year suffered from uncertainty surrounding the start of the new administration, which affected both private investment and consumption, things could settle down by 2H19. However, the environment remains challenging. The pledge of fiscal discipline by the administration means that government expenditures are way behind schedule. Meanwhile, private sector investment is still awaiting more clarity on the high real interest rate environment, assessing the new administration's plans, waiting for USMCA to be approved, and becoming more cautious given the perceived risks to global growth.

Fixed investment (1Q2007=100 S.A.)



Sources: INEGI and Santander.

We believe global growth risk could intensify next year, in line with the market pricing a more dovish Fed that could move preemptively before long. On that basis, we also revised downward our Mexican GDP growth forecast for 2020. It is unclear at this juncture whether the global economy was already decelerating, with the trade disputes exacerbating the problem, or if the global economy was doing merely all right and the trade disputes have begun to threaten a global deceleration. Whichever is the case, global growth is at risk, and we believe the risk could intensify in 2020. A global deceleration in 2020, especially in the US economy, would make any recovery in the Mexican economy a challenge. As we have argued, the private sector is looking to improve its relationship with the new administration and is also hoping for USMCA to be approved soon. Hopefully, too, the recent agreement between US President Donald Trump and the Mexican government that prevented the imposition of tariffs on Mexican exports to the US will pave the way for a prompt resolution on USMCA.

Fed has signaled cuts, while Banxico is still trapped by the Ramos Francia critique

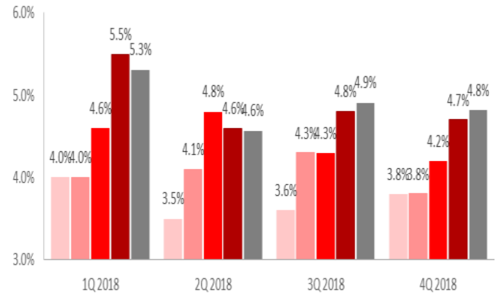
At Banxico's meeting on October 4, 2018, Deputy Governor Manuel Ramos Francia dissented from the rest of the board by calling for a hike, criticizing the current inflation-forecast targeting framework. Ramos Francia saw that core inflation showed a high degree of persistence, and together with the outlook for non-core inflation, he thought that made it unlikely that the current target for headline inflation would be attained. At that time, Banxico had already adjusted its estimates for the time frame during which headline inflation was expected to converge to its target. So, considering the current inflation-forecast targeting framework for monetary policy, as well as the factors affecting core inflation, his opinion stated that not responding with a monetary policy action as a consequence of this environment could be costly for the Central Bank's credibility.

Banxico is still under Ramos Francia's critique (as was the case in the last inflation report of May 29, 2019), and that report once again pushed forward the time frame for achieving the target of 3.0%. According to the May 29 report, Banxico now expects 4Q19 average headline inflation of 3.7%, up from 3.4%. Moreover, Banxico now forecasts headline inflation to reach 3.0% by YE2020; previously, Banxico expected that to happen by 2Q20. Banxico only cited transitory factors for the revisions without any concern about a continued loss of credibility in its framework, according to the Ramos Francia critique. According to the latest Citibanamex survey of market economists released on June 20, Banxico's new forecasts for YE2020 differ significantly from market expectations: 3.0% for headline and core compared with 3.6% and 3.5%, respectively, for market consensus (including Santander).

Since launching its inflation-forecast targeting framework in 1Q17, Banxico has not stopped raising its inflation forecast, and we expect this pattern to continue. In the top chart at right, we plot for each quarter starting in 1Q18 the Banxico inflation forecast presented in its inflation reports of the prior four quarters, as well as its revisions for the following quarters, then compare this to the actual data. Standing out in the exercise, we note that the revision trend has been upward ever since 1Q17, even for the most recent quarter (4Q19). We do not believe that Ramos Francia meant to suggest that each time there was a revision, a hike was warranted, though we believe the tone of the communique reflects Banxico's focus on reaching the inflation goal of 3.0% while avoiding complacency about a number higher than 3.0%.

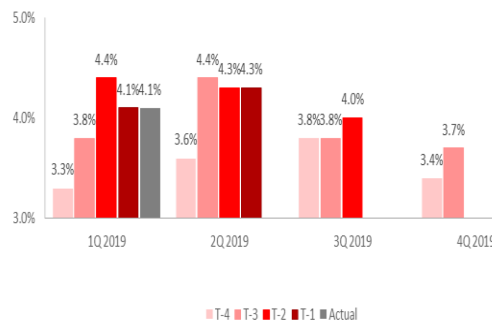
With release of the inflation print on June 24, showing core inflation in 1H June not only sticky but trending higher, we believe that Banxico has no choice but to maintain a restrictive tone. Mexico has the highest real rates in many years, along with rapidly decelerating growth and upward-trending core inflation, leaving Banxico no choice but to maintain a restrictive stance, in our view. Banxico has often stated that it believes that lowering the policy rate will do little to help economic growth and that achieving the inflation target of 3.0% would do more for economic growth in the medium term. Banxico sees the interest rate as having a greater impact on the level of the exchange rate. A higher differential spread with the Fed could potentially lead the MXN to appreciate, in our opinion, as foreign investors perceive Mexico's risks as lower than what Banxico is currently considering in its balance of risks. In addition, such tight financial conditions are detrimental to economic growth.

Banxico CPI forecast by quarter (%)



Sources: Banxico and Santander.

Banxico CPI forecast by quarter (%) (continued)



Sources: Banxico and Santander.

MEXICO

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		2.8	3.3	2.9	2.1	2.0	1.0	1.5
Private Consumption (Δ% y/y)	73.9	2.1	2.7	3.8	3.1	2.2	1.8	2.0
Public Consumption (Δ% y/y)	10.9	2.9	1.9	2.6	1.0	1.4	-3.0	1.0
Investment (Δ% y/y)	20.9	3.1	5.0	1.0	-1.6	0.6	-1.5	2.4
Exports (Δ% y/y Local Currency)	17	7.0	8.4	3.7	3.9	5.7	4.7	4.6
Imports (Δ% y/y Local Currency)	21.5	5.9	5.9	2.9	6.2	6.2	4.3	4.6
GDP (US$ bn)		1,313	1,170	1,077	1,162	1,224	1,257	1,271
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.1	2.1	3.3	6.8	4.8	3.8	3.6
CPI core Inflation (Dec Cumulative)		3.2	2.4	3.4	4.9	3.7	3.7	3.5
US$ Exchange Rate (Average)		13.3	15.9	18.7	18.9	19.2	19.3	20.1
Central Bank Reference Rate (eop)		3.00	3.25	5.75	7.25	8.25	8.25	7.75
Bank Lending to Private Sector (% of GDP)		14.8	16	16.9	17.5	18.9	19.4	19.8
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-3.2	-3.5	-2.6	-1.1	-2.1	-2.0	-2.5
Primary Balance, % of GDP		-1.1	-1.1	-0.1	1.4	0.6	1.0	0.5
Balance of Payments								
Trade Balance		-0.2	-1.3	-1.2	-0.9	-1.1	-1.1	-1.1
Current Account, % of GDP		-1.8	-2.5	-2.2	-1.7	-1.8	-1.7	-1.8
Debt Profile								
Central Bank International Reserves (US$ bn)		193.2	176.7	176.5	172.8	174.8	180.0	182.0
Total Public Debt (gross, % of GDP)		43.2	47.3	48.7	45.8	44.9	45.3	46.0
Of which: Foreign-currency denominated (% of GDP)		11.9	14.6	18.3	15.7	16.4	16.2	16.3
Labor Markets								
Unemployment Rate (year-end, % of EAP)		4.8	4.3	3.9	3.4	3.3	3.7	3.8

F = Santander forecast Sources: Economy Ministry, Central Bank, and Santander estimates.

PERU

Growth Pickup in Sight

- **After a slow start in 2019, economic activity is starting to show signs of dynamism, which we expect to continue in 2H19. However, as a result of lower than expected public investment, we have revised downward our GDP forecasts for 2019 and 2020 to 3.8% from 4.2% and 4.0%, respectively.**
- **Inflationary pressures are picking up, in part due to food prices normalizing but also due to demand side pressures, in our view. As a result, we now expect headline inflation to end 2019 at 2.4%, above our previous forecast of 2.2%.**
- **The Central Bank remains comfortable with its holding stance, and given slower than expected growth in 1H19, we consider that the board will try to remain on hold for longer, but will deliver its first hike by the end of this year, as the output gap closes.**
- **President Vizcarra's approval rating has recovered recently, after the cabinet won its second vote of confidence under his administration, as they continue to push forward the reforms approved in December's referendum. A continuing clash between the two legislative branches may, however, have a negative effect on the economy.**

Santander Macroeconomics Team

Slow start in activity, but we expect a pickup in 2H19

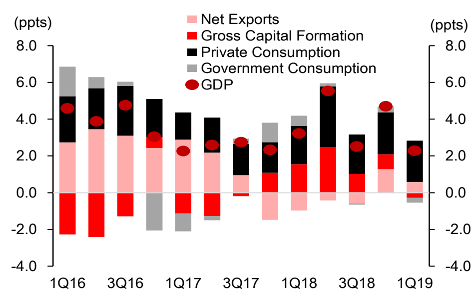
In 2019 the economy had a slower start than expected, with GDP growing 2.3% y/y, below 4Q18's 4.7% y/y growth and average growth of 4.0% in 2018. On the demand side, public investment disappointed, contracting 10.9% y/y in 1Q19, subtracting 32 ppts from annual growth. Additionally, public expenditure fell 2.5% y/y in 1Q19, subtracting a further 26 ppts from annual growth. Public investment monthly series indicate that public investment remained sluggish in 2Q19, contracting 31% y/y in May and accumulating a 6.6% y/y decline year to date. The slowdown in both public investment and consumption, however, reflects the change in local governments. In effect, public investment figures show that year-to-date, investment locally has declined 20%, whereas at the national level it has increased 11%. We expect this slowdown in investment to be temporary, as expenditure and investment should pick up in the second half of the year. In contrast, private consumption and private investment remain dynamic, increasing 3.4% y/y and 2.9% y/y, respectively, in 1Q19. On the supply side, primary activities, in particular fishing and mining, have been a drag on the economy, with fishing in particular contracting 20.5% y/y in 1Q19. In contrast, non-primary activities in general remain dynamic.

The latest economic activity indicators point to moderate growth in 2Q19. In effect, in April, annual economic growth remained flat, dragged down again mainly by the primary sector, but also as a result of fewer working days during the month due to Easter week. Although leading indicators, such as electricity production, suggest a pickup in economic activity, we think it is unlikely to offset the weak growth reported in April. While we still see the economy performing better in 2H19, as local public investment and expenditure normalize, we have revised downward our GDP forecast for 2019 to 3.8% from 4.2%, as a result of the lower than expected growth in 1H19.

Inflation on the rise

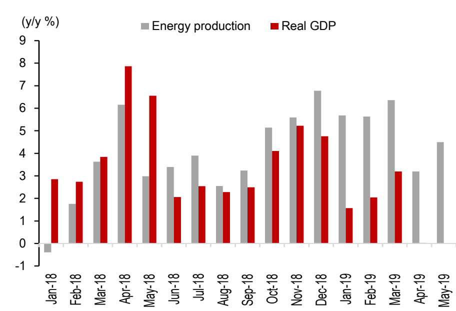
Since March, headline inflation has been trending up, with Lima-Metropolitan headline inflation reaching 2.73% y/y in May, up from 2.00% in February, moving closer to the 3% upper band. In 2Q19, we have seen substantial inflationary pressure from food and beverages in particular. Food prices have picked up rapidly during the year, after remaining at historically low levels last year, increasing to 2.74% y/y in May, up from 1.94% y/y in December 2018.

GDP contribution by component



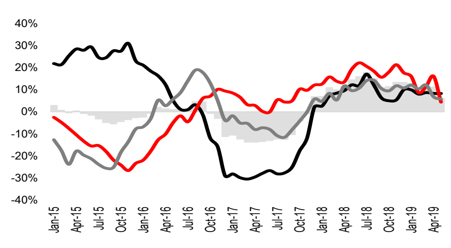
Sources: Central Bank and Santander.

Electricity production picking up



Sources: COES, Central Bank, and Santander.

Public investment contracts in 1H19



Note: Annual growth. Sources: Ministry of Finance and Santander.

According to INEI, food alone accounted for one third of monthly inflation in May and has been consistently the top contributor to inflation in the past several months. However, in addition to food, we are seeing also significant pressure from other components. In effect, annual inflation excluding food has also been heading higher, reaching 2.71% y/y in May, up from 2.36% in December 2018. Besides food, we note that part of the pressure is coming from energy prices, reflecting higher oil international prices in particular. Yet, CPI ex food and energy remains sticky at around 2.6% y/y, suggesting that there are also some demand side pressures. The month of May reported notable increases in entertainment services, such as cable fees and movie tickets, contributing one third to monthly inflation and registering accumulated year-to-date inflation of 3.92%.

In general, we expect inflation to remain above the 2.0% target for the rest of the year. We now see inflation ending 2019 at 2.4% y/y instead of 2.2%, as we consider that food prices will continue to normalize and that we may also continue to see some stronger demand-side pressures as consumption remains strong.

Central Bank on hold in the short term

The Central Bank of Peru remains comfortable with its holding stance. In its June 13 meeting the board kept the interest rate unchanged at 2.75% for the 14th consecutive month. In general, we consider that the board maintains a neutral tone but with a hint of hawkishness, as, similar to its previous communique, the board differentiated the primary sector from other activities and acknowledged that the economy ex primary sector remains dynamic, expressing its continued belief that the output gap for these activities is narrowing. In terms of inflation, the board maintains its positive view, as it noted that inflation is within the target range and stated that it expects inflation to remain close to the 2.0% target. The MPC also noted that 12-month inflation expectations stood at 2.47% in May, also still within the target range.

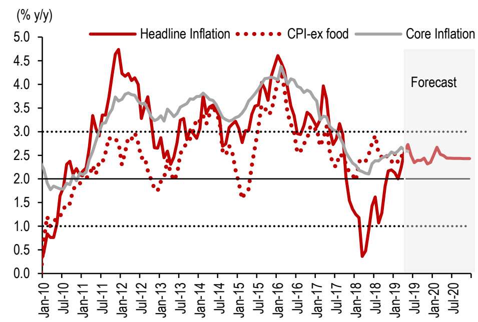
In general, we consider that the economy will pick up in the coming quarters, as local public investment normalizes. However, given the weakness of the first quarter, we anticipate a delay in the closing of the economy's output gap, and thus we believe that the Central Bank will try to hold the monetary policy rate on hold for longer to continue to provide support to the economy. Thus, we now expect the Central Bank to deliver its first hike in 4Q19 instead of 3Q19 and bring the interest rate up to 3.00% by end-2019.

Political environment in the spotlight

Following the December referendum, the political environment continues to be in the spotlight. At the end of May, President Vizcarra announced that he would seek a vote of confidence after opposition lawmakers rejected the first of 12 proposals presented to Congress that sought to toughen campaign financing and elections rules. This was the second confidence vote in less than nine months, as the first one took place in September 2018 over the judicial reform, which was later passed with the December referendum. On June 5, Peru's cabinet won a vote of confidence, with 77 votes in favor, 44 against, and three abstentions. After this second win, the government submitted to Congress a package of six bills aiming to improve the electoral system, including measures to restrict the use of illicit money in funding campaigns.

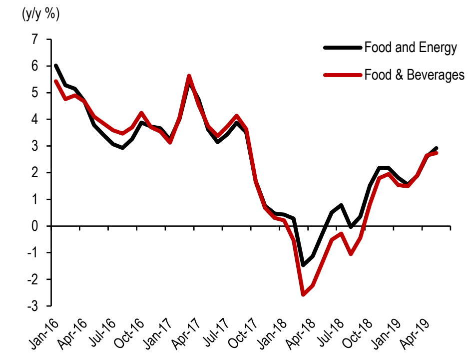
President Vizcarra's approval rating recovered notably after the cabinet won its second vote of confidence under his administration, continuing to give him support to push the reforms, in our view (see bottom chart at right). However, the clash between the two legislative branches is likely to continue, in our view, and the longer this contention lasts, the higher the probability that it may have a negative impact on the economy. According to APOYO Consultoria's index, business confidence to invest collapsed to -6 pts in 2Q19, from 27 in 1Q19, the lowest level since 2015, reflecting, according to APOYO Consultoria, the instability of the political environment. The impact on investment has been limited so far, yet if the negative view continues, we believe it could potentially translate into lower investment and thus lower growth.

CPI expected to remain above 2.0%



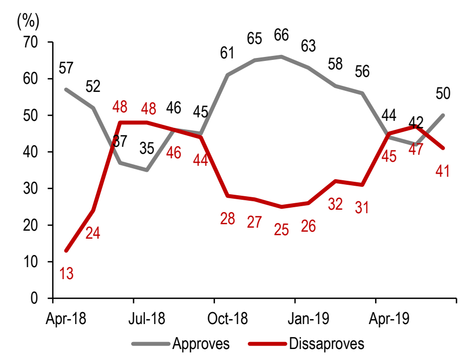
Sources: BCRP and Santander

Food and energy prices on the rise



Sources: BCRP and Santander

Vizcarra' s approval bounces back



Sources: El Comercio- Ipsos.

PERU

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (∆% y/y)		2.4	3.3	4.0	2.5	4.0	3.8	3.9
Private Consumption (∆% y/y)	61.4	3.9	4.0	3.7	2.6	3.8	3.8	4.1
Public Consumption (∆% y/y)	11.2	6.0	9.8	0.3	0.5	2.0	2.1	1.8
Investment (∆% y/y)	28.2	-2.3	-4.7	-4.3	-0.2	4.9	3.0	6.1
Exports (∆% y/y Local Currency)	23.9	-0.8	4.7	9.1	7.6	2.5	1.5	2.9
Imports (∆% y/y Local Currency)	24.6	-1.3	2.2	-2.3	4.0	3.4	4.2	5.3
GDP (US$ bn)		202	191	195	214	225	235	247
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.2	4.4	3.2	1.4	2.2	2.4	2.4
WPI Inflation (Dec Cumulative)		3.3	4.1	3.7	2.3	2.4	2.5	2.5
US$ Exchange Rate (Average)		2.8	3.2	3.4	3.3	3.3	3.4	3.4
Central Bank Reference Rate (eop)		3.50	3.75	4.25	3.25	2.75	3.00	3.75
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-0.3	-2.0	-2.5	-3.1	-2.5	-2.3	-1.8
**Primary Balance, % of GDP		0.8	-1.0	-1.4	-1.9	-1.1	-0.8	-0.5
Balance of Payments								
Trade Balance, % of GDP		-0.7	-1.5	1.0	2.9	3.1	2.9	2.7
Current Account, % of GDP		-4.4	-4.8	-2.7	-1.1	-1.5	-1.8	-2.0
Debt Profile								
Central Bank International Reserves (US$ bn)		62.3	61.5	61.7	63.6	60.1	64.5	67.5
Total Public Debt (gross, % of GDP)		20.1	23.3	23.8	24.9	25.5	26.0	26.0
Of which: Foreign-currency denominated (% of GDP)		8.7	11.1	10.4	8.8	10.3	9.1	9.3
Labor Markets								
Unemployment Rate (year-end, % of EAP)		5.2	6.2	6.7	6.5	5.7	6.5	6.5

F = Santander forecast Sources: Economy Ministry, Central Bank, and Santander estimates.

URUGUAY

GDP STAGNATES AMID PERSISTENT OVERVALUATION OF UYU

- **Real GDP fell 0.2% y/y in 1Q19 (0% q/q), slightly below expectations, driven by declining household consumption, exports, and investment. We expect modest 0.5% y/y growth in 2019.**
- **Following substantial FX weakening and Central Bank sales in May, the peso stabilized around UYU 35.2/USD, due to expectations of more accommodative policies in the US. In our view, the currency remains 11% overvalued from a real exchange rate (RER) standpoint.**
- **The primary elections that took place on June 30 decided the candidates who will now contest the presidential elections to be held in October and November (first and second round, respectively).**

Marcela Bension*

598 1747 6805

Activity fell 0.2% y/y in 1Q19, driven by consumption, investment, and exports

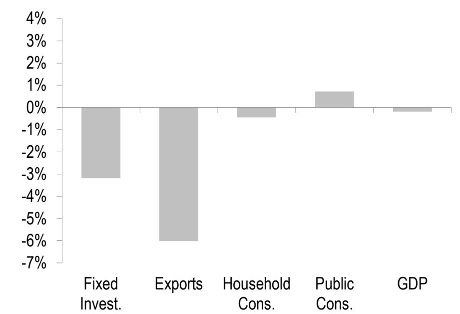
GDP fell 0.2% y/y in real terms in 1Q19, stagnant compared to 4Q18. All private sector components of demand fell, continuing the poor performance seen in recent years. Household consumption, the main growth engine since 2015, fell by 0.4% y/y, following a 0.5% y/y decline in 4Q18. Unemployment stood at 8.6% in April (moving quarter), and, similar to 2018, we expect real wages to stagnate this year in contrast to a 3.4% p.a. average increase since 2005. In addition, the peso has weakened nearly 9% ytd, negatively affecting the purchases of durable goods such as new cars (-19.4% y/y as of May). As a result, the Ucudal consumer confidence index remains in negative territory, at 45 as of April.

Fixed private investment declined by 4.8% y/y in real terms, now having fallen non-stop for two and a half years (on a quarterly basis). In our view, negative investment and business sentiment reflect the global and regional economic slowdown as well as growing domestic imbalances – mostly on the fiscal side – that impose a high burden on production costs of local firms.

Exports fell by 6% y/y, the fourth quarterly decline in a row, driven by a negative summer season that ended with a 27% y/y decline in tourism receipts – measured in US dollars – in January and February. In our view, tourism is the main channel through which economic distress in Argentina hits the Uruguayan economy, considering that nearly 70% of total inflows come from the neighboring country. In contrast, goods exports to Argentina account for only 5% of total sales, while Argentinean deposits in the local banking system account for less than 10%. Finally, FX and risk premiums between the two countries have clearly detached since 2003, with Brazil now being a much more important driver of financial readings. The Uruguayan economy's reduced reliance on Argentina is a key factor distinguishing it from the last financial crisis affecting Uruguay, in 2002. In any case, we cannot rule out marginal FX pressures from Argentina through the tourism channel, particularly considering that the UYU remains strong from a RER perspective.

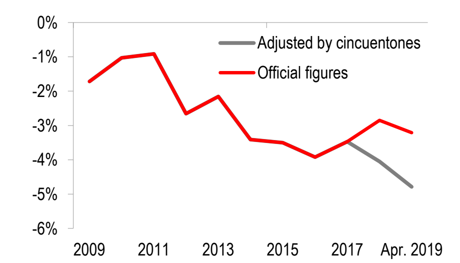
Taking these factors together, we have slightly lowered our growth expectation for 2019 to 0.5% (from the previous 0.7% y/y). Our forecast is based on our assumption of a modest pickup in household consumption in the coming quarters (0.5% y/y), rising fixed investment (2.2% y/y), and higher exports (3% y/y). We expect investment to recover as a result of the recent kick-off of the construction of a new railroad under a private-public partnership – a prerequisite for Finnish company UPM to install its second pulp mill toward 2020-21 – while we expect exports to gain traction following much better soybean production compared to the previous season. Finally, it is worth noting that our forecast is based on the assumption that Uruguay maintains its sovereign investment-grade status, particularly as per Fitch (BBB-), which lowered the country's outlook to negative in October. This assumption is increasingly challenged by a persistently worsening fiscal picture, although rating agencies continue to highlight the country's strengths.

GDP fell 0.2% y/y in 1Q19, driven by most components of demand



% real y/y change (annual average). Sources: BCU and Santander.

The fiscal deficit continues to worsen



As % of GDP. The adjusted result includes amendment for a one-off effect from the "cincuentones" law. Sources: MEF and Santander.

Fiscal deficit nears 5% of GDP, excluding one-off income

Excluding one-off revenue resulting from the popularly known "cincuentones law," the public sector deficit reached 4.8% of GDP as of April, up from 4.1% of GDP at the close of 2018. Pensions, wages, and health subsidies remain the key drivers of fiscal worsening. Pension spending has risen as a result of an aging population and looser policies implemented within the past decade (the latter involving the "cincuentones law"). However, discretionary spending, such as wages, is also on the rise on the back of non-stop growth in public sector payrolls and higher wages within the public sector. Finally, in April revenue set a new trend, declining in terms of GDP, capturing the effects of the recession. Tax collection fell by 1% y/y in real terms, the first decline since February 2015, driven by the decline of the most significant taxes, such as VAT and income taxes. Considering that fiscal deficits tend to worsen in election years, we would find it no surprise if the deficit were to close the year above 5% of GDP.

Despite fiscal worsening and higher central government debt, all three major credit agencies have reiterated their sovereign rating views this year – S&P (BBB, neutral), Moody's (Baa2, neutral) and Fitch (BBB–, negative). Their statements have, in general, pointed to the country's strengths, such as strong institutions, ample liquidity, and extended debt maturity. In addition, the agencies have expressed confidence that prudent policies will be carried out regardless of the administration that takes office on March 1, 2020, and they see it as likely that FDI could rise in the coming years due to UPM inflows (USD 3 billion of FDI, 5% of GDP). In any case, the incoming administration will inherit a fiscal burden that will test its political ability to implement structural reforms so as to put a lid on public sector expenses in order to preserve Uruguay's investment-grade status and restore the competitiveness of domestic firms.

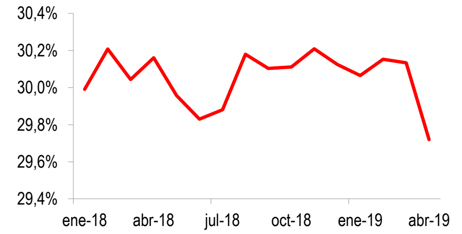
The first political milestone this year was the primaries held on June 30, when political parties elected their candidates to contest the presidency in the October 27 and November 24 rounds of elections. The most competitive balloting involved the traditional center-right parties currently in the opposition, the Partido Colorado (PC) and the Partido Nacional (PN), where market-friendly candidates were elected with ample majorities. Ernesto Talvi, a prestigious economist running for the presidency for the first time, and Luis Lacalle, a senator and lawyer running for the second time, will now have to put forward their political agendas with a view to the presidential rounds where, in our view, the most likely outcome will be a government without a simple majority in Congress. The PN appears as the main challenger to the Frente Amplio (FA) administration that has governed for the past 15 years with majorities in Congress. The FA selected a moderate candidate, Daniel Martinez, with nearly 40% of votes. However, alternative candidates, on the left side of the political spectrum, won nearly 50% of votes, creating uncertainty about the tone of the political agenda to be put forward going into October.

UYU weakened 3% m/m in May; the Central Bank sold USD 1.2 billion in reserves but still holds enough reserve ammunition

Since March, the UYU weakened 5.6%, detaching from significant drivers such as the BRL and the US 10-year yield. In May, the Central Bank intervened in the FX market, selling an impressive USD 1.2 billion of international reserves – USD 0.6 billion in direct sales within the FX market and another USD 0.5 billion in a debt offer tendered to investors willing to shorten positions in Central Bank instruments. As a result, CB own reserves – that is, international reserves excluding bank reserves and central government holdings – fell from USD 7 billion at the end of 2018 to USD 5.7 billion as of June 20. Still, we think the Central Bank continues to hold sufficient reserve ammunition to address further UYU weakening potentially arising from external or regional shocks. In fact, between July 2015 and July 2016, amid global financial turmoil, the monetary authority sold USD 4.1 billion in reserves, reducing its own reserves to USD 3.5 billion.

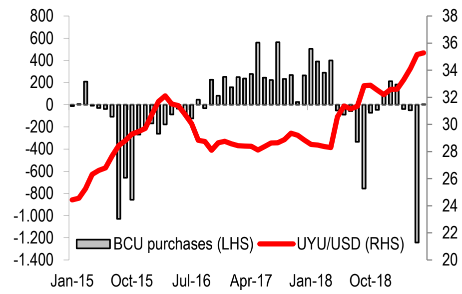
Despite greater than expected weakening at the start of the year, our estimates indicate that the UYU remains 11% overvalued from a real exchange rate standpoint. Our current year-end FX expectation, UYU 36.2/USD, implies stabilization of currency overvaluation around current levels, albeit at the expense of external competitiveness of local firms and, thus, GDP growth.

Central government revenue declines owing to weak activity



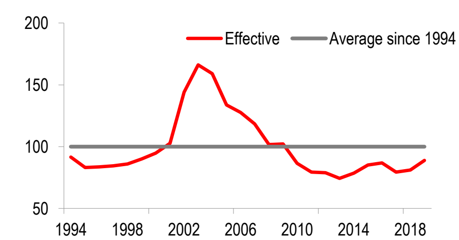
Central Government revenue excluding one-off effect from the "cincuentones" law (including BPS). Sources: MEF and Santander estimates.

UYU weakens 8.7% ytd, forcing substantial Central Bank sales in May



Monthly net purchases by the BCU in USD million against UYU/USD average monthly quote. Source: Central Bank (BCU).

Despite significant worsening, UYU remains overvalued from a RER standpoint



Real exchange rate index Uruguay-US. 1994-2018= 100. Below average: currency overvaluation and vice versa. Source: Santander estimates.

URUGUAY

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		3.2	0.4	1.7	2.6	1.6	0.5	1.8
Private Consumption (Δ% y/y)	74.7	3.0	-0.5	0.1	4.6	1.5	0.5	1.5
Public Consumption (Δ% y/y)	10.3	2.5	2.2	2.9	-0.7	0.8	0.5	-0.5
Investment (Δ% y/y)	17.5	0.0	-9.0	-3.9	-13.0	7.3	1.0	6.8
Exports (Δ% y/y USD)	28.0	3.5	-0.6	-0.2	6.9	-4.8	3.0	3.8
Imports (Δ% y/y USD)	30.5	0.8	-7.3	-6.2	0.5	-2.0	3.0	5.0
GDP (US$ bn)		57.3	53.4	52.8	59.6	59.6	57.6	59.7
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		8.3	9.4	8.1	6.6	8.0	8.0	8.0
WPI Inflation (Dec Cumulative)		10.3	10.0	7.7	6.6	7.5	7.8	7.5
US$ Exchange Rate (Average)		23.2	27.3	30.1	28.7	30.7	34.9	37.2
Central Bank Reference Rate (eop)		n/a	n/a	n/a	n/a	n/a	n/a	n/a
Monetary Base (Δ% y/y)		10.7	9.5	6.1	12.9	5.8	8.6	9.1
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-3.4	-3.5	-3.9	-3.5	-4.0	-4.9	-4.6
**Primary Balance, % of GDP		-0.6	0.0	-0.6	-0.2	-0.6	-1.5	-1.0
Balance of Payments								
Trade Balance, % of GDP		2.8	3.2	5.2	6.1	5.9	5.0	4.7
Current Account, % of GDP		-3.2	-0.9	0.6	0.8	-0.6	-1.9	-2.2
Debt Profile								
Central Bank International Reserves (US$ bn)		17.6	16.0	13.8	16.2	15.8	16.0	16.7
Total Public Debt (gross, % of GDP)		58.5	58.9	63.2	65.0	64.2	72.5	74.1
Of which: Foreign-currency denominated (% of GDP)		43.9	53.8	52.8	41.5	42.9	43.3	43.7
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.6	7.5	7.8	7.9	8.4	8.5	8.2

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

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