Mexico

2020: A LACKLUSTER OUTLOOK

- **After a flat 2019, modest growth is expected in 2020 as the negative shocks of last year are absorbed. Stronger growth will require a significant increase in consumer and business confidence.**
- **Prospects for investment generally remain challenging as poor security in some regions paired with changes in the energy policy pose a headwind to what should be a more favorable investment climate now that USMCA seems set for ratification.**
- **The fiscal situation remains challenging to low growth and the government's support for Pemex. To meet fiscal objectives, more spending cuts may be required, as credit rating agencies will be focused on budgetary execution.**
- **Inflation has been declining, opening space for some reductions in monetary reference interest rate that could provide some limited relief, with one more 25 basis point cut expected shortly.**
- **In this environment, we forecast a modest increase of 1.0% GDP growth for 2020. Firms and households are expected to remain very cautious with their spending.**

A COMPLEX MIX FOR 2020

A new year and a new decade are starting, and usually this represents a fresh opportunity to set new goals and to evaluate if we are on the desired path. For the Mexican economy, 2020 will be a decisive year, and prospects remain challenging.

In 2019, a toxic combination of factors generated significant uncertainty, taking growth to a standstill, with many sectors contracting, investment falling and subdued private consumption.

Many of these factors holding back growth appear to be in the rear-view mirror, opening the possibility of a return to growth in 2020. Anxiety produced by commercial frictions between USA and China or by a possible chaotic Brexit have lessened after latest developments. The agreement reached around the USMCA eliminates a key factor contributing to elevated uncertainty, even though a final ratification by the US Senate is still pending. Within Mexico, the natural uneasiness following a change of government and the learning curve of the new officials should now be in the past and no longer be a drag on the economy. Inflation has descended to reach the official target, opening some room for Banco de Mexico to reduce interest rates. The Mexican Peso (MXN) has strengthened to levels below 19 MXN/USD, signaling a low risk perception from international financial investors. Retail sales kept growing at positive real rates and remittances kept rising.

Looking forward, the outlook seems less stressful but not free of concerns, as some factors will keep producing uncertainty, holding back the business

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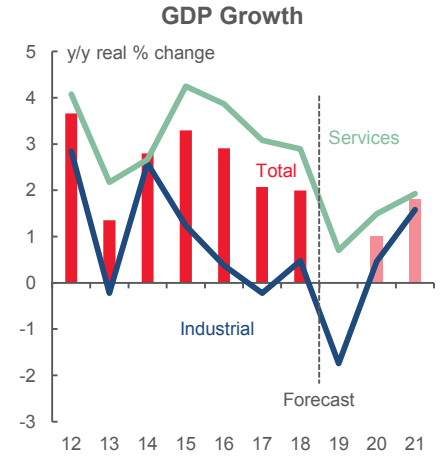
Mexico	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.1	0.0	1.0	1.8
CPI (y/y %, eop)	4.8	2.8	3.8	3.7
Central bank policy rate (%, eop)	8.25	7.25	7.00	7.00
Mexican peso (USDMXN, eop)	19.65	18.85	20.52	21.21

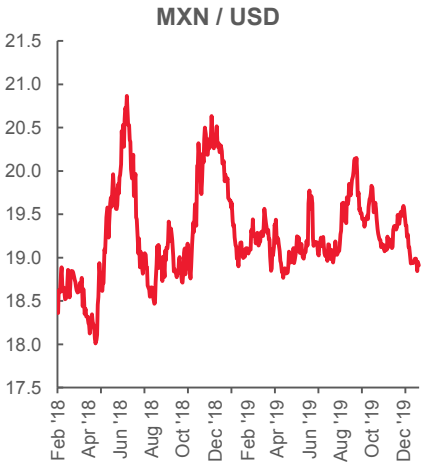
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, INEGI.

Chart 2



Sources: Scotiabank Economics.

environment. On the external front, the US political situation remains complicated, with a polarized population immersed in the impeachment process of President Trump and the 2020 Presidential election. We should not forget how threatening Mexico politically benefitted President Trump, and that could happen again.

On the domestic front, there are some remaining concerns that will weigh on the economy. If aggregate demand reignites, economic growth could accelerate, but it is yet to be seen if firms would reactivate investment projects and households start spending more. For private investment to improve, confidence levels need to rise, which will depend on issues such as strengthening the rule of law and increasing the perception of security. Especially important is to tip the balance between opportunities and risks in favor of the former. One of the perceived obstacles to this is the changes happening in the energy sector, where actions taken by the government are blocking or restricting private sector participation. It is also uncertain if the final USMCA agreement will be good enough to revive large investments.

On the macroeconomic side, fiscal discipline could be at stake, since the lack of economic growth is curbing tax revenues and could compromise fiscal targets. Pemex's performance will be key, as failing to reach the ambitious production plan laid down by the firm will produce poor financial results and will require more support from the federal government, thus weakening the fiscal stance. If things go off plan, a new reduction in credit ratings could occur, which would pressure the financial markets and the MXN.

Inflation is expected to rise a bit from the low level reached in 2019, as some of the favorable shocks that helped to bring inflation down fade away, but it should remain within the range defined by Banco de Mexico. It is yet to be seen if the recent 20% increase in minimum wages will have some perceivable impact on inflation, since those firms that don't have profit margins wide enough to absorb a wage increase above productivity growth, could try to transfer it to prices or could translate it into lower employment or higher informality. An increase in year-to-year inflation is anticipated in the first half of the year.

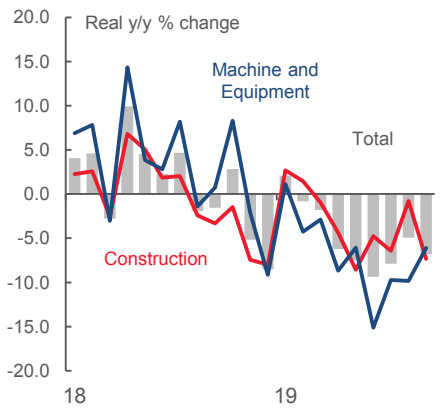
Monetary policy is expected to be data dependent. One more 25 basis point cut of the monetary reference interest rate is expected in the first quarter, then remaining at 7.0% for the rest of the year. Further reductions will depend on inflation and exchange rate performance.

In this environment, a 1.0% growth in GDP is expected for 2020. Investment is expected to contract some more as firms remain skeptical and cautious while private consumption is forecast to grow a little bit faster, but at a weak pace.

Finally, high uncertainty still lingers over the outlook, with some possibility to have a better than expected growth but a more relevant bias to the downside.

Chart 3

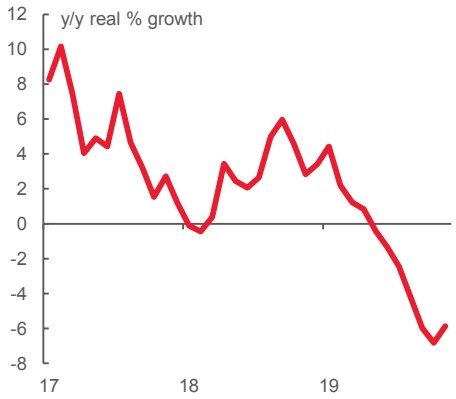
Gross Fixed Investment



Sources: Scotiabank Economics, INEGI.

Chart 4

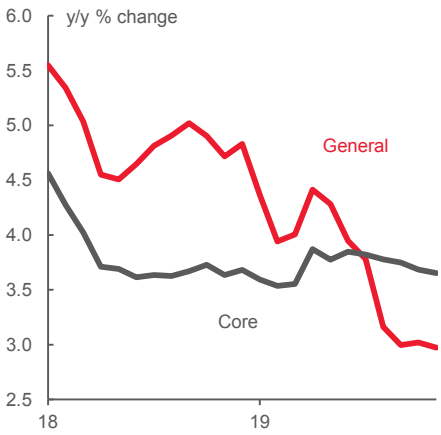
Tax Revenues Excluding Fuel Taxes



Sources: Scotiabank Economics, Ministry of Finance.

Chart 5

Inflation



Sources: Scotiabank Economics, INEGI.

Brazil

- **As 2019 drew to a close, retail sales, manufacturing PMIs, and industrial confidence indicators showed signs of green shoots for 2020 growth. Still-subdued growth and tame inflation supports the Central Bank of Brazil's (BCB) very loose monetary policy settings, but on the flip side of that, historically low rates make the BRL vulnerable, as we saw in Q3 & Q4 2019. We think BRL pressure is what will force a BCB hike cycle.**
- **The Bolsonaro government delivered a somewhat stronger pension reform than we anticipated, which we see as a great starting point for fiscal consolidation efforts. Now the government needs to deliver on a material reform of both public spending and taxes.**
- **Brazil needs growth-boosting micro-reforms, as well as continuing to open the country's economy. Without progress on this front, alongside the expected increase in investment rates this would bring, Brazil's potential GDP would likely remain around 2%.**

SANTA DELIVERING HAPPIER 2020 ON THE DATA FRONT?

It has been a while since we've seen Brazilian growth forecasts revised upwards. That's precisely what we saw as 2019 drew to a close. In its December update, the BCB upgraded its 2019 GDP forecast from 0.9% to 1.2%, and 2020 from 1.8% to 2.2%. On the inflation front, the BCB expects 3.6% IPCA inflation for 2020. Those forecasts are broadly in line with the last survey among private economists that Bloomberg conducted: 2019 growth of 1.1%, 2020 growth of 2.3% and 2020 inflation of 3.7%. Our own forecasts have also been revised higher on growth, and lower on inflation: for 2019 we expect growth just above 1.1%, and for 2020 we foresee a 100bps acceleration in growth. On the inflation front we now see a 2019 close of 3.3%, rising to an average of 4.0%–4.2% in 2020. However, risks to our inflation forecasts remain tilted to the upside, with the Selic rate (and the whole yield curve) sitting at historic lows, making the BRL very vulnerable.

Among the drivers of the upward growth revision were stronger manufacturing PMIs for November (now printing in the 52–53 range), resilient services PMIs (around 51), material strengthening in retail sales data (+4.2% y/y in October), as well as better industrial confidence numbers (now in the 64 range, materially stronger than the prints below 40 we saw at the lowest point of the downturn in 2015). Note that the more rosy growth picture is still only suggesting a return to the country's modest potential growth rate of around 2%.

2020 KICKS OFF WITH FISCAL REFORM IN FOCUS

Brazil's tax system is so complex, that a local lawyer decided to print out the whole tax code, and came up with a document that weighs 8 tons in paper. The country's cumbersome tax code has many costs. According to the World Bank's "Doing Business" report, Brazil overall scores quite poorly in competitiveness, ranking 124th in the planet in terms of the quality of its business environment. One of the weak links is its tax system, where it ranks 184th, out of 190 economies. The country's byzantine tax & contribution system accounts for an average 65% of company profits, and takes an average 1,500 hours of company time to meet tax obligations. Fiscal

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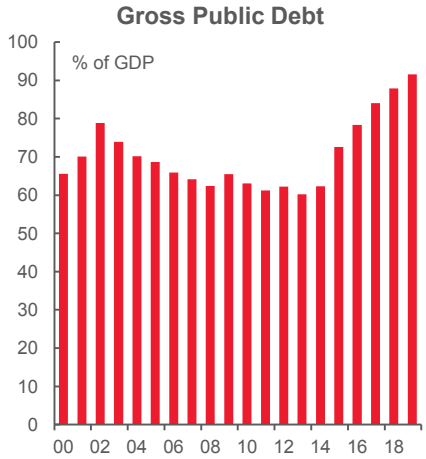
Brazil	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.3	1.1	2.1	2.1
CPI (y/y %, eop)	3.8	3.3	4.2	4.1
Central bank policy rate (%, eop)	6.50	4.50	6.00	7.00
Brazilian real (USDBRL, eop)	3.88	4.09	4.18	4.30

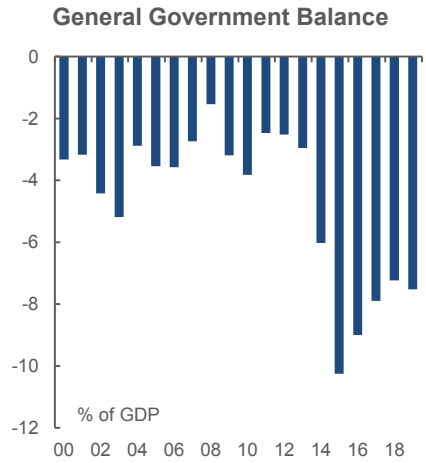
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2

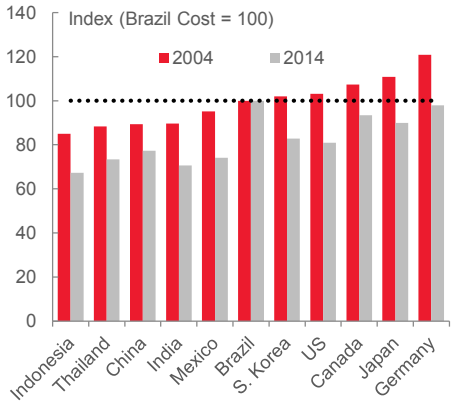


Sources: Scotiabank Economics, IMF.

consolidation could also be one of the factors contributing to improving the country's growth potential (more on this later). A study conducted by the IMF shows that like in much of LATAM, Brazilian public spending is very ineffective. One way of lifting growth could be to reduce the government's very large share of the economy (public spending represents over 38% of GDP—as opposed to much of the region where the government accounts for about a quarter of GDP), putting more resources in the hands of private players to allocate them.

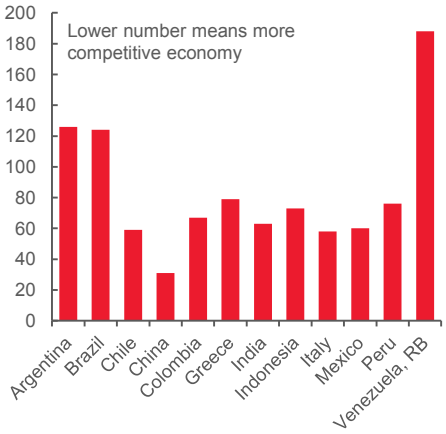
Fiscal sustainability is also an issue. Brazil is rated junk by all major rating agencies (Moody's Ba2, S&P BB-, and Fitch BB-), and to recover investment grade there is a lot of heavy lifting to be done on both the income and spending side of fiscal accounts. Inertially, gross debt could exceed 95% of GDP by the mid-2020s. The pension reform of 2019 was relevant, and is expected to stabilize pension spending, and save about 10 percentage points of spending over the next decade. However, according to IMF Article IV estimates, it only represents about one-third of the total adjustment that needs to be made in order to meet medium-term fiscal targets. Moreover with gross public debt at roughly 90% of GDP, debt having a short 4-year average life, and yields currently sitting below their steady state level—a rebound in the yield curve could eat up more fiscal space than that saved by the pension reform. Based on our estimates, current monetary policy settings are 200bps on the loose side at potential growth (which we expect in 2020), and the 10 year part of the curve should trade at least 550–650bps wide of the US 10-year.

Chart 3 **Manufacturing Costs**



Sources: Scotiabank Economics, Boston Consulting Group.

Chart 4 **Doing Business Rank**



Sources: Scotiabank Economics, World Bank.

WITHOUT HIGHER INVESTMENT, GROWTH SHOULD REMAIN CONSTRAINED

As we mentioned earlier, 2020 kicks off a little more upbeat on the growth front, but we highlight that Brazil has only printed one quarter above 2% y/y growth (Q4 2017) since 2014, and the old glamorous "BRICS" days seem long gone. Without a material increase in the country's investment rate, our estimates suggest the potential growth rate lies somewhere in the 1.5%–2.5% range, which is where the government's own estimates fall as well. Among the 6 largest economies in LATAM, since 2000 Brazil's average investment rate of 18.5% of GDP is only higher than Argentina's (17.3%), and is 3–5 percentage points lower than the averages seen in the PAC countries. How to boost growth?

Brazil is among the more closed major economies in the world. Heading into the 2014 slowdown (that is still lingering), the rise in the cost of manufacturing in Brazil increased more than in all but 3 of the 25 leading global manufacturers (only Austria, France and Switzerland increased more). Since the 2014 slump, which saw Brazil's manufacturing output dip about 15% off its top, the country has failed to get back above 2005 production levels. One potential root for this problem is that, in an economy as closed as Brazil's, there is not enough competition to keep costs in check relative to what happens elsewhere in the world. This cost-driven hangover could be part of the explanation for the slump—opening the economy should help check cost increases.

As measured by the World Bank's Doing Business survey, Brazil ranks as 124th out of 190 economies, in terms of the cost of doing business there. In order to make doing business easier, and boost investment, a very ambitious micro-reform agenda is necessary. According to the World Bank's index, Brazil only approaches being in the top-30% of the most competitive economies in: protecting minority investors (61st), enforcing contracts (58th), and resolving insolvency (77th). Outside of those three categories, Brazil tends to rank closer to the bottom 30%.

BRAZILIAN MARKETS—TOUGHER 2020?

Besides global factors, we see a number of domestic issues contributing to self-driven market moves as well as an increased level of vulnerability to external shocks. Key among them is historically low rate settings by the BCB (the current 4.5% SELIC rate is the lowest on record, and less than half of the 10% average since 2010). Our estimates suggest that Brazil's "neutral real rate" is around 3.5%, meaning that with IPCA at 3.3%, rate settings are decidedly on the loose side (about 200bps). Looking at its carry-risk ratio, BRL now ranks weaker than ARS, COP, MXN and CLP within the region, meaning that its liquidity (second only to MXN in LATAM) and relatively low cost of carry make the BRL vulnerable to risk-off shocks.

Colombia

DOMESTIC DEMAND STRENGTH TO CONTINUE, SOCIAL DISCONTENT IS CONTAINED SO FAR

- **In 2019, the Colombian economy outpaced its main Latam peers, due to idiosyncratic conditions that strengthened domestic demand. In 2020 GDP growth should remain strong as our forecast remains at 3.6% (same is expected for 2021), but external uncertainty and social discontent locally are downward risks.**
- **FX pass-through has been low as usual, and temporary supply shocks that affected headline inflation are about to vanish. In 2020 CPI inflation should converge to the central bank target (3%) and remain there in 2021 in the absence of additional shocks.**
- **In 2020 BanRep will likely adjust the MPR to a neutral level. We anticipate a rate hike of 25bps in 1H20, on the back of closing output gap, CPI inflation converging to the target (3%) and a widening current account deficit.**
- **Social protest leaders are not demanding a change in the status quo. Fiscal policy is in the spotlight since negotiations to end the protests implied some government concessions and extra expenditures.**

Colombian economic activity continues to outpace Latam peers, owing to a strong recovery in domestic demand, relatively stable inflation in the upper half of the target range and an extended period of low interest rates. Investment has benefited from the 2018 Financial Law and 4G infrastructure program, while private consumption accelerated partially a result of a demand shock on perishable goods due to Venezuelan migration. In 2020 Venezuelan migration and the 4G program will continue to boost domestic demand, and a moderation of imports should improve the external balance in the GPD.

November protests in Colombia demonstrated that the country is not insulated from regional political unrest, and have added some downside risks to domestic recovery that were not present in October. Although there is yet no hard data for 4Q19, preliminary calculations lead us to anticipate a rather mild impact from November protests, but we put downside risk on private investment decisions if manifestations remain. All in, our base case scenario continues to be slightly higher growth in 2020 than in 2019, although external uncertainty and local social and political tensions are downward risks. Both can exacerbate the already-high twin deficits. It is worth noting that fiscal policy is in the spotlight since it is already tight and social protest could lead to some deterioration. Finally, on monetary policy we still expect BanRep to remain on hold for the near future, while the temporary pick-up in headline inflation will likely vanish during 1H20.

ECONOMIC RECOVERY REMAINS STRONG ALTHOUGH RISKS ARE TILTED TO THE DOWNSIDE

Colombia's year-to-date GDP to 3Q19 showed that domestic demand growth continues to be strong. Domestic demand grew at 4.5% y/y up to September, well

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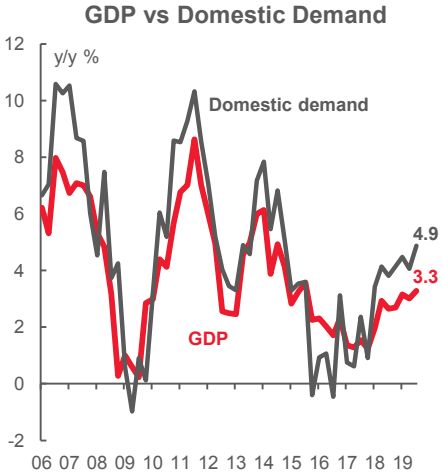
Colombia	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.6	3.2	3.6	3.6
CPI (y/y %, eop)	3.2	3.8	3.3	3.1
Central bank policy rate (%, eop)	4.25	4.25	4.50	4.75
Colombian peso (USDCOP, eop)	3,254	3,287	3,250	3,180

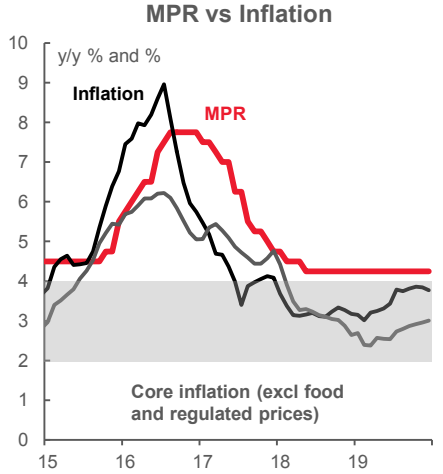
Source: Scotiabank Economics.

Chart 1



Sources: DANE, Scotiabank Economics.

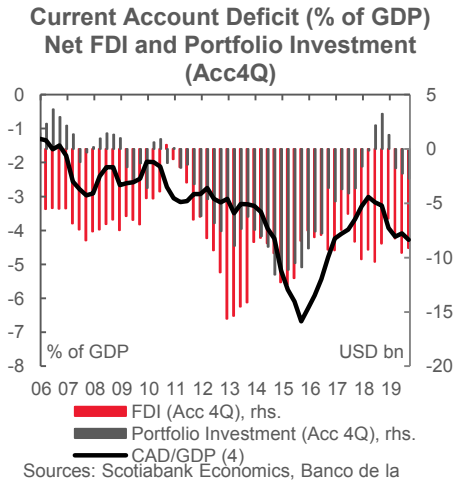
Chart 2



Sources: Scotiabank Economics, Banrep, DANE.

above GDP growth (3.2% y/y). The trade deficit remained wide due to stagnant exports and strong imports of capital goods. Robust capital imports mirror the investment recovery and are one of the reasons why domestic demand outpaced GDP growth. Capital imports goods expanded by 8.3% y/y, and investment has recovered (+4.6% y/y YTD up to 3Q19). On the supply side, services sectors continue to lead growth in 2019, while construction, and specifically building construction, is the only sector of the economy with annual declines (-7.9% y/y YTD up to 3Q19). It is worth noting that the recovery in economic activity is not being reflected by labor dynamics—unemployment remains above 10%. Venezuelan migration may be a partial explanation for the high unemployment rate (supply shock), but is not the whole explanation. Higher automatization and a structural change of the economy to be more services-based and less labor intensive are also affecting labor demand.

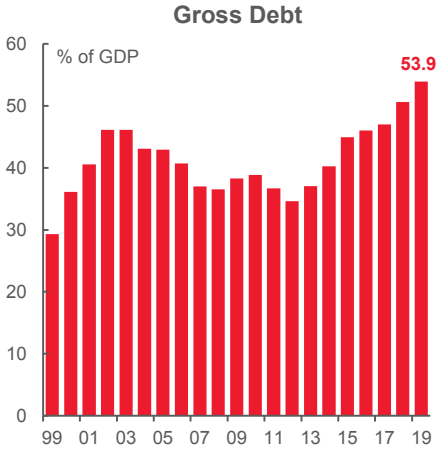
Chart 3



Sources: Scotiabank Economics, Banco de la Republica.

Financial services and commerce grew above 4%. October coincident indicators, such as retail sales, manufacturing, energy demand, and oil production, among others, point to a still-strong domestic demand in 4Q19. Having said that, November's nationwide protests may affect 4Q19 GDP. Preliminary calculations indicate that protests (especially November 21st and 22nd) could cost around 0.07pp of GDP in nominal terms which, although appearing minor, does tilt risks to the downside. Additionally, weaker global demand also puts a downward bias on our economic activity projections, especially for 2020–21.

Chart 4



Sources: Scotiabank Economics, Ministerio de Hacienda y Credito Publico.

Inflation continues to hover near BanRep's target range ceiling due to a temporary supply shock in food prices and a mild FX pass-through effect. In fact, headline inflation ended at 3.8% in 2019, while core inflation (excluding food and regulated prices) remains close to 3%, although with a slightly positive trend since March. A base effect in foodstuffs should start to vanish as soon as in January 2020. The only current upside risk for headline inflation in the near term is a higher FX pass-through due to an average depreciation of 11.6% in 2019. However, since we are projecting a mild appreciation this year, we think headline inflation will converge to the central bank target (3%) by 2H20. Beyond 2020 we do not anticipate shocks; therefore, with a closing output gap, inflation in 2021 should continue close to 3%. BanRep's staff and some board members have explicitly said that they prefer to keep policy rate at the current slightly expansionary level (4.25%) for longer. Higher temporary headline inflation has not affected inflation expectations, so far, while economic activity recovery, although stronger than BanRep's expectations, is still below potential output growth. Central bank staff said that, according to their models, normalization of the policy rate (for them neutral real rate is 1.4%) should start beyond 1H20 once it is clear that the output gap is close to zero. Having said that, without a perspective of additional monetary stimulus in developed countries' central banks, depreciation risks and a wider current account deficit would be the trigger to a rate hike. Additionally, an increase in domestic demand also could make BanRep to turn a bit more hawkish. Our base case scenario involves strong domestic demand in 1H20, which we think will trigger one hike to 4.5% as soon as April 2020, although we are aware that domestic demand can surprise us to the downside if political and social uncertainty escalate and investment projects are postponed.

Another important topic that recently has been relevant for markets is the possibility that BanRep intervenes in the FX market if USDCOP continues to weaken. Banrep's Board members have said that, although mechanisms are already set up, any kind of FX intervention is currently not under discussion within the Board. Additionally, it is worth remembering that despite 90% COP depreciation in 2015–2016 BanRep did not intervene in the FX market, arguing that Colombia has a flexible exchange rate. Thus, although the exchange rate touched historical highs back in November 2019 we do not see the possibility of BanRep's intervention in the short run.

The 2019 USDCOP weakness was mainly explained by three factors: i) High external imbalance creates a structural and natural demand for dollars that produces depreciation. In fact, the current account deficit reached approximately USD14bn that although well-financed naturally pushed the exchange rate up; ii) External uncertainty due to political and social conflicts around the world triggered risk aversion in big trust funds that liquidated some EM assets and strengthened the dollar against the majority of currencies; and iii) In Latam there was an amplified effect from the global risk aversion due to the regional social unrest that characterized some of the big economies in the region. We think that Trump's campaign ahead of the 2020 US elections may ease the external uncertainty and the USD could weaken. Additionally, in our base case scenario, regional political and social unrest already peaked, and therefore currencies should stabilize a bit in the region. Therefore we expect a mild appreciation of the USDCOP this year although it will be similar to last year's average. For 2020 we think USDCOP will end the year at 3,250 and, on average, the Colombian exchange rate will hover around 3,280.

SOCIAL UNREST IS CONTROLLED, AND DEMANDS ARE FAR FROM CHANGING THE STATUS QUO

Despite protests having lasted longer than initially anticipated, economic and confidence losses have been contained. In fact, preliminary calculations are such that during the most violent and difficult days of the protests (November 21–22) economic losses were between 0.07 and 0.09pp of GDP in nominal terms, and after protests became peaceful, commerce and industry went back to normal. So far, protests have lost steam in number of people (from around 300,000 people on the 21st to less than 1,000 people in recent protests), and protest leaders' petitions have been related to the tax reform that was already passed in congress and reforms of pensions and labor that are not yet under discussion in congress. Therefore, none of the disagreements are trying to change the status quo of a pro-market economic model or change any institutions such as congress, the presidency, central bank independence, free-floating exchange rate framework or fiscal rule. Therefore we have not changed our forecasts due to recent social unrest since we see it as controlled with little significant effect on economic activity.

Having said that, this mild social unrest skewed economic activity risks to the downside for two reasons: i) Duque's governability was shown to be weak and tax reform turned out to be much more costly to the fiscal side. Thus government has to adjust other expenditures to comply with the fiscal rule; and ii) protests can increase uncertainty and make some agents postpone investment projects.

Finally, fiscal and external imbalances continue to be the main concern for longer-term Colombian economic stability. Current account deficit continued to widen in 3Q19 and came in at 4.9% of GDP, although 100% financed by FDI. After negotiations with protesters, the tax reform passed in congress in December 2019 reduced government revenues by 0.3pp of GDP, mainly on the back of VAT rebates to the most vulnerable 20% of the population, which puts more pressure on already tight fiscal accounts after cutting corporate tax from 37% to 32% and with tax evasion estimated to cost 0.5pp of GDP.

Peru

2020: NO REAL ACCELERATION IN GROWTH, BUT GOOD MACRO BALANCES AND LOWER POLITICAL TENSION

- **There has been a sharp decrease in political tension that will likely continue in 2020, despite a new Congress, more corruption news, and the uncertainty of the 2021 elections.**
- **The government is focused more on policy, but not actively enough.**
- **Headline GDP growth will be higher in 2020 (3.0% versus 2.3% in 2019), but the difference is not really material.**
- **Private investment appears to be reviving, but we need more continuity to be convinced.**
- **The PEN is consistently stronger than expected. We're revising our 2020 year-end forecast from 3.42 to 3.35.**
- **The government softens its fiscal rules, even as fiscal accounts surpass expectations.**

Politics has finally taken a back seat to policy, since President Vizcarra legally maneuvered a closing of Congress in September and called for new Congressional elections to take place on January 26th. Political news hasn't disappeared, and corruption and controversies that have led to three cabinet members being replaced have continued to headline newspapers, but political tension has eased, and there is more confidence now that there is a clear electoral path forward. Business sentiment has improved, and the remaining malaise is now more linked to weak economic growth than to politics.

Now that it need not contend with Congress, the government is more focused on the economy and social policy, and has issued a number of decrees with economic and social overtones. Although many of the measures are simply housekeeping (renewing tax exemptions, for example), a number are of greater importance, and point to the direction the government wishes to take. Among these are measures to accelerate 52 high-priority infrastructure projects by dealing with the legal/regulatory obstacles. The government is indeed showing that it is motivated to increase public sector investment, even though it hasn't really been successful in doing so.

As we enter 2020, we are maintaining nearly all of our forecasts for the year. The one exception is the Peruvian sol (PEN), which ended 2019 at 3.31, versus our forecast of 3.35. Given this lower start, together with the ongoing strength of the PEN, and the relatively unexpected improvement in terms of trade, we are revising our 2020 year-end forecast from 3.42 to 3.35. Global uncertainty, a reversal in metal prices, or local political uncertainty (the elections period will begin in earnest at the end of 2020), are risks. However, one of the significant messages given in 2019 was that the PEN has proved exceedingly resilient to local and global uncertainty.

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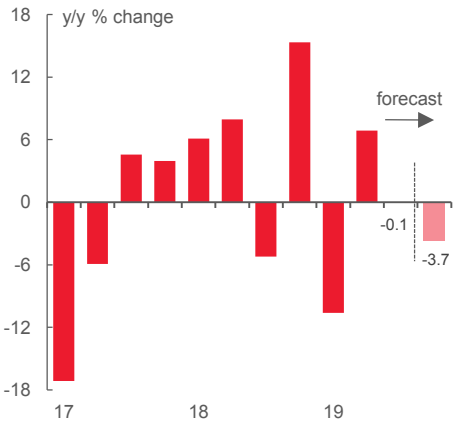
Peru	2018	2019e	2020f	2021f
Real GDP (annual % change)	4.0	2.3	3.0	3.5
CPI (y/y %, eop)	2.2	1.9	2.0	2.3
Central bank policy rate (%, eop)	2.75	2.25	2.25	2.50
Peruvian sol (USDPEN, eop)	3.37	3.31	3.35	3.35

Source: Scotiabank Economics.

Chart 1

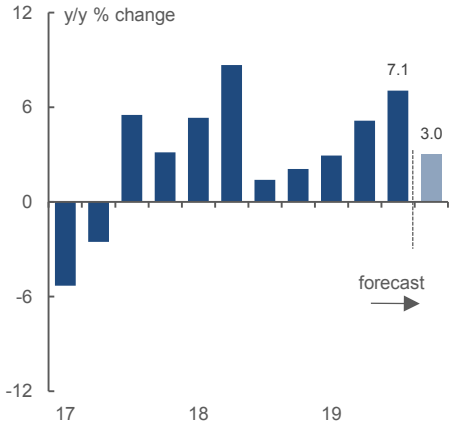
Quarterly Public Investment Growth



Sources: Scotiabank Economics, BCR.

Chart 2

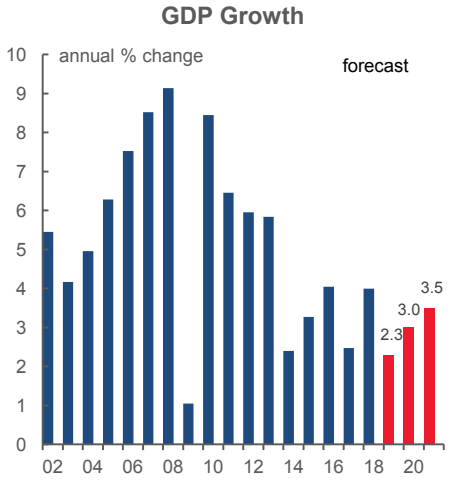
Quarterly Private Investment Growth



Sources: Scotiabank Economics, BCR.

Another figure we shall be taking a closer look at, once the final 2019 full-year number is released in mid-January, is the 2020 fiscal deficit. However, the change is likely to be mild and not really material. The 2019 fiscal deficit to November was 1.6% of GDP, and is likely to come in at or below our 2% forecast for the full year. This not only reflects weak public spending growth, which is trending at only 1%, but also robust tax revenue, which is rising at a healthy +8% clip, apparently reflecting a better job by the government at collecting sales taxes.

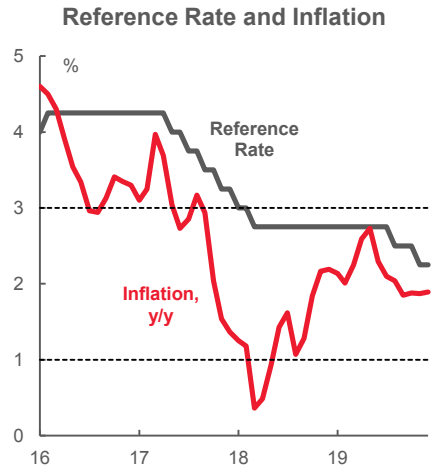
Chart 3



Sources: Scotiabank Economics, BCR.

Meanwhile, in December, the government changed the fiscal deficit ceilings for 2021 to 2024. The debt ceiling for 2020 remains at 1.8%. The new ceilings are: 1.8% of GDP for 2021, 1.6% for 2022, 1.3% for 2023, and 1.0% from 2024 onwards (previous: 1.0% from 2021 onwards). These revised ceilings are feasible and more realistic. The new 2021 ceiling coincides with our forecast. For 2020, our forecast is 2.0%, which actually looks a little high given the fact that the deficit is trending under 2% as we close 2019. Note that these ceilings are legally binding (non-compliance is not punished, however), although they will need to be ratified by Congress once a new Parliament is in place.

Chart 4



Sources: Scotiabank Economics, BCR, INEI, EE.

We are maintaining our GDP growth forecast for 2020 at 3.0%, even though 4Q2019 is appearing mildly weaker than expected. GDP growth for October was a disappointing 2.1%, and growth is trending at 2.2% for the year, just below our 2.3% full-year forecast. Most sectors are performing as expected, but the exceptions—manufacturing and construction (1.2%)—are key to domestic demand. The basic story for 2020 hasn't changed much. It is likely to feel very much like 2019 in terms of domestic demand. Some of the improvement will come from resource sectors (although less so than we initially thought, as the current fishing season is turning out to be dismal), some will come from public sector investment, specifically from regional and local governments which, if precedent holds true, will begin spending more in their second year in office. Finally, some improvement may come from private investment. This is new. Private investment performed mildly better than expected in the second half of 2019. If there is any hopeful sign in terms of growth, this is it. Our forecast of 1.1% private investment growth for 2020 now seems to have more upside to it than we initially thought. Consumption growth will remain stable. Exports may also add a couple of decimal points to growth, as agroindustry continues booming, and mining output stops falling. We are forecasting 3.5% growth for 2021, but admit that uncertainty is so high in this election year (who will win?) that the number is more referential than anything else. The assumption is that the new government will be not only sufficiently market-friendly, but also at least adequate in terms of governance.

Inflation for full-year 2019 came in at 1.9%, in line with our 2.0% forecast. We see no looming inflationary pressures in 2020, and, therefore, expect a repeat of close to 2% inflation for the year.

The Central Bank kept its rate at 2.25% in December, as expected. The forward-looking statement given by the CB was very neutral. With inflation hovering around the Central Bank's sweet spot (not too high, not too low), the CB is likely to focus more on growth in determining its reference rate policy in 2020. In 2019 two arguments swayed the CB decision to lower rates: 1. GDP growth significantly below the CB's expectations, and 2. lack of fiscal stimulus, and, therefore, a perceived need for the CB to compensate. Although both factors will likely persist in 2020, they will do so to a much lesser degree, which makes it difficult to determine whether the CB will continue lowering rates. Given this grey area, and the fact that the CB officials do not really seem comfortable reducing rates, we maintain our expectation that it will not reduce rates further in 2020, but consider it a close call.

Chile

SOCIAL UNREST WILL DELAY BUT NOT PREVENT ECONOMIC RECOVERY

- **The social protests of October have increased political uncertainty, affecting business conditions. Accordingly, we have updated our GDP growth projections to 1.0% and 1.4% for 2019 and 2020, respectively. In the political arena, lawmakers have agreed to an April 2020 referendum on changing the Constitution.**
- **We have modestly adjusted downward our forecast for investment growth to 3.8% and 4% for 2019 and 2020, respectively, since a significant amount of public and private investment is at advanced stages of construction. Additionally, higher political and economic uncertainty will probably deepen the deceleration in household consumption, postponing the recovery in domestic demand.**
- **Financial markets saw increased volatility in October and November, along with a significant depreciation of the peso following the first weeks of the outbreak, but volatility eased toward year-end after a successful FX intervention and liquidity provision by the Central Bank. We do not discard the possibility of new outbreaks of volatility during the year.**

MACRO UPDATE

GDP for 3Q19 confirmed the Chilean economy was going through a process of sustained recovery, although not across all sectors. Weak consumption of durable goods contrasted with the solid growth in consumption of services and investment in construction. All in all, as of September, we projected a GDP expansion of 2.7% for 2019. However, the social outbreak of October prompted significant changes in the economic outlook, and we now forecast a GDP growth of 1.0% for this year. This social unrest started when Metro de Santiago, the capital's subway operator, raised the price of its tickets, just weeks after the government announced a 10% hike in electricity bills. This triggered massive protests in several cities around Chile, with waves of violence that had a significant short-term impact as many industries were paralyzed and looting took a toll on infrastructure (chart 1). In the medium-term, the loss in confidence measures will certainly impact investment and consumption decisions (chart 2).

As of September, projected investment projects were increasing and the outlook for this sector was optimistic, especially in the mining industry. But then, the social protests arose and many investment projects suffered changes. It is notable that, according to the investment land tax register published by the *Corporación de Bienes de Capital*, most of the projects in the pipeline for the period 2019–2023 are already under construction, which makes it hard for them to be cancelled. Nevertheless, we do expect a delay in projects that are in preliminary stages (conceptual, basic and detailed engineering), especially in non-tradable sectors. But we still forecast stable growth through 2019 and 2020, although we acknowledge there has been a downward correction in this component.

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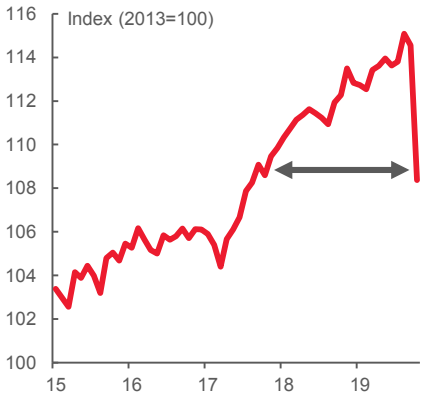
Chile	2018	2019e	2020f	2021f
Real GDP (annual % change)	4.0	1.0	1.4	3.0
CPI (y/y %, eop)	2.6	3.0	2.9	3.0
Central bank policy rate (%, eop)	2.75	1.75	1.00	2.00
Chilean peso (USDCLP, eop)	694	753	700	680

Source: Scotiabank Economics.

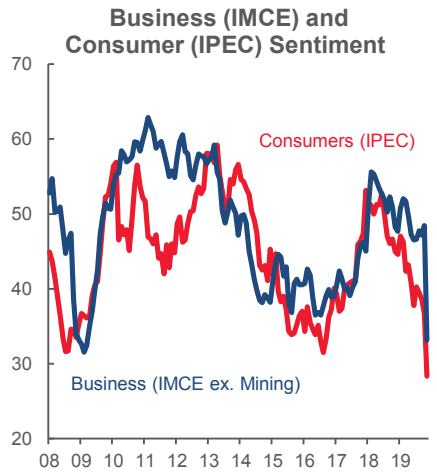
Chart 1



Sources: Scotiabank Economics, Central Bank of Chile.

Throughout most of 2019, household consumption was experiencing a deceleration related to higher precautionary savings. This was the result of rising external risks associated with the trade war. In contrast, disposable income was growing at a stable pace as of September. But then the events of October took place, which increased uncertainty levels domestically, and we anticipate a deepening of this precautionary savings behavior, postponing the recovery in confidence and domestic demand. In addition, we have seen a multilateral depreciation of the real exchange rate, which has also contributed to the increased cost of consumption. To compensate for this decline in private consumption, the Government has announced a massive fiscal package, proposing measures that entail a major increase in fiscal spending in 2020, which should be the main driver of growth next year. This increase in government spending is similar to the one implemented after the subprime crisis of 2008.

Chart 2



Sources: Scotiabank Economics, Adimark GFK.

The labor market is already showing signs of deterioration, as reflected in various sources of information. Even though the unemployment rate remained at 7% in October, the impact of October events will be seen in the coming months. On the one hand, the labor market shows weakness in private jobs, especially in manufacturing and commerce, as these sectors have seen reductions in wage-earners jobs. On the other hand, there are still many investment projects under construction, which will require labor force and thus will likely offset the damage in the labor market caused by the social protests of October. We project the unemployment rate will reach 8.5% in 2020.

Inflation normalization is progressing but at a slow pace. The path of inflation in the monetary policy horizon will be determined by two key factors: lower inflationary pressures deriving from widened capacity gaps, and; cost-push pressures above those previously considered, in particular because of the idiosyncratic nature of the recent peso depreciation. The uncertainty that surrounds the future evolution of the macroeconomic scenario is higher than normal, but we forecast an annual inflation slightly above 3% during the first half of 2020, followed by a deceleration toward 2.9% by December next year. Thus, we anticipate the widened capacity gap effect to dominate in the coming months.

Given this scenario, we expect the Central Bank to cut the Monetary Policy Rate to 1.0% by the first half of 2020. The widening of output gaps, in a context of controlled inflation, requires a larger monetary stimulus that could only be reached with a lower MPR. In addition, the FX intervention has been successful, which increases the scope of the Central Bank to expand its monetary stimulus.

In the FX market, we experienced a sharp depreciation of the peso in November—reaching historical levels—and high volatility, leading the Central Bank to intervene. This intervention, followed by a mitigation of violence and political uncertainty, has led the peso to appreciate more than CLP80 (~10%) since late-November. We still expect high volatility in the FX market, especially as the referendum for a new constitution approaches (it will be held in April 2020).

All in all, the Chilean economy suffered a significant shock in October, prompting a change in activity and financial indicators. We have updated our estimates in the short run, but we acknowledge the level of uncertainty has risen sharply, and we still await more economic releases to better assess the impact of this social outbreak.

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