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Economics Newsletter

Regional analysis by Ec. Javier De Haedo

October 2021

Global Outlook

A new edition of the World Economic Outlook (WEO), produced quarterly by the staff of the International Monetary Fund (IMF), was released mid-October:

The IMF projects that the global economy will grow 5.9 percent this year (0.1 percentage point lower than in the July forecast) and 4.9 percent next year. Meanwhile, a global economic growth rate of 3.3% has been projected for the medium term. According to the IMF, the *"rapid spread of Delta and the threat of new variants have increased uncertainty about how quickly the pandemic can be overcome."*. In this context, *"the balance of risks for growth is tilted to the downside."*

The IMF also states that "*headline inflation rates have increased rapidly in the United States and in some emerging market and developing economies. In most cases, rising inflation reflects pandemic-related supply-demand mismatches and higher commodity prices compared to their low base from a year ago."* In this sense, *"inflation risks are skewed to the upside."*

If this risk materializes, it will anticipate monetary normalization in advanced economies, negatively affecting emerging economies and especially those with greater vulnerabilities.

Regarding recommendations on monetary policy, the IMF mentions that "although central banks can generally look through transitory inflation pressures and avoid tightening until there is more clarity on underlying price dynamics, they should be prepared to act quickly if the recovery strengthens faster than expected or risks of rising inflation expectations become tangible."

The issue on the table for the global economy is, without a doubt, the permanent or temporary nature of inflation. The consensus points to it being transitory, and in fact inflation rates implied in nominal and real Treasury yields would confirm this position.

However, these implied rates have recorded slight increases in recent weeks, both for the first five years and for the five years that follow. As of Monday, October 18, implied inflation for the first five years is 2.75% p.a. and 2.38% p.a. for the next five years. On September 24, they stood at 2.51% and 2.21%, respectively.

In the United States, inflation remains high across all indicators (CPI, PPI and PCE, both headline and core) but some moderation has been observed recently when considering seasonally adjusted changes over recent months. As for employment indicators, everything seems to indicate they have been affected by pandemic-related benefits, which are coming to an end. In any case, the main indicator of labor underutilization, the U-6 rate ("U-6") - which includes not only the unemployed but also the underemployed and the discouraged - has fallen steadily in recent months to 8.5% in September, slightly above the 7.0% level in February

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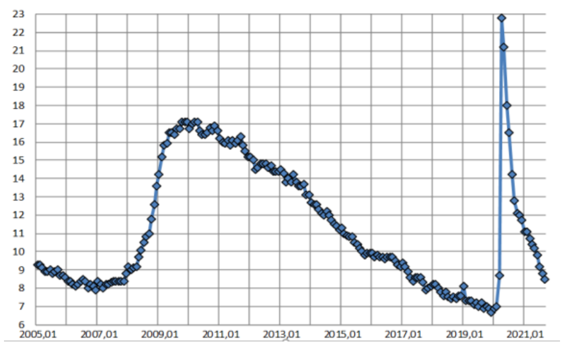
2020, prior to the pandemic's outbreak (see graph below).

In the Euro Area, inflation has also accelerated and reached 3.4% in September. Meanwhile, PMI indicators are clearly in positive territory, although they have fallen back in recent months. In September, the manufacturing PMI stood at 58.6 points and the services PMI at 56.4 points.

In China, GDP performed poorly in Q3, growing only by 0.2% in seasonally adjusted terms compared to Q2, bringing the year-over-year growth rate to 4.9%. What happened with the Evergrande real estate group is a sign of bad news that may come from China at any time, as a result of poor policies and bad regulations from the past which may affect bank balance sheets.

As for the countries in our region that are monitored in this Newsletter, the projected economic performance for the 2020-2023 four-year period (with the final data for 2020 and projections from the respective expectation surveys for 2021 - 2023) reveals a modest level of growth can for all countries. This is evidently a result of the sharp growth declines in 2020 and subsequent modest levels of growth. For the four-year period, Brazil is expected to grow by 4.4%, Uruguay by 3.2%, the Mexican economy by 2.1% and Argentina by only 1.3%. These are all very lackluster growth rates for a four-year period (see chart).

The U-6 rate in the US
Alternative indicator of labor underutilization



Source: BLS

	2020	2021	2022	2023	2020-23
Balance of the 2020 – 2023 period					
According to expectations for 2021 to 2023					
Mexico	-8,5	6,2	3,0	2,0	**2,1**
Brazil	-4,1	5,0	1,5	2,1	**4,4**
Argentina	-9,9	7,6	2,3	2,1	**1,3**
Uruguay	-5,9	3,0	3,5	2,9	**3,2**

Compiled based on expectation surveys from the respective central banks.

Brazil

Inflation continues to be well ahead of the SELIC rate, even though the latter has already had successive increases and is growth rate has risen. It reached 6.25% at the COPOM meeting on September 22, when it was once again anticipated the rate will increase by one percentage point at the next COPOM meeting. However, inflation reached 10.25% in the 12 months to September and 6.83% for the core indicator, well above the target range of 3.75% plus and minus 1.50%.

In its latest statement, the COPOM highlighted that, *"(its) baseline scenario for inflation encompasses risk factors in both directions. On the one hand, a possible reversion, even if partial, of the recent increase in the price of international commodities measured in local currency would produce a lower-than-projected inflation in the baseline scenario. On the other hand, further extensions of fiscal policy responses to the pandemic that increase aggregate demand and deteriorate the fiscal path may pressure the country's risk premium. In spite of the recent improvement of debt sustainability indicators, the elevated fiscal risk creates an upward asymmetry in the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy."*

The uncertainty coming from the political arena, where polls point to President Bolsonaro easily losing next year's elections against former President Lula de Silva, and where the President's impeachment risk is always present, does nothing to calm the situation. Thus, the dollar is volatile and standing at higher levels than those of recent months. From an average of BR$ 5.25 in August and BR$ 5.29 in September, it has jumped to an average of BR$ 5.48 during the first half of October (as of October 18). Exchange rate instability is also fueled by continuing doubts regarding the future of fiscal and reform issues.

In terms of economic activity, the saying "all that glitters is not gold" is well worth quoting. The consensus points to a growth rate of 5% this year, but if we look at the numbers closely, almost all of it is a statistical carry-over from 2020, that is, a "legacy" from last year and not "new" growth this year. This becomes clear if we compare the December value for the monthly indicator of economic activity, the IBC-Br, versus the average for the year, resulting in an increase of 4%. In other words, at the beginning of 2021 there was already a 4% growth floor from last year. In addition, the

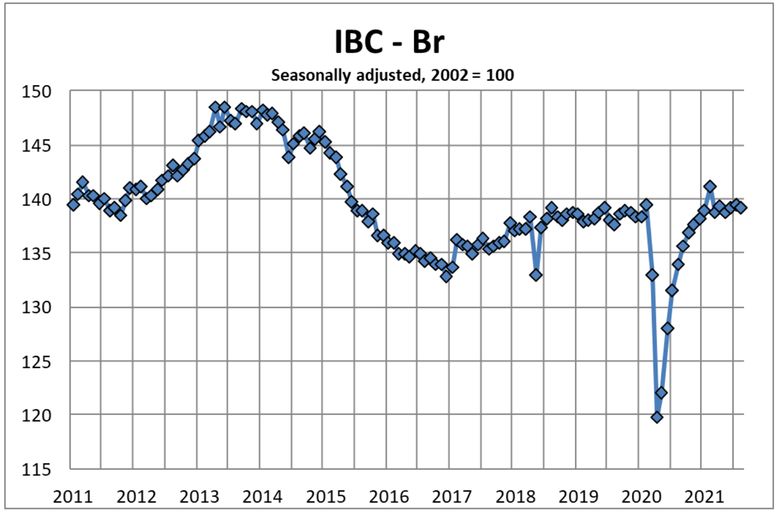
Brazil

growth expectations of Brazilian economists and consultants are being revised downwards from week to week (see graph).

On the fiscal front, further progress continues to be made. In the 12 months to August, the primary balance was -1.6% of GDP (-9.5% in 2020) and the nominal balance was -5.6% of GDP (-13.7% in 2020). Meanwhile, the general government gross debt, which had reached 90% of GDP in February, fell to 82.7 points in August.

Finally, the FOCUS expectations survey conducted weekly by the BCB projects GDP growth at 5.01% for 2021, 1.50% for 2022 and 2.10% for 2023. Inflation is expected to reach 8.69% this year, 4.18% in 2022 and 3.25% in 2023.

In terms of the dollar, expectations point to a closing price of BR$ 5.25 in both 2021 and 2022, and BR$ 5.10 in 2023. And as for the SELIC rate, it is expected to increase by a further two points this year (to 8.25%), and to close at 8.75% in 2022 and 6.50% in 2023.



Compiled based on IBGE and BCB data.

Argentina

Since the previous edition of this Newsletter, the PASO elections took place in Argentina. Although they are only internal elections held by parties to define candidates for the mid-term legislative elections of November 14, their results were interpreted as a preview of what may happen in the future. And, from that point of view, they were a resounding defeat for the current government, which faced a severe internal crisis in the days that followed and led to cabinet changes, including its leadership. However, the economic team led by Minister Guzmán remained unchanged. In any case, if the projected results for November are confirmed, new changes are expected to take place in how the Argentine government will be constituted.

Once the PASO results were announced, two apparently contradictory paths emerged.

On the one hand, talks with the IMF were resumed in order to reach a new agreement for debt restructuring (at some point after the November elections but before March). It is difficult to imagine that the political conditions are in place for an agreement of the "extended facilities" type, designed for the medium term, with macroeconomic adjustments and structural reforms. But the IMF needs Argentina not to default and therefore, perhaps the middle way is a "light" agreement, which takes care of appearances and does not result in anything substantial.

On the other hand, the " model" was given a new twist: import restrictions were tightened in order to stop reserves from draining; a new price control will be imposed between October and the beginning of next year; a very strong fiscal expansion will be implemented for electoral purposes, and this expansion will be financed by printing money. This explosive combination may suppress inflation in the more immediate term, but it may also make it soar in the medium term, namely by 2022. In other words, “short-term gain, long-term pain."

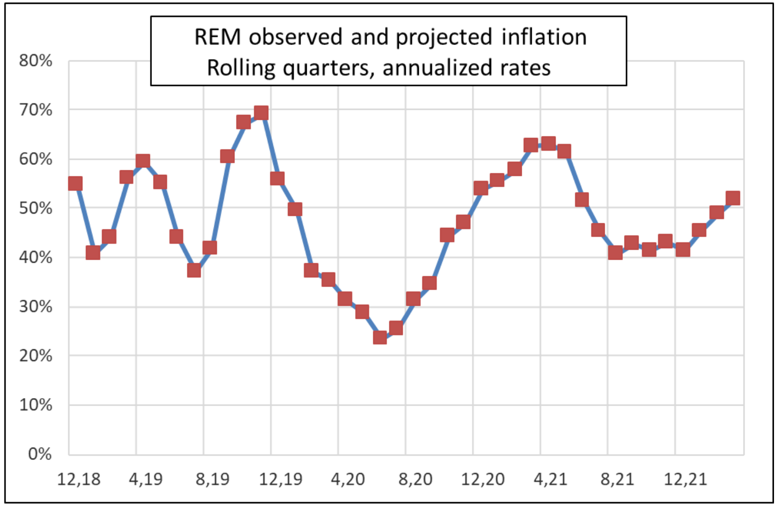
In the previous edition of this Newsletter, we warned that there had been a fiscal and monetary break in June, when the BCRA started to assist the Treasury. This was fully confirmed

Argentina

in Q3 where - excluding the effects of creative accounting related to SDRs the IMF lent to the Government - the BCRA had an expansionary position that benefited the National Treasury in AR$ 688 billion. Likewise, during that quarter the BCRA sold dollars (as opposed to what happened in the first half of the year) for AR$ 183 billion.

Meanwhile, despite price controls, continued subsidies and a slowdown in the rate of decline of the US dollar, inflation has not budged and stood at 3.5% in September - above expectations - bringing the annual rate to 52.5%. Inflation has been declining throughout the year, with annualized rates of 63%, 52% and 43% respectively over the three quarters already elapsed. However, the expectations arising from the BCRA survey (REM) indicate it will remain stable in Q4 and once again stand at above 50% in Q1 of next year. This is consistent with the current monetary expansion and expectations of a certain post-election correction in relative prices (see graph).

As for the level of economic activity, we can say something similar to what was mentioned about Brazil: most of the economic growth expected for this year (7.6%) is “inherited” from 2020 (5.8% is the statistical drag according to the EMAE).



Compiled based on INDEC and BCRA’s REM survey

Mexico

The monetary policy rate was raised once again by one quarter of a point - the third consecutive increase - at the meeting of the Board of Governors of the Banco de Mexico on September 30, bringing the monetary policy rate to 4.70% (see graph next page).

Inflation stood at 6.00% in the last 12 months through September, while the core indicator reached 4.92%, both clearly above the target of 3% plus and minus 1%. While the year-over-year growth of the headline index has remained relatively stable, that of the core index has accelerated, now reaching its peak.

The monetary authority based its decision on the fact that *"although the shocks that have increased inflation are expected to be transitory, due to their variety, magnitude, and the extended horizon over which they have affected it, they may pose risks to the price formation process and to inflation expectations."*

In its statement, it pointed out that *"In domestic financial markets, the volatility of the peso exchange rate and interest rates have increased.*

The recovery of the Mexican economy continued during the third quarter and is expected to endure for the rest of the year and 2022. Uncertainty about the pandemic persists and slack conditions are anticipated, with significant differences across sectors. Global inflationary pressures and bottlenecks in production continue affecting headline and core inflation."

It also stated that *"annual headline and core inflation projections are expected to decrease, particularly for one year and beyond, and to converge to the 3% target by the end of the forecast horizon. These forecasts are subject to risks. On the upside: external inflationary pressures, cost-related pressures, core inflation persistence, exchange rate depreciation and increases in agricultural and livestock product prices. On the downside: a widening of the negative output gap, additional social distancing and exchange rate appreciation. The balance of risks for the trajectory of inflation within the forecast horizon is biased to the upside."*

According to the latest expectations survey released by Banxico, a 6.20% growth rate is expected for 2021, 3.00% for 2022 and 2.00% for 2023. The survey projects inflation at

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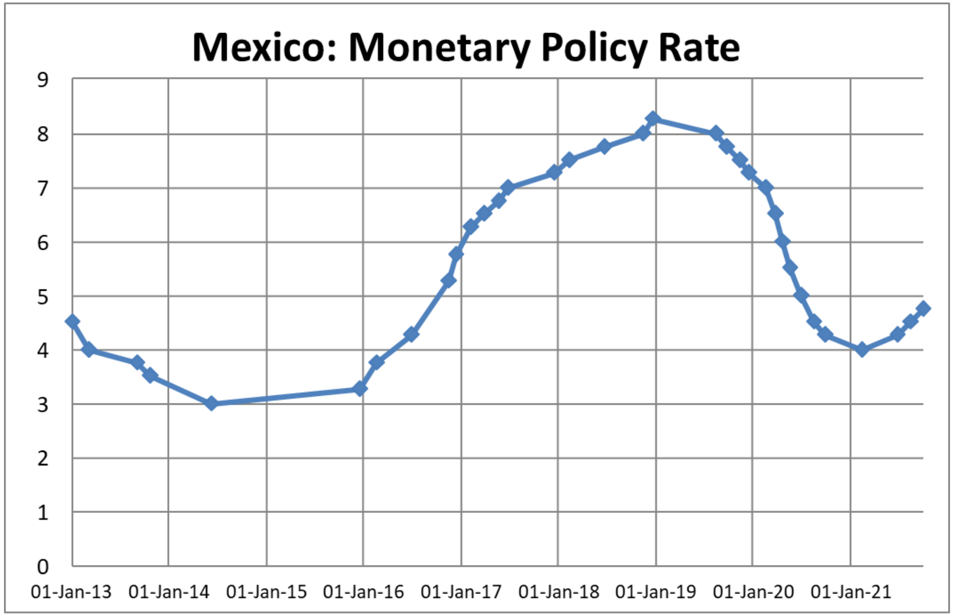
Mexico

6.28% for this year, 3.80% for next year and 3.53% in 2023, with a year-end exchange rate of MXN 20.30 in 2021, MXN 20.99 in 2022 and MXN 21.20 in 2023.

Regarding other confidence and activity indicators, the following stand out:

- Business confidence recovered after the initial pandemic shock and peaked at 52 points in June. It remained high in September at 51.2 points.
- Consumer confidence has had a similar run, but the June peak came in below the 50-point mark (44.2 points). Meanwhile, the September indicator stood at 43.4 points.
- The manufacturing PMI has been hovering around 48 points since April and stood at 48.6 points in September. Industrial production grew 5.5% y-o-y in August and retail sales grew 9.9% y-o-y in July.

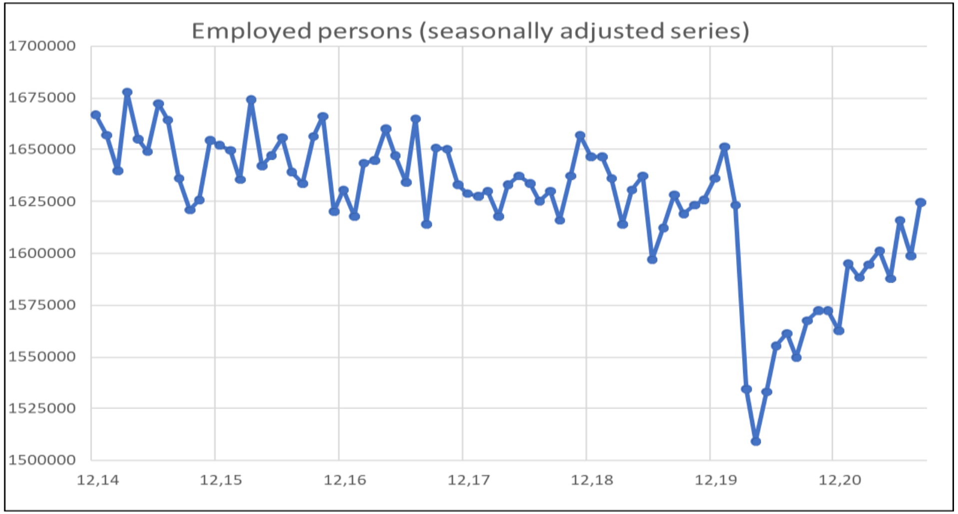


Source: Banxico

Uruguay

In Uruguay, GDP growth for the second quarter was 0.9% in seasonally adjusted terms, resulting in a year-over-year change of 11.3% compared to the pandemic's worst impact point in terms of economic activity. Despite this, economic activity was 2.8% below its Q4 2019 level, before the virus reached the country.

Although Uruguay does not have an official monthly estimate of economic activity, consensus forecasts show that in Q3 the economy returned to growth, and the government expects GDP to end the year with a 2021 growth rate of 3.5%. Accordingly, employment in August already reached the pre-pandemic level of February last year, considering seasonally adjusted figures (see graph).



Compiled using INE data

In terms of activity sectors, construction stands out for having spearheaded growth over the last two years. The installation of the third pulp production plant – Finnish UPM's second one - on the Negro River in the center of the country, has been decisive in this regard. Both construction (among sectors) and investment are among the components of aggregate supply and demand that display significant growth largely due to this project currently under construction, as well as the railroad that will connect it with Montevideo's port.

Things are still not going well in terms of inflation, which has remained above the target range (5% plus and minus 2%), as per usual in Uruguay. In the 12 months to September the CPI was up 7.4% but

Uruguay

core inflation was 7.9%. Th expectations of both economists and businesses remain above the target: over the 24-month monetary policy horizon, the former expect inflation to be 6.3% and the latter 8%. The target range for that 24-month horizon has been set at 3% to 6%.

In this context, the BCU has already raised the monetary policy rate twice, from 4.5% to 5.25%, but this has not affected expectations. This is because expectations consider not only monetary policy, but also wage policy - where CPI indexation remains in place, together with commitments to "recover" real wages lost due to the pandemic - and fiscal policy, which continues to run a high deficit, partly due to coping with the virus crisis.

On this topic, it is worth noting that fiscal performance continues to be acceptable, with a deficit of 5.1% of GDP, of which one third is due to the "COVID effect". However, even subtracting the COVID effect, the fiscal deficit is still clearly above the level that would stabilize the debt to GDP ratio, which is estimated at 2% of GDP.

According to the September economic expectations survey conducted by the BCU, GDP is expected to grow 3% in 2021, 3.5% in 2022 and 2.9% in 2023. In terms of inflation, projections are 7.2%, 6.7% and 6%, respectively. And for the exchange rate, the forecast is UY$ 43.4 by the end of 2021, UY$ 45.5 by the end of 2022 and UY$ 48 by the end of 2023.

Finally, one last comment regarding the possible referendum over the Urgent Consideration Law approved last year, which includes several public policy changes and is one of the government's milestones. Even though the process of verifying signatures presented to oppose part of this law (which is conducted by the Electoral Court) is still ongoing, everyone assumes there will be a referendum next fall. This is anticipated to be a "mid-term election" of sorts in Uruguay, where rather than the content of this law, arguments will be made and votes will be cast for and against the government.

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Thank you!

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