



## Americas: Economic Review February 2010

Even as the global recovery continues to gain strength, attention has shifted to some of the key long-term risks to growth. The most alarming is the worsening public debt in several economies, especially in Europe. The fiscal crisis in Greece may slow down the entire Euro-zone, where economic growth crawled to nearly a standstill during the last quarter of 2009. It appears that several other economies in the region, including Spain, Portugal, and Italy may face worsening fiscal conditions in the coming years. Though far less worrisome, the rising public debt in the U.S. and the U.K. will also keep investors concerned.

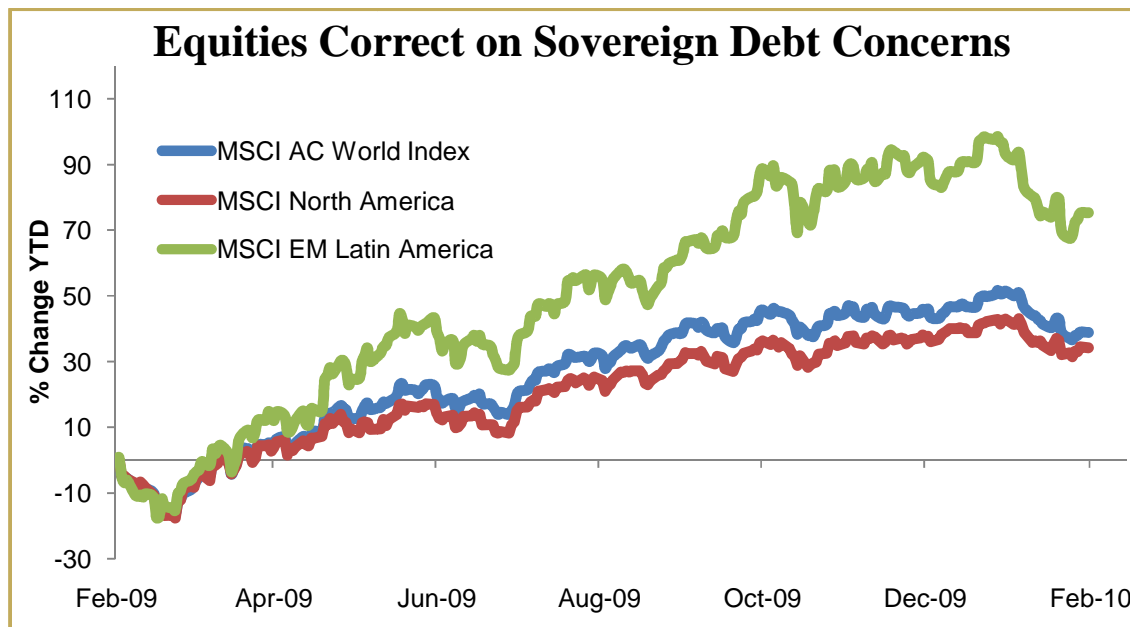
### At a Glance

- **United States:** Though most leading economic signals continue to gain strength, concerns about rising public debt and other long-term risks have increased. The Fed has detailed its exit strategy and has initiated some of the early steps.
- **Canada:** The stronger than expected recovery in the housing market has led to fears of another bubble, forcing the government to tighten mortgage rules.
- **Brazil:** As manufacturing is growing at a record pace, the economy is adding new jobs. This will likely lift consumer spending further and increase inflation expectations.
- **Mexico:** The recovery in industrial activity has lifted capital investments and further gains are expected this year. GDP growth forecasts have been revised higher by the government.
- **Argentina:** Investor concerns about the country's economic governance standards worsened after the new central bank chief appeared ready to accept directives from the government.
- **Chile:** Higher export demand continues to drive the economy, which recovered during the last quarter of 2009 after declining for the previous three quarters.
- **Peru:** The economy accelerated further in December as domestic consumption also seemed to be picking up. The central bank left its benchmark rate unchanged.
- **Colombia:** Though the country's economic recovery has been slower than expected, the central bank continues to hold interest rates steady on inflation fears.

Investor apprehensions about sovereign debt problems will increase if the global economic recovery sheds pace later this year. Unless the governments and central banks are dexterous enough in timing their stimulus exits perfectly, slower growth remains likely. The Asian economies, which have led the global recovery, may be forced to withdraw the fiscal and monetary stimulus earlier than expected. China has already taken several such steps, including the recent move to increase bank reserve requirements to cool down credit growth.

Economic data from most countries in the Americas region have shown further improvement this month. While the recovery in many of the regional economies was initially driven by external demand and higher commodity prices, domestic demand is now picking up in several of them. Despite the improved signals, governments remain committed to sustain higher public spending this year as well. As inflation remains contained across the region, central banks, without exception, have left their benchmark rates unchanged.

With the notable exceptions of Argentina and Venezuela, the fiscal conditions in Latin American countries are better than any time before. Several years of prudent policies and building of reserves from excess export earnings have brought down their debt levels and increased their ability to step up public investments. Unlike in earlier years, these countries do not face any difficulty in issuing new bonds or refinancing existing debt, which will help them sustain the growth momentum.



## **United States: Higher fiscal deficit and public debt cast shadow over long-term economic outlook**

**Forecasts about the fiscal deficit and total public debt in the latest budget documents have once again attracted investor attention to the worsening fiscal situation in the U.S.** Though the fiscal deficit, expected to touch double-digits this year, is forecast to decline over the next few years, total public debt will continue to rise in relation to the GDP. These measures could become worse if economic growth falls short of budget projections. One of the credit raters has warned that the country's AAA sovereign rating may come under pressure, unless economic growth exceeds expectations or efforts to cut down the deficit are more aggressive. While it is highly improbable that the rating will be downgraded, the warning highlights one of the major long-term risks facing the U.S. economy.

**As the labor market recovery has been muted, despite the overall economic recovery, the administration has included measures to boost employment in the budget.** The new budget includes a tax credit for employers, initiatives for creating new jobs and tax benefits for small businesses, besides an extension of the existing programs.

**The Federal Reserve detailed the planned exit from the extraordinary monetary measures initiated since 2008 to stabilize the financial markets.** The Fed suggested that it may pay a higher interest rate on excess reserves held by banks, which may become its primary policy tool for a while. The Fed is in the process of winding down the emergency liquidity facilities for banks and this month increased the discount rate charged on emergency loans to banks. However, the central bank remains committed to keeping the target federal funds rate low until the economic recovery gets a stronger hold.

**Meanwhile, most leading economic indicators have sustained the uptrend.** Manufacturing activity in January was at its strongest in several years, and further gains in the new orders index suggest sustained manufacturing growth in coming months. The services sector also showed expansion in January. Though the University of Michigan Consumer Sentiment Index eased moderately this month, last month's retail sales growth exceeded expectations. The Chicago Federal Reserve's National Activity Index, an indicator of the broader economy, turned positive in January, suggesting that economic activity is returning to normal.

## **Canada: Fears of a housing bubble invite tougher mortgage rules**

**Canada continues to outpace several other developed economies in the strength of its recovery.** The initial phase of the recovery was supported by increased demand and better prices for energy and other commodity exports. As industrial activity improved, it led to a swift recovery in the jobs market, and in recent months, lifted domestic consumer demand. The economy added 43,000 jobs in January and the unemployment rate declined. Retail sales have been trending higher for the last several months, except for a modest decline in November. Meanwhile, with both exports and imports growing, the momentum in external trade continues.

**Just as the economic outlook has turned stronger, the stronger than expected recovery in the housing sector has led to fears of another bubble taking shape.** Among developed markets in 2009, the recovery in average home prices was the highest in Canada. Sales of existing home sales jumped more than 70% in December and housing starts increased again in January. By several measures, home prices are now above their long-term averages. To reduce the risk of an asset price bubble, the Canadian government has proposed to tighten the mortgage standards beginning in April. Borrowers will have to meet higher credit standards and make a higher down payment of 20%.

**The housing market recovery was partly fueled by low mortgage rates, as the Bank of Canada left its benchmark rate unchanged at 0.25% since last April.** Consumer prices increased more than expected in January, but remain below the central bank's target. The central bank is committed to keeping the benchmark rate steady at least until June this year.

## **Brazil: Record industrial growth and job additions heighten inflation fears**

**Unlike most developed economies where employment has lagged the recovery, emerging economies like Brazil are seeing robust job growth. Job additions in Brazil for the month of January were at a record high, and the trend is expected to continue this year.** As in other economies, the recovery is the most robust in manufacturing. During the month of December, manufacturing output jumped nearly 20%, the biggest ever monthly increase reported.

**The acceleration in industrial activity in recent months has been partly fueled by increased investments in capacity expansion.** While sustaining the industrial growth momentum in the short term, capital investments will prevent capacity shortages and the resultant price pressures in the future. Infrastructure investments related to the 2014 Soccer World Cup and the 2016 Summer Olympics alone are estimated to touch \$85 billion. The government may also invest nearly \$11 billion to improve the communication infrastructure, providing capital support to a state-owned communication services provider.

**However, concerns about higher inflation have increased in recent months. In January, the consumer inflation rate exceeded expectations and was above the central bank's target.** The improvement in domestic demand has narrowed the capacity surplus in the economy and may push up prices, the central bank noted. Though the central bank left its benchmark rate unchanged at its most recent meeting and suggested that it may not hike the rate before April, faster rate increases are now expected for later this year.

### **Mexico: Higher capital investments to sustain economic growth this year**

**Encouraged by the improved economic signals, the Mexican government has lifted its GDP growth forecast for the current year to nearly 4%.** After last year's 7% decline in economic output, the revised growth rate is impressive. The demand recovery for exports, especially from the U.S. which is the biggest market for Mexican goods, has fueled a revival in manufacturing. Output increased more than expected in December, the first gain in over 18 months. The improvement in automobile manufacture is the most striking. Automobile production is estimated to rise 20% this year, with a 10% increase forecasted in domestic sales.

**As both external and internal demand picks up, there are signs of a revival in capital investments as well. The index of capital formation, tracked by the central bank, has gained in recent months, as the import of capital goods increased.** However, the uptrend continues to be disproportionately dependent on increased public spending. The country's National Infrastructure Fund will invest close to \$2.5 billion in several projects, while its private partners are expected to invest much more. Private investments are more forthcoming in sectors like automobiles, where investments of up to \$1 billion have been lined up for this year.

**Despite the improvement in demand, earlier this month, the Bank of Mexico left its benchmark rate unchanged at 4.5% for the fifth consecutive month.** The decision was influenced by subdued inflationary pressures. Consumer prices are anticipated to rise by over 4.5%, which is within the central bank's target range, but the rate of increase is expected to slow down next year.

### **Argentina: Highest credit default swap premiums reflect investor concerns**

**The dismissal of the country's central bank head last month has eroded investor confidence in Argentina.** Former central bank chief, Martin Redrado was removed from his office for his refusal to accept a government proposal to use part of the currency reserves to repay debt. The new head, thought to be personally close to the president, has heightened investor concerns by suggesting that central bank independence is not very important. Reflecting the increased investor anxiety, the Argentinean peso is at a record low to the dollar and credit default swaps to insure the country's debt are the most expensive of all sovereign debt.

**Though the economy is expected to grow this year, mostly aided by higher prices of farm produce like soybeans, the outlook remains very uncertain.** While the central bank expects inflation to remain below 11% this year, private forecasters estimate the rate to be considerably higher at around 30%. Meanwhile, the country has progressed on its plan to swap \$20 billion in defaulted bonds held by foreign investors for new bonds. The exchange is likely to be completed by next month, and will allow Argentina to issue new bonds in the international market.

### **Chile: Export growth continues to drive economic recovery**

**Chile's rebound from recession has gained strength in recent months, aided by firm copper prices in the international market.** After declining for the first three quarters of last year, economic activity recovered during the last quarter. GDP growth in December was nearly 4% from a year ago, helped by demand improvement in services and utilities. Higher domestic demand lifted imports by 23% in January while exports jumped 50%. Expectations from the new government, which will assume office next month, are high. The country's president-elect has promised increased investments to accelerate growth and create jobs.

**At its meeting earlier this month, the Central Bank of Chile decided to hold its benchmark rate steady at 0.5%.** Rates have been on hold since the second half of last year as the pace of the recovery was slower than expected. Besides, inflationary pressures remain contained which will help the central bank to maintain a low interest rate a while longer. January consumer inflation at 0.5% is well below the central bank's target range. The bank expects inflation to rise to 2.5% by the end of this year, while economists surveyed by the central bank expect that figure to be slightly higher. The Chilean economy is forecast to grow at nearly 5% this year, according to the survey.

### **Peru: Recovery gains pace, but interest rate left unchanged on low inflation**

**Helped by strong export demand and a more measured revival in domestic demand, Peru's recovery from the recession has been impressive.** During December, GDP growth accelerated to over 6% from a year ago, which is the fastest monthly expansion in more than a year. Though much of the expansion was powered by government spending, there are signs that domestic consumption is improving. In December, imports increased for the first time in over a year, suggesting a recovery in domestic demand. Consumer credit is expected to improve this year, which will boost consumption. Firm commodity prices drove exports up by more than 50% in December.

However, the subdued recovery in manufacturing pushed up the unemployment rate in January. **To support growth, the Central Reserve Bank of Peru, earlier this month held its benchmark rate unchanged at 1.25% for the sixth successive month.** Inflation remains well

below the central bank's target rate and is not a concern at this point. As the recovery takes hold, it is widely expected that the central bank will hike rates later this year.

### **Colombia: Rates remain on hold on inflation fears; export outlook improves**

**The Central Bank of Colombia left its benchmark rate unchanged at 3.5% late last month.** The central bank said economic conditions have improved, though some of the key economic indicators have not strengthened as much as expected. Concerns about higher inflation later this year have encouraged the central bank to hold the benchmark rate steady, instead of cutting the rate further to promote growth. The IMF recently improved its current year GDP growth forecast for Colombia to 2.5%, matching the central bank's expectation.

**Improved global demand boosted Colombian exports up more than 7% in December.** Firm commodity prices, especially for agricultural produce like coffee and cocoa, have also helped the export recovery. Though coffee output may be lower this year because of adverse weather conditions, higher prices will likely limit the decline in export revenues. International cocoa prices are at a three-decade high on concerns of lower supplies from Africa. However, exports to Venezuela are expected to decline to \$1.5 billion from over \$6 billion in 2008, due to weak demand there and political tensions between the two countries. 🌍

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