



## Americas: Economic Review June 2010

As leaders of the G-20 nations prepare for another summit, it is notable that there has been little progress in their stated ambition to reduce the global imbalances which contributed to the financial crisis. Efforts to encourage consumers in the developed countries to save more, and savers in the emerging world to consume more, have yielded little. Though there has been some improvement in domestic consumption in larger emerging economies like China and India, a good part of the gains were most likely induced by fiscal incentives. Private savings in the U.S. improved last year, but have flattened out subsequently on tepid income growth.

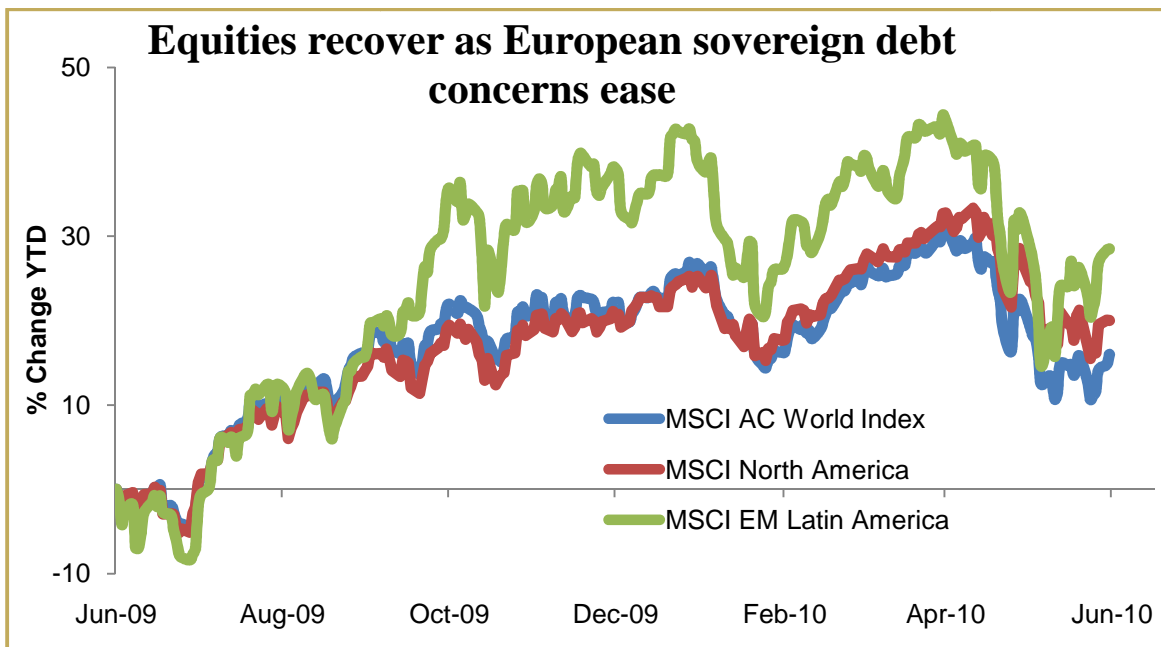
### At a Glance

- **United States:** Select economic data releases indicate a possible moderation in the pace of expansion, but manufacturing growth continues. The Fed may keep the target rate unchanged for an even longer period and some stimulus measures may be extended.
- **Canada:** While first quarter GDP growth exceeded expectations, some of the sectors fueling the expansion may see a slowdown in subsequent quarters.
- **Brazil:** The more than 9% first quarter expansion has heightened fears of overheating. With this, the central bank has become more aggressive, hiking interest rates for the second successive month.
- **Mexico:** The economy continues to be driven by the manufacturing sector. As the recovery in consumer demand remains fragile and inflation is low, interest rates are on hold.
- **Argentina:** Data from the first quarter indicate that the economy may have recovered from last year's recession, helped by higher output and prices of farm produce.
- **Chile:** It has taken less time than expected for the economy to recover from the damages caused by the February earthquake. The central bank hiked interest rate to restrain inflationary pressures.
- **Peru:** As anticipated, the first quarter growth rate for Peru was the best in the region. The central bank is expected to sustain rate hikes as GDP growth forecasts are being revised higher.
- **Colombia:** The country's president-elect will have to renew the efforts to boost economic growth, as Colombia has lagged most other economies in the region.

It is likely that the larger emerging economies will see sustained expansion of their domestic markets in the future. However, the process will be rather slow and countries like China are unlikely to shed their dependence on exports anytime soon. If the Chinese currency is allowed to appreciate against the dollar following the government decision to make it more flexible, it is expected that the growth of Chinese exports to the U.S. could slow down. However, since Chinese exports to Europe have become less competitive because of a weaker euro, China may seek to protect its exports to the U.S. through calibrated currency movements. At the same time, because of the weaker euro, European exporters are better placed to gain U.S. market share from the Chinese and other emerging market exporters.

Meanwhile, concerns about the European debt crisis have subsided somewhat and financial market volatility has declined. Spain's success in selling bonds at a premium to the market helped ease fears, though the fate of future debt issues remain uncertain. Concerns over the structural issues in the peripheral European economies linger, but market fears about default risks have declined.

In the Americas region, several of the emerging economies are facing inflationary pressures. Brazil, Peru and Chile, which are among the best performing economies in the region, have already hiked interest rates. Even laggards like Argentina are now showing signs of a recovery. Earlier this month, Canada became the first developed economy to announce an interest rate increase, as first quarter growth exceeded expectations. Some of the recent U.S. economic indicators suggest a possible slowdown in the growth momentum, which will encourage the Fed to maintain low interest rates and may force the federal government to extend some of the stimulus measures.



## **United States: Weaker economic signals will delay Fed rate hikes and may force extension of stimulus programs**

**After several months of better than expected economic data releases, the most recent readings of select indicators have been rather underwhelming.** Though the economy added more than 430,000 jobs in May, less than a tenth of the total came from the private sector. Most of the new jobs were temporary government hires for the census, which will disappear later this year. While it may be too early to arrive at any definitive conclusions, the May data has reinforced fears that it will take much longer for the unemployment rate to decline to its long-term average of around 6%.

**Retail sales, which had increased consistently for the previous seven months, declined unexpectedly in May.** Though consumer sentiment surveys continue to suggest positive trends, the apparent weakness in core sales, excluding food and energy, indicate that domestic consumption remains restricted. Housing starts slipped by as much as 10% in May and new building permits were also lower from the previous month. Most likely, the decline was exaggerated due to the expiry of the new home buyer tax credit in April, but stagnant income growth and tighter credit conditions may continue to contain housing demand.

**These weaker than expected economic trends may also indicate that the positive effects of the massive government stimulus programs and record low interest rates are waning.** This is likely to trigger calls for the extension of government stimulus programs and increase the pressure on the Federal Reserve to maintain low interest rates.

**However, manufacturing growth has been sustained, with a 1.2% gain in May over the previous month.** Capacity utilization increased to nearly 75%, on strong demand for machinery, cars, and other durables. While the economy-wide factory utilization level is still lower than the long-term average, several manufacturers are planning capacity increases to meet increased demand, especially from export markets. Though the recent strength of the U.S. dollar has affected export margins, China's decision to allow moderate appreciation of its currency will make U.S. exports of machinery and other manufactured goods to that country more profitable.

**Meanwhile, businesses continue to strengthen their balance sheets after the difficult experiences during the recession.** Non-financial firms are sitting on more than \$1.8 trillion in cash and other liquid assets, the most in several decades. Credit defaults, even by high-yield issuers, are running below 1% this year. These improvements will help firms finance further capacity expansion even as bank lending remains restrictive.

## **Canada: Stronger than expected growth leads to first interest rate hike since the recovery**

**As Canada prepares to host the G-20 summit later this month, its economy is undoubtedly the best performing in the developed world.** The Canadian economy expanded over 6% in the first quarter, helped by strong external demand and buoyant domestic consumption. The labor and housing markets in Canada have recovered earlier and faster than any other developed economy. The upturn in housing has been strong enough to raise concerns of another price bubble and the economy has so far regained nearly three-fourths of the jobs lost during the recession. The Canadian economy is forecasted to grow 3.5% this year.

**However, fears of overheating are premature as the fastest growing sectors are already showing early signs of cooling off.** Pricier homes and modestly higher mortgage rates may have combined to slow the growth in housing demand. The supply of existing homes in the market has increased, while both housing starts and new building permits declined in May. The tax incentive for home improvements has ended, which may restrict the demand for building products.

**Factory sales growth for the month of April was lower than expected, though the growth for the previous month was revised higher.** While shipment of metals and energy increased, sectors like automobiles and food products declined. April wholesale sales declined marginally, mostly because of lower prices. It is likely that sales growth will recover in the subsequent months, but the rate of growth may fall below the first quarter average. Further, both exports and imports fell in April due to price declines, and also because the trade account moved to a surplus.

**Since the global recession, Canada became the first developed economy to raise interest rates, with the Bank of Canada hiking its target rate by 25 basis points to 0.5%.** The bank observed that consumer inflation remains in line with expectations and believes consumer spending will moderate in the coming months. Both stronger economic growth and the prospect of higher interest rates have pushed up demand for Canadian bonds among foreigners, who invested nearly \$30 billion in Canadian credit securities during the first four months of this year.

## **Brazil: Central bank turns more aggressive on fears of overheating in the economy**

**Brazil's GDP expanded 9% during the first quarter from a year ago, heightening concerns of overheating.** This is the most rapid growth among all economies in the region and the second fastest among large economies, only behind China. For the full year, the economy is forecasted to advance more than 7%, according to a survey conducted by the central bank. Private forecasters have predicted even faster growth rates, prompting the government to curtail public spending and the central bank to become more aggressive in its rate hikes.

**The Central Bank of Brazil followed up its 75 basis point rate hike in April with a similar increase this month, on inflation fears.** The stronger than expected domestic demand has led to shortages of several consumer products, which has pushed up prices. Consumer inflation has consistently exceeded the central bank's target of 4.5% this year and is forecasted to be above 5.5% by the year-end. The central bank expects prices to remain high for the rest of the year and may hike interest rates yet again next month. On its part, the government said it may consider lowering duties on products like steel to cool down prices.

**At the same time, there are signs of domestic demand growth slowing down.** April retail sales declined more than expected from the previous month, but increased from a year ago. While this may be due to seasonal effects, the aggressive rate increases by the central bank may push up average interest rates in the economy and restrain credit growth. The government has extended the tax break for new trucks and pick-ups until the end of this year, though benefits for the purchase of passenger cars have been withdrawn.

**As fears of the European debt crisis spreading to other regions have eased and credit markets have stabilized, Brazilian firms are lining up more bond offerings.** More than \$2 billion in new bond sales may hit the domestic market shortly, while select banks are planning international bond issues. Unlike other emerging markets like China and India, the savings rate in Brazil is very low which has kept borrowing costs relatively high. The government is aiming to bring down real interest rates further through more responsible fiscal policies and spending cuts.

### **Mexico: Interest rate on hold as domestic demand is slow to recovery and inflation is subdued**

**Despite the improved economic conditions, interest rates in Mexico remain on hold as the outlook continues to be more uncertain when compared to other Latin American economies.** The economic recovery in Mexico has been primarily facilitated by the revival in export demand from the U.S., which accounts for nearly 80% of all Mexican shipments. While economic growth signals in the U.S. remain healthy, there are concerns that global economic activity may slow down if the European debt crisis prolongs. This may restrict the Mexican recovery, which is still believed to be fragile. To extend further support to the economic recovery, the Mexican central bank left its benchmark rate unchanged at 4.5% this month.

**Consumer inflation remains under control as domestic demand has not yet picked up in a big way.** Though there are signs of a recovery in consumer spending, aided by improved labor market conditions and very modest growth in consumer credit, demand is not strong enough to push up prices. Retail sales declined in April after gaining for the previous two months, though consumer confidence indicators were firm. These trends may encourage the central bank to hold the benchmark rate steady for the rest of this year.

**Meanwhile, the expansion in manufacturing activity continues on sustained export demand.** The growth is most visible in auto manufacturing, which increased more than 75% in April. Several global car makers are increasing the output from their Mexican factories to supply the U.S. market. China's decision to make its currency more flexible against the U.S. dollar may help sustain this trend by making Mexican goods more price-competitive.

### **Argentina: Economy showing signs of recovery, but capital remains scarce**

**After lagging behind last year when its regional peers recovered strongly, the Argentinean economy is now showing signs of a revival.** The economy expanded nearly 7% during the first quarter, from a year ago, helped by higher domestic investment and consumption. From the last quarter of 2009, aggregate output increased 3%. Though there are persistent doubts about the accuracy of economic statistics produced by the government agencies, several private forecasters also believe that the economy is now recovering. They expect GDP growth for the current year to exceed 5%, as industrial production, which increased more than 10% in May, has gained pace. Besides, farm output, which accounts for more than half of the country's exports, is forecasted to expand by 15% this year.

**However, businesses are finding it difficult to raise funds to finance capacity expansion.** Argentinean firms will be able to access international bond markets only after the ongoing sovereign debt swap offer is concluded successfully. The Argentinean government's offer to defaulted bondholders is set to expire later this month, after a revised deadline, but maybe extended again depending on overall investor response. To ease the difficulty of domestic firms seeking additional capital, the Argentinean government announced a \$2 billion loan program last month.

### **Chile: Interest rate hiked as recovery from earthquake comes sooner than expected**

**Chile became the third country in Latin America, after Brazil and Peru, to hike interest rates as the recovery appears to have taken hold.** The central bank increased its benchmark rate by a more than expected 50 basis points to 1%. The economy has recovered sooner than anticipated from the massive earthquake in February, which is estimated to have caused economic losses of over \$30 billion. A leading index of economic activity, tracked by the central bank, advanced in April as retail sales jumped more than 20%. Domestic demand, expected to expand 15% this year, will continue to drive the recovery. However, the central bank has lowered its GDP growth expectations for the current year on higher forecasted inflation, which may necessitate more interest rate hikes.

**As the restraining effect of the earthquake on economic output seems to have eased sooner than expected, rating agency Moody's upgraded Chile's credit rating by one level and**

**retained the stable outlook for the country.** Chile now enjoys the best credit rating in South America as the surplus built from past copper exports will be sufficient to finance a large part of the reconstruction efforts. Chile's senate this week approved higher taxes on miners and other businesses, to part-finance reconstruction and additional government spending. The country is also expected to raise \$1.5 billion from new bond issues in the international market this year.

### **Peru: Overheating fears surface as economy expands 9.3% in April**

**Peru's economic recovery over the last year has been so impressive that there are now fears of the economy overheating.** Output growth was 9.3% for the month of April, from a year earlier, sustaining the strong pace from previous months. The IMF recently increased its growth forecast for Peru for the current year to 6.3% while most private forecasters expect the economy to expand by nearly 7%. The government has slowed down fiscal spending and expects to bring down the fiscal deficit this year. Encouraged by the improved economic conditions and macroeconomic policies, rating agency Fitch has lifted Peru's credit rating outlook to positive. The country may see its rating move up by two levels from the lowest investment grade it is now. Credit default swaps on the country's sovereign debt has declined steadily over the last year, confirming the improved investor confidence.

**With faster than expected economic growth, the country's central bank followed up last month's interest rate hike with another 25 basis point increase this month.** Though consumer inflation is still subdued, prices have been rising in recent months. May consumer inflation was slightly above 1% annualized, and after several months, has re-entered the central bank's target range of between 1% and 3%. The central bank expects year-end inflation to be around 2.2% and the benchmark interest rate is forecasted to rise to 3.25% by the end of this year from 1.75% currently.

### **Colombia: Subdued economic recovery will be a challenge for the new president**

**Colombia was in the middle of an intense and closely contested presidential election, which overshadowed the challenges facing the country's economy.** As expected, neither of the leading candidates managed to get a majority in the first round held last month, which forced a second round this month. Juan Manuel Santos, the former defense minister and candidate of the current ruling party, won with more than two-thirds of the vote. He is expected to continue the security policies he implemented as defense minister, helped by more than \$700 million in annual aid from the U.S. However, the slower than expected economic recovery will shift most of the attention to higher domestic investments to create more jobs. Santos, a Harvard trained economist, is expected to target GDP growth rate of over 6% and a balanced budget by 2014.

**After last month's unexpected rate cut, the Bank of the Republic, Colombia's central bank, left the benchmark rate unchanged this month.** The bank observed that the accommodative monetary policy stance is contributing to overall economic growth, and inflationary pressures have been contained. Though the improvement in domestic consumption growth has exceeded expectations, the sharp slump in exports to neighboring Venezuela, due to the ongoing political dispute between the two countries, has affected the economic recovery. According to the most recent IMF forecasts, Colombia will see the slowest GDP expansion in the region this year, only after Venezuela which remains in recession. 🌐

## **Thomas White International, Ltd.**

One Financial Place,  
440 South LaSalle Street,  
Suite 3900,  
Chicago, Illinois 60605.  
Email: [feedback@thomaswhite.com](mailto:feedback@thomaswhite.com)

## **Thomas White India Pvt., Ltd.**

Suite 300, 3rd Floor  
Phoenix Towers  
16/1 Museum Road  
Bangalore 560001  
Tel.: 91-80-40187777

[www.thomaswhite.com](http://www.thomaswhite.com)

*The information contained in this publication does not, in any way, constitute investment advice and should not be considered a recommendation to buy or sell any security discussed herein. It should not be assumed that any investment will be profitable or will equal the performance of any security mentioned herein. Thomas White International, Ltd. may, from time to time, have a position or interest in, or may buy, sell or otherwise transact in, or with respect to, a particular security, issuer or market on our own behalf or on behalf of a client account.*

© Thomas White International, Ltd. 2010