

## Latam Weekly: Higher Inflation, Higher Rates

### FORECAST UPDATES

- Developments on the inflation front highlight substantial and wide-ranging revisions to key variables. Changes are identified in the following table.

### ECONOMIC OVERVIEW

- Higher inflation has brought monetary policy to the forefront. While recent price pressures undoubtedly reflect supply-side shocks emanating from bottlenecks in global supply chains, there is no room for complacency.
- Central banks must guard against temporary inflation surprises becoming entrenched in inflation expectations. This means higher interest rates. Our country teams have revised their forecasts.

### PACIFIC ALLIANCE COUNTRY UPDATES

- We assess key insights from the last week, with highlights on the main issues to watch over the coming fortnight in the Pacific Alliance countries: Chile, Colombia, Mexico, and Peru.

### MARKET EVENTS & INDICATORS

- A comprehensive risk calendar with selected highlights for the period September 11–24 across the Pacific Alliance countries, plus their regional neighbours Argentina and Brazil.

### Chart of the Week

Colombia: Output Gap



Sources: Scotiabank Economics, BanRep.

### CONTACTS

**James Haley, Special Advisor**  
 416.607.0058  
 Scotiabank Economics  
[jim.haley@scotiabank.com](mailto:jim.haley@scotiabank.com)

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### THIS WEEK'S CONTRIBUTORS:

**Jorge Selaive, Chief Economist, Chile**  
 +56.2.2619.5435 (Chile)  
[jorge.selaive@scotiabank.cl](mailto:jorge.selaive@scotiabank.cl)

**Anibal Alarcón, Senior Economist**  
 +56.2.2619.5435 (Chile)  
[anibal.alarcon@scotiabank.cl](mailto:anibal.alarcon@scotiabank.cl)

**Waldo Riveras, Senior Economist**  
 +56.2.2939.1495 (Chile)  
[waldo.riveras@scotiabank.cl](mailto:waldo.riveras@scotiabank.cl)

**Sergio Olarte, Head Economist, Colombia**  
 +57.1.745.6300 Ext. 9166 (Colombia)  
[sergio.olarte@scotiabankcolpatria.com](mailto:sergio.olarte@scotiabankcolpatria.com)

**Jackeline Piraján, Economist**  
 +57.1.745.6300 Ext. 9400 (Colombia)  
[jackeline.pirajan@scotiabankcolpatria.com](mailto:jackeline.pirajan@scotiabankcolpatria.com)

**Eduardo Suárez, VP, Latin America Economics**  
 +52.55.9179.5174 (Mexico)  
[esuarezm@scotiabank.com.mx](mailto:esuarezm@scotiabank.com.mx)

**Guillermo Arbe, Head of Economic Research**  
 +51.1.211.6052 (Peru)  
[guillermo.arbe@scotiabank.com.pe](mailto:guillermo.arbe@scotiabank.com.pe)

**Mario Guerrero, Deputy Head of Economic Research**  
 +51.1.211.6000 Ext. 16557 (Peru)  
[mario.guerrero@scotiabank.com.pe](mailto:mario.guerrero@scotiabank.com.pe)

**John Fanjoy, Economic Analyst**  
 416.866.4735  
 Scotiabank Economics  
[john.fanjoy@scotiabank.com](mailto:john.fanjoy@scotiabank.com)

## Forecast Updates

	2020		2021			2022				2023							
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	2020	2021f	2022f	2023f
<b>Argentina</b>																	
Real GDP (y/y % change)	-4.3	2.5	17.8	6.6	2.8	2.3	1.1	2.1	2.2	2.6	1.4	3.1	3.1	-9.9	7.3	1.9	2.5
CPI (y/y %, eop)	36.1	42.6	50.2	53.6	51.8	45.8	42.6	39.5	36.5	34.5	32.5	31.6	30.6	36.1	51.8	36.5	30.6
Unemployment rate (% avg)	11.0	10.2	11.5	11.2	10.9	10.7	10.3	9.8	9.6	9.5	9.5	9.3	9.1	11.6	11.0	10.1	9.4
Central bank policy rate (% eop)	38.00	38.00	38.00	38.00	42.00	46.00	46.00	44.00	40.00	39.00	38.00	37.00	36.00	38.00	42.00	40.00	36.00
Foreign exchange (USDARS, eop)	84.15	91.99	95.72	99.70	108.50	112.00	121.00	132.00	141.00	138.00	135.00	132.00	131.00	84.15	108.50	141.00	131.00
<b>Brazil</b>																	
Real GDP (y/y % change)	-1.1	1.0	12.4	5.2	3.1	2.7	2.1	1.9	2.6	3.1	2.2	2.3	2.5	-4.1	5.4	2.3	2.5
CPI (y/y %, eop)	4.5	6.1	8.3	9.7	8.7	6.9	5.2	4.1	3.6	3.1	3.3	3.6	3.5	4.5	8.7	3.6	3.5
Unemployment rate (% avg)	13.9	14.7	14.1	14.0	13.1	13.5	12.4	11.9	11.8	11.2	10.7	10.3	9.9	13.9	14.1	12.1	10.5
Central bank policy rate (% eop)	2.00	2.75	4.25	6.00	7.00	7.50	7.50	7.50	7.50	7.50	7.50	7.25	7.00	2.00	7.00	7.50	7.00
Foreign exchange (USDBRL, eop)	5.19	5.63	4.97	5.11	4.96	4.85	4.81	4.85	4.92	4.85	4.77	4.70	4.63	5.19	4.96	4.92	4.63
<b>Chile</b>																	
Real GDP (y/y % change)	0.0	0.5	18.1	15.9	9.6	8.5	7.5	2.5	2.1	2.1	1.8	2.2	2.8	-5.8	10.7	5.0	2.2
CPI (y/y %, eop)	3.0	2.9	3.8	4.7	5.0	4.6	4.6	3.6	3.0	3.0	3.0	3.0	3.0	3.0	5.0	3.0	3.0
Unemployment rate (% avg)	10.3	10.4	9.5	8.0	6.7	6.6	6.6	6.5	6.0	6.4	6.4	6.4	6.0	10.9	8.6	6.4	6.3
Central bank policy rate (% eop)	0.50	0.50	0.50	1.50	2.50	3.50	4.00	4.00	4.00	4.00	3.75	3.75	3.50	0.50	2.50	4.00	3.50
Foreign exchange (USDCLP, eop)	711	719	734	750	720	720	720	710	700	680	680	680	680	711	720	700	680
<b>Colombia</b>																	
Real GDP (y/y % change)	-3.6	1.1	17.6	7.5	3.4	4.3	6.3	3.6	2.7	3.8	3.7	3.6	3.6	-6.8	7.4	4.2	3.7
CPI (y/y %, eop)	1.6	1.5	3.6	4.4	4.8	4.5	3.7	3.2	3.3	3.1	3.1	3.1	3.0	1.6	4.8	3.3	3.0
Unemployment rate (% avg)	13.8	15.8	15.0	14.6	13.5	13.1	13.5	14.0	12.7	12.0	12.0	12.0	12.0	16.1	14.6	13.3	12.0
Central bank policy rate (% eop)	1.75	1.75	1.75	2.00	2.50	3.00	3.50	4.00	4.00	4.25	4.50	4.75	4.75	1.75	2.50	4.00	4.75
Foreign exchange (USDCOP, eop)	3,428	3,663	3,755	3,730	3,525	3,468	3,455	3,443	3,450	3,430	3,420	3,410	3,400	3,428	3,525	3,450	3,400
<b>Mexico</b>																	
Real GDP (y/y % change)	-4.5	-3.6	19.6	5.2	3.5	3.7	3.4	2.4	2.1	1.8	1.3	1.9	1.4	-8.3	6.2	2.9	1.5
CPI (y/y %, eop)	3.2	4.7	5.9	5.8	6.0	5.5	3.8	3.3	3.5	3.1	3.2	3.6	3.5	3.2	6.0	3.5	3.5
Unemployment rate (% avg)	4.3	4.3	4.2	4.1	3.9	3.9	3.8	4.4	4.2	4.3	4.0	4.1	4.1	4.4	4.0	4.1	4.1
Central bank policy rate (% eop)	4.25	4.00	4.25	4.75	5.25	5.50	5.75	6.00	6.00	6.00	6.00	6.00	6.00	4.25	5.25	6.00	6.00
Foreign exchange (USDMXN, eop)	19.91	20.43	19.94	20.21	20.54	20.76	21.03	21.27	21.45	21.38	21.51	21.62	21.78	19.91	20.54	21.45	21.78
<b>Peru</b>																	
Real GDP (y/y % change)	-1.4	4.5	41.9	8.6	2.0	1.7	0.5	4.9	3.1	2.5	4.3	1.5	3.2	-11.0	12.3	2.6	2.8
CPI (y/y %, eop)	2.0	2.6	3.3	5.2	6.5	6.7	6.5	5.4	4.5	4.1	3.9	3.4	3.0	2.0	6.5	4.5	3.0
Unemployment rate (% avg)	13.8	15.3	10.3	9.2	9.0	8.8	8.8	8.7	8.7	8.8	8.8	8.8	8.8	13.6	9.0	8.7	8.8
Central bank policy rate (% eop)	0.25	0.25	0.25	1.00	1.25	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	0.25	1.25	2.50	2.50
Foreign exchange (USDPEN, eop)	3.62	3.74	3.87	4.10	4.15	4.15	4.20	4.20	4.25	4.25	4.25	4.25	4.25	3.62	4.15	4.25	4.25
<b>United States</b>																	
Real GDP (y/y % change)	-2.3	0.5	12.2	6.1	6.7	6.3	5.5	4.2	2.8	2.2	1.8	1.8	1.8	-3.4	6.3	4.7	1.9
CPI (y/y %, eop)	1.3	2.6	5.3	5.3	4.8	4.4	3.8	3.0	3.0	2.9	2.7	2.6	2.6	1.2	4.8	3.0	2.6
Unemployment rate (% avg)	6.8	6.2	5.9	5.2	4.6	4.0	3.5	3.1	2.9	2.8	2.8	2.9	2.9	8.1	5.5	3.4	2.9
Central bank policy rate (% eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	0.25	0.25	0.25	1.25
Foreign exchange (EURUSD, eop)	1.22	1.17	1.19	1.18	1.18	1.17	1.17	1.15	1.15	1.15	1.15	1.18	1.18	1.22	1.18	1.15	1.18

Source: Scotiabank Economics.

 Red indicates changes in estimates and forecasts since previous *Latam Weekly* on August 13, 2021.

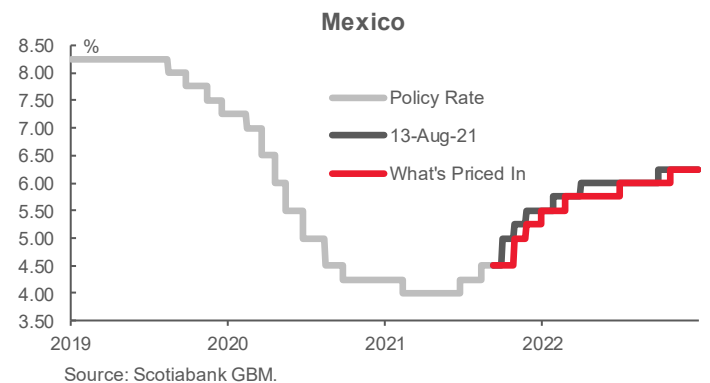
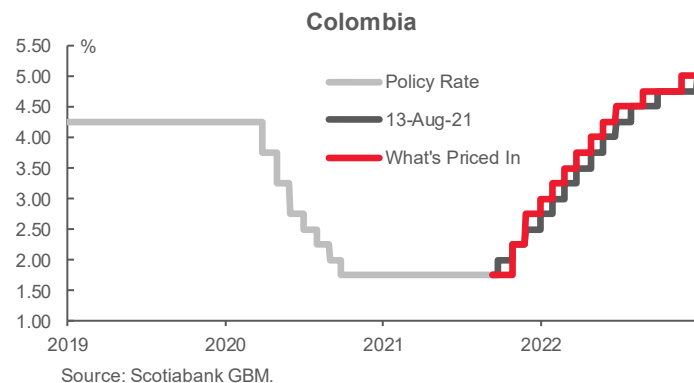
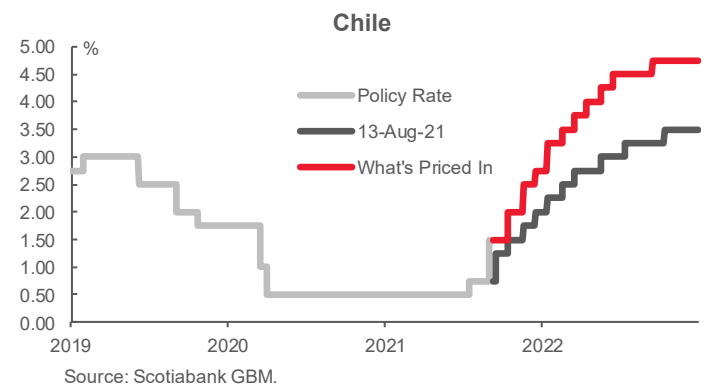
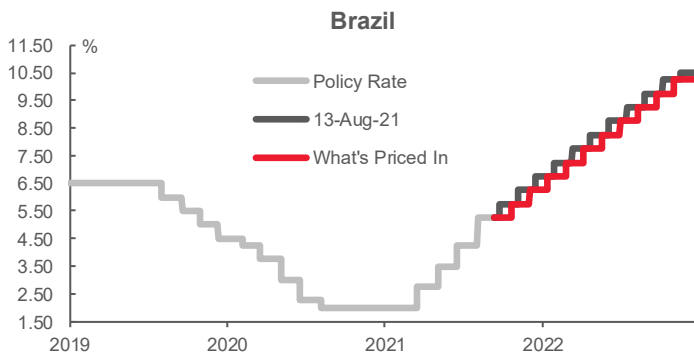
## Forecast Updates: Central Bank Policy Rates and Outlook

Latam Central Banks: Policy Rates and Outlook

	Next Scheduled Meeting			Market Pricing		BNS Forecast		BNS guidance for next monetary policy meeting	
	Current	Date	Market	BNS	12 mos	24 mos	End-2021		End-2022
<b>Argentina, BCRA, TPM, n.a.</b>	38.00%	n.a.	n.a.	38.00%	n.a.	n.a.	42.00%	40.00%	After cutting the benchmark Leliq rate by -200 bps in October 2020, the BCRA reversed these moves on Nov. 12, 2020 as negotiations resumed with the IMF mission. Talks with the Fund aren't likely to conclude until after the October 2021 elections. At this point, our rate call is speculative and wholly contingent on whether the authorities want to begin gradually hiking to take real rates back into positive territory or move in a sharper fashion in late-2021.
<b>Brazil, BCB, Selic</b>	5.25%	Sep-22	5.15%	6.00%	9.65%	12.80%	7.00%	7.50%	Inflation has accelerated faster than we anticipated, which should keep the BCB signalling an aggressive, front-loaded tightening cycle. Accordingly, we look for the Copom to keep hiking in 75 bps increments. The key outstanding question concerns the Committee's indication on May 5 that it is pursuing only a "partial" normalization process. Our call for a 7% terminal Selic is consistent with this guidance if the hiking cycle remains steep.
<b>Chile, BCCh, TPM</b>	1.50%	Oct-13	1.50%	2.00%	4.66%	4.87%	2.50%	4.00%	The Board of the Central Bank surprised the market increasing the policy rate by 75 basis points up to 1.5%. The measure is justified by activity data above what was expected in the BCCh's baseline scenario for the second quarter, as well as the extension of new fiscal aid recently delivered by the government that will remain until the end of this year, which implies a fiscal boost greater than that previously considered. The scenario described by the BCCh considers a Monetary Policy Rate that will increase rapidly to its neutral level towards the first quarter of 2022 (3.5%), being able to be above said level towards the second quarter of next year.
<b>Colombia, BanRep, TII</b>	1.75%	Sep-30	1.71%	2.00%	4.73%	5.36%	2.50%	4.00%	Recent inflation results are increasing speculation of a potential 50 bps hike. However, as the recent inflation spike are due to temporary pressures, we affirm our expectation of a gradual hiking cycle of 25 bps each meeting. The inflation would remain above 4% (or even closer to 5%) until April 2022; after that, we expect inflation to decrease and get closer to the 3% target.
<b>Mexico, Banxico, TO</b>	4.50%	Sep-30	4.74%	4.75%	6.09%	6.75%	5.25%	6.00%	The latest release of the Citibanamex survey showed that 26 out of 28 participants expect the Bank of Mexico to raise the reference rate by 25 basis points on September 30, making it three consecutive hikes. The median forecast for the benchmark rate at the end of 2021 stands at 5.13%, up from 5.00% in the previous survey. Our forecasts however, suggest that inflation is set to remain out of range for the remainder of 2021 and will end the year closer to 6.0%, nearly double the central bank's target of 3%. This will likely push Banxico to further increase by 75 bps the policy rate and close the year at 5.25%.
<b>Peru, BCRP, TIR</b>	1.00%	Oct-07	n.a.	1.25%	n.a.	n.a.	1.25%	2.50%	At its meeting on September 9, the BCRP raised its key interest rate by 50 bps to 1.00%. The central bank has become more aggressive, and should continue raising rates. We expect the reference rate to end 2021 at 1.25%, and 2022 at 2.50%, but, with inflation running at 5% and rising, the risk is clearly to the upside. Uncertainty persists over the designations for the new BCRP board of directors.

Sources: Scotiabank Economics, Scotiabank GBM, Bloomberg.

### What's Priced In



## Economic Overview: Higher Inflation, Higher Rates

- Inflation has risen across the Latam region, testing central bank price stability commitments.
- Failure to provide a nominal anchor to the economy could risk transforming transitory price shocks into sustained inflation.
- Central banks have already responded to higher inflation, or are poised to do so, to prevent temporary price pressures becoming entrenched into inflation expectations. Key policy rates have been raised; our country teams project further rate hikes are coming.
- The overarching message is clear—higher inflation means higher rates.

### INFLATION, MONEY AND INTEREST RATES

As noted in the recent update to Scotiabank's [Forecast Tables](#), supply chain constraints appear to be longer-lasting and more binding than previously assessed. These constraints are not only impairing short-term growth prospects in advanced countries, they represent a global inflation shock that could, potentially, test central bank price stability targets if not addressed in a timely fashion. Inflation has already surged across the Latam region.

**Most Latam central banks have responded to higher inflation.** The central banks of Brazil, Chile, Mexico and Peru have all moved to raise key policy rates; our team in Colombia expects BanRep to follow suit at its next policy meeting, scheduled for September 30. In Peru, the BCRP coupled rate hikes with a steep increase in reserve requirements, which our experts in Lima point out is not without precedent (see discussion below).

**In raising their policy rates, central banks are balancing short-term support for the economic recovery with longer-term commitments to price stability.** A key issue here is the extent to which the current surge in inflation is temporary. While all countries in the region have been affected by disruptions to global supply chains, there are, as well, country-specific idiosyncratic shocks (see discussion below on Colombia).

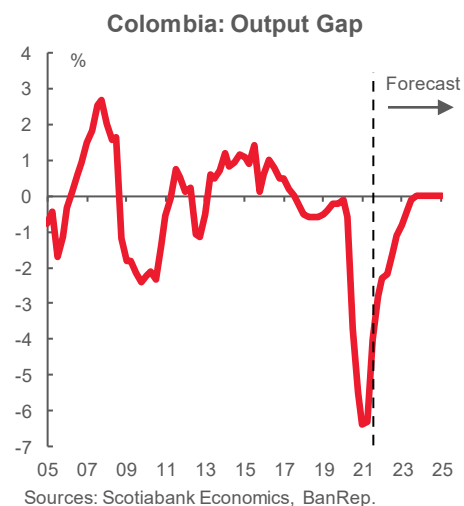
**But even if recent price pressures reflect transitory supply-side shocks and bottlenecks in global supply chains, there is a risk that they could become embedded in inflation expectations.** The potential for this effect explains the importance central banks attach to monitoring expectations. In this respect, most Latam central banks have well [established](#) inflation-targeting frameworks to anchor expectations.

**The credibility accumulated through the successful operation of inflation targeting frameworks should assist Latam central banks to strike a felicitous balance in their policy balancing act.** Nevertheless, the speed with which inflation has increased clearly raises the stakes—the longer that tightening is deferred, the greater the risk that expectations become unmoored. And with inflation breaching the upper bound of inflation targets, the credibility that central banks need to anchor expectations could be eroded (table 1). Added to this is the observation that inflation can rise quickly, like an elevator, but usually only comes down slowly, like an escalator; often after a painful and protracted period of slow growth. These considerations account for the proactive policy actions by some central banks.

### CONTACTS

James Haley, Special Advisor  
 416.607.0058  
 Scotiabank Economics  
[jim.haley@scotiabank.com](mailto:jim.haley@scotiabank.com)

Chart 1



**At the same time, these measures have been taken against a background of economic recovery.**

Latam economies are bouncing back from the pandemic and, as the discussion of Mexico below highlights, with mobility restrictions easing in most countries, the recovery should continue. Reflecting these developments, growth prospects have been marked up across the region since June, substantially so in most cases. (Of course, the outlook remains uncertain and further pandemic setbacks could reverse some of the progress made in terms of the recovery.) Stronger growth over the medium term would close output and employment gaps. For example, our team in Colombia anticipates the output gap closing over the forecast horizon (chart 1). In Chile, meanwhile, the employment gap continues to steadily narrow (see discussion below). Progress in closing these gaps is being made elsewhere in the region.

Table 1

**Latam Inflation: Targets, Latest, and Forecast (end of period)**

	Target Range (%)	Latest (y/y) (08-2021)	Forecast	
			2021f	2022f
<b>Brazil</b>	2.25 - 5.25	9.7	8.7	3.6
<b>Chile</b>	2 - 4	4.8	5.0	3.0
<b>Colombia</b>	2 - 4	4.4	4.8	3.3
<b>Mexico</b>	2 - 4	5.6	6.0	3.5
<b>Peru</b>	1 - 3	5.0	6.5	4.5

Source: Scotiabank Economics.

**Maintaining the current stance of monetary policy in these circumstances would likely fuel inflation, quite apart from any supply-side price pressures.** This is because most reference rates in the region remain deeply negative in real (after inflation) terms, despite recent rate hikes, given the surge in inflation. At some point, however, real policy rates will have to “normalize,” that is, move to a level that is consistent with price stability at full employment.

**There is no debate about the direction of change.** Interest rates must move up to safeguard price stability commitments. In this respect, the lesson from the “great inflation” of the 1970s is that failure to provide a nominal anchor could well transform temporary shocks to the price level into a problem of continuing inflation. The critical question is the speed at which central banks move down the path of monetary tightening.

**All of this has led our country teams to revise their policy rate forecasts.** For Brazil, our team now anticipates the policy rate to hit 7.00% by end-2021, up from our June forecast of 5.75%. Smaller upward revisions have been made to the rate forecasts over the same horizon for Chile (100 bps), Mexico (100 bps) and Peru (75 bps). In Colombia, in contrast, our team in Bogota has pared down its forecast of year-end inflation by 100 bps owing to country-specific factors that could contain price pressures there. In all cases, however, rates move higher relative to current levels. The overarching message is clear: higher inflation means higher rates.

## Pacific Alliance Country Updates

### Chile—Positive Economic Figures Amid the Reopening

**Jorge Selaive, Chief Economist, Chile**  
 +56.2.2619.5435 (Chile)  
[jorge.selaive@scotiabank.cl](mailto:jorge.selaive@scotiabank.cl)

**Anibal Alarcón, Senior Economist**  
 +56.2.2619.5435 (Chile)  
[anibal.alarcon@scotiabank.cl](mailto:anibal.alarcon@scotiabank.cl)

**Waldo Riveras, Senior Economist**  
 +56.2.2939.1495 (Chile)  
[waldo.riveras@scotiabank.cl](mailto:waldo.riveras@scotiabank.cl)

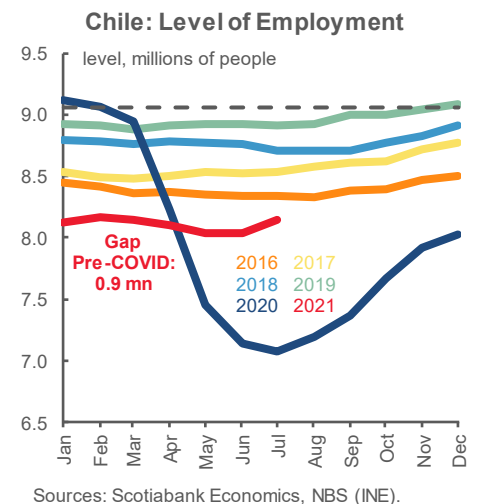
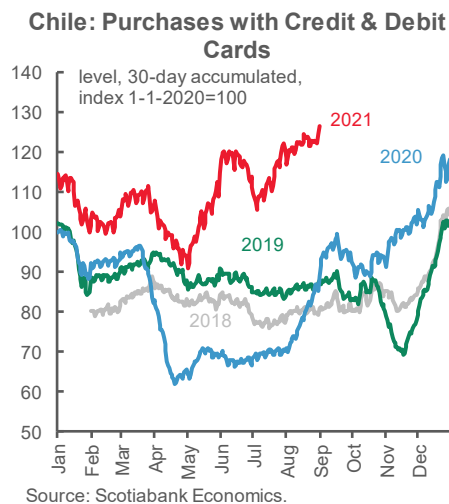
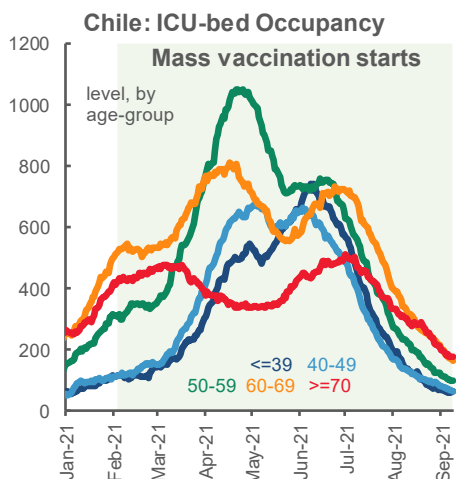
The number of confirmed COVID-19 cases per day has continued to decrease, falling to its lowest levels since April 2020. Similarly, the positivity rate is at the lowest level seen since the beginning of the pandemic and COVID-19-related deaths are decreasing. Vaccination reached 87% of the target population, while the occupancy of ICU beds continues to decrease in all age groups (first chart). Thanks to these developments, mobility has continued to increase, reaching—or surpassing for some activities—pre-pandemic levels. As of September 9, no commune is in lockdown, while more than 97% of the population has reached the highest degree of mobility in the “Paso a Paso” Plan.

In the political arena, on August 21, the centre-left coalition Unidad Constituyente, held an unofficial primary election that saw Yasna Provoste surge as the coalition’s chosen representative for the presidential first-round election on November 21. With this result, the Electoral Service (Servel) confirmed the candidacy of Gabriel Boric (left), Sebastián Sichel (centre-right), José Antonio Kast (far-right), Marco Enríquez-Ominami (Progressive Party), Franco Parisi (People’s Party) and Eduardo Artés (far-left).

On Tuesday, August 31, the Board of the central bank (BCCh) surprised the market by increasing the policy rate by 75 basis points up to 1.5%, significantly above the consensus, which expected between 25 bps and 50 bps. The measure was justified by activity data above what was expected in the BCCh’s baseline scenario for the second quarter, as well as the extension of new fiscal aid recently delivered by the government that will remain until the end of this year, which implies a fiscal boost greater than that previously considered.

On Wednesday, September 1, the BCCh published its Monetary Policy Report for the third quarter of 2021, in which it raised its GDP growth forecast for 2021 to a range between 10.5% and 11.5%, due to the most recent positive surprises and the greater dynamism of consumption. In addition, the BCCh increased its forecast for the CPI inflation from 4.4% y/y up to 5.7% y/y to December 2021. All in all, the scenario described above considers a Monetary Policy Rate (MPR) that will increase rapidly to its neutral level towards the first quarter of 2022 (3.5%), being able to be above this level towards the second quarter of next year.

On a positive note, our high-frequency indicators point to a new upturn in purchases with credit and debit cards in August and early September, evidence that the liquidity coming from fiscal aid and withdrawals of pension funds is fueling consumption. Private consumption is reaching new historical highs. Department stores continue to benefit from high





liquidity while services show some recovery due to greater mobility and reopening of the economy (second chart).

**On August 31, the statistical agency, INE reported a drop in the unemployment rate to 8.9% in the quarter that ended in July, better than expected by the market (9.2%).** Employment grew again (+108 thousand), after four consecutive months of falls or stagnation. Overall, the employment gap improved against pre-pandemic levels, narrowing to 914 thousand jobs (third chart), of which 476 thousand are formal jobs (52% of the total) and 439 thousand are informal. Moreover, on September 1, the BCCh released the July monthly activity index (Imacec), which expanded 18.1% y/y, in line with both market and Scotiabank expectations. According to the BCCh, only mining and construction sectors remain marginally below pre-COVID-19 GDP levels (fourth chart 4).

**On September 8, the INE released the Consumer Price Index for August, which increased 0.4% m/m (4.8% y/y), above our expectations (0.2% m/m).** The increase was largely explained by price rises in the restaurants and hotels component and housing. In our view, the process of reopening of the economy during August led to several services experiencing important and counter-seasonal increases in prices. Goods prices, meanwhile, showed signs of stabilizing.

In the fortnight ahead, on September 15, the BCCh will release the Minutes of its latest Monetary Policy Meeting.

## Colombia—Is Higher Inflation Temporary?

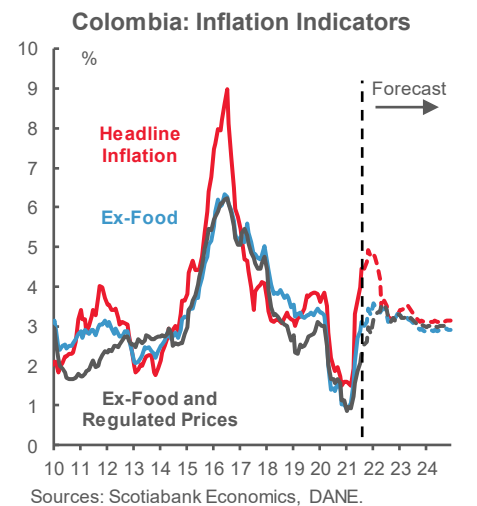
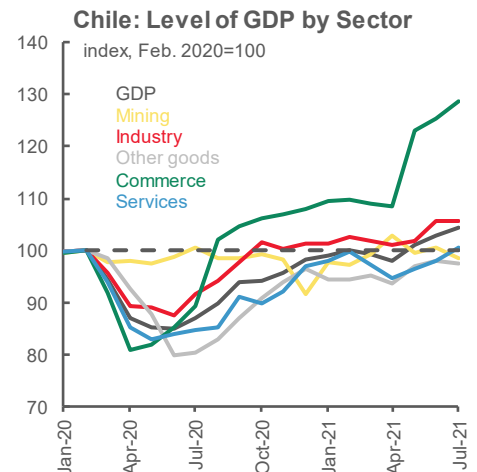
**Sergio Olarte, Head Economist, Colombia**  
+57.1.745.6300 Ext. 9166 (Colombia)  
sergio.olarte@scotiabankcolpatria.com

**Jackeline Piraján, Economist**  
+57.1.745.6300 Ext. 9400 (Colombia)  
jackeline.pirajan@scotiabankcolpatria.com

**The global spike in inflation has affected all Pacific Alliance countries (PAC), although the impacts have been rather different across countries.** For instance, inflation has gradually increased in Colombia during 2021. In fact, while inflation is twice the upper bound of central bank targets in Peru and Mexico, in Colombia, headline inflation barely exceeded the BanRep's target range in August. This more modest pace of price increases has given the central bank more time to start the hiking cycle later, and allowed it to continue to support credit and domestic demand recovery for longer. Having said that, the question that arises is whether headline inflation and, more important, core inflation will continue to remain relatively "well behaved" or if Colombia is just lagging the movement to higher inflation observed elsewhere, in which case we would need to expect much higher inflation in the coming months.

**Inflation in Colombia has been affected by several shocks that are important to understand in order to anticipate the future behavior of prices. These shocks include:**

1. Statistical base effects reflecting the effects of the pandemic that play an important role in annual inflation. In 2020, CPI inflation displayed highly unusual behaviour, with six months of price declines and inflation ending the year below BanRep's target.
2. FX depreciation that puts pressure on tradable goods. In the year to date, while the COP depreciated more than 11%, tradable inflation has accelerated by 218 bps (roughly a pass-through of 8% on total inflation), which increased headline inflation by 44 bps (tradable goods weight is 20% of the CPI basket).
3. International bottlenecks owing to problems in global supply chains have also boosted inflation from higher import costs.



4. The nationwide strike, especially in May 2021, led to large increases in some food prices. In addition, mobility restrictions and road blockages affected prices. The protests' effect on prices has also lasted longer than expected as the normalization of food distribution channels has taken more time. Currently, food inflation is 11.5% y/y and is expected to increase a bit further to almost 13% by the end of the year. However, headline inflation will face a high base effect next year, which would bring food annual inflation down to levels close to 3.5%.
5. The economic activity recovery path has been healthier, pushing up domestic demand and core prices close to BanRep's target. In fact, December 2020 Inflation ex-food and regulated prices ended at 1.1% y/y, whereas up to August 2021 this measure is at 2.31% y/y.

**In view of these considerations, we expect the economic recovery to continue and core inflation to return to 3% by the end of the year (first chart).** For 2022, we expect core inflation to hover around 3% once the base effect and bottlenecks in the distribution channels normalize, which should compensate for consumption recovery next year.

**This outlook reflects several considerations.** In this respect, among the shocks identified above, we think consolidation of the economic recovery and stronger demand next year are likely to have the most long lasting impact. Having said that, however, we anticipate that the normalization of food prices next year will reduce headline inflation by about 140 ppts. And while the resolution of global supply chain issues will not reduce prices, it would relieve further upward pressures on import goods, allowing base effects to play out in favour of lower annual inflation next year. Finally, the bias is that the COP will appreciate somewhat given stronger international demand and higher domestic investment fueled by FDI, which also helps headline inflation to return to the target range.

**All in, we think current upward CPI pressures will continue this year and start to decline gradually in the H1-2022, bringing headline inflation closer to BanRep's target range, while domestic demand will continue on its recovery path, but still under a negative output gap.** Therefore, despite recent upward inflation surprises, we stick to our base case scenario in which BanRep will start the hiking cycle at the September 30<sup>th</sup> meeting, increasing the policy rate by 25 bps to 2% by year-end and gradually getting a neutral rate of about 5% by the end of 2023 or Q1-2024. We acknowledge that the likelihood of a more front-loaded hiking cycle has increased, but we think this scenario will depend on future core inflation and inflation expectations, so we expect BanRep's Board to fine-tune the speed of the hiking cycle according to the data that comes out each month.

## Mexico—2022 Economic Package

Eduardo Suárez, VP, Latin America Economics  
+52.55.9179.5174 (Mexico)  
[esuarezm@scotiabank.com.mx](mailto:esuarezm@scotiabank.com.mx)

**On the policy front, new Finance Minister Rogelio Ramirez de la O presented his first [economic package](#), including the budget and revenues law for 2022.** Implementation of the package is a three-stage process. First, the Economic Policy Guidelines must be ratified by the Legislative, setting the assumption framework under which the package is supported (table 1). Second, the Revenues Law (including the debt ceiling) will follow and requires ratification by a 50% + 1 majority in both houses. Third, approval of the Expenditure Decree, which only needs ratification (also a 50% + 1 majority) by the Lower House by the November 15 deadline. Morena's coalition has the necessary votes in both houses, and we don't anticipate major changes to the package.

**As was expected, the budget is largely consistent with those of previous years.** However, as discussed below, there are some elements of the new Finance Minister's initial presentations that suggest differences in style relative to his predecessor, Minister Herrera. Key elements of the package include:

- The government's 2022 budget is based on a growth assumption of 4.1% for the year. This contrasts with the 2.9% consensus among private economists, and the 3.0% anticipated by Banxico. As we wrote last week, we believe that new Finance Minister Ramirez de la O sees himself playing the role that Alfonso Romo (former Presidential Chief of Staff and liaison to the private sector) held as liaison between the government and the private sector, seeking to boost investment by instilling confidence. In an [interview](#) released on September 9, the Finance Minister is said to have pointed towards a recovery in private investment as the anchor that will support the government's much more optimistic growth projection for



2022. The 4.1% growth estimate is explicitly premised on the assumption that the government will succeed in boosting confidence. To some degree, we do agree that investment should pick up somewhat in 2022—not necessarily because firms will seek to expand (which requires a recovery in private sector confidence), but because after two years of deep contractions, which has seen investment to GDP drop by almost 20% of its pre-2019 level, companies will have to invest simply to keep market share in an economy with a growing population (first chart).

- The budget assumes a 7.5% increase in revenues—including a more optimistic growth estimate than either Banxico or consensus expects, as well as a relatively optimistic estimate of oil production of 1.826 mm b/d, implying a 4% growth over 2021 (second chart)—coupled with a 9.6% growth in spending. This combination implies a widening in the deficit owing to faster spending growth, but also because of risks to missing the oil revenues target and growth that is lower than forecast, should either Banxico or private economists prove correct. However, there does not appear to be a major increase in indebtedness looming, even with these considerations. In this respect, the structural problem with Mexico's public finances is not unsustainable deficits, but rather slowing potential growth due to poor investment (i.e., a long term structural public finance risk).

**All told, while we see risks that the budget will miss the mark, we don't see a miss (or a necessary adjustment) in the debt-to-GDP ratio larger than**

**40–70 bps of GDP.** This is relative to the budgetary deficit of 3.1% of GDP that the package anticipates.

### Revising our growth and inflation forecasts higher

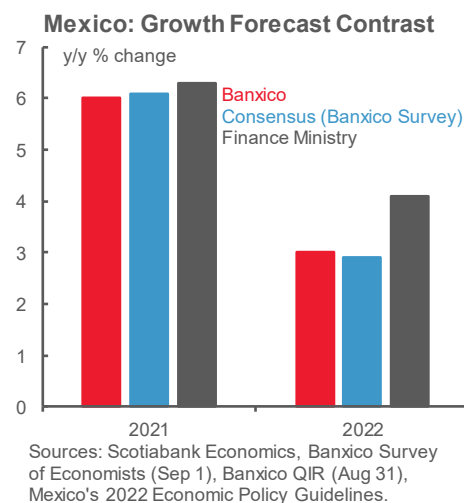
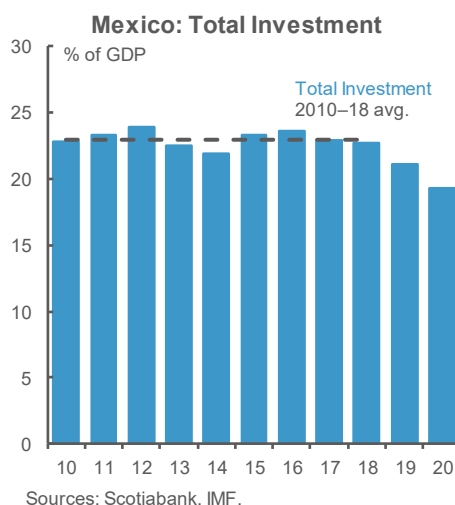
**We have revised both our 2021 and 2022 growth forecasts upwards.** Our changes are based on an earlier-than-anticipated reopening of parts of the service sector (despite the third wave of the pandemic) as well as stronger-than-anticipated impulse from the US economy. We had expected the third wave to lead to broader lockdowns at the end of Q2 and the start of Q3, but the government decided that, with progress being made in vaccinating some of the more vulnerable members of the population, stronger restrictions were not necessary.

**Next week we expect Banxico to publish its Report on Regional Economies, in which we anticipate seeing a continuation of some trends that back our upwards growth revisions, including:**

**Table 1**  
**Mexico: Key Assumptions for 2022 in the Economic Package**

Variable	Government Assumption	Our take
<b>Growth</b>	4.1%	Banxico has 3.0%, the private consensus is 2.9%, and our own forecast is 2.9%. We think this assumption is too optimistic.
<b>Inflation (eop)</b>	3.4%	We forecast 3.5%, Banxico has 3.4%, and consensus 3.7%. This may be somewhat optimistic, but not seriously so.
<b>USDMXN (eop)</b>	20.4	Our own forecast is 21.45, while the rate implicit in the swaps market is around 21.2, so it's a bit optimistic, but should not result in a major budget miss.
<b>Average interest rate (28d cetes)</b>	5%	We think Banxico's policy rate will end 2022 at 6%, while TIE swaps have an implied rate of close to 6%. We think on average this forecast will miss the mark by about 50bps, which could cause a moderate underestimation of financing costs, or roughly 20-30bps of GDP.
<b>Oil Price Forecast (US\$/bbl)</b>	US\$55.1	We expect the government to continue to hedge the oil price it budgets for the coming year, so it doesn't matter.

Sources: Scotiabank Economics, FinMin.



- A recovery in south of the country, which has lagged the rest of Mexico, led by improvements in activity levels in tourism and entertainment-linked services. With the tourism sector recovering, we also expect the employment gap will continue to close (it is almost shut now).
- Stronger infrastructure spending—heavily concentrated in the south of the country as the government accelerates its Maya Train and Dos Bocas refinery investments.
- A modest loss of steam in industrial activity in the north of the country, which is partly caused by supply chain disruptions. Banxico’s Quarterly Inflation Report (Box 3, p. 38) included an interesting and detailed analysis of this issue, with estimates showing that the supply chain disruptions would actually be more costly in 2021 H2 than in H1.

### Peru—It’s All About Monetary Policy

**Guillermo Arbe, Head of Economic Research**  
 +51.1.211.6052 (Peru)  
[guillermo.arbe@scotiabank.com.pe](mailto:guillermo.arbe@scotiabank.com.pe)

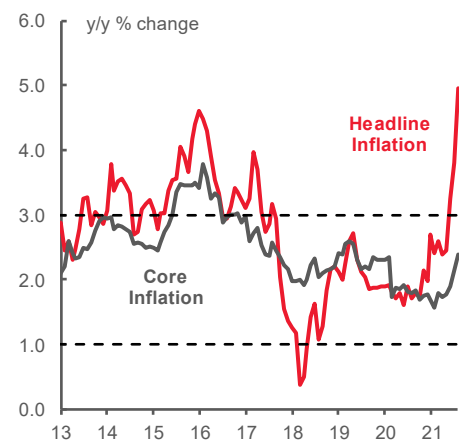
**Mario Guerrero**  
 +51.1.211.6000 Ext. 16557 (Peru)  
[mario.guerrero@scotiabank.com.pe](mailto:mario.guerrero@scotiabank.com.pe)

**The week was fraught with events having to do with the future of monetary policy in Peru.** Much of the domestic debate this week focused on whether the government would or would not ratify Julio Velarde as head of the BCRP. The signals the government had been giving in the past about their intentions to do so have grown somewhat stale, and their delay in confirming Velarde’s designation makes one wonder about their conviction. Finance Minister Pedro Francke stated this week that a decision would not be made until the end of the month. This seems to suggest that the government is still weighing its options.

**Meanwhile, yearly inflation surged to 5% in August (first chart).** The BCRP answered in force, raising the reference rate by 25 bps in August, and 50 bps on September 10. The reference rate now stands at 1.0%. Furthermore, the BCRP raised the marginal reserve requirement that banks must deliver on PEN deposits (second chart). Whereas before banks had to withhold PEN 5 out of each PEN 100 in new deposits they received for purposes of meeting BCRP reserve requirements, it will now have to reserve PEN 25 out of each PEN 100 received. This is a huge increase, although not without precedent. The BCRP did something similar in 2010. Note that this occurred as it raised its reference rate by 300 bps over the course of little over a year, from 1.25% to 4.25%. The context is different now, what with the risk of a third wave of COVID-19 looming, and an economy still trying to catch up with 2019 levels.

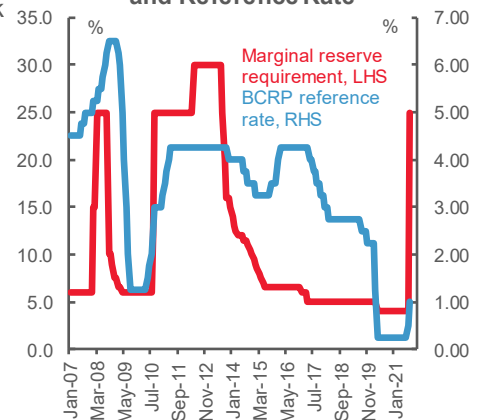
**The question is, given current circumstances, just how quickly the BCRP will move.** On the one hand, the BCRP surely recognizes the need to control price instability as soon as possible. Earlier this week we had brought forward the BCRP tightening schedule, with a view that the BCRP would raise its reference rate to 1.25% in 2021 (our previous forecast was 0.50%), and to 2.5% in 2022, from 1.0% previously. However, the 50 bps increase suggests that the BCRP may be even more aggressive, and the risk is now clearly to the upside. This in spite of the fact that core inflation is still within the target range, at 2.6%, and that inflation expectations are at a still-mild 3.07%, up very little from 3.03% in July. In its guidance document, the BCRP continued stressing that inflationary pressures are transitory, and that it expects inflation to return to the target range in 12 months’ time. At the same time, the document states that the BCRP will keep a keen eye on inflation expectations. Although inflation expectations, at 3.07%, continue to be relatively subdued, this most likely simply reflects a lag between expectations and a headline inflation which has risen with surprising speed. Over time, the gap should close, putting more pressure on the BCRP.

**Peru: Headline and Core Inflation**



Sources: Scotiabank Economics, BCRP.

**Peru: Reserve Requirements and Reference Rate**



Sources: Scotiabank Economics, BCRP.

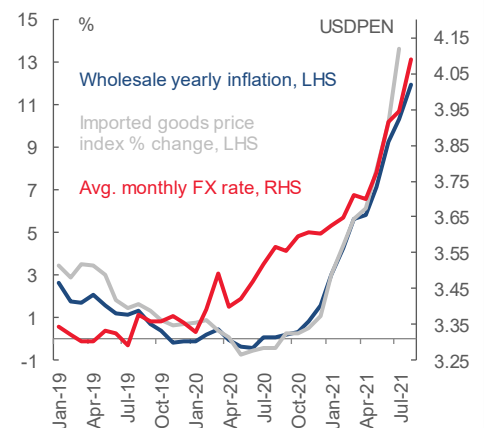
**Provided, of course, that the new BCRP Board will behave similarly to the current one.** Until we have greater insight on the composition of the Board, this is also a source of uncertainty.

**The reality of inflation has changed swiftly in the country.** Earlier this week we raised our inflation forecast to 6.5% for 2021, from 3.5%, and to 4.5% for 2022, from 3.0%. These are hefty changes. The pass-through from higher import prices (especially energy, and soft commodities such as wheat and maize), higher freight, containers and other transportation costs, and a rising FX rate, has still to be felt fully in headline inflation (third chart). Wholesale price inflation, soaring at 12% yearly, is telling in this regard. A year ago, wholesale inflation was negligible at 0.1%. Domestic political and policy uncertainty is also spurring volatility, with the risk that the PEN depreciation of recent months could generate a feedback loop with inflation. The BCRP needs to disrupt this loop quickly, which is why it is acting more aggressively, despite an economy that is still trying to get back on its feet after the 2020 COVID-19 lockdown.

**In sum, there are a number of factors that will be putting pressure on headline inflation for some time still, and it will likely take some time before the BCRP's tighter monetary policy will get inflation back within the bounds of the BCRP target range.** More so, considering that much of inflation is due to global cost factors outside of the BCRP's control.

**Finally, given persistent political turbulence, and in view that the USDPEN continues to ignore external account fundamentals, we are raising our FX forecast from 3.65 to 4.15 for 2021, and from 3.60 to 4.25 for 2022.** We note, however, that visibility is low, and there are strong countervailing forces in play. Terms of trade are at their best level since 2012. The trade balance is on its way to an all-time high of USD 13.8 bn this year, and then on to USD 16 bn in 2022, according to our forecasts. Given this background, the PEN should be strengthening. And yet, it's not. With inflation rising, and political uncertainty high, both local businesses and households are taking refuge in the USD. There has been a record outflow of nearly USD 10 bn of business and household short-term capital in the first half of 2021, mostly in the second quarter. We understand that this outflow has since slowed, but it has not been stemmed. At the same time, and to add to the conflicting factors bearing on the FX market, the withdrawal of monetary stimulus by the BCRP should give support to the PEN. Considering the complexity and degrees of uncertainty of the factors involved, the PEN FX market has become very hard to forecast. Our forecast is somewhat of a compromise: the weakening trend continues, but at a slower pace than in the past.

**Peru: Inflation Indicators and FX Rate**



Sources: Scotiabank Economics, INEI.

## Market Events & Indicators for September 11–24

### ARGENTINA

Date	Time	Event	Period	BNS	Consensus	Latest	BNS Comments
09-14	15:00	Greater Buenos Aires CPI (y/y)	Aug	--	--	50.4	
09-14	15:00	Greater Buenos Aires CPI (m/m)	Aug	--	--	3.1	
09-14	15:00	National CPI (m/m)	Aug	--	--	3.0	
09-14	15:00	National CPI (y/y)	Aug	--	--	51.8	
09-15	15:00	Capacity Utilization (%)	Jul	--	--	64.9	
09-16	15:00	Current Account Balance (USD, mn)	2Q	--	--	690.2	
09-21	15:00	GDP (q/q)	2Q	--	--	2.6	
09-21	15:00	GDP (y/y)	2Q	--	--	2.5	
09-21		Budget Balance (ARS, mn)	Aug	--	--	-98,570.3	
09-22	15:00	Trade Balance (USD, mn)	Aug	--	--	1,537.0	
09-22	15:00	Exports Total (USD, mn)	Aug	--	--	7,252.0	
09-22	15:00	Imports Total (USD, mn)	Aug	--	--	5,715.0	
09-22		UTDT Leading Indicator	Aug	--	--	-1.1	
09-23	15:00	Unemployment Rate (%)	2Q	--	--	10.2	

### BRAZIL

Date	Time	Event	Period	BNS	Consensus	Latest	BNS Comments
09-13	14:00	Trade Balance Weekly (USD, mn)	12-Sep	--	--	673.2	
09-14	8:00	IBGE Services Sector Volume (y/y)	Jul	--	18.0	21.1	
09-15	8:00	Economic Activity (y/y)	Jul	--	5.0	9.1	
09-15	8:00	Economic Activity (m/m)	Jul	--	0.5	1.1	
09-16	7:00	FGV CPI IPC-S	15-Sep	--	--	0.9	
09-16	7:00	FGV Inflation IGP-10 (m/m)	Sep	--	0.4	1.2	
09-17	4:00	FIPE CPI - Weekly	15-Sep	--	1.4	1.3	
09-20	14:00	Trade Balance Weekly (USD, mn)	19-Sep	--	--	673.2	
SEP 20-27		Tax Collections (BRL, mn)	Aug	--	--	171,270.0	
09-22	17:00	<b>Selic Rate (%)</b>	<b>22-Sep</b>	--	--	<b>5.3</b>	
09-23	7:00	FGV CPI IPC-S	22-Sep	--	--	0.9	
09-24	8:00	IBGE Inflation IPCA-15 (m/m)	Sep	--	--	0.9	
09-24	8:00	IBGE Inflation IPCA-15 (y/y)	Sep	--	--	9.3	
09-24	8:30	Current Account Balance (USD, mn)	Aug	--	--	-1,584.1	
09-24	8:30	Foreign Direct Investment (USD, mn)	Aug	--	--	6,103.5	
SEP 24-30		Federal Debt Total (BRL, bn)	Aug	--	--	5,396.0	

### CHILE

Date	Time	Event	Period	BNS	Consensus	Latest	BNS Comments
09-20	7:30	Central Bank Traders Survey		--	--		
09-24	8:00	PPI (m/m)	Aug	--	--	1.9	

### COLOMBIA

Date	Time	Event	Period	BNS	Consensus	Latest	BNS Comments
09-14		Central Bank Economist Survey		--	--		
09-15	11:00	Manufacturing Production (y/y)	Jul	13.2	--	20.8	The economic activity would continue improving as reopening consolidates. Manufacturing production would have an impact due to fewer business days. However, retail sales have room to continue improving.
09-15	11:00	Retail Sales (y/y)	Jul	18.3	--	24.7	
09-15	15:00	Industrial Production (y/y)	Jul	--	--	13.9	
09-17	11:00	Trade Balance (USD, mn)	Jul	--	--	-1,559.0	
09-17	11:00	Imports CIF Total (USD, mn)	Jul	--	--	4,922.9	
09-17	12:00	Economic Activity NSA (y/y)	Jul	11.5	--	14.5	The overall economic activity would surpass pre-pandemic levels in July, as leisure-related activities were allowed to operate with higher capacity. Additionally, in-person schools reopened and it would lead to better dynamics.
09-17		Industrial Confidence	Aug	--	--	16.3	
09-17		Retail Confidence	Aug	--	--	35.8	

Forecasts at time of publication.

Sources: Scotiabank Economics, Bloomberg.

## Market Events & Indicators for September 11–24

### MEXICO

<u>Date</u>	<u>Time</u>	<u>Event</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
09-12	13:00	Formal Job Creation Total	Aug	--	--	116.5
09-13		ANTAD Same-Store Sales (y/y)	Aug	--	--	15.3
09-14	10:00	International Reserves Weekly (USD, mn)	10-Sep	--	--	205,559.0
09-20	7:00	Aggregate Supply and Demand	2Q	--	--	-2.9
09-21	10:00	International Reserves Weekly (USD, mn)	17-Sep	--	--	205,559.0
09-21		Citibanamex Survey of Economists		--	--	
09-23	7:00	Bi-Weekly CPI	15-Sep	0.6	--	0.2
09-23	7:00	Bi-Weekly Core CPI	15-Sep	0.4	--	0.2
09-23	7:00	Bi-Weekly CPI (y/y)	15-Sep	5.9	--	5.6
09-24	7:00	Retail Sales (m/m)	Jul	--	--	-0.6
09-24	7:00	Retail Sales (y/y)	Jul	--	--	17.7

### PERU

<u>Date</u>	<u>Time</u>	<u>Event</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
09-15	11:00	Lima Unemployment Rate (%)	Aug	9.3	--	9.4
09-15		Economic Activity (y/y)	Jul	12.8	--	23.5

Partial lockdown continued in July 2020, thus growth is mostly rebound off a low base.

Forecasts at time of publication.

Sources: Scotiabank Economics, Bloomberg.

## Scotiabank Economics Latam Coverage



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