REPORT ON THE LATIN AMERICAN ECONOMY

Resilient economic activity and slowing inflation, in a still highly uncertain setting

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Editorial

Economic activity in Latin America is proving more buoyant than expected some months ago, although the pace of growth has, as usual, been highly uneven across the different countries in the region, with GDP growth in 2022 ranging from 2.5% in Chile to 7.5% in Colombia.

Despite its relative resilience, economic activity is clearly moving on a slowing path. Average growth in the region's main economies was below 0.5% in 2022 H2, significantly lower than in 2022 H1 (1.1%).

Going forward, the outlook regarding the duration and intensity of the slowdown in activity is highly uncertain. Among other aspects, it will depend on the macroeconomic impact of the tighter global and domestic financial conditions, the resilience of household consumption to the loss of purchasing power resulting from the persistent inflationary episode, and the strength of external demand, particularly from China, whose reopening could boost economic activity in the region given their close trade links and the important role China plays in commodity price dynamics worldwide.

As regards price developments, in recent months, inflation in Latin America has gradually lost momentum, as in other parts of the world, although year-on-year price growth rates remain relatively high. For example, in January, the region's main economies whose central banks have set inflation targets had a year-on-year inflation rate of 7.9%. In any event, as the region's central banks have pointed out in their latest inflation reports, the upward pressure on prices in recent months appears to be essentially due to demand factors, as opposed to the greater weight of supply factors in the early phases of the current inflationary episode.

The analysts continue to forecast a gradual decline in inflation over the current year, although how sharply it does so will depend, among other factors, on developments in services prices (which have not yet shown clear signs of deceleration in any of the region's main economies) and food prices (which make up a relatively large share of the consumption basket of Latin American households). Although long-term inflation expectations remain anchored to the target, short-term expectations are above the target levels set by the region's central banks and increasingly influenced by past inflation.

Overall, the monetary policy stance in Latin America is clearly restrictive. Policy interest rates are relatively high, compared with those of other emerging and advanced areas and with those observed in the region during previous monetary tightening cycles. To some degree, this appears to have helped mitigate the high inflationary pressures, for instance, by easing currency depreciation pressures, but also by keeping medium and long-term inflation expectations anchored to the inflation targets set by the region's central banks.

Looking ahead, the analysts' consensus suggests that policy interest rates could already have peaked (or be close to peaking) in the region's main economies and that they could fall in some countries in the second half of the year. However, these expectations are subject to considerable uncertainty and will be strongly influenced by the also uncertain monetary policy developments in the main advanced economies, particularly the United States.

On the evidence provided by this report, the policy rate increases in Latin America since the start of the region's monetary tightening phase in the 2021 H1 appear to have gradually passed through to bank lending rates, attesting to the functioning of the bank lending channel in the transmission of monetary policy. However, during this period the rates of growth in lending have remained relatively high owing to different counterbalancing factors, such as the continuation – until a few months ago – of the credit support programmes launched in the most acute phase of the pandemic, and the buoyancy of activity and employment. In this regard, it should be noted that economic activity, lending and capital inflows appear to have been buttressed by the fact that several countries in the region are net commodity exporters and that geopolitical risks in Latin America are relatively contained, especially compared with the risks associated with the war in Ukraine or the trade tensions between the United States and China.

For the region as a whole, fiscal policy currently maintains a neutral or slightly restrictive stance. Although this is helping to somewhat reduce the public debt-to-GDP ratio, in historical terms and compared with other emerging market economies, the ratio remains high. The region's main vulnerabilities continue to lie in the fiscal realm. Thus, for example, the probability of the public debt-to-GDP ratio in ten years' time being higher than the pre-pandemic figure has increased notably for some countries such as Chile and, especially, Colombia.

The vulnerability indicators of the banking industry and the external sector remain at relatively low levels, with some exceptions, although Latin America could witness significant capital outflows in particularly adverse global and domestic scenarios. Also worth noting is the fact that, despite the across-the-board improvement in the region's terms of trade in 2022, trade balances deteriorated as a result of the sharp rise in imports driven by the buoyancy of domestic demand.

Moreover, the region has recently seen a fresh upsurge in economic policy uncertainty and in social and political unrest which could have a negative impact on economic activity. Also, at the global level, the risk of further fragmentation of world trade has increased. Should this risk materialise, it would affect the economies of Latin America and the Caribbean unevenly, as documented in this report.

This report includes two boxes. Box 1 analyses, for the first time, in collaboration with the SECMCA,[1] key developments in economic activity, prices, financial conditions and economic policy in the Central American region. Box 2 sets out in detail the recent changes that have taken place in the banking systems of Latin American countries that are of material significance for Spanish banks, including a description of the main risks to financial stability in those countries according to the reports published by the region's central banks.

1 Secretaría Ejecutiva del Consejo Monetario Centroamericano.

Report

Contents

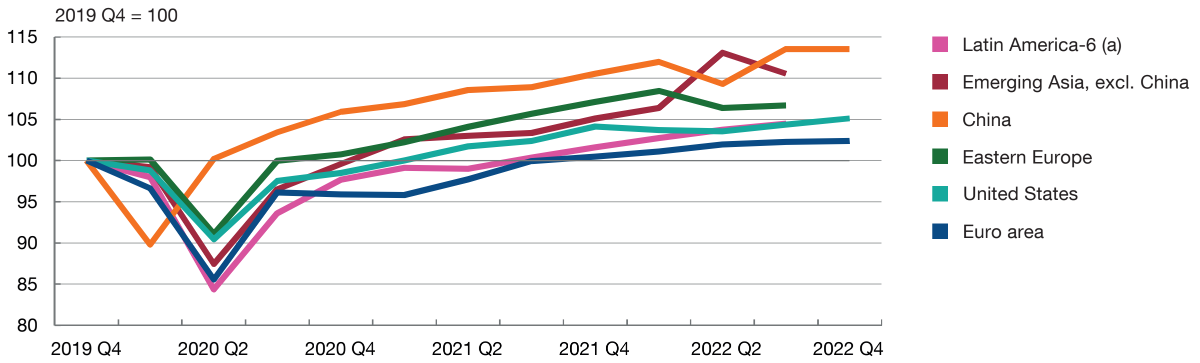
1 Economic activity in Latin America is proving more resilient than expected a few months ago

— GDP growth in Latin America surprised on the upside in 2022, standing somewhat above 3%, similar to the rate recorded in emerging Asia and higher than that observed in eastern Europe (see Chart 1.a). Growth slightly exceeded 4% in Central America and the Dominican Republic (see Box 1). This enabled activity in the region's main economies to surpass its pre-pandemic level.

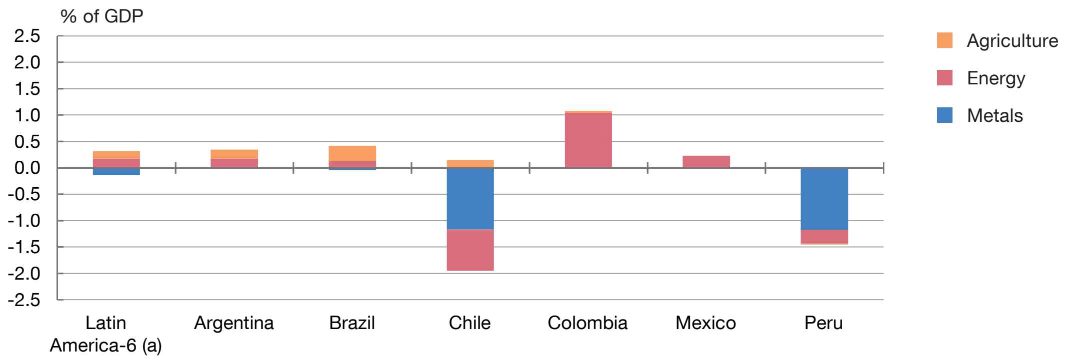
— Economic performance was uneven across countries, however, with growth rates ranging from 2.5% in Chile to 7.5% in Colombia.[1] These differences owed, among other factors, to economic policies, migrant remittances,[2] external demand and commodity prices. In this respect, the Chilean and Peruvian economies felt the adverse impact of commodity prices on their terms of trade (see Chart 1.b).

Chart 1

1.a Real GDP by economic area



1.b Effects of commodity price developments in 2022 on the trade balance (b)



SOURCES: OECD, Refinitiv, national statistics and Banco de España.

a Weighted aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b The depicted shock is calculated using average trade, for each of the three commodities aggregates, between 2015 and 2018. Two price indices are applied: one for January 2022 and another for 24 February 2022-31 January 2023. The difference is represented as a percentage of GDP. For the commodity prices, in the case of Argentina and Brazil, the soy price is taken as the price for agriculture, and the aggregate prices (Dow Jones) are used for metals and energy; in the case of Chile and Peru, the copper price is taken as the price for metals, and the aggregate prices are used for agriculture and energy; and, in the case of Colombia and Mexico, oil prices are taken as the price of energy, and the aggregate prices are used for agriculture and metals.

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1 Latin American Consensus Forecasts (January 2023).

2 World Bank. (2022). "Migration and Development Brief 37 (Remittances Brave Global Headwinds)", November.

2 Despite its resilience, economic activity is moving on a slowing path

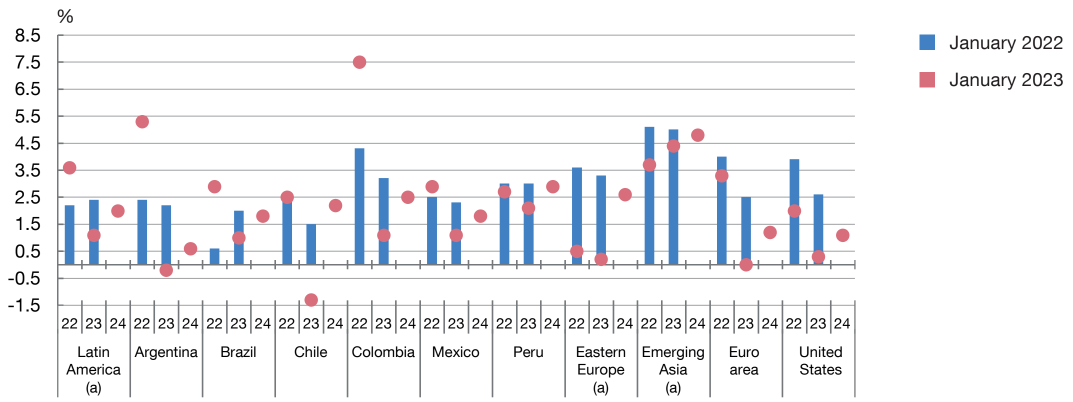
— According to the latest estimates, quarter-on-quarter growth in the six main economies fell from 1.1% in 2022 H1 to below 0.5% in H2. The outlook regarding how long this slowing trajectory will last is highly uncertain and will depend, among other factors, on the macroeconomic impact of the tighter global and domestic financial conditions, the resilience of household consumption to the loss of purchasing power resulting from the persistent inflationary episode, and the strength of external demand.

— As regards this last risk factor, there is uncertainty surrounding the buoyancy of external demand from China, whose reopening could boost economic activity in Latin America, given their close trade links and the important role this country plays in commodity price dynamics worldwide.

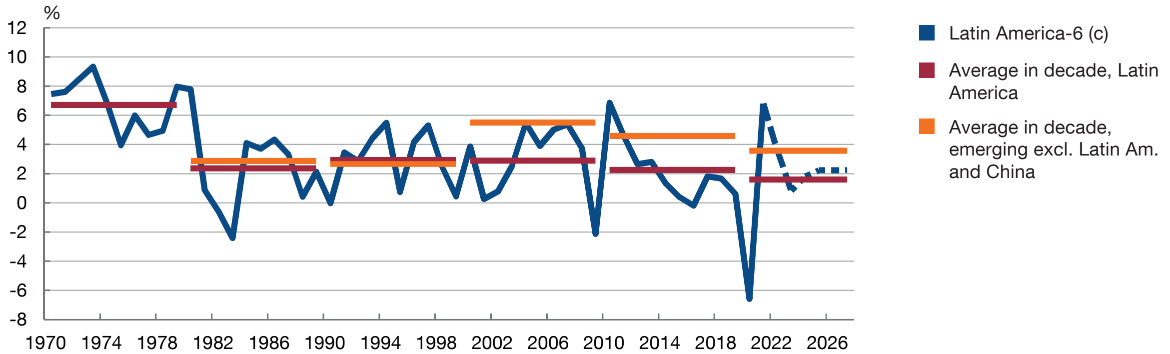
— The latest consensus forecasts point to growth of somewhat below 1% in 2023 and 2% in 2024 for the main Latin American economies (see Chart 2.a). Growth in subsequent years is expected to stand slightly above 2%, according to the IMF (see Chart 2.b).

Chart 2

2.a GDP growth projections for 2022, 2023 and 2024



2.b Long-term GDP outlook (b)



SOURCES: IMF, World Bank and Consensus Forecasts.

a Consensus Forecasts aggregates for Latin America, Eastern Europe and Asia (excl. Japan).
b January 2023 Consensus Forecasts for 2022, 2023 and 2024 and October 2022 WEO forecasts for 2025, 2026 and 2027.
c Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru. The last tranche represents the average for 2020-2027 and includes the WEO forecasts for the period 2022-2027 in the calculation.

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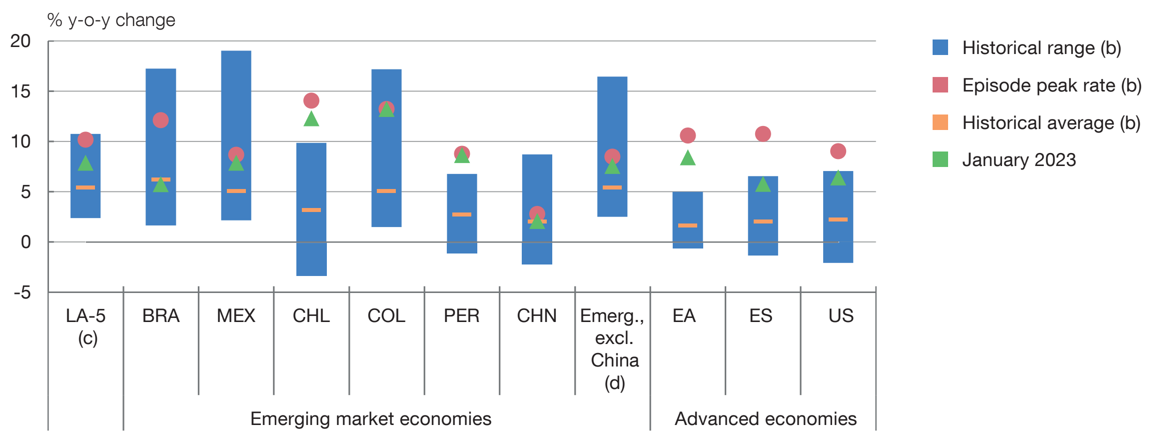
3 The rate of price growth has moderated in some Latin American countries

— In recent months, headline inflation has declined in Mexico and, especially, in Brazil (see Chart 3.a). Elsewhere in the region, inflation has not decreased as sharply and is not very far from the peaks reached some months ago.

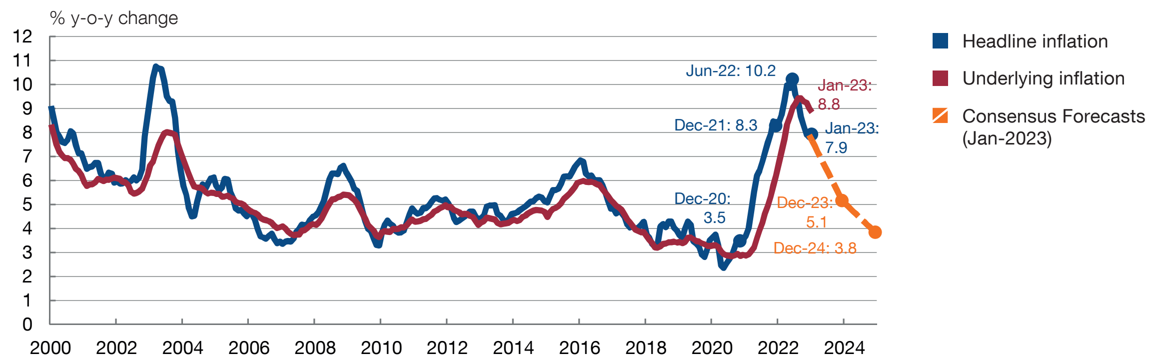
— Similarly, as has been observed in the main world economies, underlying inflation in Latin America at end-2022 was still very close to the highs reached in the current inflationary episode (see Chart 3.b). Indeed, in countries such as Brazil and Mexico, underlying inflation is higher than the headline rate.

Chart 3

3.a Headline inflation (a)



3.b Latin America-5. Headline and underlying inflation (e)



SOURCES: IMF, Refinitiv, Consensus Forecasts and national statistics.

a ES: Spain; US: United States; CHN: China, BRA: Brazil; MEX: Mexico; CHL: Chile; COL: Colombia; PER: Peru.
b The historical averages and ranges cover the period January 1999-December 2021. The episode peak rate is the highest rate of headline inflation in the recent period (January 2021-January 2023). Inflation data at January 2023 are not available for the Emerging market economies, excl. China aggregate or for the United States; the latest figure available (December 2022) is presented in their place.
c Latin America-5: aggregate of Brazil, Chile, Colombia, Mexico and Peru.
d Includes Brazil, Chile, Colombia, Mexico, Peru, Hungary, Poland, the Czech Republic, Bulgaria, Romania, India, Indonesia, Malaysia, Thailand and the Philippines.
e Aggregate of Brazil, Chile, Colombia, Mexico and Peru weighted by GDP in PPP terms.

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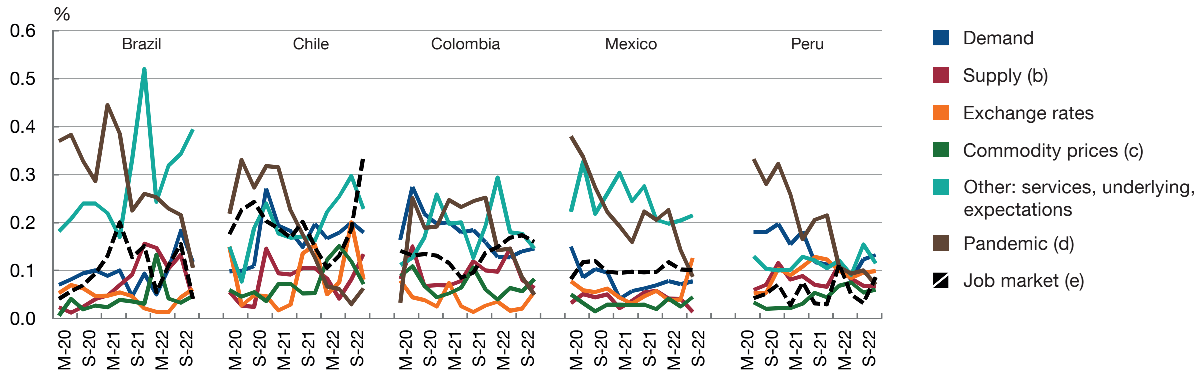
4 According to the region's central banks, the main factors driving the latest inflation developments are demand and services inflation

— When analysing the determinants of the latest inflation developments in their quarterly reports, the narrative of the region's central banks primarily references terms and concepts related to services, underlying inflation and inflation expectations, and demand (see Chart 4.a).[3]

— Meanwhile, concepts directly related to the pandemic are becoming progressively less important in the inflation narrative, and reference is increasingly made to the job market, particularly in Colombia and Chile.

Chart 4

4.a Latin America. Frequency of words in quarterly inflation reports (a)



SOURCE: Banco de España.

a Frequency (percentage of total) with which the words or groups of words indicated appear in central banks' quarterly inflation reports. The dates shown in the chart correspond to the quarter in which the inflation report was published.
b Includes references to supply shocks and bottlenecks.
c References to commodity prices, food prices, energy prices, oil prices or import prices.
d References to the pandemic, COVID-19, coronavirus, virus or infection.
e References to wages, employment, unemployment rate or indexation.

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3 The analysis conducted is confined to counting words and does not consider relationships between groups of words. For instance, services inflation may have been driven by a boost in demand, or underlying inflation may have increased owing to supply bottleneck problems.

5 The contribution of food to inflation remains very high in Latin America

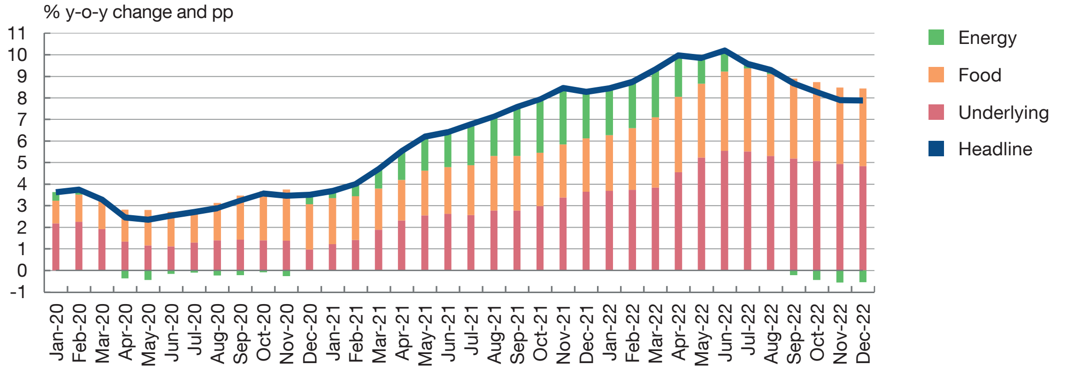
— The decline in inflation in the region's main economies in recent months is largely attributable to energy prices, whose contribution to the year-on-year growth rate of prices has turned negative (see Chart 5.a).

— However, food continues to contribute significantly to inflation, more so than in the developed economies (where food accounts for a smaller share of the consumption basket) or in emerging Asia.

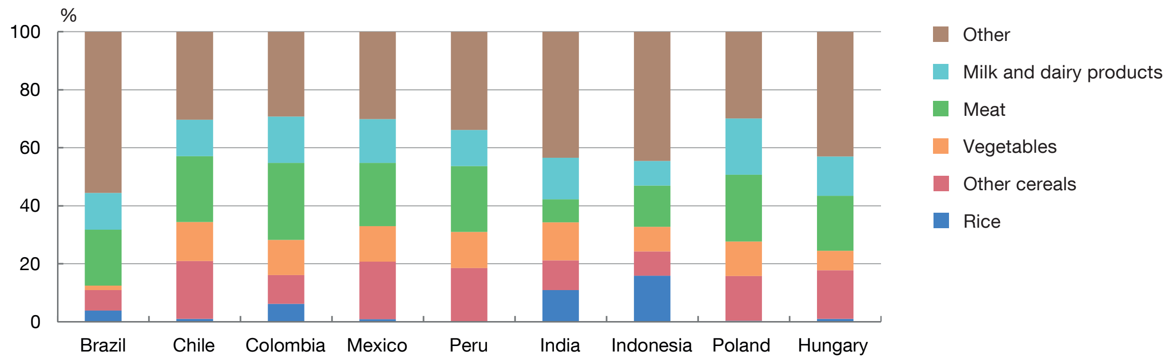
— The fact that food makes a larger contribution to inflation in Latin America than in emerging Asia is not related to the weight of food overall in households' consumption basket, but rather to the basket's specific composition in the region. For example, rice accounts for a relatively large share of the consumption basket in Asian countries, and in recent quarters its price has been less volatile than those of other cereals (such as wheat and maize) that make up a larger share of households' consumption basket in Latin America (see Chart 5.b).

Chart 5

5.a Latin America: contributions to inflation (a)



5.b Weightings of the basket of food and non-alcoholic beverages (b)



SOURCES: Refinitiv Eikon and national statistics.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.
b In the case of Peru, "Rice" is included in "Other cereals" as its weighting is not available. Moreover, in Poland this component has a very low weight in the basket.

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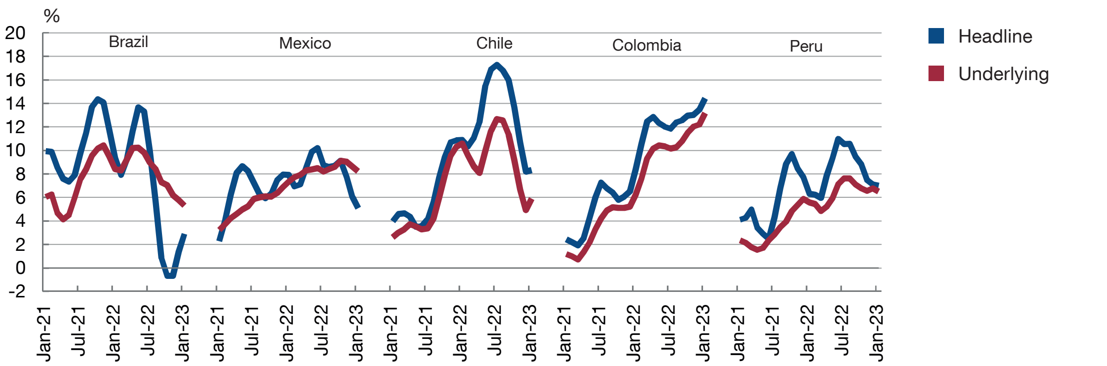
6 Short-term inflation rates point to an easing of inflationary pressures in the region, while analysts expect inflation will continue to decline gradually over the coming quarters

— The inflation indicators used to estimate the intensity of the latest inflationary pressures suggest that these are easing in Latin America, especially in Brazil and Chile, but that these upward pressures remain relatively strong in Colombia (see Chart 6.a).

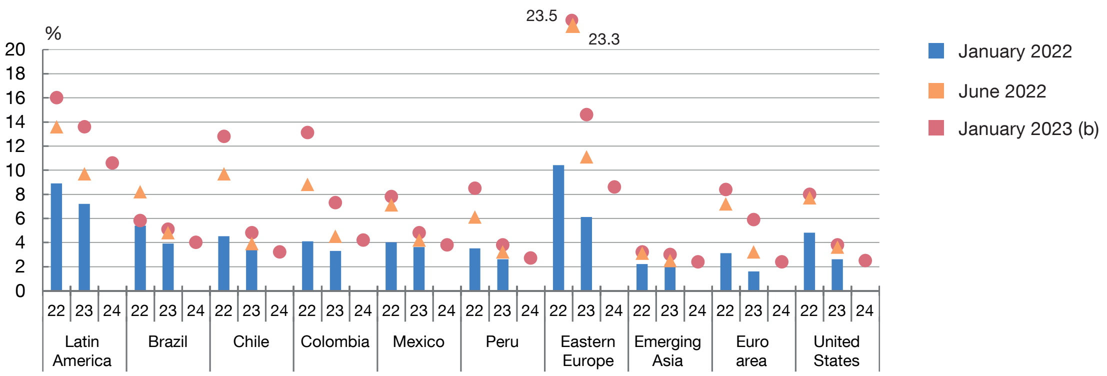
— In line with this evidence, the analysts' consensus expects headline inflation rates to continue to decline gradually over 2023 and 2024 (see Chart 6.b).

Chart 6

6.a Short-term inflation indicators (a)



6.b Inflation forecasts



SOURCES: Consensus Forecast and Refinitiv.

a Annualised quarter-on-quarter rates.
b Published values, in the case of 2022.

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7 This outlook, however, is subject to risk, owing to the increasing influence of past inflation on short-term inflation expectations …

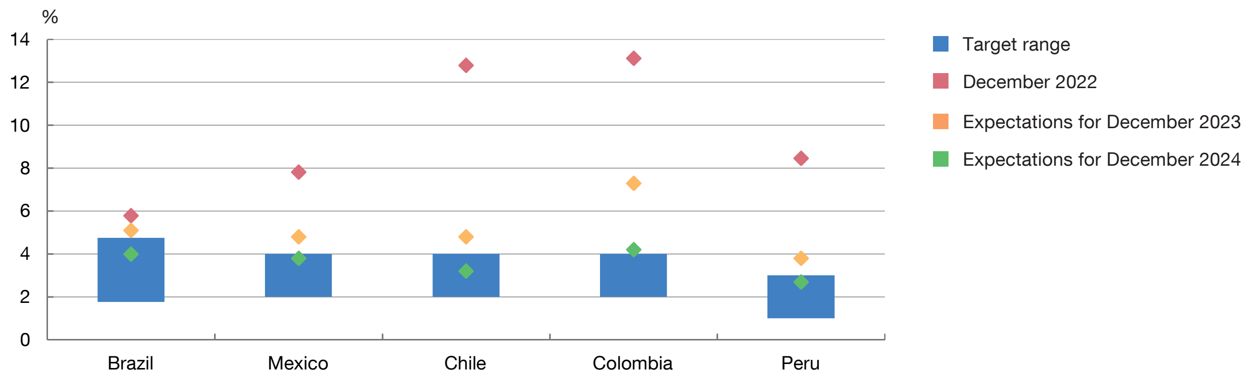
— Although long-term inflation expectations are still anchored to the target, short-term expectations remain above the target levels set by the region's central banks (see Chart 7.a), and their sensitivity to past inflation continues to increase in nearly all the countries (see Chart 7.b). This could make the current inflationary episode more persistent and pose an upside risk for the latest inflation forecasts.

— On a positive note, the more backward-looking nature and consequent greater persistence of inflation in short-term expectations has not been reflected in a greater sensitivity of long-term inflation expectations to recent inflation (see Chart 7.b).

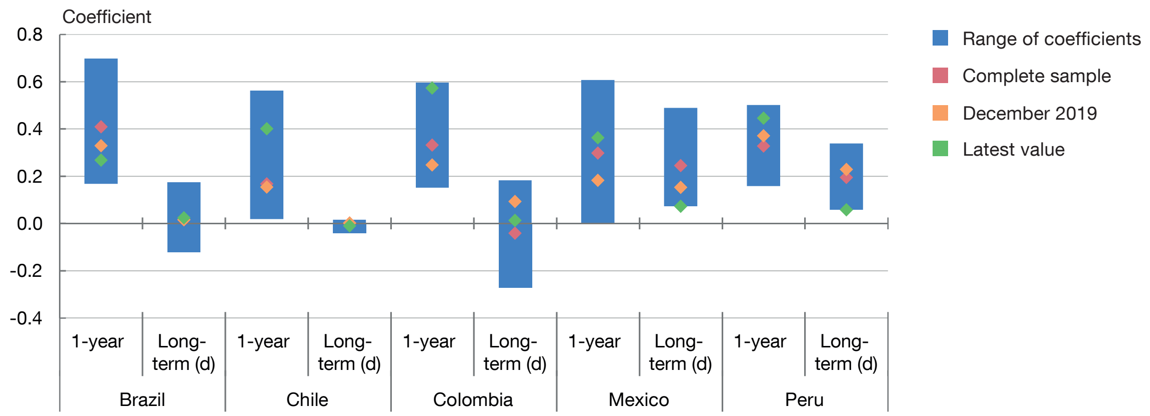
— The sensitivity of long-term inflation expectations to recent inflation allows for an optimistic view as regards the risk of significant indirect and second-round effects materialising and, therefore, of a "deanchoring" of inflation expectations.

Chart 7

7.a Inflation, inflation targets and inflation expectations (a) (b)



7.b Sensitivity of inflation expectations to past inflation (c)



SOURCES: Consensus Forecast, Refinitiv and national statistics.

a The central banks' inflation target is 3% in the case of Brazil (from 2024 onwards), Chile, Colombia and Mexico, and 2% in the case of Peru.
b Inflation expectations taken from Consensus Forecast (January 2023).
c Coefficient α of regression equations: $\pi_t^{ecp} = \alpha\pi_{t-1} + (1-\alpha)\pi_t^{elp} + \varepsilon_t$ and $\pi_t^{elp} = \alpha\pi_{t-1} + (1-\alpha)\pi^* + \varepsilon_t$, estimated across 5-year sliding windows, where π_t^{ecp} denotes 1-year inflation expectations, π_{t-1} year-on-year inflation in the previous quarter, π_t^{elp} long-term inflation expectations and π^* the inflation target. Drawing on quarterly data, using a sample period ranging from 2004 Q1 to 2022 Q4.
d Long-term expectations taken from Latin American Consensus Forecasts at 6 to 10 years.

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8 … and the current uncertainty about exchange rate developments, amid a global tightening of monetary policies

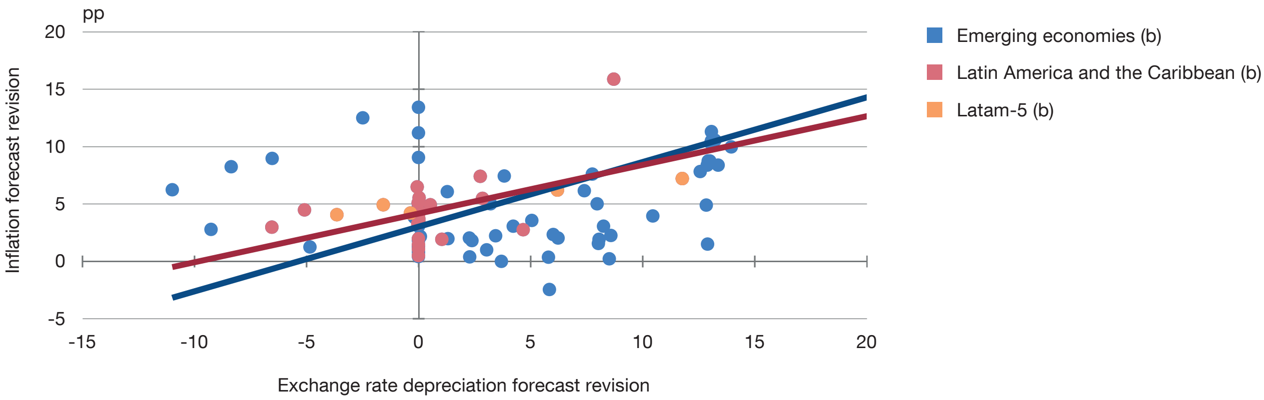
— Moreover, the inflation outlook for the coming quarters is also largely shaped by current expectations about the future path of exchange rates, whose performance (which is strongly influenced, among other factors, by domestic and global monetary policy stances) is highly uncertain.

— In this regard, the upward revisions to inflation forecasts for Latin America in 2022 seem to have stemmed in part from surprises in the performance of some economies' exchange rates against the dollar (i.e. higher-than-expected depreciation).

— Thus, Chart 8 shows a positive correlation, on IMF data, between the scale of the upward revisions to inflation forecasts throughout 2022 in Latin America and several emerging economies and the surprises observed in terms of expected exchange rate depreciation.

Chart 8

8.a Correlation between inflation forecast revisions and exchange rate depreciation forecast revisions (a)



SOURCES: Banco de España and IMF.

a Revisions to inflation forecasts are found by comparing the October 2022 WEO forecast with that of October 2021. The WEO does not explicitly include exchange rate forecasts. However, the exchange rate depreciation implicit in the forecasts can be found as the ratio between the GDP forecast in dollars and the GDP forecast in local currency.
b Latam-5 includes Brazil, Chile, Colombia, Mexico and Peru. The aggregates Emerging economies and Latin America and the Caribbean do not include data for Argentina or Venezuela.

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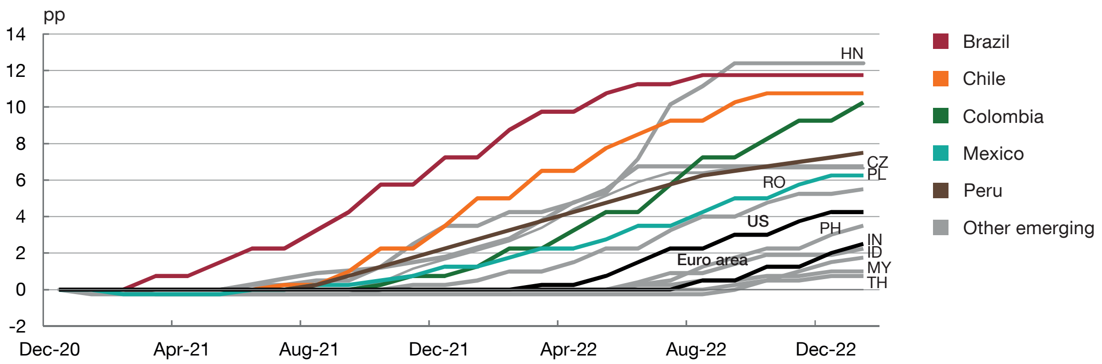
9 The monetary policy stance in Latin America is clearly restrictive

— The early and forceful monetary policy response in Latin America, compared to that of other central banks, during the current inflationary episode is largely responsible for long-term inflation expectations holding around the targets set by the region's central banks (see Chart 9.a).

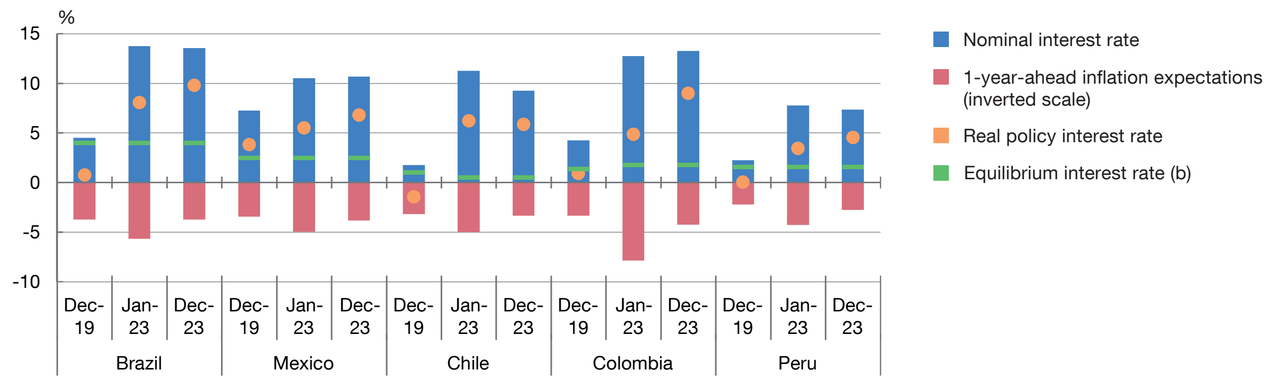
— In the main Latin American economies that employ inflation targeting, real interest rates point to a clearly restrictive monetary policy stance (see Chart 9.b). Moreover, in the coming months, this restrictive stance could tighten further if current expectations in financial markets (which broadly indicate that policy interest rates may fall less sharply going forward than short-term inflation expectations) are borne out.

Chart 9

9.a Cumulative policy interest rate rises since December 2020



9.b Real policy interest rates in the main Latin American economies (a)



SOURCES: National statistics and Refinitiv.

a Real policy interest rates calculated as the difference between policy interest rates and 1-year-ahead inflation expectations, drawn from central bank surveys, except for December 2023, where they are calculated as the policy interest rate according to futures markets or interest rate swaps less the end-2024 expected inflation from Consensus (January 2023).
b Equilibrium interest rate based on the estimates of the region's different central banks.

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10 A slow and moderate monetary easing cycle has been priced in

— Financial markets are confident that Latin American central banks have already completed their policy interest rate hike cycle or are very close to completing it.

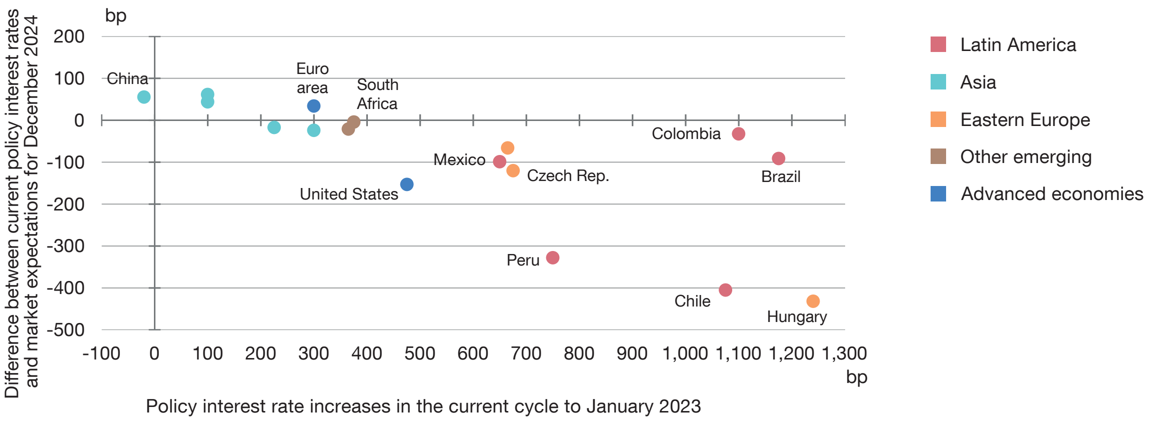
— Indeed, they are pricing in the first policy interest rate cuts for 2023 H2, which would nevertheless be much smaller than the increases recorded during the current cycle of monetary policy tightening (see Chart 10.a).

— The process of monetary easing anticipated by the financial markets would also be more moderate and slower than that observed in previous cycles, except in Chile (see Chart 10.b).

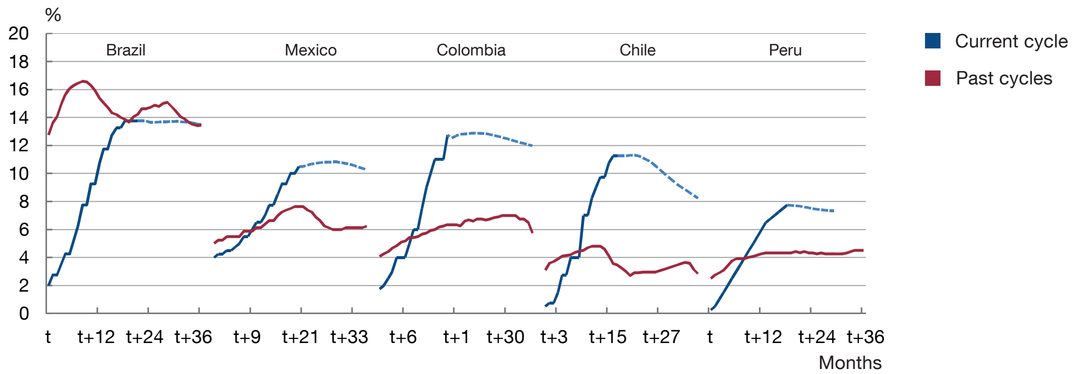
— However, these expectations regarding monetary policy in Latin America are subject to considerable uncertainty and will be strongly influenced by the (likewise uncertain) monetary policy developments in the main developed economies, particularly the United States.

Chart 10

10.a Policy interest rate increases and policy interest rates expected by financial markets (a)



10.b Policy interest rate cycles (b)



SOURCES: Refinitiv, Consensus and JP Morgan.

a End-2024 policy interest rates according to futures markets or interest rates swaps (as at the last week of January 2023), except for Peru (Consensus, January 2023).

b The broken lines represent the policy interest rates priced in by futures markets in the last week of January 2023. Current cycles begin in March (Brazil), June (Mexico), October (Colombia), July (Chile) and August (Peru) 2021. Past cycles begin in 2000, when the five countries adopted the inflation-targeting regime.

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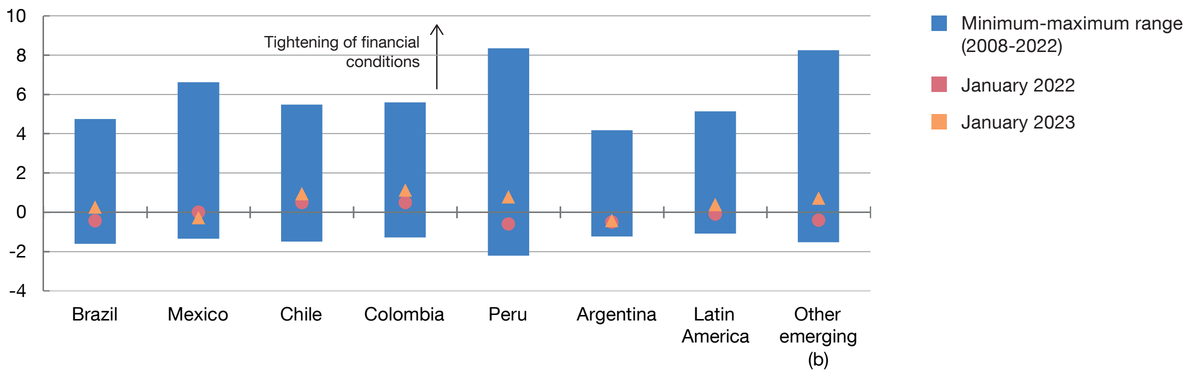
11 Financial conditions have continued to tighten, albeit less sharply than in other emerging economies

— In recent months the tightening of global financial conditions and a sustained restrictive monetary stance in Latin America have continued to strain financial conditions in the region, albeit somewhat less than in other emerging economies (see Chart 11.a).

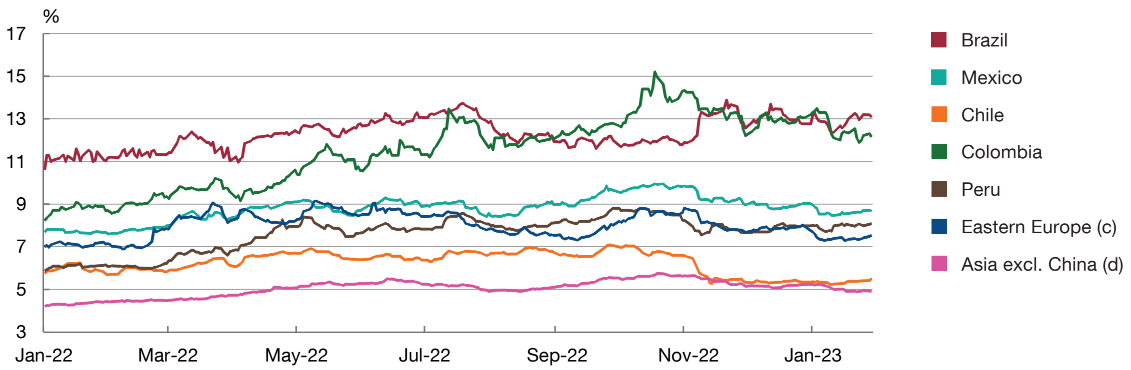
— Part of this tightening of financial conditions was due to the increase in long-term government bond rates in some countries (see Chart 11.b), such as Brazil (prompted in part by the uncertainty generated by the election) and Peru and Colombia (in part due to the internal political tensions in both countries).

Chart 11

11.a Financial conditions indices (a)



11.b Long-term debt interest rates in local currency



SOURCES: Banco de España, Refinitiv and national statistics.

a Drawing on the main components of between 7 and 12 significant financial variables for each country. An increase denotes a tightening of financial conditions and all values above zero indicate tighter financial conditions than the historical average.
b Prepared by Goldman Sachs. Average for China, Thailand, India, Russia, Turkey, South Africa, Indonesia, the Czech Republic, South Korea, Israel, Hungary, Malaysia, Poland and the Philippines.
c Simple average of the long-term interest rates in local currency of Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and Turkey.
d Simple average of the long-term interest rates in local currency of South Korea, Malaysia, the Philippines, Thailand, India and Indonesia.

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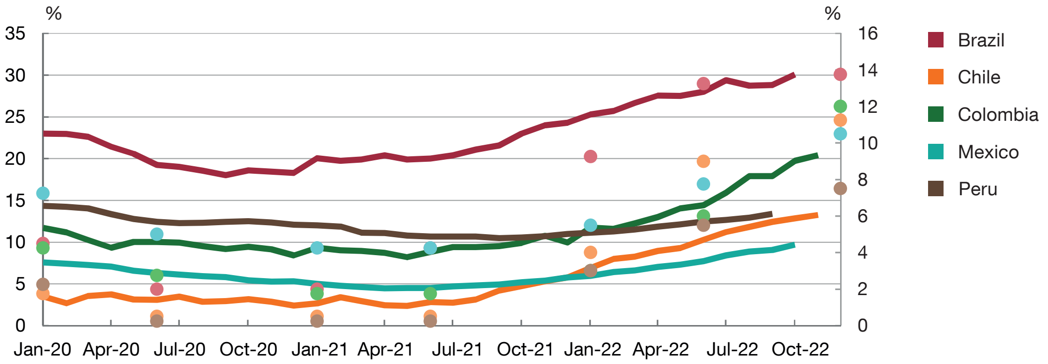
12 The rise in policy interest rates has been passed through to interest rates on bank loans; nevertheless, lending has continued to grow at high rates

— In line with the rise in policy interest rates, bank lending rates have increased since the start of the monetary policy tightening cycle (see Chart 12.a). Despite this, real credit growth has not moderated, buoyed, among other factors, by the dynamism of employment (see Box 2).

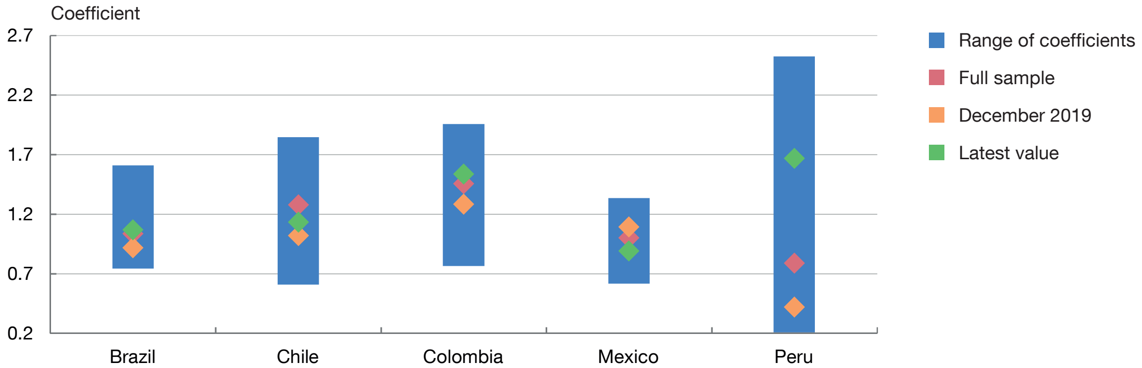
— In the current contractionary monetary policy cycle, the estimated sensitivity of bank lending rates to policy rate fluctuations has remained broadly in line with its average historical pattern. Only in Peru is sensitivity significantly higher than the observed historical average, although it is still well short of the peak values recorded since 1999 (see Chart 12.b).

Chart 12

12.a Policy interest rates (r-h scale, dots) and interest rate on loans (a)



12.b Sensitivity of interest rates on loans to policy interest rates (b)



SOURCES: Banco de España and Refinitiv.

a The dots on the right-hand scale represent the policy interest rate levels at the start of each six-month period.
b Coefficient of the regression equations: $i_{LOANS} = a * i_{POLICY} + b *$ non-performing loans + c * unemployment rate + d * change in industrial output + e * US interest rate, estimated using five-year rolling windows. Monthly data are used, with a sample period ranging from January 1999 to November 2022 (the inflation targeting period for these countries). The full sample refers to the estimate for the period January 1999-November 2022. The exercise is robust to the use of seven-year rolling windows.

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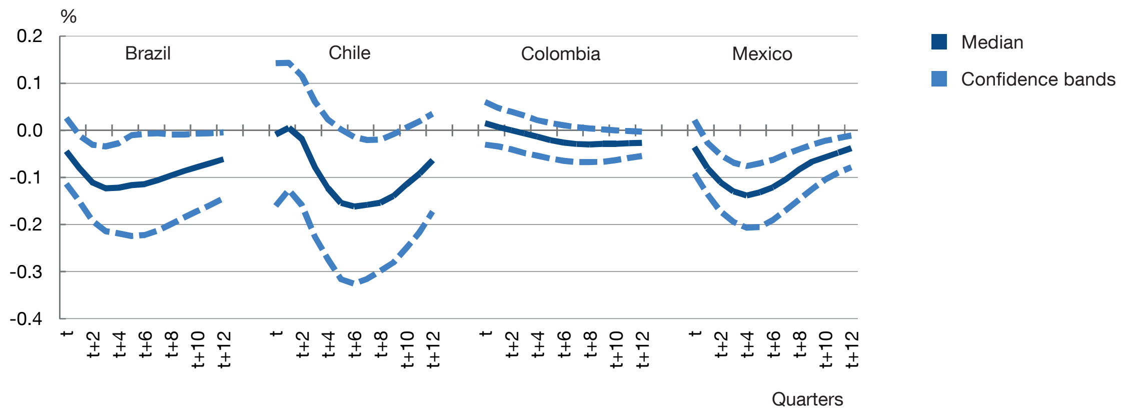
13 Credit growth would have been higher without the restrictive monetary policy cycle

— According to estimates based on BVAR models, in Latin America the response of lending to policy interest rate rises has the expected sign (negative) and is significant and persistent (see Chart 13.a).

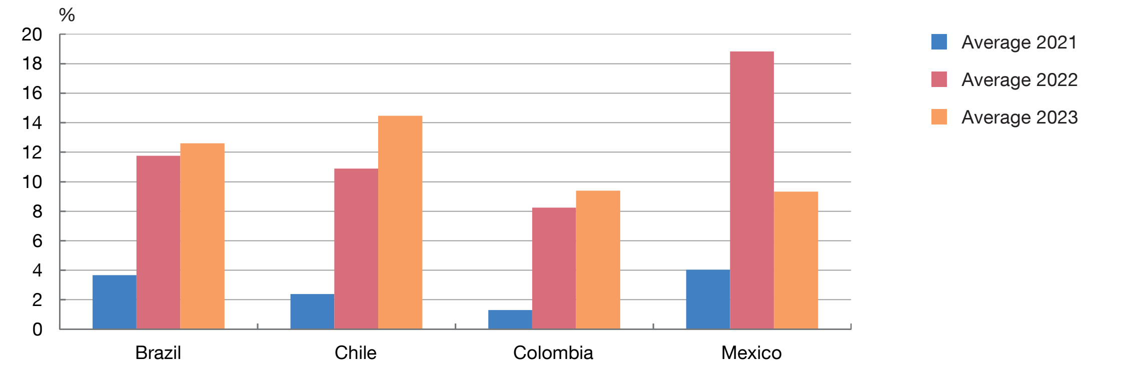
— In this respect, if during 2021 and 2022 the region's policy interest rates had remained at the level they had at the outset of the monetary tightening cycle, real credit growth rates would have been between 2 and 19 percentage points (pp) higher, on average (see Chart 13.b).[4]

Chart 13

13.a Latin America. Response of nominal lending to changes in policy interest rates (a)



13.b Latin America. Additional increases in real lending had policy interest rates not risen: deviations from the reference model (b)



SOURCE: Banco de España.

a Impulse response function of nominal credit to a 1 pp-increase shock to the policy interest rate, median of a set of BVAR models with five macroeconomic variables (GDP growth, inflation rate, policy interest rate, unemployment rate, long-term interest rate, nominal credit growth) using quarterly data for the period 1996-2019 and with one to four endogenous variable lags.
b Estimates of the average rate of growth of real credit in each year if policy interest rates had remained at the floor they reached before the start of the period of monetary tightening until 2022 Q3. Deviations from the reference model are shown.

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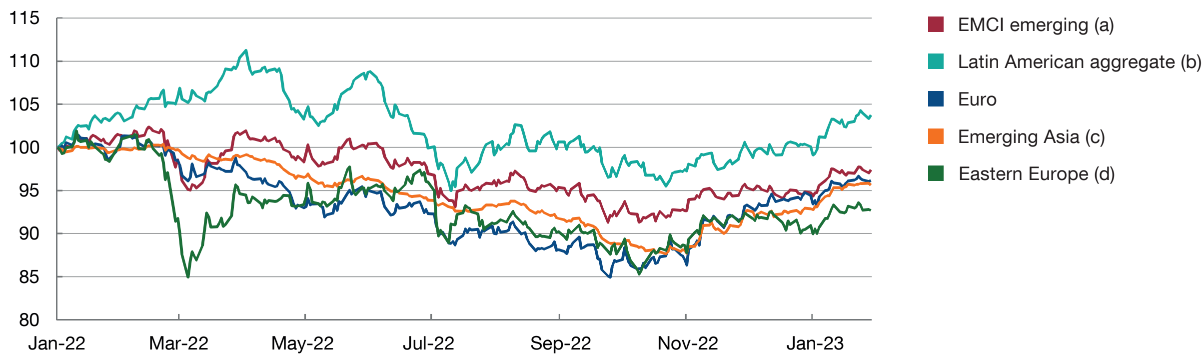
4 This counterfactual exercise is similar to that conducted for emerging Asia countries after the 2008 global financial crisis in S. Elekdag and F. Han. (2015). "What drives credit growth in emerging Asia?", *Journal of Asian Economics,* Vol. 38, pp. 1-13.

14 Despite the volatility that has characterised international financial market developments in recent quarters, financial markets in Latin America have continued to perform relatively well

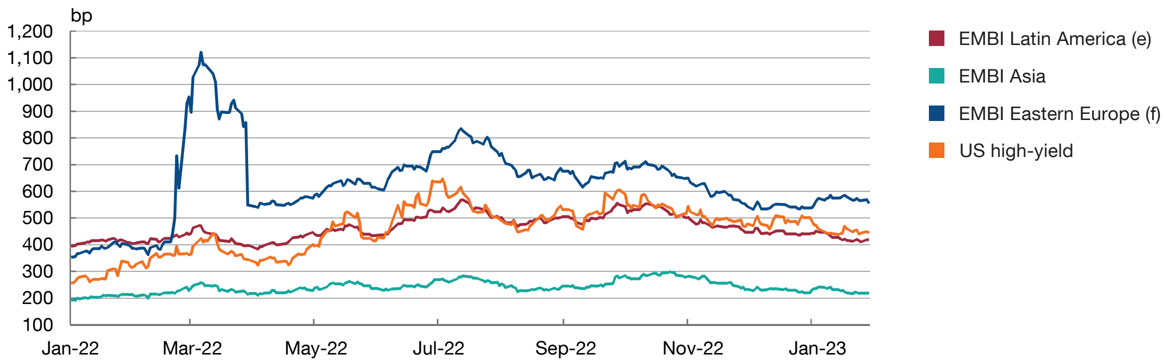
— In recent quarters, the better relative performance of Latin American financial markets, particularly as regards exchange rates (see Charts 14.a and 14.b), appears to be associated, at least in part, with (i) the region's higher prevailing interest rates – which stem from a rate hike cycle that started sooner and has been relatively forceful –, (ii) the fact that many Latin American countries are net exporters of commodities, and (iii) the low sensitivity of the region to the geopolitical risks associated with the war in Ukraine.

Chart 14

14.a Exchange rate against the dollar (January 2022 = 100)



14.b Spread vis-à-vis the US interest rate



SOURCES: Refinitiv and JP Morgan.

a Aggregate exchange rate for emerging economies, compiled by JP Morgan.
b Simple average of the exchange rate indices against the dollar of Brazil, Mexico, Chile, Colombia and Peru.
c Simple average of the exchange rate indices against the dollar of China, India, Indonesia, South Korea, Thailand, the Philippines and Malaysia.
d Simple average of the exchange rate indices against the dollar of the Czech Republic, Poland, Hungary, Romania, Russia and Turkey.
e JP Morgan's Emerging Markets Bond Index (EMBI) is a composite bond of sovereign and quasi-sovereign debt securities issued under certain liquidity and nominal value conditions in international markets.
f The performance of this indicator has been strongly affected, among other factors, by the weight of the Russian assets it includes. This weight has been significantly reduced since the start of the war in Ukraine

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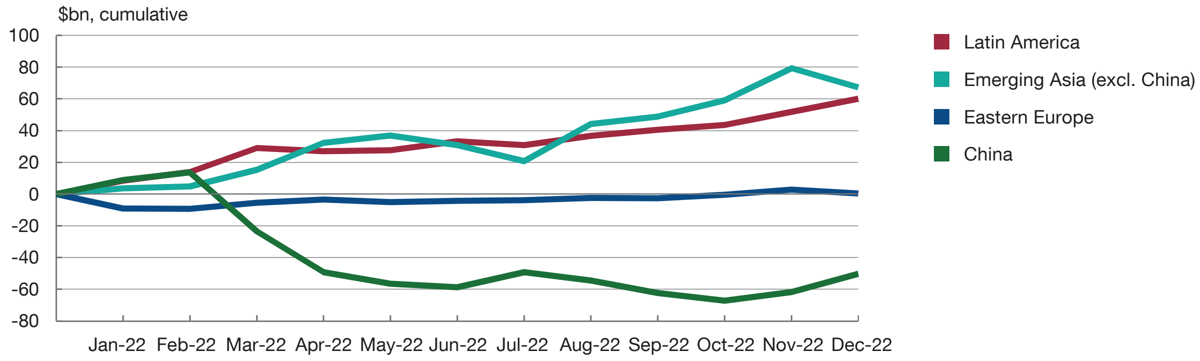
15 In 2022 Latin America received more portfolio capital inflows than other emerging regions

— Latin America recorded portfolio capital inflows throughout 2022, in contrast to the sluggishness of these flows in eastern Europe and the outflows seen in China (see Chart 15.a). The rest of emerging Asia also received portfolio capital inflows during 2022, although only enough to offset the outflows recorded in 2021.

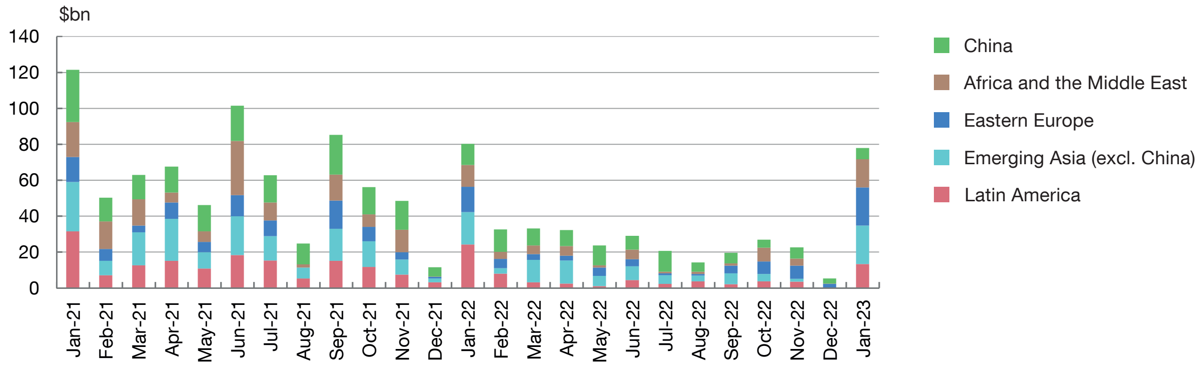
— Fixed-income issues in international markets slowed very sharply from February 2022 (see Chart 15.b), leading to a decline in placements over the year as whole of more than 50% compared with 2021. In eastern Europe and Latin America, the placements that did take place were mainly of sovereign bonds. At the beginning of 2023, issues had returned to their January 2022 levels, thanks mainly to high sovereign placements.

Chart 15

15.a Portfolio capital flows



15.b Fixed-income issues in international markets



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SOURCES: IIF and Dealogic.

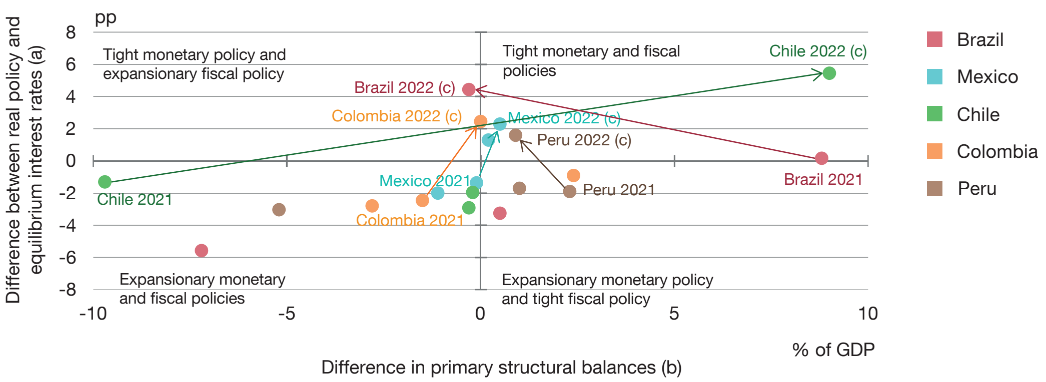
16 The fiscal policy stance is broadly neutral or slightly restrictive

— In 2022 the fiscal impulse was negative and very large (around 9 pp of GDP) in Chile, slightly negative in Mexico and Peru, practically zero in Colombia and slightly positive in Brazil, after the notable negative fiscal impulse deployed in this country in 2021 (see Chart 16.a).

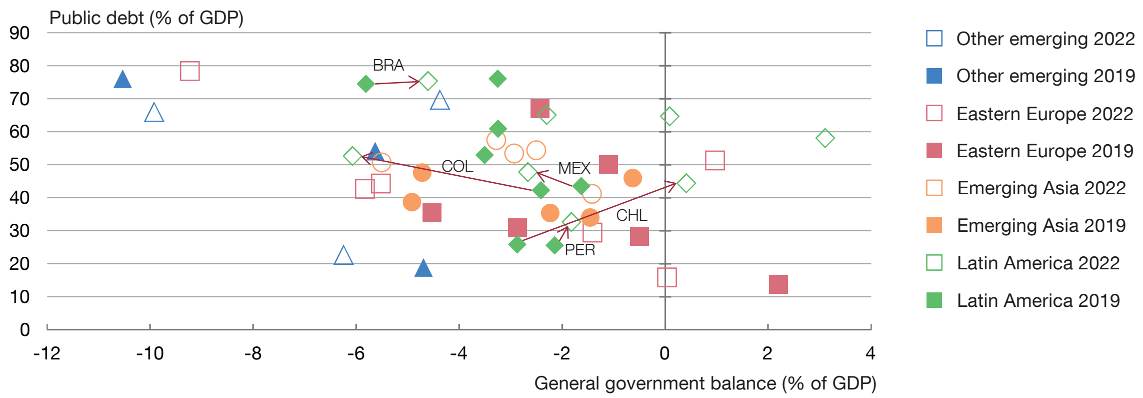
— In any event, the region's fiscal vulnerabilities remain high. Thus, although public deficits were reduced in 2022 (see Chart 16.b), the degree of public sector indebtedness is still significant. Moreover, the composite indicators that approximate the probability of episodes of fiscal stress continued to increase in the second half of the year (see "Note on vulnerability indicators").

Chart 16

16.a Monetary and fiscal policy



16.b Fiscal vulnerabilities (d)



SOURCES: Refinitiv and IMF (October 2022 Fiscal Monitor).

a Real policy interest rates calculated as the difference between policy interest rates and expected inflation one-year ahead, obtained from central bank surveys. Equilibrium interest rate obtained from the estimates of individual central banks in the region.
b Difference between the primary structural balance in one year and that of the previous year. An increase in the balance indicates a tighter policy and a decrease indicates a more expansionary policy.
c December 2022 figures for the interest rate difference and forecasts from the IMF's October 2022 Fiscal Monitor for the 2022 primary structural balance.
d Comparison of pairs of each variable at end-2019 and in 2022 Q3 (latest data available for all countries).

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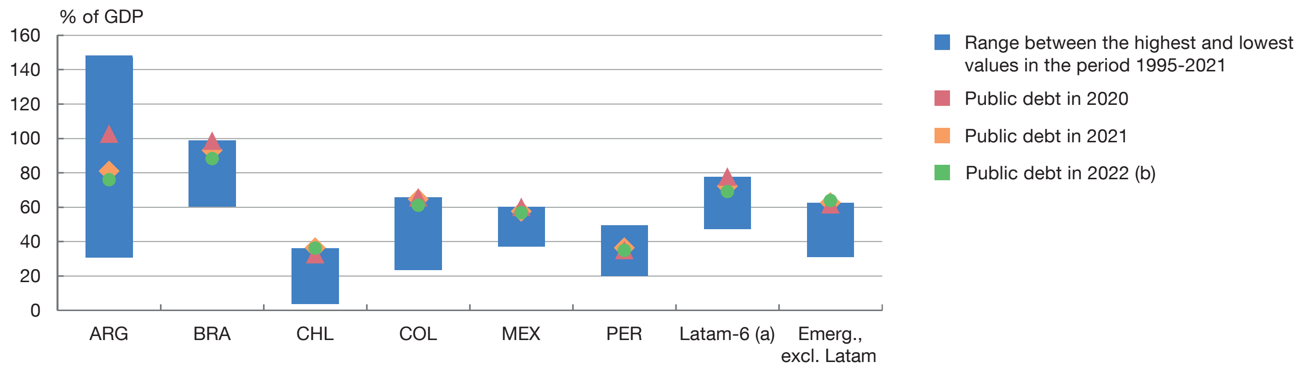
17 The probability that in ten years' time public debt will be higher than it was before the pandemic has increased in recent quarters

— The public debt-to-GDP ratio in Latin America remains high by historical standards and compared with the rest of the emerging economies, despite having fallen over 2022 in most of the region's countries (thanks, in part, to nominal GDP growth) (see Chart 17.a).

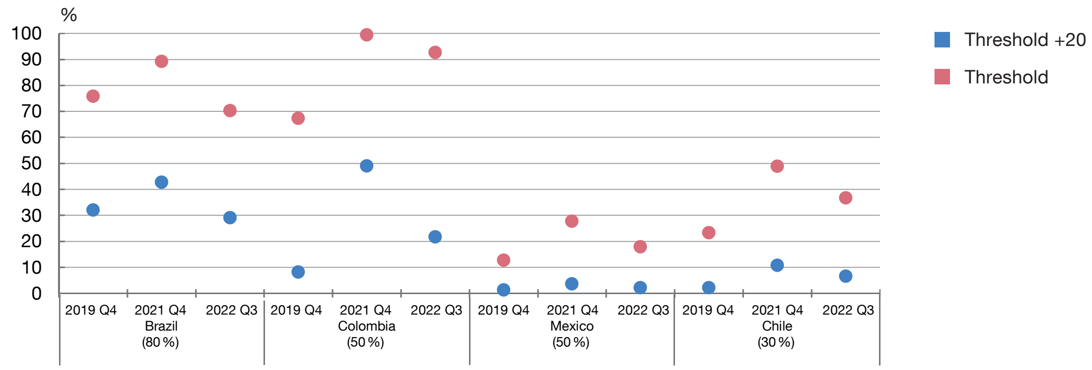
— According to Banco de España estimates,[5] the probability of the public debt ratio exceeding a certain threshold (in particular, its pre-pandemic level) in ten years' time has increased appreciably in Colombia (to more than 90%) and Chile, and somewhat more modestly in Mexico (see Chart 17.b).

Chart 17

17.a Gross public debt



17.b Probability that the debt will exceed a threshold in ten years's time



SOURCES: IMF, Refinitiv, national statistics and Banco de España.

a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b The 2022 figure correponds to the IMF's October 2022 WEO estimate.

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5 For a description of the methodology used, see Box 3, "Public debt sustainability in Latin America", in Report on the Latin American Economy, first half of 2022.

18 Current account imbalances widened compared with the pre-pandemic period, largely due to deteriorating trade balances …

— With data for 2022 Q4 still pending, the current account balances of the main Latin American economies stood in deficit in 2022, and, with the exception of Brazil, more so than prior to the pandemic (see Chart 18.a).

— This deterioration was chiefly driven by worsening trade balances, as a result of the sharp increase in imports fuelled by vibrant domestic demand, and despite the rise in commodity prices in exporting countries.

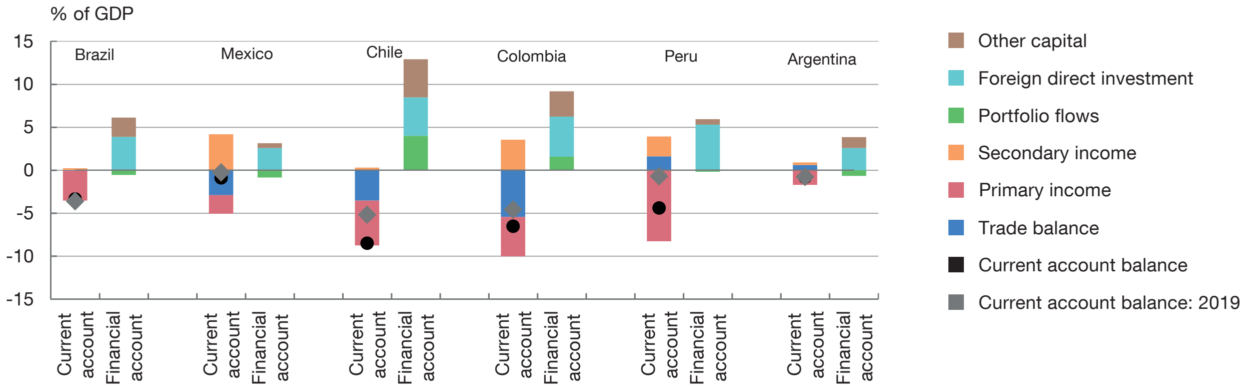
— Balances on primary income – which include, among other items, profit repatriation by firms exploiting natural resources in the region – deteriorated virtually across Latin America, and especially in Chile, Colombia and Peru.

— Balances on secondary income – which include, inter alia, workers' remittances – increased in all countries except for Chile, with particularly large surpluses in Mexico and Colombia.

— The current account deficits were largely financed by foreign direct investment, which held relatively stable at 2019 levels. However, portfolio capital inflows, normally in the form of debt, played a significant role in the two countries with the largest current account deficits, Colombia and Chile (1.5% and 4% of GDP, respectively).

Chart 18

18.a Breakdown of the balance of payments. 2022 (a)



SOURCES: IMF and Refinitiv.

a Calculated as the moving average between 2021 Q4 and 2022 Q3.

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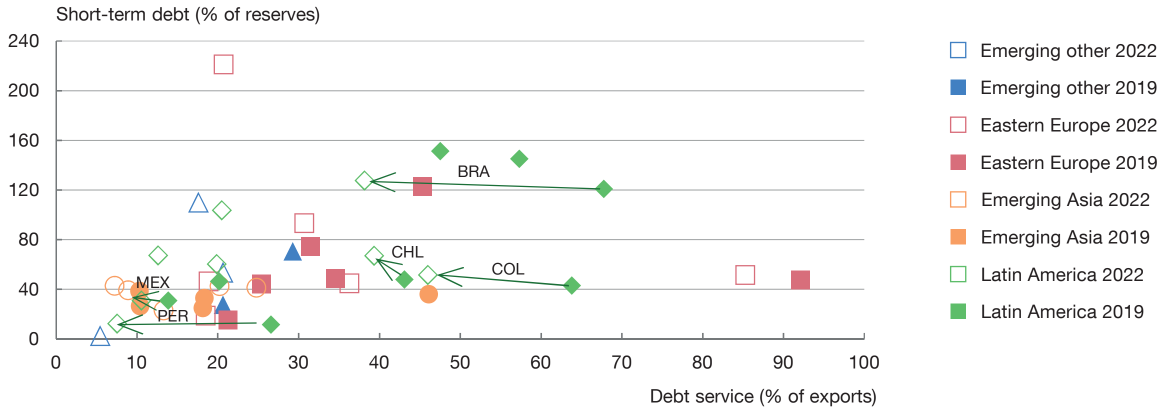
19 … although there were improvements in the external vulnerabilities

— Despite balances of payments deteriorating in 2022, the external sustainability indicators trended favourably, with a marked decline in external debt service in the period 2019-2022 and (in contrast with eastern European countries) relatively stable levels of short-term debt (see Chart 19.a).

— Conversely, external debt as a percentage of GDP rose sharply in the same period (see the vulnerability indicators).

Chart 19

19.a External vulnerabilities: sustainability indicators (a)



SOURCES: IMF and Refinitiv.

a Peer comparison for the two variables at end-2019 and 2022 Q3.

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20 Under an adverse global and domestic scenario, capital outflows from Latin American economies could amount to around 0.3% of GDP

— Against the current backdrop (tightening global financial conditions, weak growth and fiscal sustainability concerns in some regions following the pandemic-induced borrowing), spells of significant contraction of capital flows to certain economies cannot be ruled out.

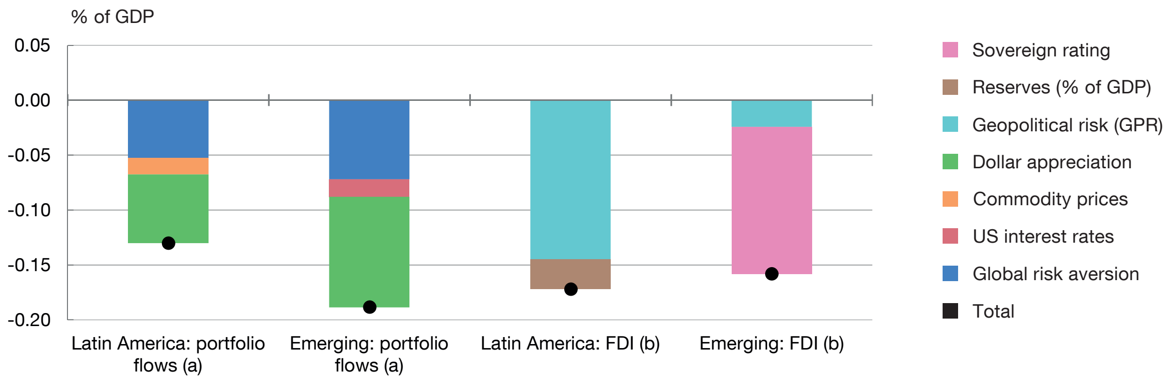
— To assess the significance of this risk, portfolio and direct investment flows have been simulated for the 25 largest emerging economies under plausible global scenarios, using models that include push and pull factors.[6]

— In the case of portfolio flows, a scenario combining (i) a 1 pp increase in US policy interest rates, (ii) higher risk aversion, (iii) additional dollar appreciation, and (iv) declining commodity prices would generate additional capital outflows for emerging economies as a whole equivalent to 0.19% of GDP (or nearly 17% of total portfolio inflows in 2021) (see Chart 20.a). In Latin America, this scenario would prompt additional outflows equivalent to 0.11% of GDP (or 16% of total inflows in 2021).[7]

— In the case of direct investment, a risk scenario combining (i) higher geopolitical risk, (ii) a one-notch downgrade in sovereign ratings, and (iii) foreign exchange reserve losses of 1 pp of GDP would reduce inward foreign direct investment by 0.15% of GDP for emerging economies as a whole (6% of the inflows recorded in 2021) and by a somewhat larger percentage for Latin America.

Chart 20

20.a Estimated impact on capital flows to emerging economies



SOURCES: IMF and Refinitiv.

a Results of a quarterly panel model for 23 emerging countries from 1999 (see Molina and Viani, 2019), simulating the impact of a rise in US policy interest rates (100 bp) together with an increase in global risk aversion (132 bp), a dollar appreciation (4.1%) and a drop in commodity prices (10.9%) based on past correlations between Fed Fund rates and each of the variables. Some factors do not appear in one of the two groups of countries where they are insignificant coefficients.

b Results of a quarterly panel model for 23 emerging countries from 1999 (see Molina and Viani, 2019), simulating the impact of a one-standard deviation increase in the geopolitical risk (GPR) index, a one-notch downgrade in sovereign ratings and a drop of 1 pp of GDP in the country's international reserves. Some factors do not appear in one of the two groups of countries where they are insignificant coefficients.

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6 Molina, L. and F. Viani. (2019). "Capital flows to emerging economies: recent developments and drivers", Analytical Articles, *Economic Bulletin* – Banco de España 2/2019.

7 A more favourable commodity price performance would benefit the region. For instance, all else being constant, prices rising by 15%, as they did in the first few weeks of the war in Ukraine, would generate around $1 billion in portfolio capital inflows.

21 Hypothetical scenarios of global geopolitical fragmentation would affect Latin America's international trade

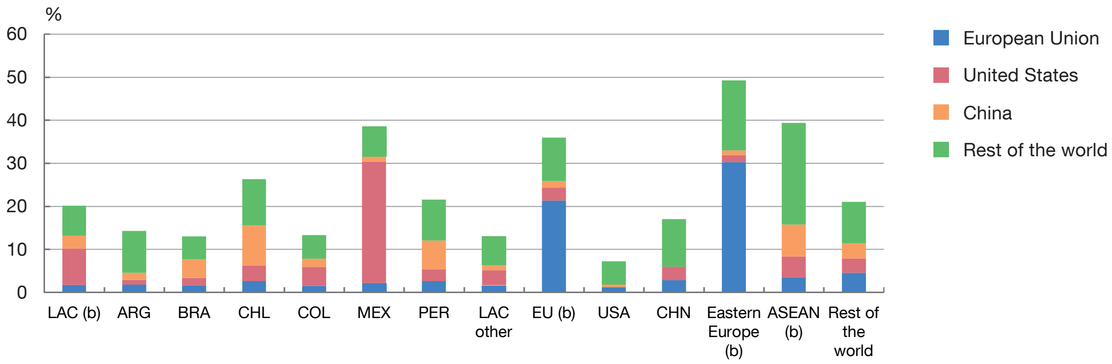
— Countries in Latin America and the Caribbean differ in their trade openness and the origin and destination of their international trade flows. The close trade relations of the region's countries with the United States and China (see Charts 21.a and 21.b), which could end up in a trade war with each other, leave them exposed to significant geopolitical risk.

— According to a simulation exercise,[8] a rise in international trade barriers to Cold War levels could prompt trade to decline by more than 10% in some countries in the region, including Chile and Peru.

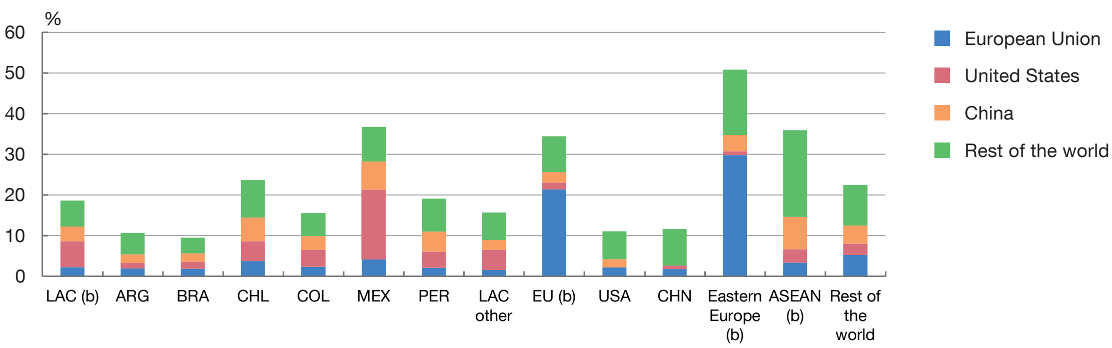
— The scale of these adverse effects underlines the need to find multilateral solutions to geopolitical conflicts. In fact, strengthening trade relations between Latin America and the Caribbean and the European Union could largely offset the fall-off in trade resulting from the geopolitical fragmentation described above.

Chart 21

21.a Destination of exports expressed as a percentage of GDP (a)



21.b Origin of imports expressed as a percentage of GDP (a)



SOURCES: Banco de España and CEPII.

a Both for exports and imports, the ratio of nominal trade flows to nominal GDP (both expressed in current dollars) is calculated for each country and country aggregate. Data for 2019.
b Country aggregates are defined as: LAC: Latin America and the Caribbean; EU: European Union; Eastern Europe: eastern European countries that are non-euro area EU Member States; ASEAN: Association of Southeast Asian Nations.

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8 Campos, Rodolfo and Jacopo Timini. (2023). "Latin America and the Caribbean: trade relations in the face of global geopolitical fragmentation risks", Article 13, *Economic Bulletin* – Banco de España, 2023/Q1.

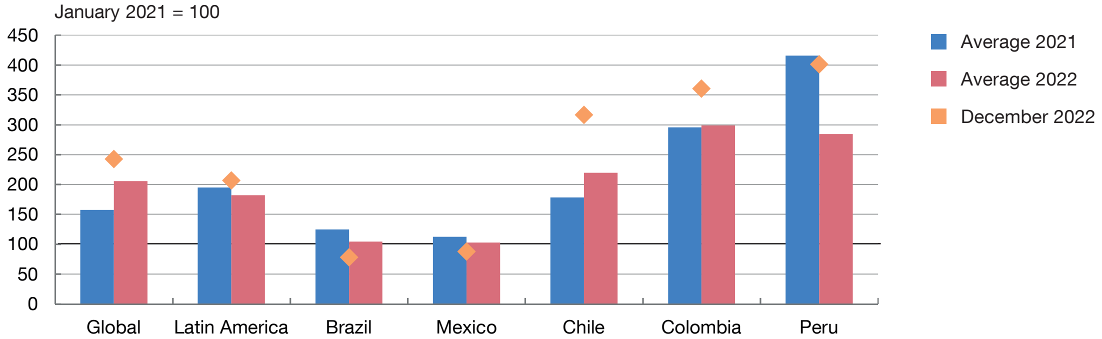
22 The region has seen a fresh upsurge in economic policy uncertainty and in social and political unrest

— The uncertainty indicator over the future trajectory of economic policy recorded a mixed performance in 2022 (see Chart 22.a), with the aggregate figure standing 14% above the average for 2021. This increase was driven by Colombia and Chile, following recent changes of government which could entail a substantial shift in economic policy. Uncertainty over fiscal policy was also reflected in Brazil's economic policy uncertainty (EPU) index in the months leading up to the presidential elections.

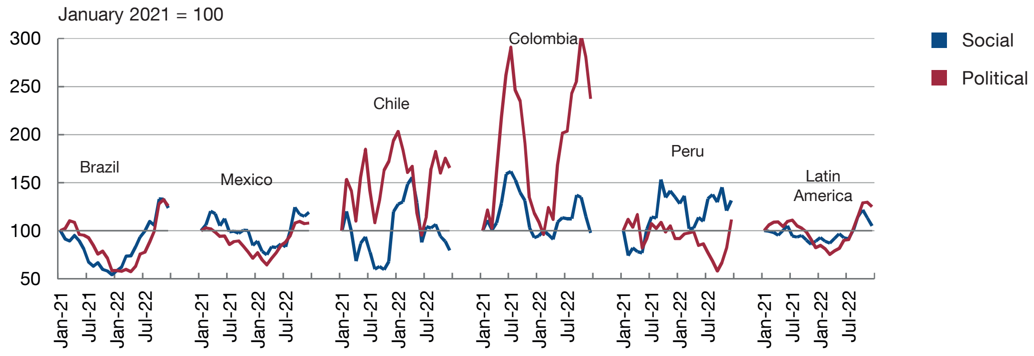
— Meanwhile, the indicators of social and political unrest likewise pointed to an increase in 2022 (see Chart 22.b), a year that saw the culmination of a busy electoral cycle in Latin America, a flare-up of social protests and increased polarisation of societies. In this respect, it should be noted that according to Banco de España estimates, marked and persistent increases in these indicators of unrest can have grave consequences for economic activity.[9]

Chart 22

22.a Indicators of economic policy uncertainty (EPU) (a)



22.b Indicators of social and political unrest (b)



SOURCES: Banco de España and Economic Policy Uncertainty.

a Andres-Escayola, Erik, Corinna Ghirelli, Luis Molina, Javier J. Pérez and Elena Vidal. (2022). "Using newspapers for textual indicators: which and how many?". Documentos de Trabajo - Banco de España, 2235. Economic Policy Uncertainty (EPU) is a foreign and local-press based index using keywords related to economic policy uncertainty.

b Measures of social and political unrest following the methodology of Baker, Bloom and Davis, based on keywords related to each topic used in foreign and local press (Andres-Escayola, Erik, Corinna Ghirelli, Luis Molina, Javier J. Pérez and Elena Vidal. "What do we mean when we talk about social unrest?", mimeo).

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9 See Diakonova, Marina, Luis Molina, Hannes Mueller, Javier J. Pérez and Cristopher Rauh. (2022). "The information content of conflict, social unrest and policy uncertainty measures for macroeconomic forecasting", Documentos de Trabajo - Banco de España, 2232, and Banco de España. (2022). *Report on the Latin American economy*, first half of 2022.

Table 1

Latin America: Main economic indicators

	2007-2021 average	2022	IMF projections (October 2022 WEO)		2021				2022			
			2023	2024	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (change on previous period) (a)												
Latin America and the Caribbean (b)	1.9	—	1.7	2.4	1.5	-0.1	1.1	1.5	1.1	1.0	0.6	—
Argentina	1.4	—	2.0	2.0	3.5	-0.8	3.9	2.0	1.0	1.0	1.7	—
Brazil	1.7	—	1.0	1.9	1.1	-0.3	0.4	0.9	1.3	1.0	0.4	—
Mexico (c)	1.4	3.0	1.2	1.8	0.5	0.7	-1.1	1.0	1.2	1.1	0.9	0.4
Chile	3.1	—	-1.0	2.0	3.7	1.3	4.6	1.7	-0.7	0.1	-1.2	—
Colombia (c)	3.5	7.5	2.2	2.8	3.8	-2.8	4.6	5.4	0.6	1.1	0.5	0.7
Peru	4.4	—	2.6	3.2	0.3	0.4	2.3	0.1	0.8	0.2	0.6	—
CPI (year-on-year rate) (a)												
Latin America and the Caribbean (b)	5.8	9.8	11.4	8.1	4.1	6.0	7.2	8.2	8.8	10.0	9.2	8.0
Argentina	22.4	72.4	76.1	51.2	40.6	48.5	51.9	51.4	52.8	61.0	77.6	91.8
Brazil	5.6	9.3	4.7	3.9	5.3	7.7	9.6	10.5	10.7	11.9	8.7	6.1
Mexico	4.2	7.9	6.3	3.9	4.0	6.0	5.8	7.0	7.3	7.8	8.5	8.0
Chile	3.4	11.6	8.7	4.1	3.0	3.6	4.9	6.6	8.3	11.5	13.7	13.0
Colombia	4.0	10.2	7.1	4.8	1.6	3.0	4.3	5.2	7.8	9.3	10.8	12.6
Peru	3.0	7.9	4.4	2.5	2.6	2.7	4.7	6.0	6.2	8.3	8.6	8.4
Budget balance (% of GDP) (a) (d)												
Latin America and the Caribbean (b)	-4.1	—	-4.6	-4.0	-8.2	-5.4	-4.2	-4.3	-3.7	-3.7	-3.7	—
Argentina	-3.8	—	-3.3	-3.5	-7.1	-4.5	-2.9	-3.6	-3.7	-4.0	-3.9	—
Brazil	-5.5	—	-7.5	-6.8	-12.3	-7.1	-4.7	-4.3	-3.1	-4.2	-4.3	—
Mexico	-3.1	—	-4.1	-2.7	-2.8	-2.3	-2.7	-3.2	-3.3	-3.1	-3.4	—
Chile	-1.3	—	-1.2	-0.9	-7.7	-7.1	-7.4	-7.7	-6.3	-2.0	0.4	—
Colombia	-2.8	—	-2.9	-2.1	-9.0	-7.8	-5.8	-6.9	-6.5	-5.4	-5.8	—
Peru	-0.8	—	-2.3	-1.9	-9.4	-7.3	-4.9	-3.4	-2.1	-1.2	-1.8	—
Public debt (% of GDP) (a)												
Latin America and the Caribbean (b)	56.9	—	69.2	69.9	68.6	64.3	64.3	63.2	62.6	60.7	60.5	—
Argentina	60.2	—	69.5	69.6	83.4	70.8	71.6	68.5	69.3	60.5	63.0	—
Brazil	73.4	—	88.9	90.6	85.2	81.0	80.3	78.3	77.4	76.7	75.3	—
Mexico	48.9	—	58.7	59.0	55.3	51.8	52.6	52.3	52.9	51.8	51.4	—
Chile	17.3	—	36.9	37.8	34.5	35.1	35.5	36.3	34.5	31.1	31.2	—
Colombia	44.9	—	60.0	59.2	63.9	63.2	61.5	60.7	58.1	57.3	58.4	—
Peru	26.4	—	35.7	35.7	36.2	33.8	34.5	35.9	33.4	33.8	34.4	—
Current account balance (% of GDP) (a) (d)												
Latin America and the Caribbean (b)	-1.8	—	-1.4	-1.4	-0.4	-0.4	-1.3	-2.1	-2.1	-2.6	-3.1	—
Argentina	-0.9	—	0.6	0.4	0.9	0.7	1.2	1.4	0.9	0.2	-0.8	—
Brazil	-2.4	—	-1.6	-1.7	-2.1	-1.8	-2.3	-2.8	-2.4	-2.9	-3.3	-3.9
Mexico	-1.2	—	-1.2	-1.1	2.3	2.6	0.8	-0.4	-0.4	-0.8	-0.9	—
Chile	-2.8	—	-4.4	-3.6	-1.8	-2.9	-4.5	-6.4	-7.1	-8.7	-9.8	—
Colombia	-3.8	—	-4.4	-4.3	-3.7	-4.2	-4.9	-5.7	-6.2	-6.2	-6.4	—
Peru	-2.3	—	-2.1	-2.0	0.1	-0.8	-1.6	-2.7	-3.5	-3.6	-4.5	—
External debt (% of GDP) (a)												
Latin America and the Caribbean (b)	37.7	—	45.1	—	47.1	44.5	43.4	42.7	—	—	—	—
Argentina	41.4	—	—	—	69.6	64.0	59.7	55.3	52.8	48.9	44.8	—
Brazil	29.0	—	—	—	43.3	42.2	41.0	40.6	40.2	37.0	36.0	—
Mexico	22.7	—	—	—	34.2	31.5	30.0	29.3	—	—	—	—
Chile	55.4	—	—	—	78.6	73.4	75.6	75.5	76.5	74.1	73.8	—
Colombia	33.1	—	—	—	56.1	54.0	54.1	53.8	53.6	51.3	50.7	—
Peru	34.1	—	—	—	44.8	41.7	43.5	46.0	45.0	43.4	42.6	—
MEMORANDUM ITEMS: Aggregate of emerging economies excluding Latin America and China (IMF, October 2022 WEO)												
GDP (year-on-year rate)	4.1	4.1	3.8	4.5								
CPI (year-on-year rate)	7.1	13.4	10.7	6.8								
Budget balance (% of GDP)	-2.9	-4.9	-4.5	-4.6								
Public debt (% of GDP)	41.9	56.2	57.5	59.0								
Current account balance (% of GDP)	0.7	1.7	1.3	0.7								
External debt (% of GDP)	27.5	24.6	24.0	—								
Share of global GDP, in PPP (%)	31.8	32.3	32.6	33.1								

SOURCES: IMF, Refinitiv, LatinFocus and national statistics.

a Latin America and the Caribbean account for 7.3% of global GDP measured in PPP. The six economies shown account for 86% of all Latin America and the Caribbean (IMF).
b Quarterly data, aggregate of the six main economies (Argentina, Brazil, Chile, Colombia, Mexico and Peru), and for inflation, aggregate excluding Argentina.
c Seasonally adjusted series.
d 4-quarter moving average.

Box 1

CENTRAL AMERICA AND THE DOMINICAN REPUBLIC: MACROECONOMIC OUTLOOK

The countries comprising Central America and the Dominican Republic (CADR) (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic) have a shared institutional framework to deepen their trade and financial integration, whereby they aspire to become an economic union in the future and thus participate as a bloc in international trade. In 2021 this region represented Latin America's third largest economy by population (56.8 million) and fifth largest by output (GDP of $316 billion).

Economic activity and inflation

Growth in the CADR's (trend-cycle) monthly index of economic activity (IMAE by its Spanish initials)[1] has decelerated since May 2021. On data to September 2022, that slowdown has moderated, converging to a monthly average of 3.9% in 2022 Q3[2] (see Chart 1). However, the performance of the region's different productive sectors remains considerably heterogeneous. For instance, transportation, communication and accommodation and food service activities are displaying greater momentum than agriculture.

The average annual change in the consumer price index (CPI) in the region stood at 8.4% in January 2023, having seemingly reached its inflection point after peaking at 9.6% in August (see Chart 2). Provided there are no significant external shocks, this downward trend may take hold over the coming months, as the restrictive measures implemented by the monetary authorities (detailed below) take effect and global commodity prices stabilise. Overall, food and non-alcoholic beverages have recorded the greatest inflationary pressures in the region of late, mainly as a result of higher global commodity prices.

Public finances

CADR's public finances, at central government level, strengthened further at the beginning of 2022 Q4, boosted by year-on-year tax revenue growth of 16% (1.8% of regional GDP). This was consistent with the recovery in productive activity following the pandemic and higher inflation, which contributed to a $6 billion increase in tax revenue, explained mostly by income and consumption taxes. Government spending grew year-on-year by 10.9% (1.4% of GDP), mainly as a result of the increase in financial resources allocated to subsidies and other forms of public support in the region to contend with the overall increase in prices (mainly fuel, electricity and food prices).

To October 2022, the region had a budget deficit of 0.8% of its GDP (see Chart 3). The public debt-to-GDP ratio, at central government level, was 48.6%, having gradually fallen from its December 2020 peak of 53.4%.[3] This helped improve the region's overall risk profile, mainly from July 2022. However, despite this improvement, internal and external financing costs will remain high for all countries in the region over the coming quarters, limiting fiscal space in 2023 (see Chart 4).

External sector

In 2022 Q3, CADR's current account balance worsened, with the deficit growing from 0.5% of the region's GDP in the same period of 2021 to 3.2% ($8,262 million) (see Chart 5), mainly as a result of the widening trade deficit, which grew year-on-year by 45.7%. This was above all a consequence of the increase in goods imports (28.6%) caused by higher import prices and greater domestic demand associated with improved economic performance. The services surplus improved (49.3% year-on-year) as a result of the strong performance of tourism. However, net primary income payments grew by 9.4%, as direct investment enterprises reinvested their earnings. The secondary income surplus amounted to $36,359 million.

In 2022 remittances totalled $34,945 million, a rise of $3,753 million (12%) on the previous year (see Chart 6). This significant increase in remittance flows in 2022 is associated with favourable economic developments in the United States, reflected in high employment levels, particularly in the Hispanic segment. Remittances increased significantly for Guatemala, Honduras and Nicaragua, which saw growth above 20%. These external funds are of utmost importance to these economies, accounting for 28.5% of GDP in Honduras, 24.1% in El Salvador and 19.3% in Nicaragua. Remittances from Spain accounted for approximately 3.2% of the total sent to CADR ($1,140 million). The main recipients were the Dominican Republic, Honduras and Nicaragua.

1 For methodological details on how the regional IMAE is constructed, see https://www.secmca.org/wp-content/uploads/2021/03/Propuesta-de-cambio-en-el-m%c3%a9todo-de-agregaci%c3%b3n-de-variables-y-ponderadores-regionales.pdf (only available in Spanish).

2 Regional GDP totalled $87,908 million in 2022 Q3.

3 In December 2019, before the outbreak of the pandemic, the public debt-to-GDP ratio was 43.7%.

Box 1

CENTRAL AMERICA AND THE DOMINICAN REPUBLIC: MACROECONOMIC OUTLOOK (cont'd)

Monetary and financial conditions

Most central banks in CADR have raised their policy interest rates (see Chart 7). This new monetary policy stance seeks to counter the effect of external supply shocks on domestic energy and food prices, which prompted inflation to rise in 2022 and have darkened the outlook for 2023. As a result of this restrictive monetary policy, growth in monetary aggregates has slowed sharply in Costa Rica and the Dominican Republic, while in the other countries – except for Honduras, where it has picked up – the deceleration has been gradual.

However, the slowdown in monetary aggregates has not had significant repercussions for the financial systems of the region's countries, as they have sufficient liquidity and levels of capital exceeding the regulatory requirements, showing themselves to be resilient to a monetary contraction. Partly for this reason, the pace of growth of bank lending quickened in 2022, standing above 15% in some countries (see Chart 8).

Chart 1
Change in the monthly index of economic activity (IMAE) (trend-cycle)

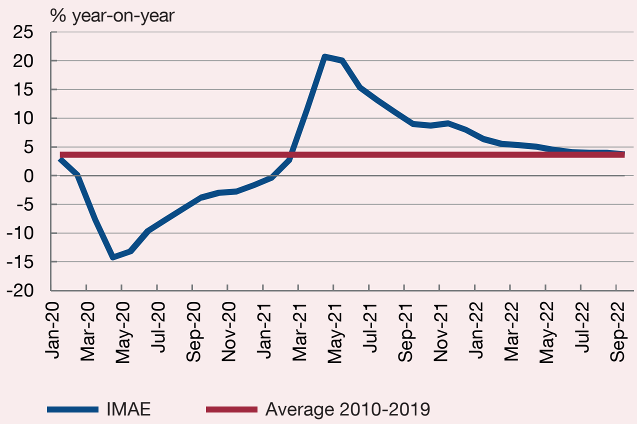


Chart 2
Inflation. Change in CPI

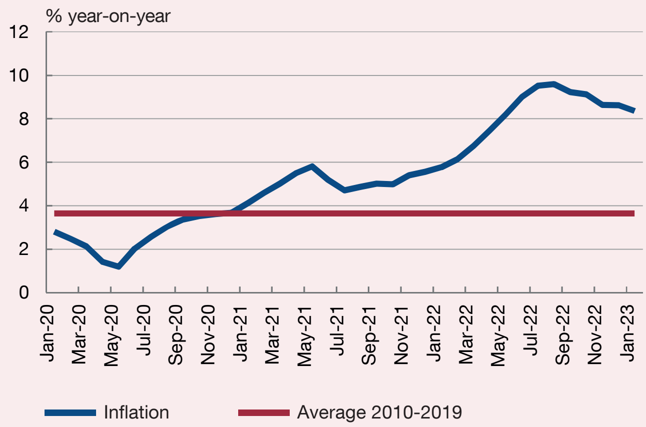


Chart 3
Central government debt and budget balance. % of GDP

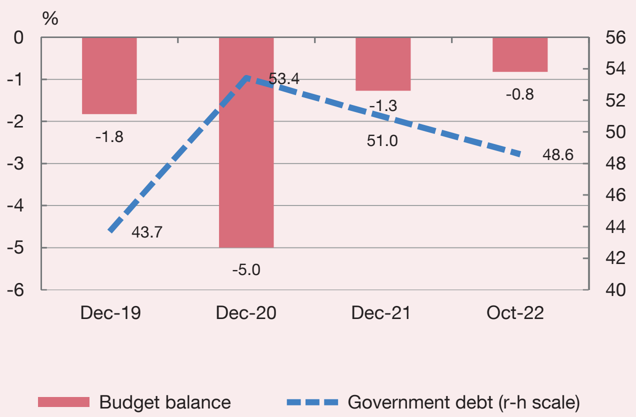
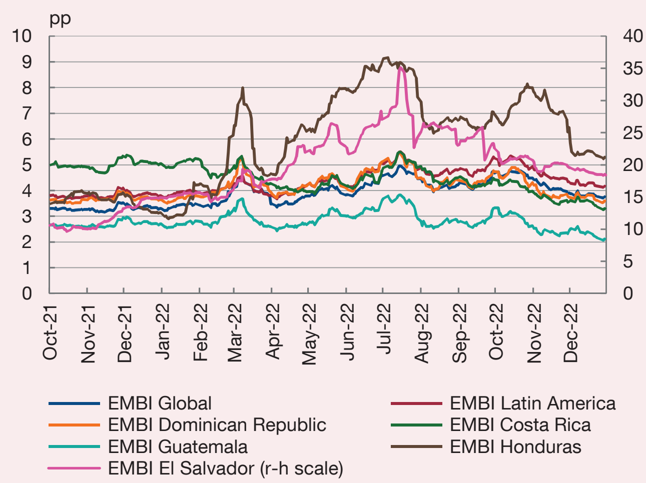


Chart 4
Sovereign spreads over US long-term yields (a)



SOURCE: CADR.

a The EMBI is the main indicator of country risk and is calculated by JPMorgan Chase. It is the difference between the yields on US dollar-denominated sovereign bonds issued by emerging countries and US Treasury Bonds.

Box 1

CENTRAL AMERICA AND THE DOMINICAN REPUBLIC: MACROECONOMIC OUTLOOK (cont'd)

Chart 5
Current account balance

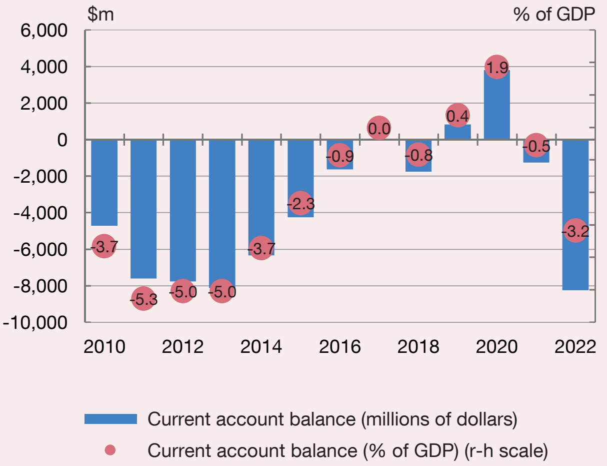


Chart 6
Remittances. $m and as a % of GDP (a)

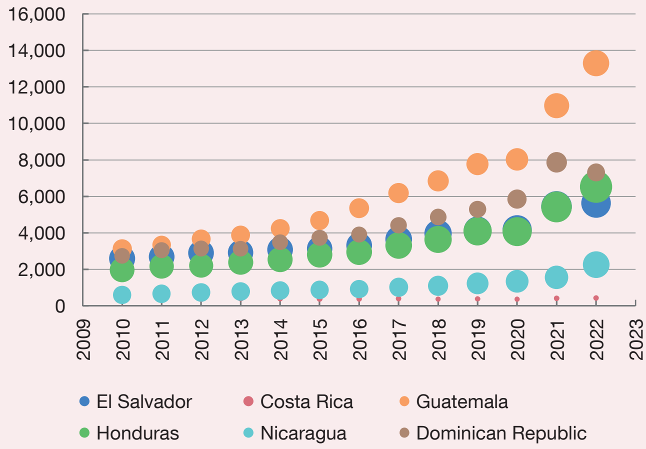


Chart 7
Policy interest rates

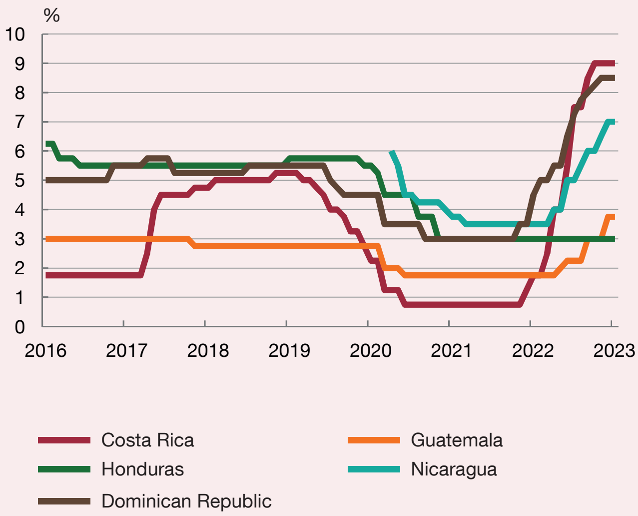
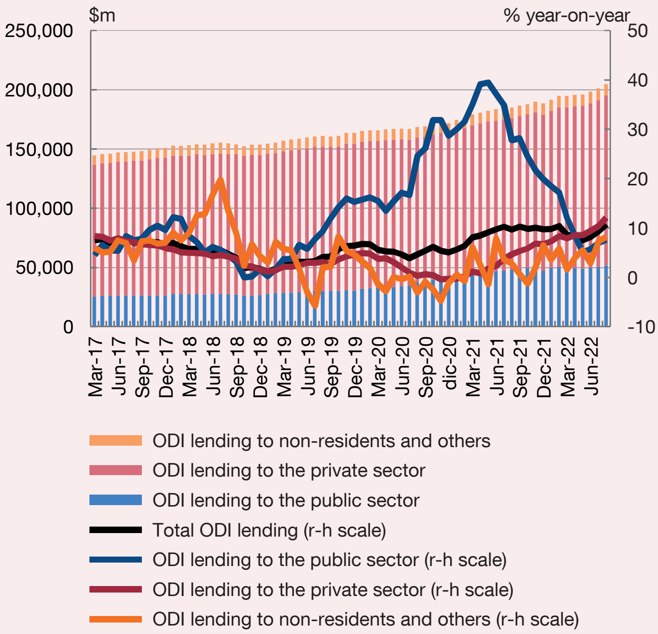


Chart 8
Total lending by ODIs (b)



SOURCE: Estadísticas del Sector Externo Armonizado.

a The size of the dot denotes the percentage of GDP.
b ODIs: Other deposit institutions, e.g. commercial banks and cooperatives.

Box 2

RECENT DEVELOPMENTS IN LATIN AMERICAN BANKING SYSTEMS

In 2022 the Banco de España identified five Latin American countries (Mexico, Brazil, Chile, Peru and Colombia) among those deemed to be of material significance to the Spanish banking system.[1] This box reviews recent developments in their banking systems.

The most recent data show that credit to the private sector has performed unevenly across these countries in real terms, with an increase from March onwards in the three larger economies (Brazil, Mexico and Colombia), a slight slowdown in Chile, and a year-on-year fall of around 4% in Peru (see Chart 1). By segment, consumer credit continued to grow at a high rate (partly owing to targeted support measures, such as those in Brazil[2]), the slowdown in mortgages came to a halt and business loans picked up significantly (see Chart 2). The exception was Peru, where business loans declined substantially against a backdrop of mounting political and economic uncertainty. Moreover, in countries for which data are available,[3] loans denominated in foreign currencies grew at far higher rates (roughly double) than loans in domestic currencies. Accordingly, loan dollarisation rose during the semester, although it remained below its pre-pandemic levels.

One of the factors that has played a part in supporting loans to households since the onset of the pandemic is the surge in digital payment methods (especially credit cards) which were even used by governments on occasion to make some of the transfers intended to shore up the incomes of the most vulnerable population groups. After the worst of the pandemic had passed, households continued to use these open credit lines.[4] While the more widespread use of these means of payment does foster people's financial inclusion, it must be noted that, at the current time, in the face of interest rate hikes, these instruments can also expose households to greater financial risk.

In spite of this sustained growth in credit, indicators commonly used to monitor whether this behaviour is excessive do not, as yet, show signs of risk. Nevertheless, it seems appropriate to continue to monitor certain developments in some countries. For instance, the gap between the credit-to-GDP ratio and its long-run trend remained negative and continued to fall throughout the region, with the exception of Brazil (see Chart 3). Growth in loans to households in Brazil was seen especially in riskier categories and those with higher interest rates (such as credit cards). Some sustainability indicators are showing signs of tightening, such as household debt as a percentage of disposable income, which, at over 50%, has reached an all-time high. Similarly, in Colombia, households' debt burden has exceeded an unprecedented 31% of disposable income, driven by consumer credit.

In 2022 H2 deposits fell in real terms, in an environment of high inflation, leading to an upswing in traditional leverage ratios. Banks offset this slowdown in deposits with higher issuances on domestic financial markets and cut their net external leverage.

The solvency and profitability indicators of Latin American banking systems have also not displayed significant signs of tightening. Capital ratios remained stable[5] and above minimum requirements in 2022 Q3 (see Chart 4). In addition, bank profitability in most countries exceeded pre-pandemic levels (see Chart 5), largely owing to the increase in net interest income.

Lastly, heterogeneity has been the most prominent feature of recent trends in non-performing loans (NPLs). NPLs continued to rise in Brazil and Chile as a result of increasing defaults in the loans to households segments (in the case of

1 Each year, the Banco de España identifies third countries (i.e. outside the European Economic Area) that are materially significant to the Spanish banking system for the purpose of the countercyclical capital buffer (CCyB). To this end, the size of Spanish banks' international exposures is analysed pursuant to the European Systemic Risk Board's guidelines. In 2022 eight material countries were identified – the United States, the United Kingdom and Turkey and the aforementioned five Latin American countries. See the section on the CCyB on the Banco de España's website.

2 Beneficiaries of social programmes – such as Auxilio Brasil – pay lower interest rates on their loans and the interest is deducted directly from the benefits they receive under the programme. https://www.gov.br/cidadania/pt-br/auxilio-brasil/credito-consignado.

3 Chile, Mexico and Peru.

4 See, among others, World Bank (2022), "Del dinero en efectivo al pago digital en pandemia"; World Bank (2021), "The Global Findex Database 2021: Financial Inclusion, Digital Payments, and Resilience in the Age of COVID-19"; and IDB (2022), "Accelerating Digital Payments in Latin America and the Caribbean". The most successful digital payments program was implemented in Brazil, dubbed Pix (part of the Brazilian instant payment ecosystem). This tool – created by the central bank at the outset of the pandemic and for which the central bank provides the necessary infrastructure – allows a wide range of transactions involving current, savings or credit accounts to be made using nothing more than a code on a mobile phone. In its two years of existence, this program has seen a high rate of adoption, with 100 annual transactions per capita in October 2022. This compares favourably with rates in other countries that have far more digitalised means of payments, such as Sweden (39) or Denmark (49).

5 With the exception of Colombia, where capital ratios declined owing to the fall in ordinary basic equity as a result of the adaptation to the Basel III accounting standards.

Box 2

RECENT DEVELOPMENTS IN LATIN AMERICAN BANKING SYSTEMS (cont'd)

Chart 1
Bank loans to the private sector: real (a)

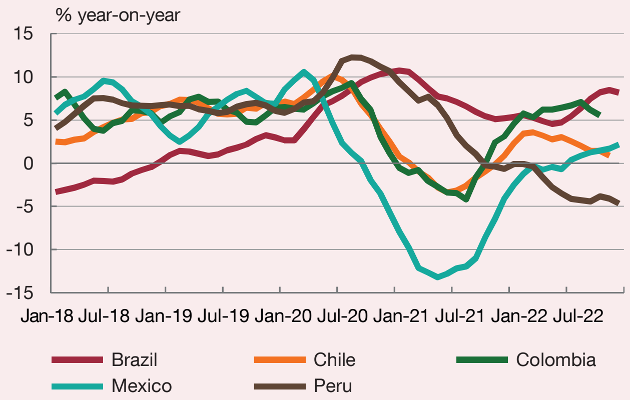


Chart 2
Bank loans to the private sector: real, by type of loan (a)

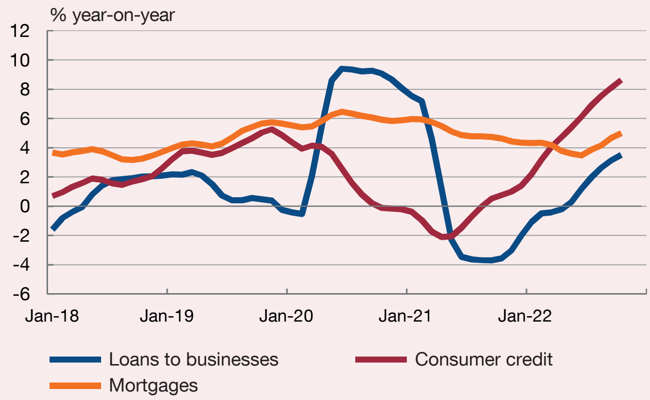


Chart 3
Bank loans to the private sector: difference from the trend

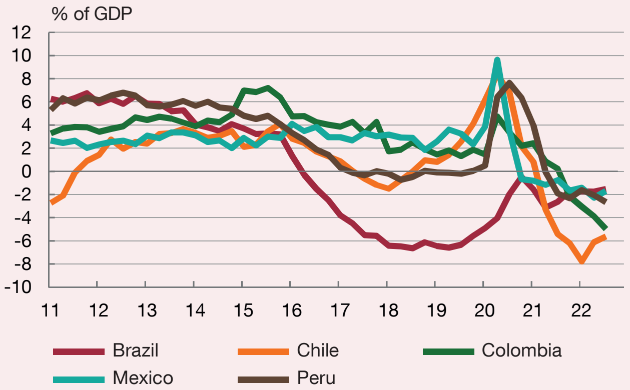


Chart 4
Regulatory capital

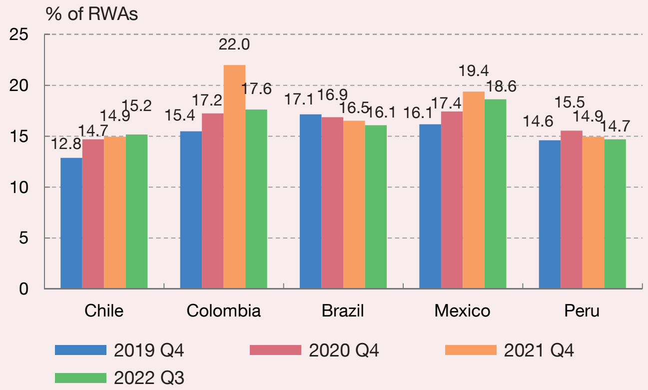


Chart 5
Profitability (b)

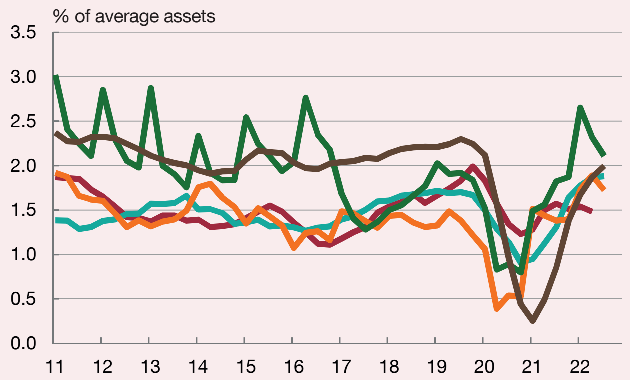
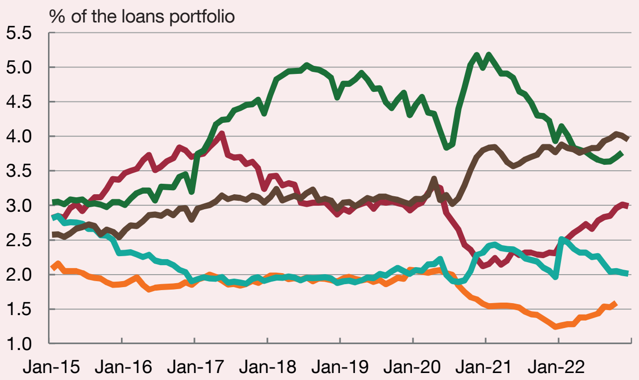


Chart 6
Non-performing loans



Brazil Mexico Chile Colombia Peru

SOURCES: National statistics, Refinitiv, IMF and Banco de España.

a Real credit growth rates are calculated as the difference between the nominal credit growth rate and the inflation rate. The aggregate for Latin America by type of credit is calculated as the average of the year-on-year rates of the five countries, weighted by the purchasing power parity-adjusted GDP.
b Return on average assets (ROA).

Box 2

RECENT DEVELOPMENTS IN LATIN AMERICAN BANKING SYSTEMS (cont'd)

Brazil, in credit cards and personal loans in particular), but remained below their pre-pandemic levels (see Chart 6). Conversely, NPLs declined in Mexico (fundamentally among loans to businesses) and Colombia (which saw a drop in non-performing business and mortgage loans and a rise in consumer loans), although in the latter country, they did so from a very high initial level. Peru is a particularly unusual case, where the non-performance ratio has been rising steadily since early 2011 and, following a surge during the pandemic, still shows no signs of falling. In November 2022, it stood at 4%, an 18-year high. Ultimately, this is due to the rising trend in the non-performance rate among micro, small and medium-sized enterprises. Conversely, non-performing consumer credit and mortgage loans fell in Peru throughout 2022.

Besides the analysis of the recent behaviour of the main indicators of the banking sector in Latin American countries of material importance to the Spanish banking system, the central banks or supervision authorities in these countries also flagged a series of risks to their banking systems in their regular financial stability reports. In particular, these reports, corresponding to the second half of 2022, identified some risks that were common to all of these economies and others that were more nationally specific.[6]

In terms of the former, economies in the region were affected by risks that tended to be external in origin. According to the region's supervisors, risks linked to the war in Ukraine are foremost, along with the global uptick in inflation, the tightening (also global), of financial conditions, the increased volatility of capital flows around the world (and the risk of disorderly capital outflows from the region) and the slowdown of the Chinese economy. There are two additional sources of risk that these reports have repeatedly highlighted in recent quarters: climate change and new technological developments in the financial sector, both challenges of an international nature.

Figure 1 summarises the main exceptional risks for the Brazilian, Chilean, Colombian, Mexican and Peruvian banking systems according to their national supervisors.

6 The aforementioned reports are available online: Financial Stability Report (Brazil), Reporte de Estabilidad Financiera (Mexico), Financial Stability Report (Chile), Reporte de Estabilidad Financiera (Colombia), and Reporte de Estabilidad Financiera (Peru).

Box 2

RECENT DEVELOPMENTS IN LATIN AMERICAN BANKING SYSTEMS (cont'd)

Figure 1
The central banks of the main economies in the region highlight specific risks

BRAZIL

Political risk

Political uncertainty associated with the presidential elections and the various proposals by the candidates regarding the loosening of fiscal rules.

Credit risk

Excessive granting of credit in recent quarters. In particular, the quality of loans to microenterprises and to households has worsened.

CHILE

Credit risk

The increase in non-performance was particularly noticeable among small enterprises that restructured their loans during the pandemic. Similarly, real estate companies' payment capacity has dropped as a result of narrower operating margins, owing to falling sales at a time of increased borrowing costs. Lower-income households have faced a slowdown in job creation and falling wages in real terms, which has caused their non-performing loans to rise.

Currency risk

The peso has depreciated exceptionally severely with an unusually high degree of volatility, above the average of comparable economies. This has increased the probability of distortions in the financial markets. In order to mitigate these risks, the Central Bank of Chile intervened in the currency market between July and September.

COLOMBIA

Credit risk

Households' debt-to-disposable income ratio stands close to its historic high, as do metrics available for the debt burden. Consequently, the Superintendencia Financiera de Colombia (Financial Superintendency of Colombia) has increased credit provisions in this segment.

Systemic risk

Colombian credit institutions are highly exposed to Central America through their subsidiaries (16.8% of all the financial system's assets). There are significant fiscal challenges in some jurisdictions that may affect financial intermediation work. However, it is thought that, in terms of their solvency, banks will remain resilient in the face of adverse external scenarios.

SOURCE: Banco de España.

Box 2

RECENT DEVELOPMENTS IN LATIN AMERICAN BANKING SYSTEMS (cont'd)

Figure 1
The central banks of the main economies in the region highlight specific risks (cont'd.)

MEXICO

Credit risk

Financial situation of state companies: (1) Petróleos Mexicanos (Pemex) has suffered losses in recent quarters, faces a high liquidity risk and is highly dependent on the Federal Government; (2) the Comisión Federal de Electricidad (Federal Electricity Commission) has been negatively affected by the rising cost of fuels as a result of the war between Russia and Ukraine.

PERU

Political risk

The political uncertainty has caused business confidence to deteriorate, which has delayed private sector investments. Conversely, measures approved by the legislative body allowing the early withdrawal of provisional funds could lead to a sharp fall in the prices of fixed and variable income assets, thereby affecting the value of insurance companies, investment funds, banks and pension fund administrators.

SOURCE: Banco de España.

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