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Report on the Latin American economy. First half of 2018

27 April 2018

Against a favourable external backdrop, the Latin American economies continued their recovery in the second half of 2017, although at a somewhat slower momentum. The most notable features of that period were more strongly performing investment and a more negative contribution to growth by the external sector. However, the improved terms of trade allowed the current account deficits to be reduced. Inflation moderated more than expected, allowing the central banks of Brazil, Colombia and Peru to continue cutting their official interest rates. However, prices moved unexpectedly upwards in Mexico and Argentina, prompting a tighter monetary policy. In the budgetary arena, most countries failed to make significant headway in the recovery of fiscal space, an issue which is analysed in the first thematic section of this Report along with the effects on the macroeconomic scenario that would result from the fiscal consolidation needed to make public debt sustainable. Financial conditions, as analysed in the other thematic section of this Report, which calculates financial conditions indices for the economies of the region, remained slack in the period analysed, since the international financial market turmoil had little impact and commodity prices (a key determinant of financial conditions in these economies) recovered.

The forecasts are for the dynamism of activity to continue in 2018 and 2019, at a pace near the potential growth rate of these economies, although the balance of external risks (change in macroeconomic policies in the United States which may finally feed through to a tightening of financial conditions worldwide, and a possible widespread increase in barriers to international trade) and internal risks (uncertainties as to what economic policies will be implemented following the elections to be held in the coming months) is tilted to the downside. The Report also includes a box which analyses, as far as the available data allow, the economic situation in Venezuela after its partial default on its external public debt.

Introduction

In 2017 and early 2018 the world economy has seen a widespread synchronised expansion accompanied by lax financial conditions worldwide and by an inflow of external funding into the emerging economies. Contributing to this favourable external environment was the gradual nature of normalisation of the monetary policies of the main developed economies, where significant inflationary pressure continues to be inappreciable. However, in recent months two changes with potentially far-reaching effects on the world outlook have taken place. The first derives from the expansionary fiscal measures approved in the United States, which may quicken the pace of monetary tightening in that country, given that its economy is ahead in the cycle.[1] The second is related to the protectionist measures adopted recently by the Trump administration, which have given rise to retaliatory measures in other countries, raising the risk of a trade war. Additionally, against a background of high prices and low volatility in the US stock markets, there were some correction and heightened volatility episodes on the international financial markets in February and March this year, linked to unexpected upward movements in US wage data and to the adoption of the aforementioned protectionist measures.

Against this external backdrop, the main Latin American economies continued to recover in the second half of 2017, although with a somewhat weaker momentum, since their average quarter-on-quarter GDP growth[2] fell from 0.7% to 0.4% due to the worse performance of Brazil and Mexico. The sound behaviour of investment, which switched to making positive contributions in the second half of the year, except in Mexico, was the most notable feature. The external sector subtracted more from growth than in the first half of the year, although the improvement in the terms of trade allowed the current account deficits to be reduced, except in Argentina.

Inflation moderated more than expected, except in Mexico and Argentina, where it moved unexpectedly upward. This moderation allowed the central banks of Brazil, Colombia and Peru to continue cutting their official interest rates; by contrast, those of Mexico and Argentina raised them. In the budgetary arena, there was no progress in the recovery of fiscal space, except in Mexico and, to a lesser extent, Colombia. Financial conditions remained loose (again with the exception of Mexico), since the international financial market turbulence had less impact on this region, and commodity prices (a key factor in these economies) recovered.

The higher-frequency indicators show that the dynamism of activity persisted in the first quarter of 2018 and it is expected that in this year and in 2019 the overall growth of the region's six main economies will stand between 2.5% and 3%, in line with the potential growth estimated by institutions such as the IMF, following the 1.7% recorded in 2017. However, the balance of risks is tilted to the downside. In the external environment, the change in the mix of macroeconomic policies in the United States may ultimately feed through to a tightening of financial conditions worldwide. Furthermore, the risk of a widespread increase in barriers to international trade has risen, and although the Latin American economies (except Mexico) are relatively closed, they are also highly sensitive to the behaviour of commodity prices, which would inevitably be affected if the heightened

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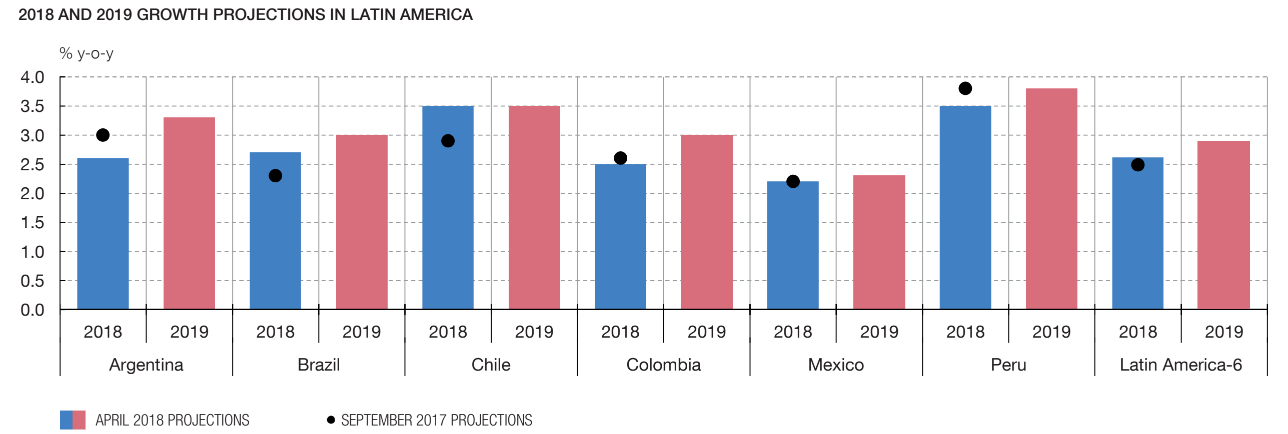
1 See Global economic situation and outlook at the start of 2018, *Economic Bulletin*, 2/2018, Banco de España.

2 Weighted average of growth in Brazil, Mexico, Argentina, Colombia, Chile and Peru.

GROWTH PROJECTIONS IN LATIN AMERICA

CHART 1



SOURCE: Latin American Consensus Forecasts.

protectionism were to significantly reduce global growth. In the domestic sphere, the presidential elections in Colombia, Mexico and Brazil pose uncertainties regarding the economic policies announced by some of the candidates.

From a longer-term perspective, the growth projected for the coming years continues to be insufficient to address some of the medium- and long-term needs of the region, particularly that of convergence towards the per-capita levels of income of the more advanced economies. The potential growth rates of the Latin American countries continue to be held back by the low investment and the behaviour of productivity, which at times even drops. These are issues on which the economic authorities must focus their efforts, along with the generation of buffers enabling the aforementioned risks to be addressed.

As usual, this half-yearly Report reviews the recent performance of the main economies of the region. Also included are two thematic sections which focus on matters of significance for the short-term outlook: the first analyses the progress made in the generation of fiscal space in relation to the sustainability of public debt; the second looks at the impact of international financial market turbulence on financial conditions in the region. Finally, a box analyses the economic situation in Venezuela insofar as the available data allow, following its partial default.

Recent developments in the Latin American economy

THE EXTERNAL ENVIRONMENT AND DEVELOPMENTS ON FINANCIAL MARKETS

The global economic reactivation which progressively firmed in 2017 was widespread and stronger than projected, and has persisted in the opening months of 2018, albeit with some loss of momentum. A notable feature of these developments has been the strong business investment, particularly in the developed economies, which had a stimulatory effect on world trade. Notable among the emerging countries was the exit from recession of major commodity exporters such as Brazil and Russia, as well as the dynamism of the eastern European economies (favoured by the healthy activity of the euro area) and of the Asian countries, which are those that are most exposed to the behaviour of international trade. In China, the economic policy mix and the external environment led to higher growth in 2017 than in the previous year.

Inflation increased moderately in the advanced economies in 2017 and early 2018, due largely to commodity price rises, while in the emerging economies decreases in inflation rates predominated; in any event, the core component held steady and far away from the targets of the advanced countries' central banks. The monetary policy stance continued to be expansionary despite the fact that in the United States the Federal Reserve (Fed) continued to make press forward in the normalisation of its monetary policy (through various official interest rate rises and the commencement of its balance sheet reduction process); the United Kingdom, Canada and some Asian economies, such as South Korea, also undertook the normalisation of their monetary policies.

On the financial markets, investors continued to move in an environment marked by the search for yields and a high risk appetite until the beginning of 2018. There were continual stock market rises, a narrowing of the spreads on emerging economies' sovereign debt and on corporate debt, and a fall in the prices of other assets, such as developed country government debt securities, with the consequent rise in yields, as shown in Chart 2.1. Volatility levels continued to be very low, touching bottom at the end of 2017 (see Chart 2.2), and the dollar depreciated against most other currencies[3] (see Chart 2.2). Against this background, carry trade yields remained near their peak (see Chart 2.3) and fuelled capital inflows into emerging markets (see Chart 2.4) and the placement of the debt securities of these economies on the international markets, favoured by the recovery of commodity prices (see Chart 2.2).

However, February 2018 saw a sharp increase in volatility as measured by the XIV (implied volatility of the S&P), due to the publication of higher-than-expected US wage growth data.[4] This prompted sharp stock market falls in most economies and moderate increases in long-term government debt rates, and checked the weakening of the dollar. Subsequently, March saw a second bout of market turmoil as a result of the approval of protectionist measures in the United States. However, the dip in emerging market asset prices was slight and short-lived compared with previous bouts of global turmoil (see Chart 2.5), and did not significantly affect risk premia or the expansionary tone of financial conditions.

The Latin American financial markets performed somewhat worse than those of the other emerging economies during these developments, particularly in Mexico due to its close trade connection with the United States. Moreover, some idiosyncratic factors, such as the difficulties in approving the pension reform in Brazil, the elections in Chile and in Colombia, the failure to meet inflation targets in Argentina and the presidential changeover in Peru following the resignation of the previous president, influenced the reaction of the markets. The Latin American MSCI increased by 6.7% between October 2017 and March 2018, which was less than the respective increases in eastern Europe and Asia (see Chart 2.6). The aforementioned idiosyncratic factors did not, however, seem to affect the performance of some stock market indices, such as those of Peru and Brazil, which rose by more than 10% and 15%, respectively, while that of Argentina increased by more than 22%. Contrastingly, the stock market of Mexico fell by nearly 6%, contributing to the slight worsening of financial conditions in the country.

The sovereign spreads of Latin American countries increased by more than those of other emerging markets due to the behaviour in Venezuela and Argentina. In Venezuela the spread reached 5,000 basis points (bp) in March. As described in Box 1, in November the Venezuelan government announced its intention to restructure its sovereign debt; days later defaults occurred in both sovereign debt and in securities of the state oil company

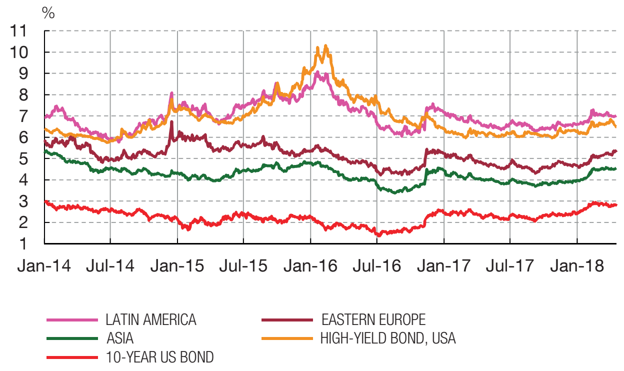
3 See Box 4 "The depreciation of the dollar since early 2017" of the "Quarterly Report on the Spanish Economy", *Economic Bulletin*, 1/2018.

4 See Box 3 "Global stock market correction and volatility episode" of the "Quarterly Report on the Spanish Economy", *Economic Bulletin*, 1/2018.

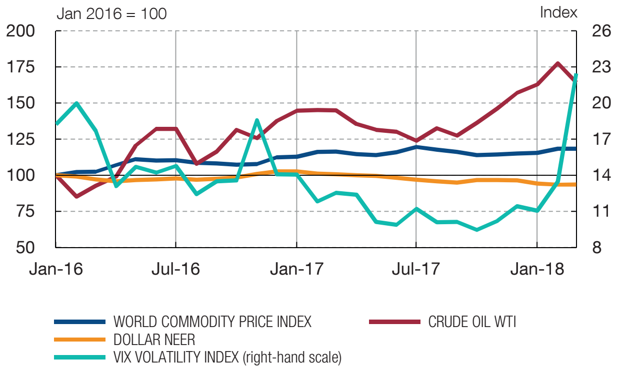
FINANCIAL INDICATORS
Percentage, $ bn, indices and basis points

CHART 2

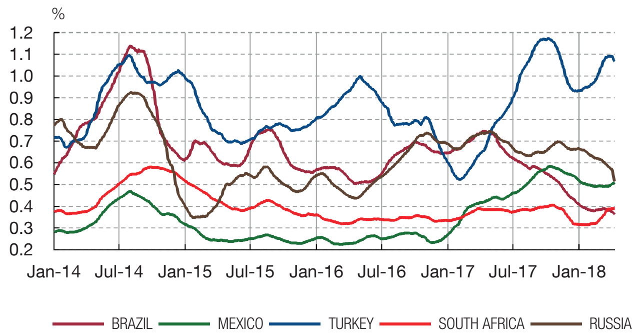
1 INTEREST RATES (a)



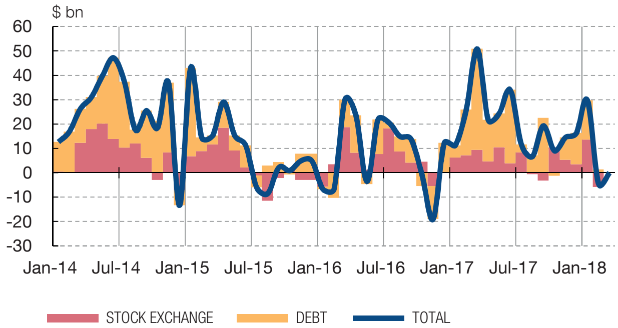
2 COMMODITIES, VOLATILITY INDEX AND NOMINAL EFFECTIVE EXCHANGE RATE AGAINST THE DOLLAR



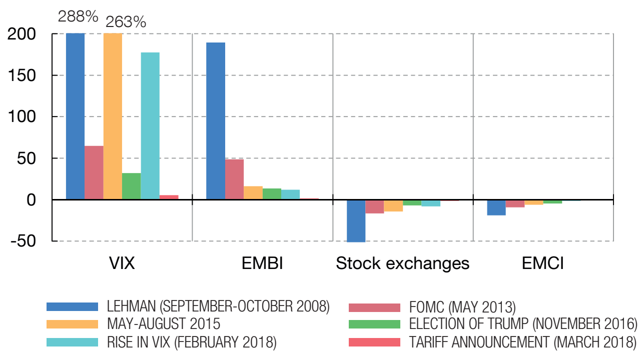
3 CARRY-TRADE YIELD INDICATOR (b)



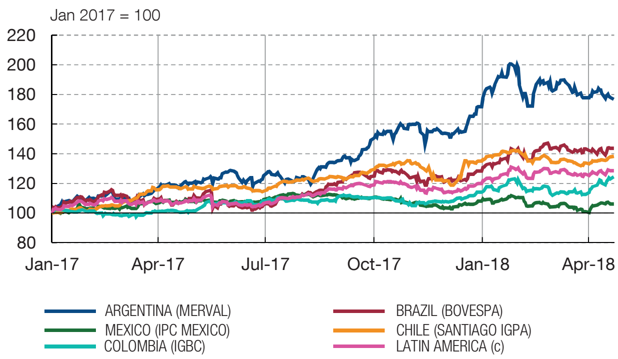
4 PORTFOLIO CAPITAL FLOWS INTO EMERGING MARKETS



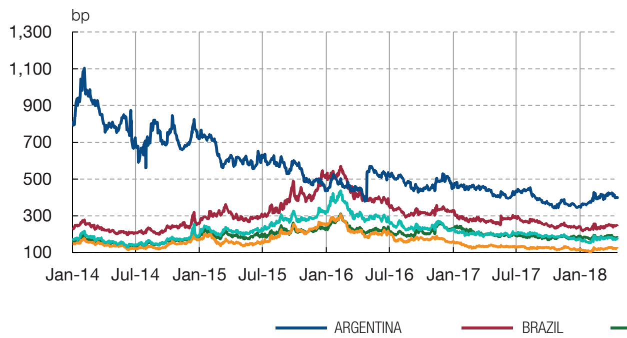
5 GLOBAL TURBULENCE (% CHANGE)



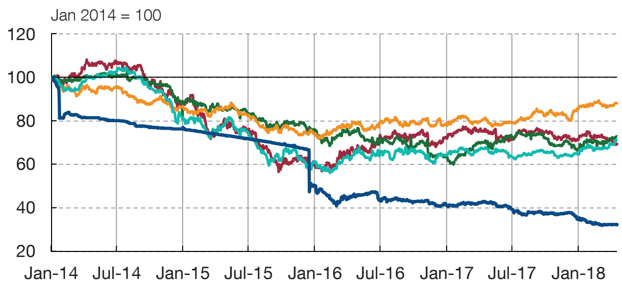
6 STOCK EXCHANGE INDICES



7 SOVEREIGN SPREADS



8 NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



SOURCES: Banco de España, Datastream, IIF and JP Morgan.

a Latin American, Asian and eastern European rates have been constructed by adding together the US 10-year government bond yield and EMBI spreads.
b Short-term interest rate spread over the United States standardised by the volatility of the one-month forward exchange rates of each currency against the dollar.
c MSCI Latin America index in local currency.

DVSA. Two of the three main credit rating agencies rated Venezuelan debt in the selective default category; to this was added the greater difficulty in restructuring debt due to the sanctions imposed by the United States. In Argentina, the sovereign spread increased by 60 bp between October 2017 and March 2018 as a result of the failure to meet the inflation target for 2017 and the increase in the inflation target for 2018 and 2019.

The Latin American currencies showed uneven behaviour from October 2017 (see Chart 2.8). The currencies of Mexico, Chile and Colombia appreciated slightly against the dollar, while those of Brazil and Peru depreciated slightly. Mexico's currency depreciated until the end of 2017, coinciding with the free-trade treaty negotiations with the United States, but appreciated again in 2018 when it became known that the new conditions would not be so adverse for Mexico. The Argentine peso, by contrast, began to depreciate from December after the inflation targets were changed, prompting the central bank's intervention in this market in March. Finally, on 5 February Venezuela decreed the unification of all the country's exchange rates at a rate of 25,000 bolivars per dollar, which was 99.96% lower than the previous subsidised rate, but much higher than the parallel market rate. The central bank maintained the dollar auctions and lowered the exchange rate by an additional 49% between February and March, and subsequently announced a currency redenomination to reduce the nominal value of banknotes and coins.

Foreign direct investment (FDI) inflows into the region recovered slightly in the second half of 2017 (see Chart 3.2) due to the increase in Colombia and Argentina; by contrast, in Brazil they fell by nearly $8 billion in the year. Portfolio investment inflows recovered significantly in the second half (see Chart 3.3), the most notable contribution being that of Brazil, where net outflows of $4 billion in the first six months of 2017 gave way to inflows of $2.9 billion. Primary market placements held steady in 2017 (see Chart 3.4), since the lower placements in Mexico were offset by increases in Brazil, Chile and other countries with lower sovereign debt ratings (such as Paraguay and Ecuador). Placements in local currency increased to 14% of the total, and the proportion of euro-denominated issues decreased; sovereign issues represented 41% of the total. In short, financial conditions in the Latin American economies continue to be expansionary (see thematic section).

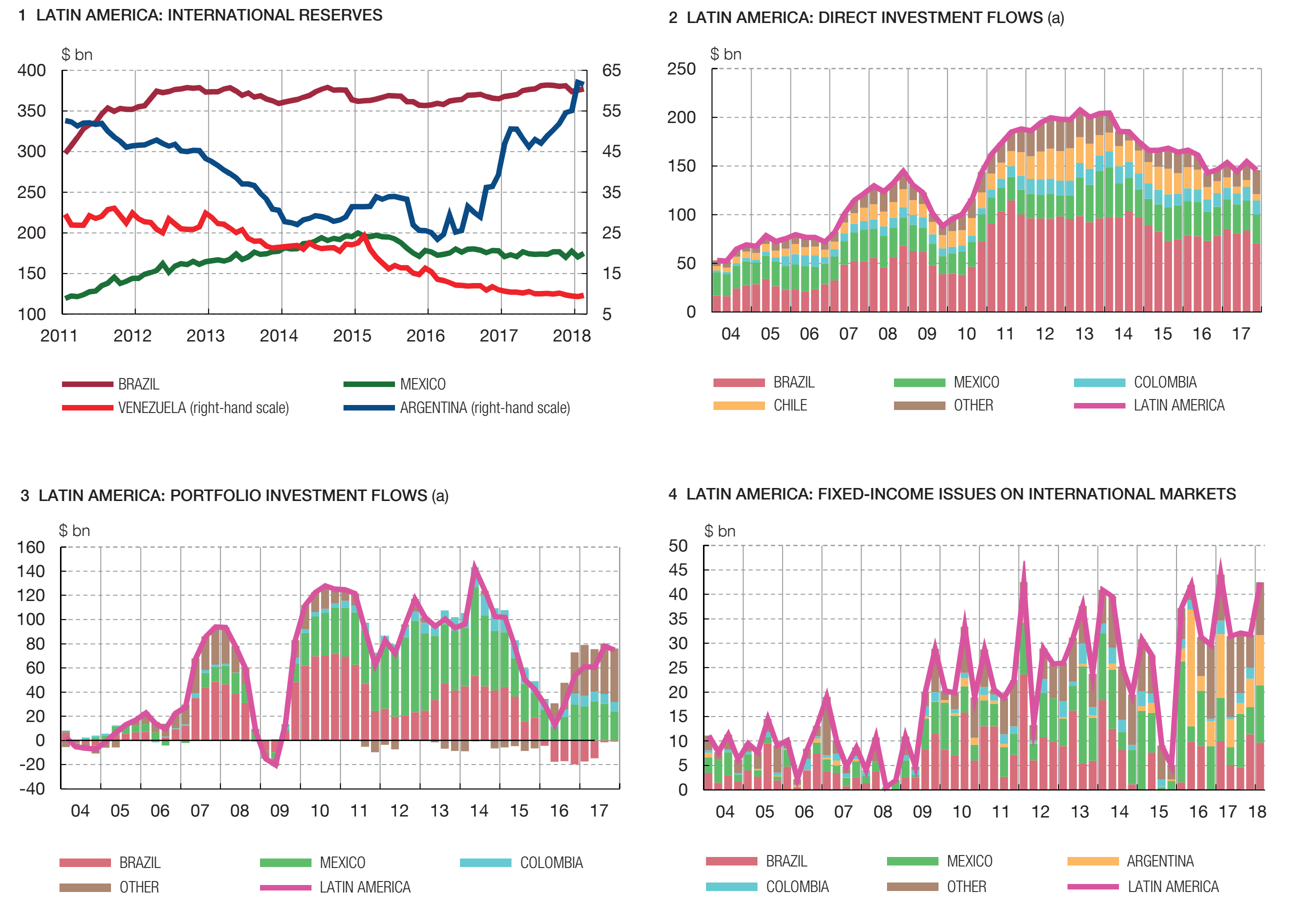
ACTIVITY AND DEMAND

In the last two quarters of 2017, the GDP growth of the main Latin American countries reached quarter-on-quarter rates of 0.3% and 0.5%, respectively, somewhat lower than those recorded in the first half of 2017 (see Table 1), due to the slowdown of the region's two main economies, Brazil and Mexico (see Chart 4.1). In the case of Mexico, the slowdown reflected the devastation wrought by the hurricanes and earthquakes which ravaged the country in those months. In Argentina, growth remained robust (with quarter-on-quarter rates of 0.9% and 1% in the last two quarters of the year), while in Chile, Colombia and Peru activity grew more than in the first half. Analysis by component reveals most notably the recovery of investment, which reversed the downward trend dating from 2014 (see Chart 4.2). Net external demand made a more negative contribution to GDP than in the first half of the year, partly due to the rise in investment, which has a high imported component. Despite this, Chart 5.1 shows that the external imbalance was corrected in all countries (except Argentina and Chile) due to the notable improvement in the terms of trade (see Chart 5.2). In Venezuela, where official data are not available, the indicators suggest that its economy continues in a deep recession.

In Brazil, the lower dynamism of activity was due to the negative contribution of net external demand and the moderate growth of consumption. Investment posted positive rates in the last two quarters, reversing the momentum of the previous quarters (it fell by

EXTERNAL CAPITAL FLOWS AND FINANCING
$ bn

CHART 3



SOURCES: Datastream, Dealogic, IIF, JP Morgan, IMF and national statistics.

a Four-quarter cumulated data.

nearly 30% in the recession); moreover, Brazil's current account deficit stood at nearly 0.7% of GDP in 2017, the lowest since 2008, despite the import stimulus from investment. The Mexican economy underwent a temporary backslide in the third quarter (-0.2% quarter-on-quarter) due to the earthquakes and bad weather; however, activity recovered in the fourth quarter, showing quarter-on-quarter growth of 0.8%. Private consumption continued to underpin domestic demand, while net exports made a negative contribution. Unlike other countries in the region, investment again declined in the second half of the year, probably due to the uncertainty surrounding the negotiation of the North American Free Trade Agreement (NAFTA). The Argentine economy held at high growth rates in the second half due to the notable dynamism of investment, which grew at quarter-on-quarter rates of 2.9% and 7.4% in the third and fourth quarters of the year; by contrast, net external demand subtracted five percentage points (pp) from growth, more than in the first half of the year (2.5 pp), raising the current account deficit to 4.8%. In Chile, activity expanded strongly in the last six months of 2017 at quarter-on-quarter rates of 2.2% and 0.6%, respectively, leaving behind the weakness of the first half caused by mining strikes which adversely affected net external demand in the year as a whole; in the fourth quarter investment extricated itself from the negative rates. In Colombia, activity accelerated in the second half to quarter-on-quarter rates of 0.8% and 0.3% in the third and fourth quarters. Noteworthy was the recovery of private and public consumption, compared with the stagnation of investment, which ended the year with annual growth of only 0.1%. Finally,

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2016	2017	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 March
GDP (quarter-on-quarter rate)											
Latin America 6 (b)			0.1	-0.5	0.4	0.2	0.9	0.5	0.3	0.5	
Argentina			-0.2	-2.1	0.3	0.8	1.6	0.6	0.8	1.0	
Brazil			-0.7	-0.7	-0.4	-0.7	1.3	0.6	0.2	0.1	
Mexico			1.0	0.0	1.2	1.0	0.6	0.2	-0.2	0.8	
Chile			0.6	-0.6	0.3	0.2	-0.3	0.7	2.2	0.6	
Colombia			0.2	0.5	0.2	1.0	-0.1	0.6	0.8	0.3	
Peru			0.0	0.5	1.7	0.4	0.4	0.6	0.3	0.9	
GDP (year-on-year rate)											
Latin America 6 (b)	-0.3	1.7	-0.5	-0.3	-0.4	0.2	1.3	1.4	1.9	2.2	
Argentina	-1.8	2.9	1.0	-3.6	-3.3	-1.1	0.6	3.0	3.8	4.0	
Brazil	-3.5	1.0	-5.2	-3.4	-2.7	-2.5	0.0	0.4	1.4	2.1	
Mexico	2.9	2.0	3.0	3.3	2.1	3.3	3.3	1.8	1.6	1.5	
Chile	1.3	1.5	2.7	0.9	1.2	0.3	-0.4	0.5	2.5	3.3	
Colombia (a)	2.0	1.8	2.5	2.4	1.5	1.8	1.5	1.7	2.3	1.6	
Peru	4.0	2.5	4.6	3.9	4.7	3.1	2.3	2.6	2.9	2.2	
CPI (year-on-year rate)											
Latin America 5 (b)	6.0	4.3	6.8	6.2	6.0	5.2	4.7	4.4	4.0	4.1	3.3
Brazil	8.7	3.4	10.1	9.1	8.7	7.0	4.9	3.6	2.6	2.8	2.7
Mexico	2.8	6.0	2.7	2.6	2.8	3.2	5.0	6.1	6.5	6.6	5.0
Chile	3.8	2.2	4.6	4.2	3.5	2.8	2.8	2.3	1.7	2.0	1.8
Colombia	7.5	4.3	7.7	8.2	8.1	6.1	5.1	4.3	3.7	4.1	3.1
Peru	3.6	2.8	4.5	3.6	3.0	3.3	3.4	3.2	3.0	1.6	0.4
Budget balance (% of GDP) (c)											
Latin America 6 (b)	-5.6	-4.7	-5.6	-5.5	-5.5	-5.6	-5.2	-5.6	-5.0	-4.7	
Argentina	-4.5	-6.0	-3.2	-3.6	-3.6	-4.5	-4.6	-5.2	-5.6	-6.0	
Brazil	-9.0	-7.8	-9.6	-9.8	-9.3	-9.0	-9.1	-9.5	-8.8	-7.8	
Mexico	-3.0	-1.0	-2.9	-2.0	-2.6	-3.0	-1.3	-1.9	-1.1	-1.0	
Chile	-2.7	-2.8	-1.7	-1.8	-2.5	-2.7	-3.3	-2.9	-2.7	-2.8	
Colombia	-3.9	-3.3	-3.1	-3.3	-3.9	-3.9	-4.3	-4.2	-3.2	-3.3	
Peru	-2.6	-3.6	-3.2	-3.2	-3.2	-2.6	-2.8	-3.2	-3.3	-3.6	
Public debt (% of GDP)											
Latin America 6 (b)	54.3	-	50.5	51.3	53.0	54.2	54.0	54.4	55.2	-	
Argentina	49.7	-	38.2	41.1	44.0	49.7	49.1	48.9	49.5	-	
Brazil	70.0	74.0	66.4	67.6	70.1	70.0	71.3	72.8	73.8	74.0	
Mexico	49.4	47.3	47.1	47.0	48.1	49.4	47.4	46.1	47.0	47.3	
Chile	21.3	26.9	18.4	19.4	20.4	21.3	21.8	23.9	24.9	26.9	
Colombia	42.8	43.8	42.4	41.9	42.1	42.8	43.3	43.5	43.9	43.8	
Peru	23.8	24.8	22.8	22.2	22.7	23.8	22.9	24.1	24.1	24.8	
Current account balance (% of GDP) (c)											
Latin America-6 (b)	-2.0	-1.7	-2.9	-2.6	-2.3	-2.0	-2.0	-1.7	-1.7	-1.7	
Argentina	-2.7	-4.8	-2.8	-2.9	-2.7	-2.7	-2.9	-3.5	-4.2	-4.8	
Brazil	-1.3	-0.5	-2.5	-1.8	-1.4	-1.3	-1.1	-0.7	-0.6	-0.5	
Mexico	-2.1	-1.6	-2.6	-2.5	-2.4	-2.1	-2.3	-1.8	-1.6	-1.6	
Chile	-1.4	-1.5	-2.1	-2.3	-2.0	-1.4	-2.0	-2.1	-1.7	-1.5	
Colombia	-4.3	-3.4	-6.0	-5.5	-4.9	-4.3	-4.1	-4.0	-3.6	-3.4	
Peru	-2.7	-1.3	-4.5	-4.3	-3.6	-2.7	-2.0	-1.2	-0.8	-1.3	
External debt (% of GDP)											
Latin America-6 (b)	36.7	34.6	36.7	38.2	37.6	36.6	35.7	35.0	35.2	34.6	
Argentina	32.7	36.6	28.6	29.6	31.5	32.7	34.3	34.1	35.2	36.6	
Brazil	37.7	32.6	39.9	41.9	40.1	37.4	35.2	33.5	33.6	32.6	
Mexico	29.3	28.9	28.0	29.1	29.2	29.3	29.7	29.6	29.6	28.9	
Chile	66.7	65.5	67.1	70.0	69.1	66.7	64.6	65.4	65.4	65.5	
Colombia	42.8	40.2	40.9	43.0	42.3	42.7	41.2	40.4	41.0	40.3	
Peru	38.2	35.7	39.5	39.0	38.9	38.2	37.5	38.4	37.8	35.7	

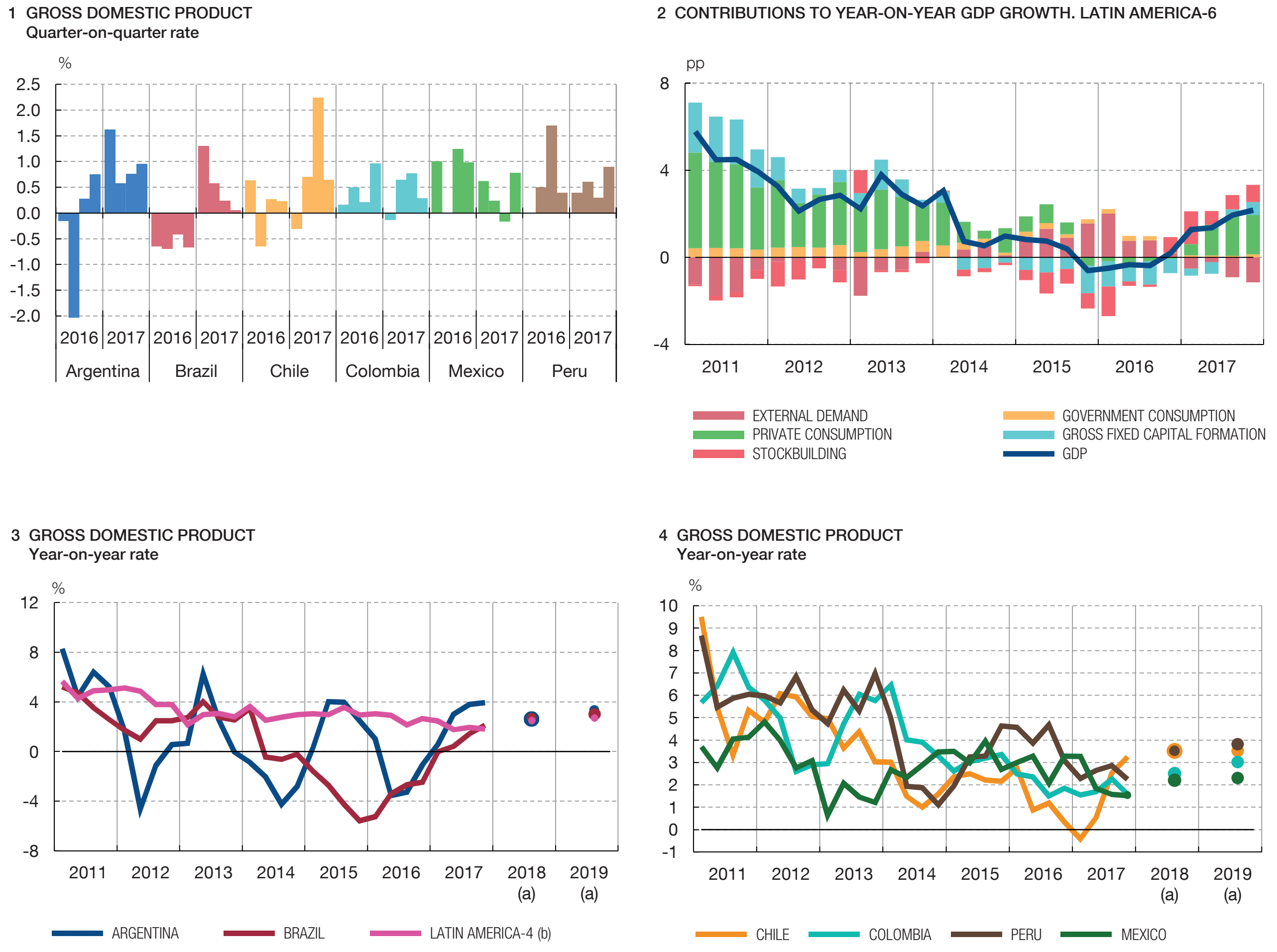
SOURCE: National statistics.

a Seasonally adjusted.
b Latin America 6: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Latin America 5: Brazil, Chile, Colombia, Mexico and Peru.
c Four-quarter moving average.

LATIN AMERICAN GDP

Year-on-year and quarter-on-quarter rates

CHART 4



SOURCES: Datastream and national statistics.

a The dots represent the April 2018 forecasts for 2018 and 2019 by Latin American Consensus Forecasts.
b Mexico, Chile, Colombia and Peru.

in Peru, once the weather-related factors which affected the first half of the year had been left behind, GDP accelerated, particularly in the fourth quarter (0.9% quarter-on-quarter), driven by the growth of public consumption and investment.

The short-term forecasting models, based on the latest updated indicators, point to a continuation of the rate of increase in the first half of the current year. Although the rate of increase of region's consumer confidence and business confidence indicators has moderated in recent months, they currently stand at their highest level since 2014; the industrial production indices hold at positive growth rates and the retail sale data are at their highest since 2015 (see Charts 5.5 and 5.6).

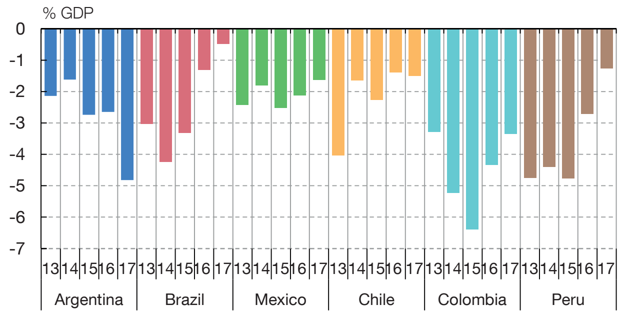
INFLATION AND ECONOMIC POLICIES

In the past six months, inflation held on its downward path in Brazil, Chile, Colombia and Peru (see Chart 6.1), moving below the lower bound of the central bank's target range in the cases of Brazil and Peru (on March data – see Table 2). Various factors contributed to the decline in inflation: the stabilisation or slight appreciation of exchange rates (linked to the favourable behaviour of commodity prices), the delayed effects of the tight monetary policy applied in 2015 and 2016, the existence of slack in the productive capacity of economies, which widened in most of them in the second half of the year, and the food

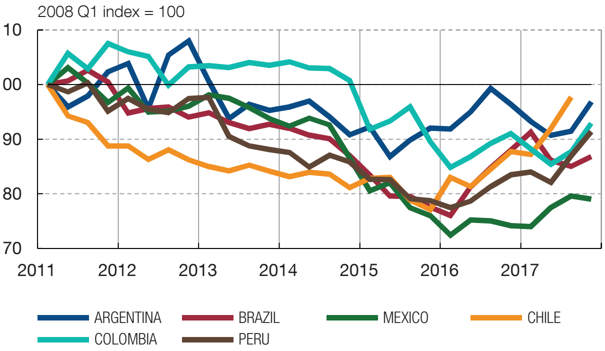
EXTERNAL SECTOR, PRIVATE-SECTOR CREDIT, EMPLOYMENT AND CONFIDENCE INDICATORS

CHART 5

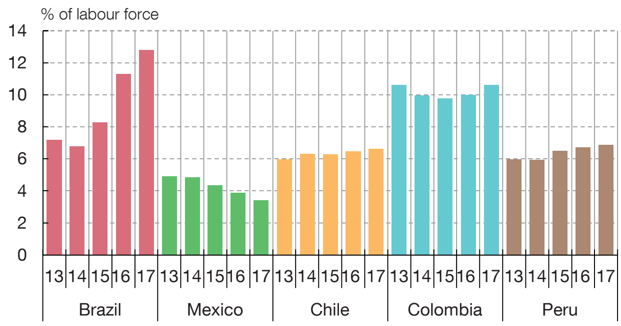
1 CURRENT ACCOUNT BALANCE



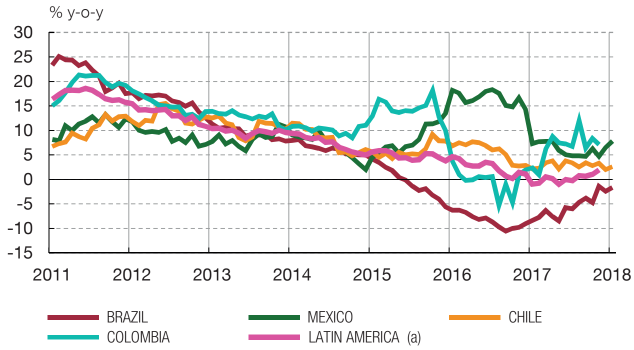
2 TERMS OF TRADE



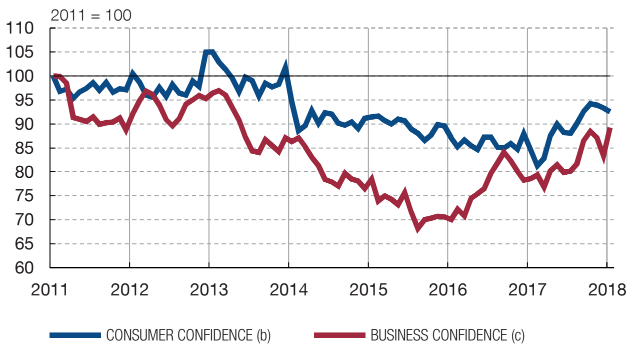
3 UNEMPLOYMENT RATE



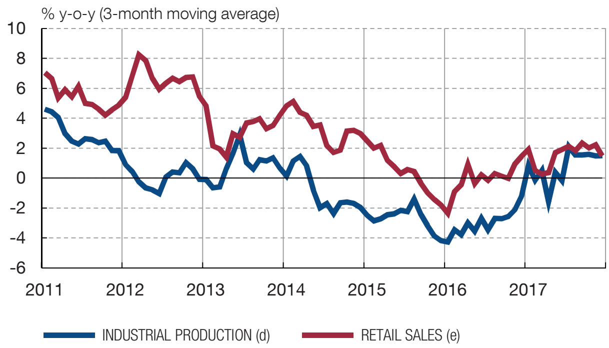
4 REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR



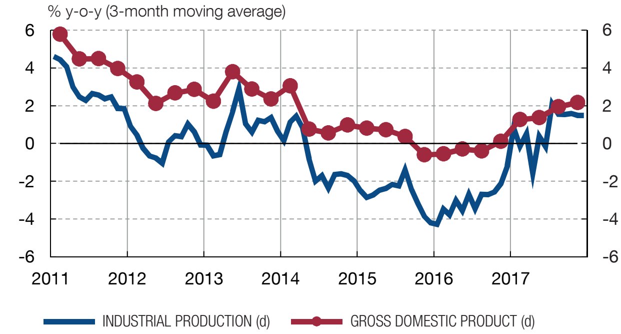
5 CONSUMER AND BUSINESS CONFIDENCE INDICES



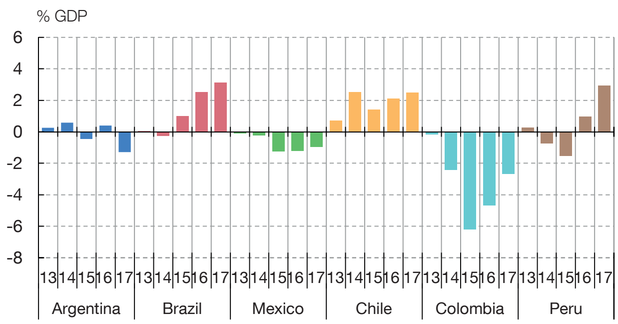
6 INDUSTRIAL PRODUCTION AND RETAIL SALES



7 GROSS DOMESTIC PRODUCT AND INDUSTRIAL PRODUCTION



8 TRADE BALANCE

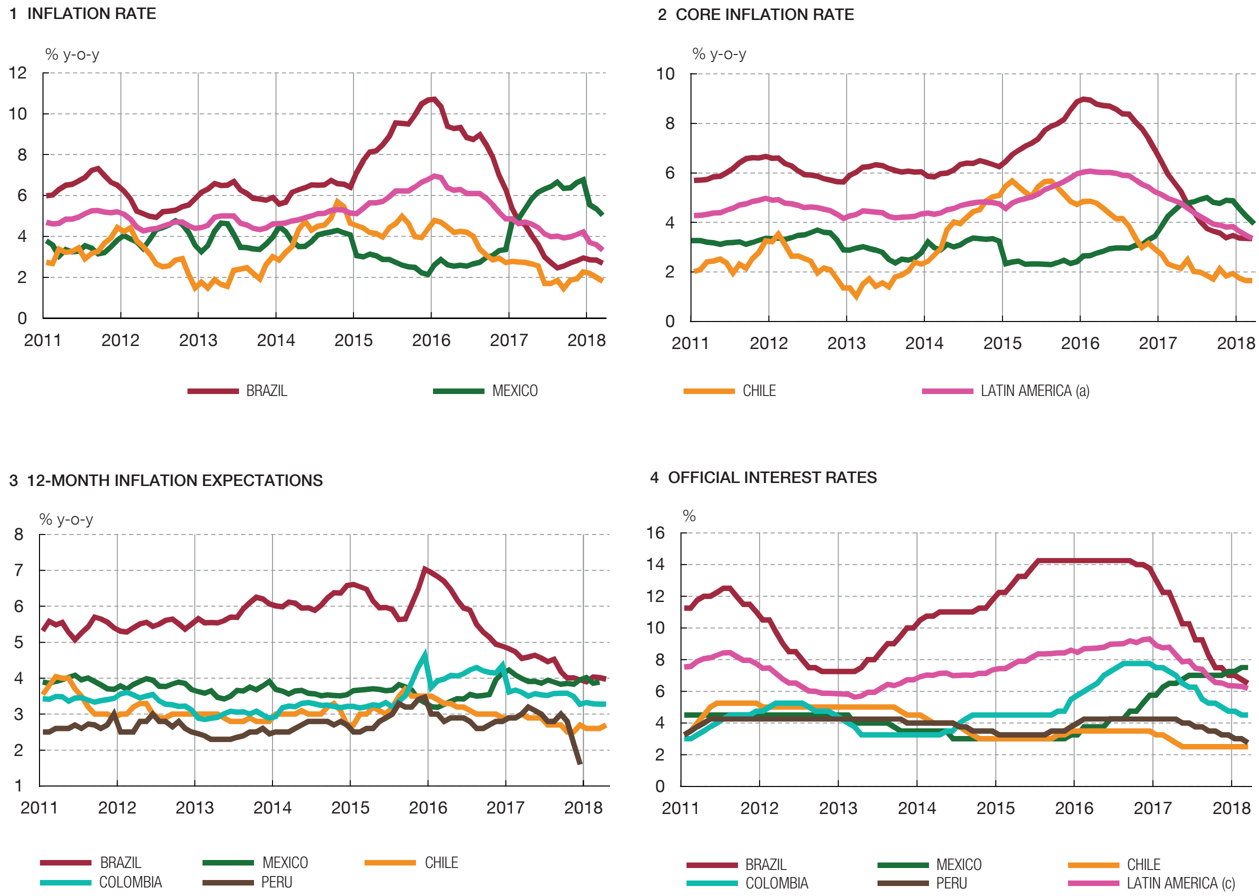


SOURCE: Datastream.

a Brazil, Chile, Colombia, Mexico and Peru.
b Argentina, Brazil, Chile, Mexico and Peru.
c Brazil, Chile, Mexico and Peru.
d Argentina, Brazil, Chile, Colombia, Mexico and Peru.
e Brazil, Chile, Colombia and Mexico.

INFLATION AND OFFICIAL INTEREST RATES
Year-on-year rate of change and percentage

CHART 6



SOURCE: Datastream.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

INFLATION
Year-on-year rates of change

TABLE 2

	2017			2018		2019
Country	Target	December	Fulfillment	March	Expectations (a)	Expectations (a)
Argentina (b)	12 - 17	24.8	No	25.4	21.3	15.0
Brazil	4,5 ± 1,5	2.9	No	2.7	3.5	4.1
Mexico	3 ± 1	6.8	No	5.0	4.1	3.7
Chile	3 ± 1	2.3	Yes	1.8	2.4	3.1
Colombia	3 ± 1	4.1	No	3.1	3.2	3.2
Peru	1 - 3	1.4	Yes	0.4	2.1	2.4

SOURCES: National statistics and Consensus Forecasts.

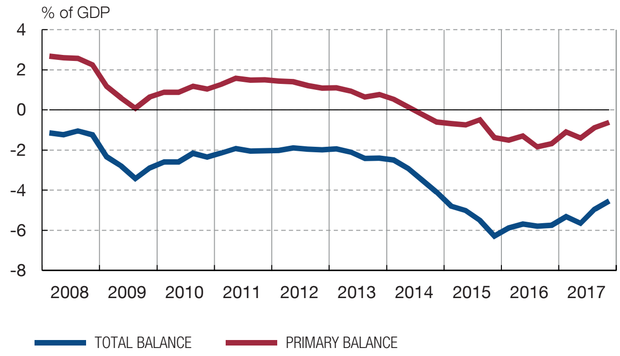
a April 2018 Consensus Forecasts for the end of the year.
b The inflation target in Argentina for 2018 is 15%, and that for 2019 is 10%.

price falls associated with the good harvests. The fall in core inflation (see Chart 6.2) was smaller. However, there are signs, as shown by inflation expectations, that in 2018 Q1 inflation seems to have touched bottom in Brazil, Chile and Peru, and their central banks expect it to rise gradually towards their targets. In the case of Colombia, the low will be reached somewhat later, when the effects of the early-2017 rise in VAT dissipate; in addition, this low may be located in the upper half of the central bank's target range in view

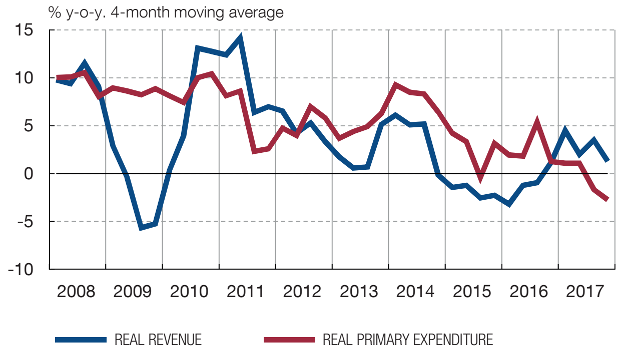
MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and year-on-year change

CHART 7

1 BUDGET SURPLUS (+) OR DEFICIT (–) IN LATIN AMERICA (a)



2 REAL PRIMARY REVENUE AND EXPENDITURE IN LATIN AMERICA (a)



SOURCE: Datastream.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

of the high inflation of the non-tradable components. In these circumstances, the central banks are near to completing, or have already completed, their official interest rate reduction cycles (Brazil, 775 bp since October 2016; Colombia, 275 bp since January 2017; Peru, 150 bp since May 2017). In Chile, the cycle concluded in May 2017. Indeed, the financial markets are discounting rises in some countries by the end of 2018, against a background in which the output gaps have closed.

In Mexico inflation rose more than expected in the second half of 2017 to stand at 6.8%, well above the central bank's inflation target, fuelled partly by the depreciation of the peso. This led the central bank to extend the cycle of official interest rate rises through two additional 25 bp increases at the December 2017 and January 2018 meetings to take it to 7.5%. However, since early 2018 inflation has declined now that the base effect of the tax hike has dropped out of petrol prices, so it seems that the latest spate of rises may have come to an end if the peso remains stable. In Argentina, inflation decreased less than expected to stand at 24.8% at the end of 2017, above the target range of 12%-17%, held up by regulated prices which rose by more than the central bank projections. In the face of these developments, monetary policy was not sufficiently tight; on the contrary, the government increased by 5 pp its targets for 2018 and 2019 (15% and 10%, respectively, holding the range at ±2 pp) and postponed to 2020 its target of 5%. This prompted an increase in inflation expectations, which remain distant from the target for 2018, strengthened by the exchange rate depreciation since the end of 2017. To counter these depreciation pressures, the central bank intervened in the foreign exchange markets in March.

In the fiscal policy arena, which is analysed in more depth below, the most notable development was that some countries reduced their budget deficits in 2017, against a background of growing real revenue and falling primary expenditure in the region as a whole (see Chart 7). The exceptions were Chile, with a slight increase in the deficit, Argentina and Peru. Government debt as a percentage of GDP tended to increase, with the exceptions of Mexico and Argentina.

The main fiscal reforms were in Argentina, which approved a change in the revaluation of pensions to enhance the sustainability of the Social Security system. Additionally, agreement was reached with the provinces under which they will continue to receive the revenues distributed by the central government and, in exchange, will limit their spending growth and reduce the distortionary taxes levied by them.[5] In 2017 the primary deficit target was met comfortably (the primary deficit was 3.8% of GDP, compared with a target of 4.2%), but the total deficit continued to increase to 6% of GDP due to higher interest payments. For 2018 and 2019, the government target is to continue reducing the primary deficit by around 1 pp each year.

In Brazil, where the budget deficit decreased by 1.2 pp to 7.8% of GDP, the primary deficit declined by less, standing at around 1.5% of GDP at the end of 2017. The Brazilian government decided to suspend passage of the pension reform, recognising that it has insufficient support in Congress. However, given that the ratio of government debt to GDP ended 2017 at 74% and has trended upwards in recent years and given the outlook for future pension expenditure, this reform is vital for ensuring the sustainability of the public finances.

Among the other countries, Chile's budget deficit increased by 0.1 pp in 2017 to 2.8% of GDP, and the structural deficit stood at 2%, which was above the forecast, sustained by the increase in government spending in recent years. In Colombia the central government's deficit decreased by 0.6 pp in 2017 (to 3.3% of GDP), assisted largely by extraordinary revenue and by the implementation of the tax reform (including a VAT rise from 16% to 19%). Finally, in Peru the budget deficit increased by 1 pp in 2017, from 2.6% to 3.6% of GDP, as a result of lower tax revenue after new tax frameworks were put in place, of lower economic growth and of higher spending associated with the reconstruction of infrastructure damaged by El Niño-related weather phenomena.

OUTLOOK

The outlook for the region is for the cyclical recovery to continue, underpinned by spare capacity. On consensus forecasts, growth will stand at 2.6% in 2018, up 0.9 pp on 2017. This greater dynamism will be widespread, except in Argentina, affected by the drought which will reduce the harvests of its main export products, and will include most notably for their exceptional size the accelerations in Chile and Brazil (see Chart 1). Peru will become the country with the highest rate and Mexico the country with the lowest rate. In 2019 the growth of the region's activity will remain similar, with a rate of 2.9%. However, these growth rates are not sufficient to maintain the process of convergence with the more advanced countries. Moreover, in some cases they come from cyclical, rather than long-term, improvements. Furthermore, the recession will foreseeably continue in Venezuela, since appreciable changes are not apparent in its government's economic policy strategy.

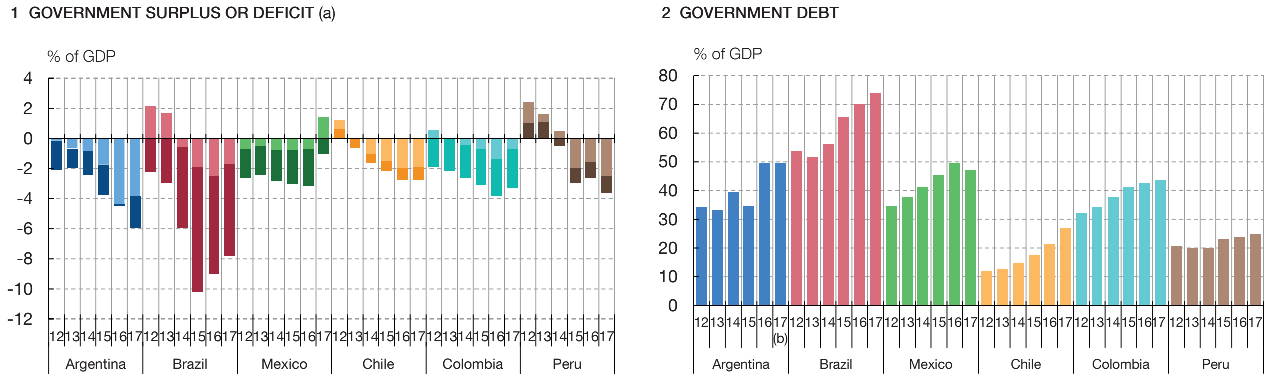
Regarding inflation, it is expected that, after touching bottom in many countries, it will increase and converge towards central bank targets as output gaps are progressively closed. Only in Mexico and Argentina is inflation expected to fall, although it is uncertain how quickly this will occur.

The balance of risks to growth remains tilted to the downside. On the external front, the main cause for concern is that global financial conditions may tighten as a result of a change in the US macroeconomic policy mix, shifting it towards a more expansionary fiscal policy stance and a less lax monetary policy stance. This change may quicken growth in the short term, but, if it is not appropriately scaled in a setting where the output

5 The provinces levy taxes on gross revenues which, since they apply to sales of all products, whether final or intermediate, limit the scope for specialisation in the economy.

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP

CHART 8



SOURCE: Datastream.

a Light shading: primary deficit; dark shading: interest burden.
b 2017 Q3.

gap is already positive, it may overheat the economy and lead to more rapid normalisation of monetary policy and to substantial adjustments in the international financial markets.

Concern has also grown over a widespread increase in barriers to international trade as a result of the tariff measures approved and announced recently by the US government and over the reprisals announced by the adversely affected countries. Brazil, Argentina and Colombia are countries relatively closed to trade, since exports amount to around 10% of GDP in the first two and to 15% in Columbia, but any increase in trade barriers would lead to slower global growth and, therefore, to a fall in commodity prices on which the area is highly dependent. Mexico is a special case because it is a more open economy, where exports (mainly industrial products integrated in global value chains) make up around 35% of GDP, and it faces the risk of renegotiation of the NAFTA[6] with the USA and Canada. Also persisting are geopolitical risks and the possibility that the slowdown in China may be much less gradual than expected.

On the domestic side, the fiscal space available to address a possible slowdown in activity is particularly small in some countries. Finally, the sequence of presidential elections (in Colombia, Mexico and Brazil) poses uncertainties regarding the economic policies announced by some candidates, to which must be added the uncertainty as to the stability of the newly formed government in Peru.

Challenges to the sustainability of public finances in Latin America

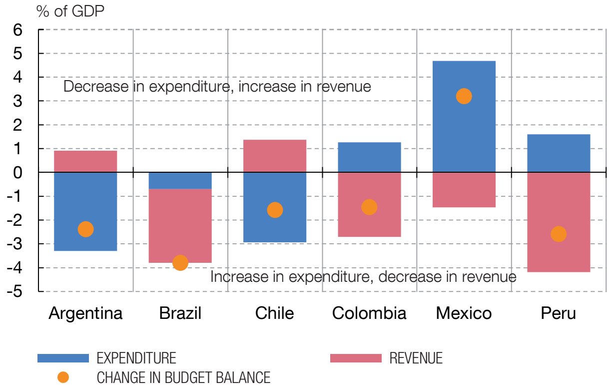
The fiscal situation of Latin America at the beginning of 2018 reflects the consequences of the fall in commodity prices in 2014-2015 and of the accompanying long economic slowdown, which significantly altered the fiscal landscape of the region. The fiscal deficits of most countries widened (see Chart 8.1). Specifically, in countries such as Argentina, Brazil, Chile, Colombia or Peru the budget deficit ended 2017 at levels above 2.5% of GDP, in contrast to the surpluses recorded in the preceding decade. When this is added the lower growth, it is not surprising that government debt has embarked on an upward course in recent years (see Chart 8.2), reversing the headway made by most countries in this area between 2002 and 2008. Indeed, in countries such as Colombia, Mexico, Chile or, particularly, Brazil, government debt as a percentage of GDP stood at levels not seen

6 See section entitled “The possible impact on Latin America of the expected changes in US economic policy” in the “Report on the Latin American Economy. First half of 2017”, *Economic Bulletin,* 2/2017, April 2017.

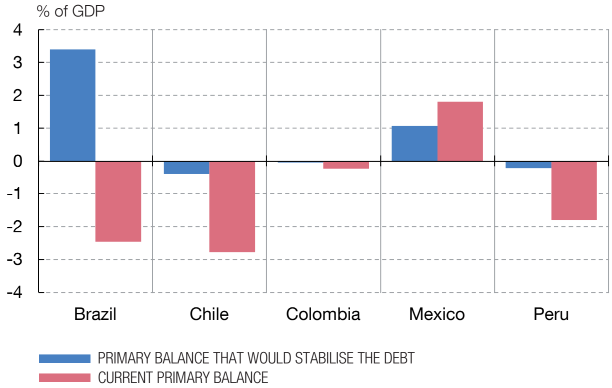
BUDGET DEFICIT COMPONENTS AND STRUCTURAL BALANCE
Percentage of GDP

CHART 9

1 EXPENDITURE AND REVENUE IN LATIN AMERICA 2014-2017 (a)



2 DIFFERENCE BETWEEN PRIMARY BUDGET DEFICIT AND THE BUDGET DEFICIT NEEDED TO KEEP THE DEBT STEADY (b)



SOURCES: IMF (October 2017 WEO) and Banco de España.

a The positive bars represent changes in expenditure or revenue as a percentage of GDP which improve the budget balance. The negative bars indicate a worsening.

b The balance which would stabilise the debt is the primary balance resulting from the equation $\frac{r-g}{1+g}D_{t-1}$, where r is the real interest rate, g is real economic growth and D is the government debt. Economic growth is taken from the WEO, and the interest rate is the latest value of that on the 10-year debt reference.

since the 1990s. This means that these economies are particularly vulnerable to changes in financial market sentiment, since the need for new funding or for the rollover of existing debt has increased. This section analyses the behaviour of the fiscal magnitudes in Latin America in recent years, looking separately at the contribution from changes in government revenue and expenditure, and simulating the effects on the macroeconomic scenario of a possible fiscal consolidation in various countries.

The commodity price falls of 2014-2015 significantly changed the fiscal outlook of many Latin American countries, both because of their direct effect on the collection of taxes linked to these products (whether they be on exports or on operating profits) and because of their indirect effect on revenue from other taxes and on expenses (due to the impact on the economic cycle of countries). Until then, many countries had embarked on major escalations of expenditure, in many cases of a structural nature,[7] partly financed by revenue derived from the favourable commodity cycle. At that moment, following the collapse of the price of these products, the dilemma centred on three possible reactions: to replace these cyclical revenues by other structural revenue, to adjust government spending to the new situation or, in those countries which took longer to recognise the structural nature of the drop in revenue, to resort to borrowing or liquidating previously accumulated assets (an option only available in countries which, like Chile or Peru, had built up stabilisation funds). Most Latin American countries resorted to a mix of these measures in varying degrees.

Chart 9.1 summarises the changes in Latin American government revenue and expenditure as a percentage of GDP between 2014 and 2017. It shows that the budget deficit of all

7 Some Latin American countries, such as Chile and Colombia, have fiscal rules based on their structural balance which limit expansion of the budget deficit and allow a certain economic stabilisation [Alberola, E., I. Kataryniuk, A. Melguizo and R. Orozco (2017). Fiscal policy and the cycle in Latin America: The role of financing conditions and fiscal rules. OECD Development Centre Working Papers 336]. These rules hinge on estimating structural revenues as a function of potential GDP and long-term commodity prices. However, the subsequent downward revision of these parameters caused significant mismatches between expenditure and revenue, since expenditure commitments had been made on the basis of an overly optimistic estimate of structural revenue. In the case of Chile, the Budget Directorate calculated that this effected increased the structural deficit by 1.8 pp of GDP in 2015 and by 0.74 pp in 2016.

countries except Mexico increased in this period, worsening their fiscal position. In Peru and Brazil, this was due basically to a fall in revenue which was not offset by other fiscal measures. In these two countries, the primary deficit expanded by more than 2 pp and accounts for the bulk of the current budget deficit. Mexico and Colombia adjusted their spending significantly and adopted some measures to increase revenue (which were insufficient to maintain its level as a percentage of GDP), such as the tax reforms of 2014 and 2015, respectively. Although their level of debt with respect to GDP increased in the period, raising their vulnerability, the dynamic is favourable and allows a correction to be anticipated in the immediate future. In Chile, the reaction brought an increase in the state's weight in the economy through rises in both spending and, to a lesser extent, structural revenue, resulting in a higher level of debt. Finally, in Argentina developments were determined by the increase in spending in 2015, which exceeded that in revenue; the fiscal consolidation is proceeding gradually, resorting to indebtedness (and thus a higher debt interest burden), but without raising the primary deficit.[8]

Advantage should be taken of the cyclical improvement in 2017, expected to continue in 2018, to strengthen the fiscal position, since it is not anticipated that commodity prices will return to their levels at the beginning of this decade. Unquestionably, it is vital to restore revenue levels and, in this connection, it seems clear that the region has leeway to expand income taxes (which, according to the OECD, represent less than 30% of total tax revenue, a significantly lower percentage than in the developed countries) and redesign them to make them more progressive, so that they act as powerful automatic stabilisers and limit the need for discretionary measures when the business cycle enters recession. In addition, the adjustment of the tax system to encourage job creation may increase revenue from Social Security contributions in the medium term. On the spending side, the forecasts vary. Some countries, such as Argentina, envisage a gradual fiscal consolidation, although its success will depend on an improvement in activity and on pension system reform. Peru, by contrast, intends to take advantage of the fiscal space provided by its low government debt to carry out a fiscal expansion in 2018, postponing consolidation to subsequent years. In Chile, the new government announced its intention to reduce the structural deficit against a background in which structural revenue fell more than expected. The situation is more serious in Brazil, as it has abandoned the debate on pension reform, which is a key measure for containing the budget deficit and complying with the constitutional spending limit introduced last year.[9]

A sequential approach was used to calibrate the fiscal space of the main Latin American economies, the need for fiscal consolidation and its impact on the macroeconomic variables. The first step was to analyse the sustainability of their debt, based on assumptions on long-term debt, inflation and interest rates.[10] Chart 9.2 shows the difference between the current primary balance and the primary balance that would keep the debt stable in the long term for five Latin American countries.[11] Specifically, it is

8 The financing of a portion of the budget deficit by the central bank of Argentina distorts the dynamic relationship between debt and deficit due to an increase in the amount of money in circulation.

9 Some studies on Brazil show, furthermore, that the pension reform may reduce inequality because it impinges on the upper portion of the income distribution.

10 Specifically, use is made of the traditional dynamic debt accumulation equation and the difference is calculated between the current primary balance and the primary balance that would keep debt stable (or alternatively, the difference between the debt of a given period and that of the following one is zero), as given by the equation $D_t - D_{t-1} = \frac{r-g}{1+g} D_{t-1} - pb_t$ where r is the real interest rate, g is real economic growth, pb is the primary balance as a percentage of GDP and D is government debt as a percentage of GDP. Economic growth is taken from the IMF's World Economic Outlook (WEO), while the interest rate used is the latest value of that on the 10-year debt reference.

11 Excluding Argentina because its long-term inflation and interest rate levels are more difficult to quantify due to its regime of convergence towards price stability.

estimated that the required improvement in Brazil's primary deficit is 5.8 pp of GDP, while the other two countries needing significant fiscal consolidation are Chile (2.4 pp of GDP) and Peru (1.6 pp of GDP). In Colombia, the difference between the current primary balance and the equilibrium balance is 0.2 pp of GDP, while the exercise reveals that Mexico, according to this metric, has fiscal space to conduct an expansion of 0.7 pp of GDP.[12] In any event, it should be taken into account that they are converging towards very different debt levels and that these are a basic determinant of the degree of vulnerability to future shocks. In the case of Brazil, for example, the stabilisation of debt as a percentage of GDP at its current level would entail maintaining it at a relatively high level by the historical standards of comparable countries.[13]

In a second step, a Bayesian vector auto-regressive model is used to calibrate the impact that this fiscal adjustment may have on the main macroeconomic variables.[14] Thus, a fiscal consolidation such as that described in the preceding paragraph, carried out in a period of three years, would entail lower year-on-year growth,[15] in the most heavily impacted quarter, of somewhat more than 1 pp in the case of Chile and of 3 pp in Brazil. By contrast, for Peru the effect would be relatively limited and would disappear by the end of the projection horizon (see Chart 10).

An analysis such as that described above is subject to uncertainty because it relies on the use of estimates for the long-term parameters of the variables in the sustainability equation, and because of the design and composition of the fiscal adjustment. In addition, the size of the estimated fiscal multipliers is based on historical episodes and may presently differ if the composition and credibility of the fiscal adjustments are also different. Furthermore, these multipliers may depend on the cyclical position, on the level of initial indebtedness and on other characteristics of the economies, such as their degree of trade openness [(Iltzezki *et al.* (2012)].[16]

In short, the main Latin American economies underwent a notable fiscal deterioration, which they have dealt with in varying ways, and which poses a challenge in the management of public finances in the coming years. The expected cyclical improvement will help to stabilise the level of debt, but some countries will find it insufficient, and the others will have to take advantage of the improved growth outlook to replenish the fiscal buffers eroded over the past decade. This is fundamental to allow them to get ready to conduct a counter-cyclical fiscal policy to cushion the impact of possible shocks and reduce economic fluctuations. In this respect, while some countries, such as Mexico or Colombia, have more favourable starting points, others, such as Brazil, are in more delicate situations which require specific measures to restore their fiscal sustainability.

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12 In all the countries analysed, the levels of primary debt reached are within the range recorded for these countries in previous upturns.

13 Another approach considers the possibility that the countries converge at an optimal level of debt as a percentage of GDP. However, this estimate is subject to considerable controversy in the literature, and the latest studies indicate that these calculations are highly dependent on the model and data used [see B. Égert (2015), "Public debt, economic growth and nonlinear effects: Myth or reality?", Journal of Macroeconomics, 43, pp 226-238].

14 The models include five variables for each country (GDP, inflation, exchange rate, monetary policy interest rate and primary balance as a percentage of GDP) and three structural shocks (demand, monetary and fiscal) are identified through sign restrictions, in a strategy similar to A. Mountford and H. Uhlig (2009), "What are the effects of fiscal policy shocks?", Journal of Applied Economics, 24, pp. 960-992. Also, use is made of a size constraint on the response shock function, defined as an upper limit on the contemporaneous response to a fiscal shock, so that the implied fiscal multipliers are in consonance with those reported in the literature for emerging countries [see N. Batini, L. Eyraud and A. Weber (2014), A Simple Method to Compute Fiscal Multipliers, IMF Working Paper, WP/14/93].

15 The results are expressed as the difference with respect to the scenario compatible with the data of the IMF World Economic Outlook of October 2017.

16 E. Ilzetzki, E. Mendoza and E. Végh (2012), "How big (small?) are fiscal multipliers?", Journal of Monetary Economics, vol. 60, No 2, pp. 239-254.

MACROECONOMIC EFFECTS OF THE FISCAL CONSOLIDATION
Percentage of GDP and percentage points

CHART 10

SOURCES: IMF (October 2017 WEO) and Banco de España.

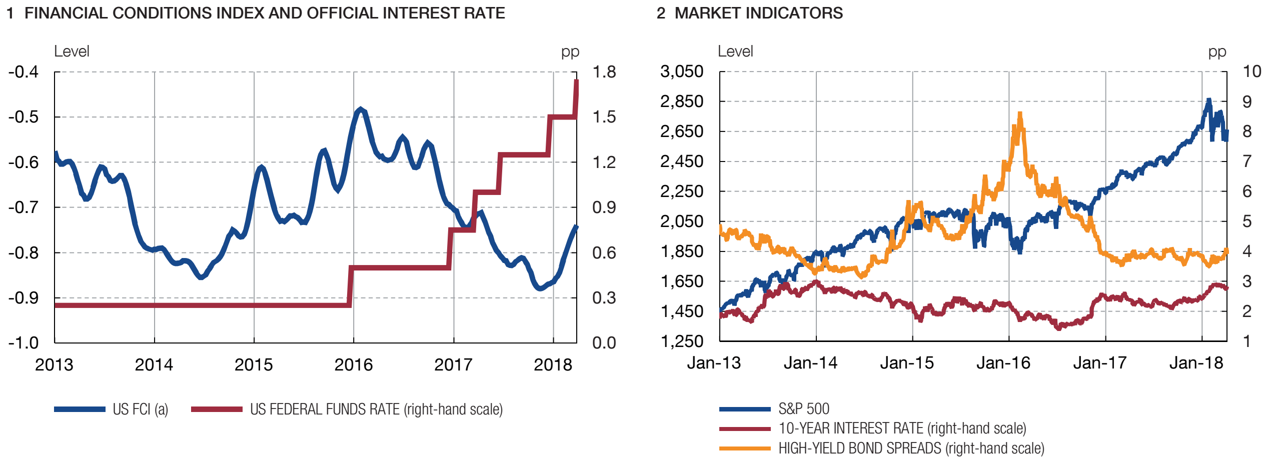
a Differing effects of scenario 1 and the baseline scenario, calculated in terms of the annualised quarter-on-quarter growth of GDP in each period, taking as the baseline scenario a primary balance path compatible with the World Economic Outlook 2017 and taking as scenario 1 a consolidation giving rise to a primary balance equivalent to that of the debt sustainability exercise explained in the text.

Financial conditions in the current recovery in Latin America

The greater or lesser ease with which agents can borrow in an economy (the financial conditions) has an effect on real economic activity. These financial conditions depend not only on the variables under the control of the central bank, such as the official interest rate, but also on how monetary policy decisions impact on other financial variables (e.g. bank credit volumes, collateral valuations, risk premia, exchange rates, etc.). Furthermore, in emerging economies these financial conditions are largely determined by external variables, since a substantial portion of their financing comes from abroad. Financing

FINANCIAL CONDITIONS IN THE UNITED STATES

CHART 11



SOURCE: Datastream.

a National Financial Conditions Index, compiled by the Federal Reserve Bank of Chicago.

conditions indices (FCIs) seek to summarise in a single indicator information on a more or less extensive set of variables reflecting the conditions of the main domestic and foreign sources of financing available in an economy.[17]

For example, the recent behaviour of the US FCI shows the importance of using a wider set of variables, rather than just the official interest rates, to appropriately characterise the financial conditions of this economy. This is illustrated by Chart 11, which sets out the US official interest rates along with the FCI estimated by the Federal Reserve Bank of Chicago.[18] As usual, an increase (decrease) in the FCI denotes tighter (looser) financial conditions. Although in the United States, the Federal Reserve has raised the official rate six times since the current cycle of monetary tightening began in December 2015, financial conditions continued to relax until the end of 2017, against a background of a weak dollar, still-low long-term interest rates and stock market indices near their peaks, and only began to timidly tighten from February 2018.

The analysis of financial conditions in Latin America is largely conditioned by the global financial integration of these economies, their still-low levels of financial development and their exposure to external shocks beyond the control of their authorities, such as US monetary policy, the US government debt yield, the US dollar exchange rate, or commodity prices. In this respect, given the importance for the region of capital flows, the global financial cycle variables and the commodity cycle, these may also heavily influence financial conditions, unlike in countries with deeper financial markets and more highly diversified economies.

This section analyses the recent behaviour of financial conditions in Latin America, for which purpose the FCIs of the six largest economies of the region (Argentina, Brazil, Chile, Colombia, Mexico and Peru) are calculated. Table 3 shows the variables selected for each country. The proposed FCIs include short- and long-term interest rates, the exchange rate,

17 FCIs are different from financial stress indices (FSIs), although some variables, such as implied volatilities and credit spreads, may be included in both indices. See Box 1 of the "Report on the Latin American Economy. Second Half of 2016", *Economic Bulletin,* October 2016 for more information on FSIs.

18 See https://www.chicagofed.org/publications/nfci/index for more information.

FINANCIAL CONDITIONS INDICES IN LATIN AMERICA
Variables used for estimating them

TABLE 3

Variable	Brazil	Mexico	Chile	Colombia	Peru	Argentina
1 Money market						
Official interest rate	SELIC	1-day interbank interest rate	Monetary policy rate	Intervention rate	Reference interest rate	BADLAR
2 Bond market						
Sovereign external debt spread	EMBI+	EMBI+	EMBI+	EMBI+	EMBI+	EMBI+
Corporate external debt spread	CEMBI	CEMBI	CEMBI	CEMBI	CEMBI	CEMBI
Local market government debt	1-year real-denominated bonds	10-year peso-denominated bonds	10-year peso-denominated bonds	10-year peso-denominated bonds	20-year sol-denominated bonds	25-year peso-denominated bonds
3 Bank financing	BNDES loans (TJLP)	Loan rate	30/90-day non-indexed peso-denominated loans	Personal loans	Local currency loan rate	Local currency current account advances
	Non-earmarked loans		Foreign currency loans		Local currency loan rate	Other non-zero rate advances in foreign currency
4 Stock markets						
General index	BOVESPA	IPC 35	IGPA	MSCI Colombia	IGBVL	MERVAL
Banking sector	Thomson Reuters bank index	Thomson Reuters bank index	Thomson Reuters bank index	Thomson Reuters bank index	Thomson Reuters bank index	Thomson Reuters bank index
5 Exchange markets	BIS nominal effective exchange rate	BIS nominal effective exchange rate	BIS nominal effective exchange rate	BIS nominal effective exchange rate	BIS nominal effective exchange rate	BIS nominal effective exchange rate
6 Commodities	WTI oil price	WTI oil price	Spot LME grade A copper price	WTI oil price	Spot LME grade A copper price	WTI oil price
					LBM troy ounce gold price	Yellow soybean price

SOURCE: Banco de España.

stock market indices and bank lending interest rates. In addition, commodity prices provide key information for FCIs, given that most countries in the region are commodity exporters and have large commodity producing firms, normally government owned, with a high weight in the rest of the economy.[19] The indices are calculated from the end of 2001, given the availability of data on corporate foreign debt spreads.

Each variable included in the FCIs is standardised so as to have an average of 0 and a standard deviation of 1 throughout the whole period. Also, where necessary, these variables are transformed so that they move in the same direction as the index it is wished to construct.[20] The index is centred around 0, so that positive (negative) values denote tighter (looser) financial conditions. The last step in constructing FCIs is to aggregate all the individual indices of each country. The aggregation methods employed are usually of

19 Specifically, the FCI of Brazil includes oil prices although this country is not a net exporter, since the state oil company PETROBRAS accounts for nearly 10% of investment and 1% of Brazil's GDP, in addition to having a high impact on other industrial activities. Similarly, the FCI of Argentina includes oil prices and that of Chile includes copper prices, owing to the importance of the state-owned enterprises YPF and Codelco, respectively.

20 For example, a priori a higher commodity price entails a relaxation of financial conditions in these economies, but since an increase in the FCI indicates tighter financial conditions, this variable is inverted before being included in the index. This transformation is also necessary for stock market prices and the exchange rate, but not for interest rates.

two types: the weighted sum of components, where the weights are the elasticities obtained from econometric models;[21] and the use of statistical procedures to reduce the dimension of the data, such as principal components analysis (PCA).

In line with Hatzius *et al.* (2010)[22] and with the method used by the Federal Reserve Bank of Chicago for calculating its US FCI, the indices for the countries of the region are obtained using PCA because of its greater flexibility, since it allows information from a set of variables of large size to be summarised without imposing a priori any economic or other constraints between them. Hence this method facilitates the incorporation of variables highly representative of the financing costs in some economies, but whose inclusion in the customary models is not trivial, such as the activity of the government-owned banks in Brazil or the dual nature of the cost of loans in domestic and foreign currency in Chile, Argentina and Peru. However, the fact that it is a strictly statistical method also has its drawbacks, since a priori assumptions have to be made on the sign of some variables. For example, when including the exchange rate in the index it has to be decided whether the trade or the financial channel predominates: if the former predominates, a depreciation would give rise to a relaxation of financial conditions; by contrast, if the financial channel were dominant, a depreciation would relax or tighten financial conditions depending on whether the volume of dollar-denominated liabilities of the economy were sufficiently high for a weakening of the currency to increase the indebtedness of national firms and banks and for this to induce a contraction in activity. In the FCIs listed in this section, it is assumed that the trade channel predominates.

Chart 12 shows the indices obtained for the six economies, along with their official interest rates.[23] All the indices tighten at the end of 2008, coinciding with the global financial crisis, and after the May 2013 turmoil, as a result of the change in expectations regarding US monetary policy *(taper tantrum).* In this case, financial conditions tightened more in Brazil and Peru, and less in Chile and Mexico, the least vulnerable countries in that period, and Argentina, isolated from global conditions at that time owing to its capital control policies and its inability to obtain international financing. From summer 2014 financial conditions tightened in all countries, initially due to falls in oil prices and, from September 2015, to the strong appreciation of their currencies against the dollar, with the exception of the Mexican peso and the Argentine peso. The subsequent rise in commodity prices from January 2016 contributed to the relaxation of financial conditions and the narrowing of sovereign spreads and, from early 2017, to the stability of nominal effective exchange rates. Financial conditions in the various economies of the region eased despite the official interest rate rises in the United States from December 2015. However, the differing monetary policy phases prevailing in each country help to explain the recent divergences between the indices: sharp cuts in official rates in Brazil, Colombia and Peru, stability in Chile and rises in Mexico.

Currently, financial conditions in the region are the loosest since 2010, except in Mexico, whose index, like that of the US, has remained steady in the past year despite its monetary policy normalisation. Finally, the tightening of financial conditions in the United States following the correction of the stock exchange volatility index (VIX) in February, along with the higher

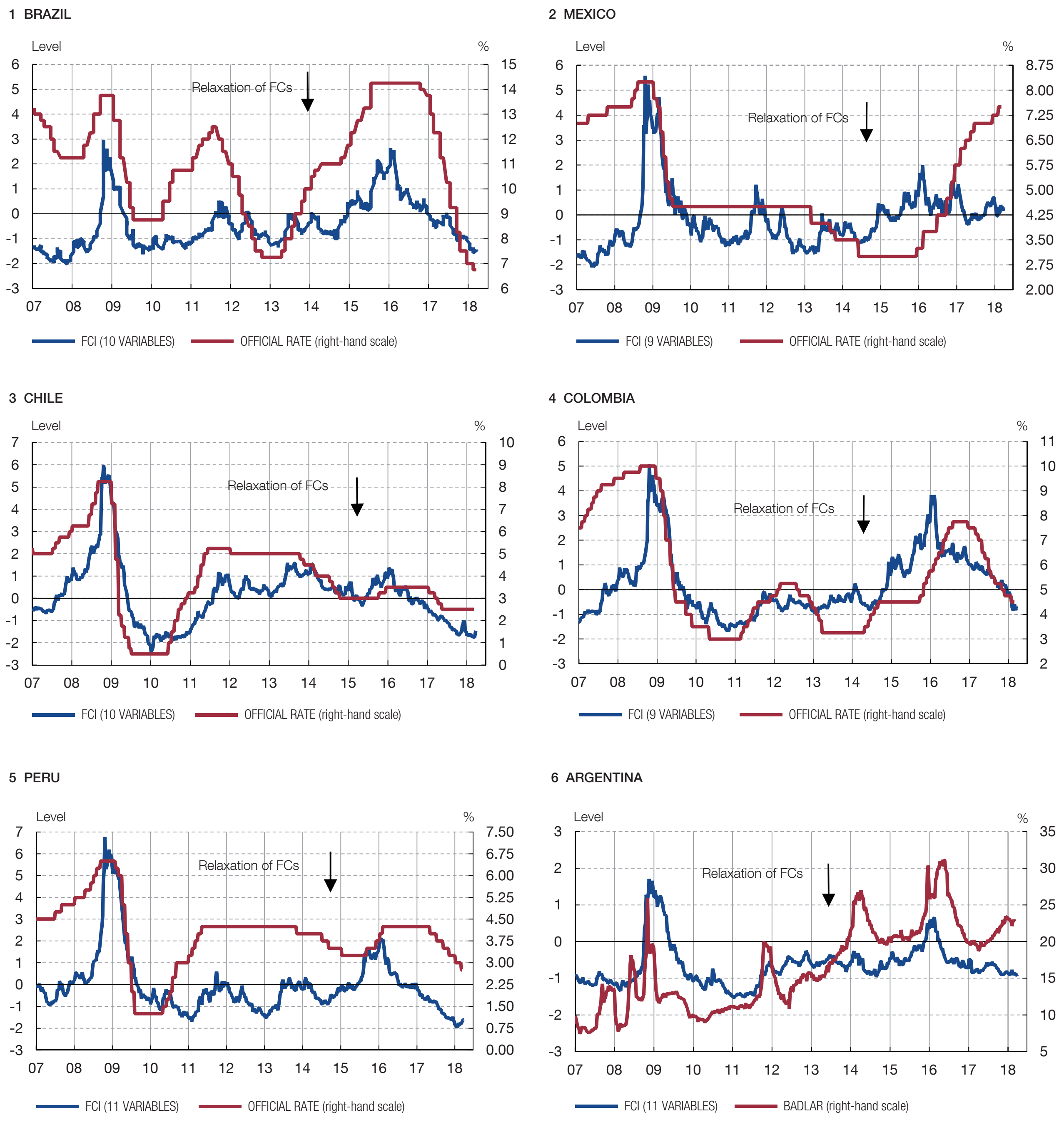
21 These elasticities capture the impact of a shock to each of the variables in the GDP of the country concerned. In the case of the FCI of the region, the models available for obtaining the elasticities do not provide satisfactory results.

22 J. Hatzius, P. Hooper, F.S. Mishkin, K.L. Schoenholtz and M.W. Watson (2010), Financial conditions indexes: A fresh look after the financial crisis, NBER working paper 16150.

23 The two main components used to summarise the information contained in all the variables of each country capture at least 65% of the total variability of the data, except in the case of Chile (59%).

FINANCIAL CONDITIONS INDICES IN LATIN AMERICA

CHART 12



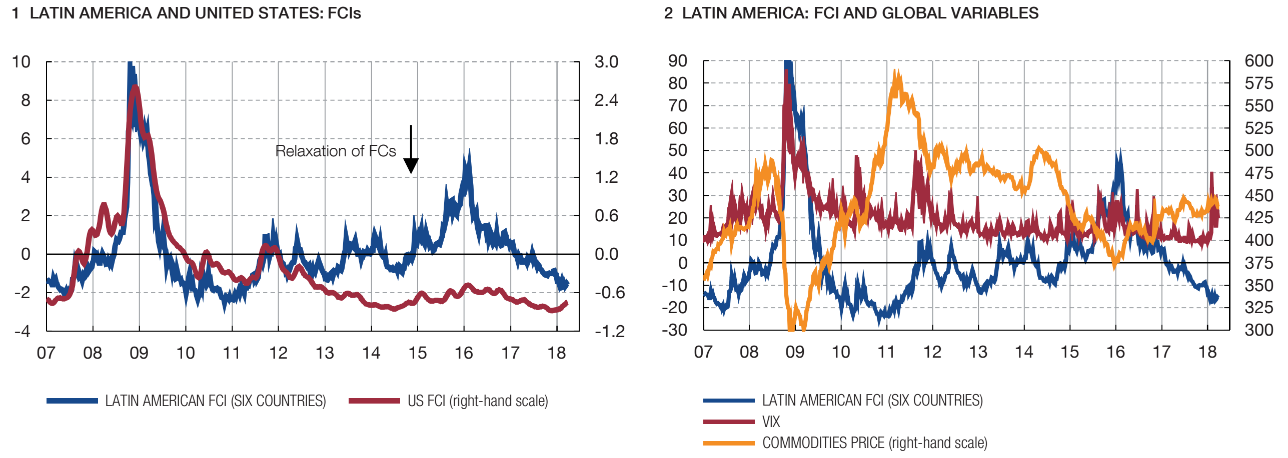
SOURCE: Banco de España.

long-term rates induced by the fiscal stimulus in that country, do not seem to have prompted a uniform response in the Latin American countries: whereas in Brazil, Colombia and Argentina financial conditions relaxed further in March, they tightened in Chile, Peru and Mexico.

Lastly, Chart 13 shows the US FCI, along with a FCI for the region constructed using the PCA method from the six indices of the respective countries.[24] The two FCIs behaved similarly until 2013. The Latin American FCI then increased following the outbreak of the

24 As in the case of individual FCIs, the aggregate index for Latin America is calculated using two main components which summarise more than 85% of the variability of the data.

FINANCIAL CONDITIONS INDICES IN LATIN AMERICA CHART 13



SOURCE: Banco de España.

a National Financial Conditions Index, compiled by the Federal Reserve Bank of Chicago.

taper tantrum episode, and subsequently decreased from early 2015, coinciding with the rise in commodity prices and despite the depreciation of some of the region's currencies against the dollar and the rise in US interest rates; the US FCI showed greater stability. From March 2018, the Latin American FCI increased only slightly and less so than that of the United States. To explain this apparent disconnection between the financial conditions of Latin America and the global indicators, and in line with Brandao and Pérez (2017),[25] we compared the regional index with the implied volatility of the US stock market and with the commodity price index: the VIX, usually considered an indicator of the global financial cycle, shows a high correlation with the Latin American FCI, although since 2013 there is a divergence between them and, in fact, the financial conditions of the region scarcely reacted to the latest rise in the VIX in February 2018; in recent years, however, the behaviour of the Latin American index has been more highly correlated with the commodity price index.

In short, the financial conditions of the region continue to be highly dependent on the external environment and are thus tightly linked to global variables beyond the control of the authorities of these countries, including most notably commodity prices in recent years. Precisely the rise in commodity prices since 2016, in a period of monetary relaxation or stability of official rates in nearly all these economies, except Mexico, has given rise to a relaxation of financial conditions to all-time lows, despite higher official and long-term interest rates in the United States. Recently, the financial conditions of these economies showed greater stickiness in the face of certain financial shocks of a global nature. Although future sharp corrections cannot be ruled out, the gradual reduction in the external vulnerability of the Latin American economies, along with the robust growth of world activity and trade, directly linked to commodity prices, underpin the resilience of the financial conditions of the region.

Data cut-off date 18.4.2018.
Publication date: 27.4.2018.

25 L. Brandao and E. Pérez (2017), How financial conditions matter differently across Latin America, IMF working paper 17/218.

The Venezuelan economy is in the throes of a long and deep recession (see Chart 1), the exact magnitude of which is unknown because official statistics have ceased to be published.[1] This box uses mainly IMF data. The decline of the Venezuelan economy began in the 1980s (its highest-ever GDP per capita was reached in 1973), saw a respite during the years of commodity price buoyancy and sharpened hugely when oil prices collapsed in mid-2014. This, along with a significant decrease in oil extraction capacity[2] due to lower investment and a continual loss of qualified staff from the state oil company PDVSA in the past 15 years, led to recession and a widening of the external and fiscal imbalances.

The strong contraction of oil exports, which account for 95% of total exports, prompted a worsening of the current account balance in 2015 and 2016 (see Chart 2). Furthermore, the fall in government revenue, nearly 50% of which is directly related to this commodity, caused the budget deficit to worsen notably in view of the government's commitment to maintain its spending and subsidies on many goods and services. Furthermore, the investments made by stabilisation funds in the years of high oil prices did not follow capital accumulation rules or financial profitability criteria.

The Venezuelan government has resorted to monetary financing of its budget deficits, which has fuelled inflation and fomented price controls (in force since 2003), the rigidities of the economy and the inability to finance imports, leading to a substantial fall in the supply of products. It is estimated that the month-on-month growth rate of consumer prices has now exceeded the barrier of 50%, a rate frequently considered as the threshold for defining a situation of hyperinflation (see Chart 3). All this has caused the demand for money[3] to collapse and the demand for foreign currencies (particularly the US dollar) to increase markedly. The government has maintained a multiple exchange rate system, with numerous modifications and devaluations over the years,[4] during which the depreciation of the market exchange rate has been exorbitant (see Chart 4), which has contributed to aggravating inflationary pressures. In these circumstances, the weight of the financial system in the economy has progressively declined, real wages have fallen notably and situations of poverty (particularly extreme poverty) have multiplied, giving rise to a massive exodus of Venezuelans.

The macroeconomic vulnerability, fiscal and political risk indicators stand at extreme values, compared with both the past levels of the Venezuelan economy and those of a broad sample of emerging countries.

According to IMF estimates,[5] the Venezuelan public sector debt (including PDVSA) stood at 162% of GDP at end-2018, a substantial part of it being to external creditors and in foreign currency. Given that the Venezuelan government has international reserves of some $10 billion, not all liquid, and has lost access to the international financial markets, its manner of satisfying its external financing needs in recent years has been to enter into financing agreements with the Russian and Chinese governments. Also, the government set up a complex system to control imports, which decreased from $57 billion in 2013 to $16 billion in 2016; this collapse had a serious social and humanitarian impact because the availability of food and medicines fell drastically.

The Venezuelan government has always shown a high "willingness to pay" which it only lost in November 2017 when the president announced his intention to refinance or restructure the Venezuelan government's payments of its external public debt (sovereign debt and that of the state oil company PDVSA). Some days later, Venezuela failed to pay an instalment (after the grace period expired) and the next day its sovereign debt was declared in restricted default by some credit rating agencies, and this status remains the same due to its default on certain bonds. The accumulated arrears relate to certain government bonds, since priority has been given to payment of PDVSA bonds, partly to avoid seizure of the company's assets abroad. The market expects the haircut on the debt to be large (see Charts 5 and 6), but a debt restructuring would be a complex process for various reasons, such as the wide diversity of the payment obligations, the problems of coordination between creditors, the sanctions approved by the US administration and the financial and political involvement of Russia and China.[6]

The solution to this economic situation is hard to imagine without foreign aid. However, the Venezuelan government does not have a fluid relationship with the IMF, which hinders its prospects of receiving financial aid from the latter. Furthermore, the success of a programme would require bilateral contributions from those countries with the closest social and economic ties with Venezuela. Partly in response to its debt payment difficulties, the Venezuelan government created the Petro, a cryptocurrency whose value is

1 In addition to the absence of official economic data, there are doubts as to the consistency and accuracy of the available data. The IMF's latest Article IV dates from September 2004. Indeed, on 3 November 2017 the IMF Board published a request for data (http://www.imf.org/en/News/Articles/2017/11/03/pr17419-statement-by-the-imf-executive-board-on-venezuela).

2 According to OPEC data, oil production decreased by 21% year-on-year in the fourth quarter of 2017.

3 The president of Venezuela has announced the launch of a new currency, the bolívar soberano (sovereign bolivar), which will be put into circulation on 4 June, in a redenomination which eliminate three zeros from the existing currency.

4 The latest version of the multiple exchange rate system is that of 26 January 2018, when the preferential exchange rate known as DIPRO (10 bolivars/dollar) was discontinued. The exchange rate known as DICOM is a crawling peg of the bolivar with respect to the dollar, setting limits on how many dollars can be purchased. At the cut-off date of this Report, it is around 36,400 bolivars/dollar. Agents needing more dollars turn to the parallel market where the exchange rate is 215,000 bolivars/dollar.

5 Fiscal Monitor: Capitalizing on Good Times, April 2018.

6 The nature of China's financial role in Venezuela (basically loans to finance energy projects) and its compensation in kind constitute an additional challenge complicating the resolution of the problem, due to the absence of similar cases. Also, it should be noted that China is not a member of the Paris Club, so specific diplomatic initiatives will be required.

backed by a barrel of oil (i.e. it can be considered a forward sale of reserves yet to be extracted).

The cross-border impact of the Venezuela crisis has been limited to date. Given Venezuela's scant trade links with its neighbours, the direct effect through the trade channel is small, even in the case of Colombia, whose trade links with Venezuela have decreased drastically in recent years. Migrant outflows have increased substantially and are mainly to neighbouring countries, and are causing significant problems for the public services in the

Chart 1
GROSS DOMESTIC PRODUCT

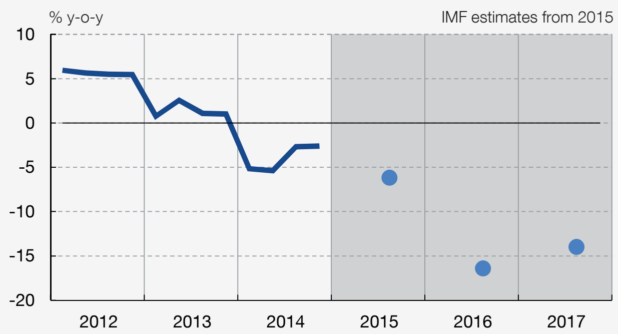


Chart 2
INTERNATIONAL RESERVES AND CURRENT ACCOUNT BALANCE

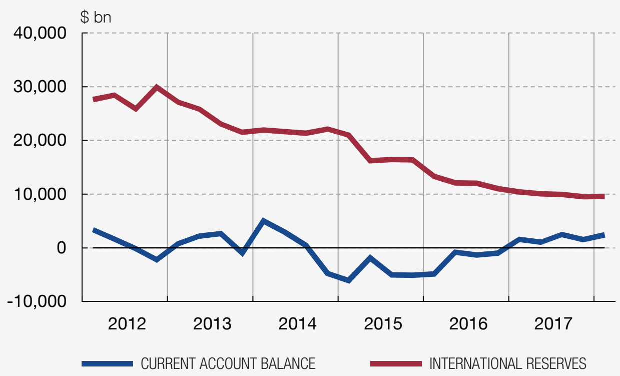


Chart 3
INFLATION

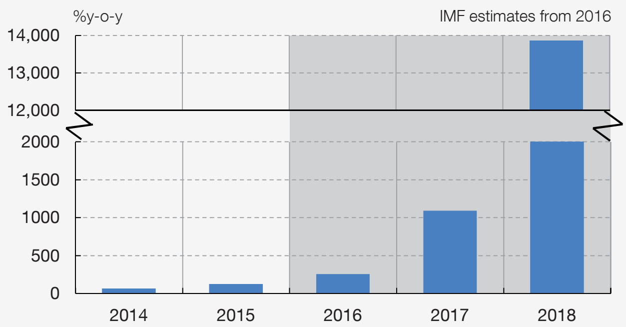


Chart 4
EXCHANGE RATE

Chart 5
VENEZUELAN GLOBAL EMBI PRICES AND INTEREST RATES

Chart 6
PDVSA 2027 BOND PRICES AND INTEREST RATES (b)

SOURCES: Datastream and IMF.

a The DIPRO (exchange rate for protected goods) ceased to be used from March 2018, leaving only the DICOM as the official rate (until then it was the rate for supplementary goods not included in the DIPRO).
b PDVSA: Petróleos de Venezuela S.A.

areas near to the borders.[7] The United States and some European countries, such as Spain and Italy, are also emigration destinations. On the other hand, the decrease in Venezuelan oil production has reduced the world oil supply, pushing up the price of this commodity in recent months.[8] Its market share in the United States would be largely covered by imports probably from Canada (given the similarity of the oil produced in the two countries). The signatory countries of the Petrocaribe energy agreement, headed by Venezuela, will be affected differently depending on their debt to Venezuela, although the advantageous conditions of the agreement have been moderating in recent years.[9]

7 According to the International Organization for Migration, a United Nations agency, in 2016 and 2017 around 900,000 people emigrated from Venezuela.

8 See "Special Feature: Commodity Market Developments and Forecasts" in Chapter 1 of the IMF's World Economic Outlook (April 2018).

9 Venezuela has been providing financing under highly advantageous conditions to Caribbean and Central American countries (Programa Petrocaribe) for the import of Venezuelan oil. However, the amount of this financing has been decreasing in recent years in parallel with the fall in oil prices and because Venezuela is finding it more and more difficult to meet the costs of the programme. The external effect of the Venezuela crisis in the Caribbean countries would be limited even more because Mexico has announced its willingness to act as an alternative provider.