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# Report on the Latin American economy. Second half of 2018

**Abstract**

This article reviews, as usual, the recent performance of the main Latin American economies, in a setting where the emerging economies have faced a series of adverse shocks. There has been a considerable downward revision of the growth forecast for the region in 2018, driven mainly by idiosyncratic factors: the severe recession in Argentina and a slower-than-expected recovery in Brazil. Furthermore, the risks remain predominantly on the downside. One of these risks – a tightening of the pace of monetary policy normalisation in the United States – is analysed in more detail in the article.

**Keywords:** global financial conditions, trade tensions.

**JEL codes:** F41, F42, F47.

## Introduction

Since the publication of the previous half-yearly report on the Latin American economy in April, the world economic recovery has shown some signs of fatigue and there are growing cross-country divergences. The US economy has achieved greater buoyancy than other developed economies and the emerging economies have faced a series of adverse shocks – tighter global financial conditions, heightened trade tensions and higher oil prices – with varying degrees of resilience. Against this backdrop, the main Latin American economies have also behaved differently, influenced by many idiosyncratic factors.

The growth forecast for the region[1] as a whole in 2018 has been revised substantially downwards, owing especially to the severe recession in Argentina and a slower-than-expected recovery in Brazil. Q2 was particularly negative, with a contraction of activity in the region, although the performance by country was mixed; in fact, Chile, Colombia and Peru remained highly buoyant. Specifically, Latin American growth is expected to stand at 1.5% in 2018, below potential growth and that posted by other emerging economies and regions, and to be slightly higher than 2% in 2019, with marked cross-country differences (see Chart 1).

The risks remain predominantly on the downside, both those stemming from the global environment – arising from a possible swifter-than-expected normalisation of monetary policy in the United States (see Box 1), the effects of trade tensions and higher oil prices – and those which are country-specific – fiscal problems in Brazil, the monetary and fiscal adjustment in Argentina and, in Mexico's case, the commercial relationship with the US. The region's economies are facing the current situation of the tightening of global financial conditions from a position of flexible exchange rates which provides them with a cushion against external shocks. Nevertheless, as occurred previously between 2015 and 2017, exchange rate depreciations can limit the capacity of monetary policies to operate counter-cyclically if they feed through to prices; furthermore, fiscal policies have hardly any room to provide support to growth. Together with this report an analytical article is published on recent developments in the Argentinian economy and the agreement negotiated between Argentina and the IMF.

## Recent developments in the Latin American economy

### THE EXTERNAL ENVIRONMENT AND DEVELOPMENTS IN FINANCIAL MARKETS

In 2018 the world economy is estimated to grow at a rate of 3.7% boosted by the United States and emerging Asia, especially China. The Chinese authorities have relaxed fiscal and monetary policies in order to moderate the impact of trade tensions with the United States and of the adjustment process towards lower debt levels. In the United States, the fiscal stimulus is contributing to maintain growth above potential, while the Federal Reserve continues the process of monetary policy normalisation. The foregoing has prompted an appreciation of the dollar and a tightening of global financial conditions. This has impacted the emerging economies (see Charts 2.1 and 2.2), many of which have high levels of foreign currency debt, triggering critical situations in those that are more reliant on external funding and have less credible economic policies, such as Argentina and Turkey. However, for the moment there has been no significant contagion to emerging markets as a whole, as indicated by the fact that the exchange rate depreciations and the widening of the credit spreads have been focused on the most vulnerable economies. Also, the stock market indices of those economies with significant links to global value

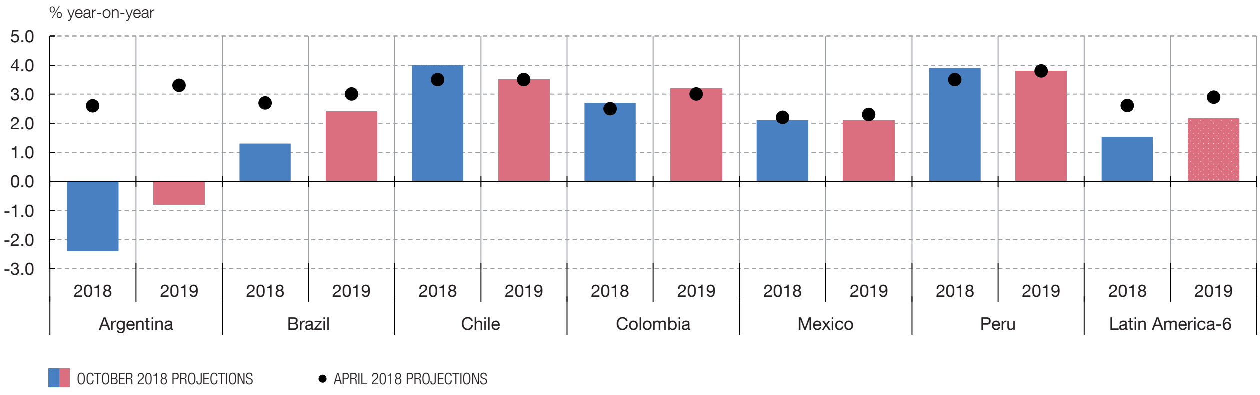
1 The aggregate of the region includes Argentina, Brazil, Chile, Colombia, Mexico and Peru. No data are available for Venezuela.

GROWTH PROJECTIONS IN LATIN AMERICA

CHART 1

The growth projections for the region decreased considerably compared with the latest report of April 2018, mainly owing to a weaker-than-expected recovery in Brazil and, in particular, to the severe recession in Argentina, leading to projected negative growth rates for 2018 and 2019. The growth estimates for the other economies remained stable and even improved slightly, as in the case of Chile.

2018 AND 2019 GROWTH PROJECTIONS IN LATIN AMERICA




SOURCE: Latin American Consensus Forecasts.

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chains (China, South Korea and Hong Kong) have also been affected. In comparative terms, this episode of instability has had a similar impact on the financial markets of emerging economies to that known as the "taper tantrum"[2] in 2013.

Between April and September 2018, the performance of Latin American financial markets, albeit highly diverse, was slightly worse than that of other emerging financial markets. Along with the Argentine peso (down 47%), the Brazilian real fell sharply, by around 19%, (Chart 2.3) owing essentially to the fiscal vulnerabilities of this economy. By contrast, the currencies of the Andean countries held relatively stable, whereas the Mexican peso appreciated significantly following the presidential elections and the progress in the renegotiation of the trade agreement with the United States and Canada. Finally, the result of the first round of the presidential elections in Brazil prompted a strong appreciation of the real.[3] There was also diversity in the stock markets (Chart 2.4) where energy-related sectors recorded a better performance; the higher weight of firms from this sector in Latin American indices may explain their slightly less negative performance compared with Asian stock markets, which posted sharp declines following the announcement of new tariffs for China. Conversely, the worsening of the sovereign spreads of Latin American countries exceeded that of other emerging markets (Chart 2.5), mainly in the case of Argentina and, to a lesser degree, of Brazil. The differences in the behaviour of the various Latin American financial markets is reflected in the changes in the financial stress indices[4] (Chart 2.6), which rose in Brazil and Colombia, fell in Mexico, and held at similar levels to those at the beginning of the year in Chile.

2 This episode refers to the financial market turmoil resulting from the announcement of the Chairman of the Federal Reserve in May 2013 that the Federal Reserve might begin to reduce the pace of asset purchases. The statement led to an increase in US Treasury longer-dated bond yields and a movement of flight to quality and of outflow of funds from emerging markets.

3 Also noteworthy is the monetary reform applied in Venezuela, with the unification of the exchange rates and the creation of a new currency, the sovereign bolivar, with an initial exchange rate against the dollar of 60 bolivar per dollar, marking a devaluation of 95% with respect to the value of the previous currency.

4 The construction of the index is described in Box 1 of the "Report on the Latin American Economy: Second Half of 2016", *Economic Bulletin,* October 2016.

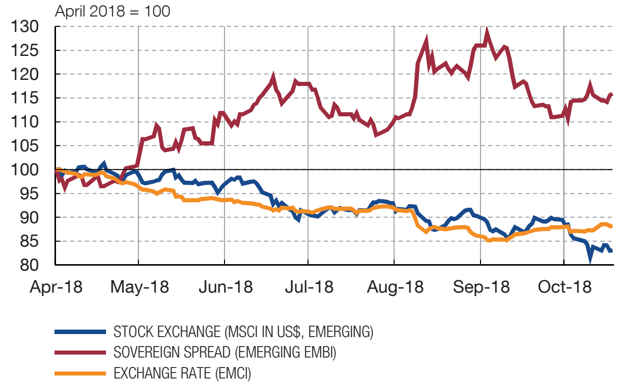
THE WORSENING OF THE FINANCIAL INDICATORS OF EMERGING ECONOMIES WAS SHARPER IN COUNTRIES SUCH AS ARGENTINA AND TURKEY, AND SHOWED SOME DEGREE OF MARKET DISCRIMINATION BASED ON ECONOMIC FUNDAMENTALS

CHART 2

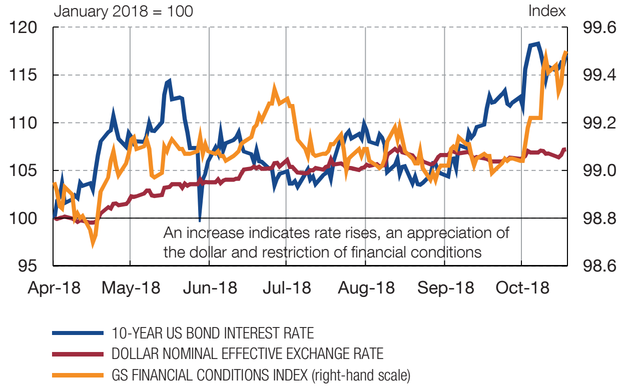
Indices and basis points

The market indicators of emerging economies deteriorated as from May, against a backdrop of tighter financial conditions in the United States. Two of the countries affected most were Argentina and Brazil, whose exchange rates depreciated sharply, whereas the Mexican peso rallied on the prospects of a new trade agreement with the United States and Canada. As in the other emerging economies, some degree of market discrimination was observed, as shown by the different developments in financial stress indices.

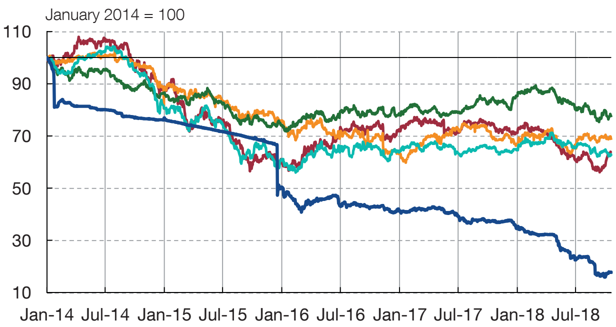
1 EMERGING MARKETS. MAIN INDICATORS




2 FINANCIAL CONDITIONS IN THE UNITED STATES



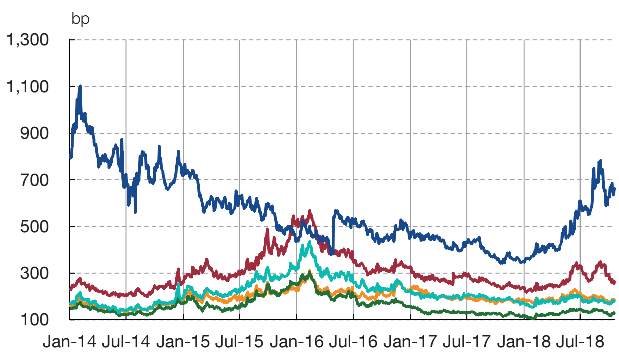

3 NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



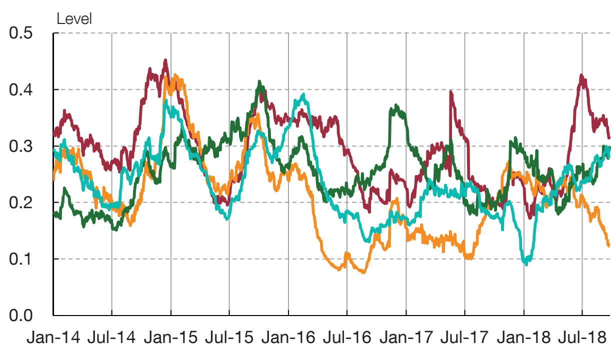

4 STOCK EXCHANGE INDICES


ARGENTINA BRAZIL MEXICO CHILE COLOMBIA LATIN AMERICA (MSCI, LOCAL CURRENCY)

5 SOVEREIGN SPREADS




6 FINANCIAL STRESS INDICES




ARGENTINA BRAZIL MEXICO CHILE COLOMBIA

SOURCES: Banco de España, Datastream and JP Morgan.

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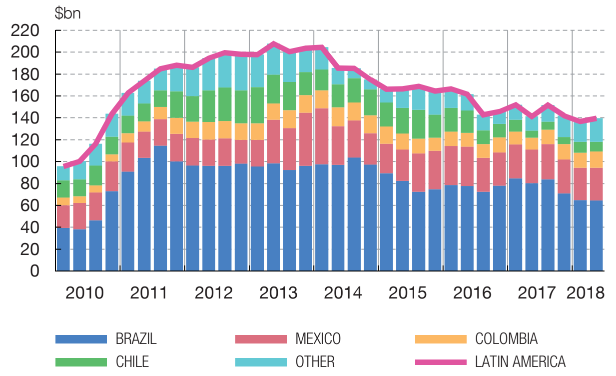
## CAPITAL INFLOWS STABILISED AT LOW LEVELS, ALTHOUGH THEY MAY DECREASE IN Q3

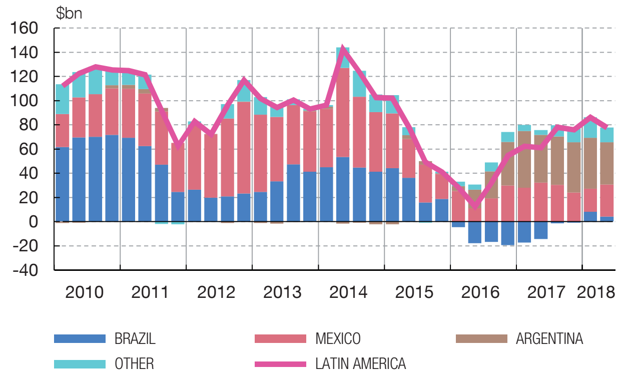
CHART 3

Capital inflows into Latin America stabilised at low levels in the second quarter, although the issue figures in the third quarter pointed to a decline in inflows in that period. The drop in issues was as a result of the absence of Argentina and the strong contraction in placements in Brazil. Despite this, international reserves did not decrease in the first half of the year.

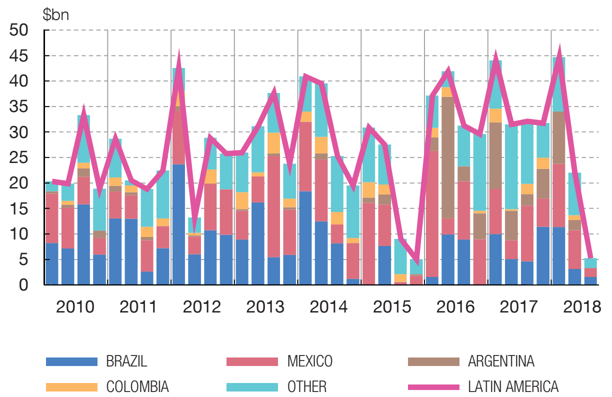
1 LATIN AMERICA: DIRECT INVESTMENT FLOWS (a)



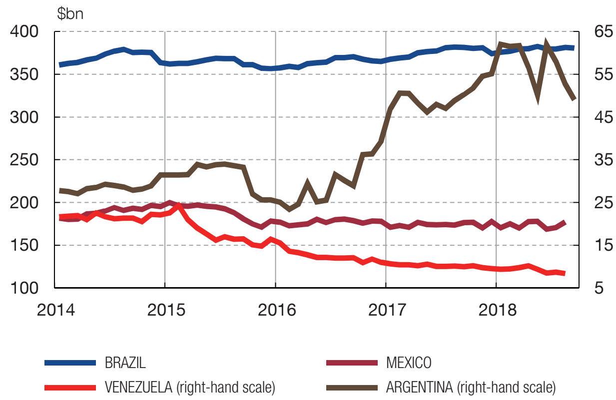

2 LATIN AMERICA: PORTFOLIO INVESTMENT FLOWS (a)




3 LATIN AMERICA: FIXED-INCOME ISSUANCE ON INTERNATIONAL MARKETS




4 LATIN AMERICA: INTERNATIONAL RESERVES




SOURCES: Datastream, Dealogic, Institute of International Finance, JPMorgan, IMF and national statistics.

**a** Four-quarter cumulated data.

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Capital flows towards Latin America changed sign in 2018, as in other emerging regions. Gross inflows of foreign direct investment (FDI) into the region shrank slightly in the first half of 2018, due to Colombia and Brazil, and portfolio inflows decreased by almost $10 billion, on account of net outflows from Argentina, Brazil and Chile in Q2 (see Charts 3.1 and 3.2). On the primary markets, the placement of debt securities, which was buoyant until April, fell by 86% between June and September with respect to the same period in 2017, on account of limited issuance in Brazil (Chart 3.3). Noteworthy is the high weight of bank debt issues in Chile and Mexico, along with sovereign and energy utility issues. International reserves fell, although they remain above the historical average (see Chart 3.4).

### ACTIVITY AND DEMAND

After posting quarter-on-quarter growth of 0.7% in 2018 Q1, the GDP of the main Latin American economies[5] contracted by 0.3% in Q2 (see Table 1 and Chart 4). The fall was

5 In Venezuela, where official data remain unavailable, despite attempts to stabilise the economy (the change of the unit of account in the monetary system, the depreciation of the official exchange rate, tax hikes, adjustments to fuel prices and the increase in the minimum wage), the indicators show its economy remains immersed in a deep recession and prices are increasing at a rate which can be described as hyperinflation according to the usual indicators.

## LATIN AMERICA: MAIN ECONOMIC INDICATORS

**TABLE 1**

| | 2016 | 2017 | 2016 | | 2017 | | | | 2018 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | September |
| GDP (quarter-on-quarter rate) (a) | | | | | | | | | | | |
| Latin America-6 (b) | | | 0.2 | 0.4 | 0.6 | 0.7 | 0.4 | 0.5 | 0.7 | -0.3 | |
| Argentina | | | 0.1 | 0.7 | 0.7 | 1.9 | 0.5 | 0.8 | 0.7 | -4.0 | |
| Brazil | | | -0.8 | -0.3 | 1.0 | 0.4 | 0.6 | 0.0 | 0.1 | 0.2 | |
| Mexico | | | 1.2 | 1.0 | 0.3 | 0.5 | -0.1 | 0.8 | 1.0 | -0.2 | |
| Chile | | | 0.3 | 0.2 | -0.5 | 0.8 | 2.4 | 0.7 | 1.2 | 0.7 | |
| Colombia | | | 0.4 | 1.2 | 0.0 | 0.7 | 0.0 | 1.0 | 0.9 | 0.6 | |
| Peru | | | 1.2 | 0.5 | 0.4 | 0.9 | 0.5 | 0.0 | 2.4 | 1.4 | |
| GDP (year-on-year rate) | | | | | | | | | | | |
| Latin America-6 (b) | -0.3 | 1.8 | -0.4 | 0.2 | 1.2 | 1.8 | 1.9 | 2.2 | 2.2 | 1.2 | |
| Argentina | -1.8 | 2.9 | -3.3 | -1.1 | 0.6 | 3.0 | 3.8 | 3.9 | 3.9 | -4.2 | |
| Brazil | -3.5 | 1.0 | -2.7 | -2.5 | 0.0 | 0.4 | 1.4 | 2.1 | 1.2 | 1.0 | |
| Mexico (a) | 2.6 | 2.3 | 2.2 | 3.3 | 3.0 | 3.0 | 1.7 | 1.6 | 2.3 | 1.6 | |
| Chile | 1.3 | 1.5 | 1.2 | 0.3 | -0.4 | 0.5 | 2.5 | 3.3 | 4.4 | 5.3 | |
| Colombia (a) | 2.0 | 1.8 | 0.8 | 1.4 | 1.4 | 2.2 | 1.8 | 1.6 | 2.6 | 2.5 | |
| Peru | 4.0 | 2.5 | 4.7 | 3.1 | 2.3 | 2.6 | 2.7 | 2.3 | 3.1 | 5.4 | |
| CPI (year-on-year rate) | | | | | | | | | | | |
| Latin America-5 (b) | 6.0 | 4.3 | 6.0 | 5.2 | 4.7 | 4.4 | 4.0 | 4.1 | 3.5 | 3.5 | 4.3 |
| Brazil | 8.7 | 3.4 | 8.7 | 7.0 | 4.9 | 3.6 | 2.6 | 2.8 | 2.8 | 3.3 | 4.5 |
| Mexico | 2.8 | 6.0 | 2.8 | 3.2 | 5.0 | 6.1 | 6.5 | 6.6 | 5.3 | 4.6 | 5.0 |
| Chile | 3.8 | 2.2 | 3.5 | 2.8 | 2.8 | 2.3 | 1.7 | 2.0 | 2.0 | 2.2 | 3.1 |
| Colombia | 7.5 | 4.3 | 8.1 | 6.1 | 5.1 | 4.3 | 3.7 | 4.1 | 3.4 | 3.2 | 3.2 |
| Peru | 3.6 | 2.8 | 3.0 | 3.3 | 3.4 | 3.2 | 3.0 | 1.6 | 0.9 | 0.9 | 1.2 |
| Budget balance (% of GDP) (c) | | | | | | | | | | | |
| Latin America-6 (b) | -5.6 | -4.7 | -5.5 | -5.6 | -5.2 | -5.6 | -5.0 | -4.7 | -5.0 | -4.8 | |
| Argentina | -4.5 | -6.0 | -3.6 | -4.5 | -4.6 | -5.2 | -5.6 | -6.0 | -5.7 | -5.1 | |
| Brazil | -9.0 | -7.8 | -9.3 | -9.0 | -9.1 | -9.5 | -8.8 | -7.8 | -7.4 | -7.3 | |
| Mexico | -3.0 | -1.0 | -2.6 | -3.0 | -1.3 | -1.9 | -1.1 | -1.0 | -2.9 | -2.7 | |
| Chile | -2.7 | -2.8 | -2.5 | -2.7 | -3.3 | -2.9 | -2.7 | -2.8 | -2.7 | -2.6 | |
| Colombia | -3.8 | -3.2 | -3.8 | -3.8 | -4.2 | -4.1 | -3.2 | -3.2 | -2.9 | -3.7 | |
| Peru | -2.3 | -3.2 | -3.0 | -2.3 | -2.2 | -2.6 | -3.0 | -3.2 | -3.4 | -2.4 | |
| Public debt (% of GDP) | | | | | | | | | | | |
| Latin America-6 (b) | 54.1 | 55.3 | 53.0 | 54.1 | 53.9 | 54.2 | 55.0 | 55.3 | 55.9 | — | |
| Argentina | 49.7 | 50.3 | 44.0 | 49.7 | 49.1 | 48.9 | 49.5 | 50.4 | 51.4 | — | |
| Brazil | 70.0 | 74.0 | 70.1 | 70.0 | 71.3 | 72.8 | 73.8 | 74.0 | 75.3 | 77.2 | |
| Mexico | 49.4 | 47.2 | 48.0 | 49.4 | 47.3 | 46.0 | 46.9 | 47.2 | 46.9 | 47.6 | |
| Chile | 21.0 | 23.6 | 20.2 | 21.0 | 21.9 | 22.5 | 23.0 | 23.6 | 24.6 | 23.5 | |
| Colombia | 42.4 | 43.0 | 41.7 | 42.4 | 42.8 | 42.9 | 43.3 | 43.0 | 43.2 | 44.6 | |
| Peru | 23.8 | 24.9 | 22.8 | 23.8 | 23.0 | 24.2 | 24.2 | 24.9 | 23.8 | 23.7 | |
| Current account balance (% of GDP) (c) | | | | | | | | | | | |
| Latin America-6 (b) | -2.1 | -1.7 | -2.3 | -2.1 | -2.0 | -1.8 | -1.7 | -1.7 | -1.6 | -1.8 | |
| Argentina | -2.7 | -4.9 | -2.7 | -2.7 | -2.9 | -3.5 | -4.2 | -4.9 | -5.2 | -5.6 | |
| Brazil | -1.3 | -0.5 | -1.4 | -1.3 | -1.1 | -0.7 | -0.6 | -0.5 | -0.5 | -0.7 | |
| Mexico | -2.2 | -1.7 | -2.5 | -2.2 | -2.4 | -1.9 | -1.8 | -1.7 | -1.5 | -1.6 | |
| Chile | -1.4 | -1.5 | -2.0 | -1.4 | -2.0 | -2.1 | -1.7 | -1.5 | -1.1 | -1.2 | |
| Colombia | -4.2 | -3.4 | -4.8 | -4.2 | -4.1 | -4.0 | -3.7 | -3.4 | -3.1 | -3.2 | |
| Peru | -2.7 | -1.1 | -3.6 | -2.7 | -2.0 | -1.1 | -0.7 | -1.1 | -1.2 | -1.4 | |
| External debt (% of GDP) | | | | | | | | | | | |
| Latin America-6 (b) | 36.7 | 34.5 | 37.6 | 36.5 | 35.7 | 35.0 | 35.1 | 34.5 | 34.8 | 34.2 | |
| Argentina | 32.7 | 36.8 | 31.5 | 32.7 | 34.3 | 34.1 | 35.2 | 36.8 | 39.3 | 41.6 | |
| Brazil | 37.6 | 32.5 | 40.0 | 37.4 | 35.2 | 33.5 | 33.6 | 32.5 | 33.1 | 32.7 | |
| Mexico | 29.3 | 29.0 | 29.1 | 29.3 | 29.6 | 29.6 | 29.6 | 29.0 | 28.7 | 28.4 | |
| Chile | 66.7 | 65.5 | 69.1 | 66.7 | 64.6 | 65.4 | 65.4 | 65.5 | 63.8 | 59.5 | |
| Colombia | 42.5 | 39.6 | 42.1 | 42.4 | 40.9 | 39.9 | 40.4 | 39.6 | 39.4 | 38.4 | |
| Peru | 38.4 | 35.9 | 39.1 | 38.3 | 37.7 | 38.6 | 38.0 | 35.9 | 35.1 | 33.8 | |

SOURCES: Datastream and national statistics.

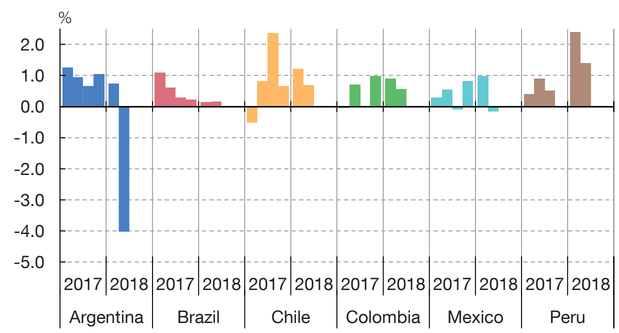
**a** Seasonally adjusted.
**b** Latin America-6: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Latin America-5: Brazil, Chile, Colombia, Mexico and Peru.
**c** Four-quarter moving average.

## STRONG SLOWDOWN IN THE ARGENTINE ECONOMY, WEAK GROWTH IN BRAZIL AND A SOUND PERFORMANCE IN CHILE, COLOMBIA AND PERU

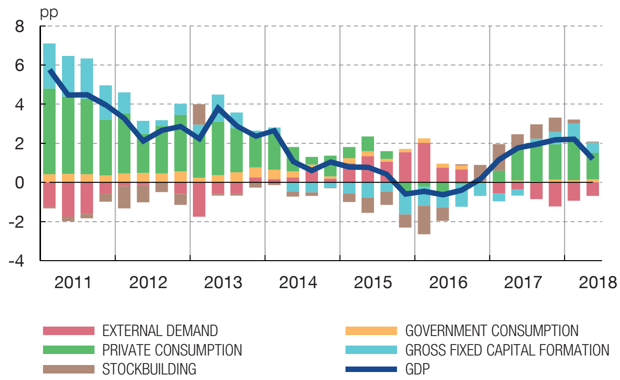
CHART 4

Aggregate growth in the region decreased to 1.2% year on year in 2018 Q2, down from 2.2% in Q1, largely weighed on by the steep decline in Argentina's GDP (-4% quarter on quarter), the falling-off of activity in Mexico and weak growth in Brazil. In Chile and Peru, growth reached year-on-year rates of above 5%. The external sector continued to make a negative contribution in Q2, although it was more moderate than in Q1, and the positive contributions of private consumption and investment fell slightly.

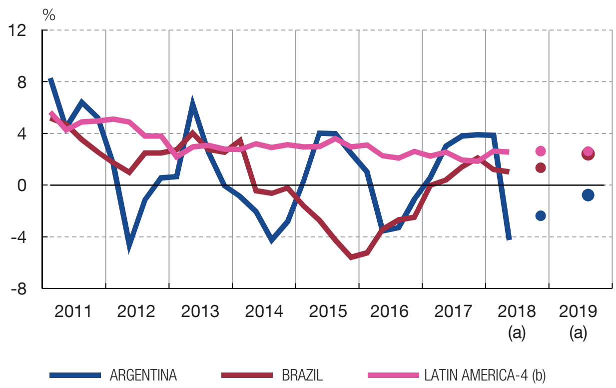
1 GROSS DOMESTIC PRODUCT
Quarter-on-quarter rate



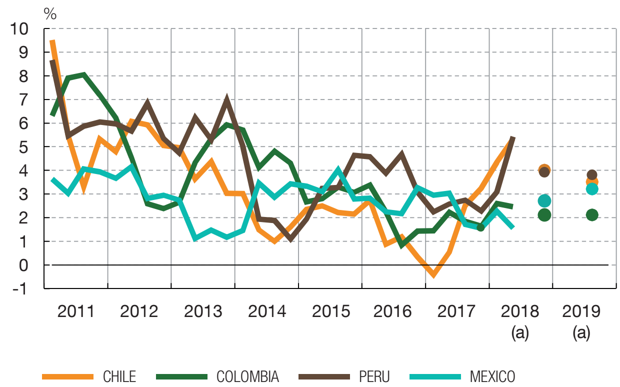

2 CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH. LATIN AMERICA-6




3 GROSS DOMESTIC PRODUCT
Year-on-year rate




4 GROSS DOMESTIC PRODUCT
Year-on-year rate




SOURCE: Datastream and national statistics.

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

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due to the steep decline in Argentina's GDP (-4%), partly caused by the drought and its effects on agricultural activity, the falling-off of activity in Mexico, which is expected to be temporary,[6] and low growth in Brazil, partly owing to the lorry drivers' strike of May and June. GDP in Colombia, Chile and Peru accelerated, reaching year-on-year rates of above 5% in these last two countries. By component, the positive contribution of investment continued, whereas a slowdown in private consumption was discernible in Q2. Net external demand continued to show a negative contribution to GDP, albeit somewhat lower than that recorded in the second half of 2017, as a result of a slight reduction in imports.

The current account balances continued to show small deficits, by historical standards, due to favourable trade balance performances, expect in Colombia, where, however, it

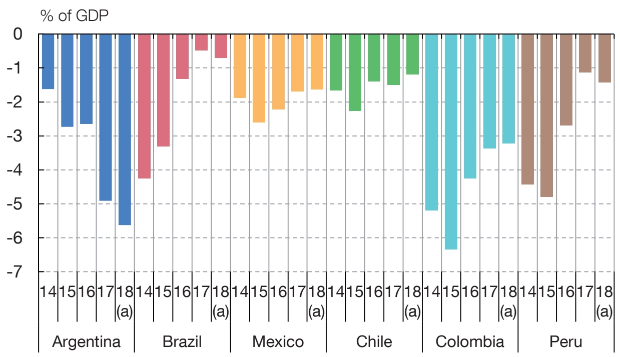
6 The preliminary GDP figure for Mexico in Q3 shows a quarter-on-quarter increase of 0.9%.

EXTERNAL SECTOR, PRIVATE-SECTOR CREDIT AND UNEMPLOYMENT

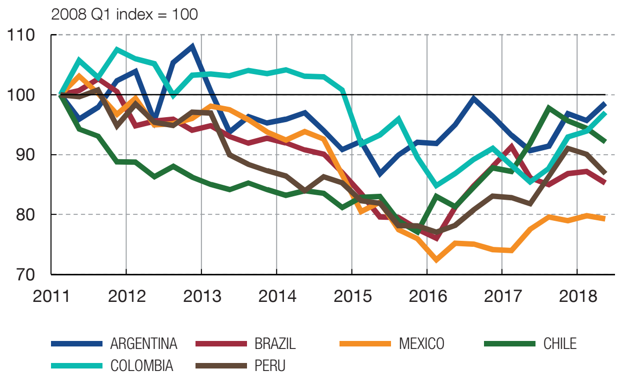
CHART 5

In general, the current account balances continued to show small deficits by historical standards, with the notable exception of Argentina. The terms of trade performed differently across countries, depending mainly on developments in commodity export prices. There were small changes in unemployment rates and private-sector credit contracted in real terms in the main economies.

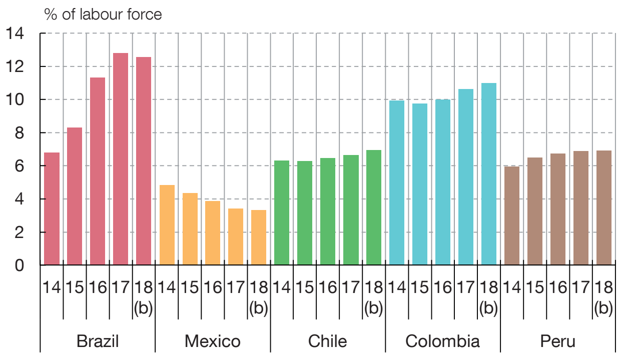
1 CURRENT ACCOUNT BALANCE



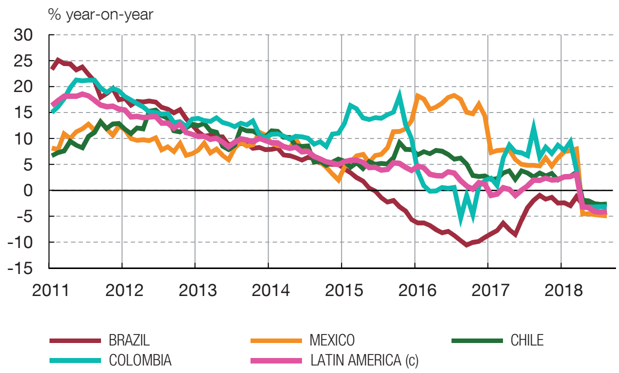

2 TERMS OF TRADE




3 UNEMPLOYMENT RATE




4 REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR




SOURCE: Datastream.

a 2018 Q2.
b August 2018.
c Brazil, Chile, Colombia, Mexico and Peru.

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decreased slightly, and in Argentina (see Chart 5.1). The terms of trade performed differently: they improved in Colombia (due to higher oil prices), were stable in Mexico and decreased in the other countries. In Chile and Peru the decline was due to the fall in copper prices, as a result of trade tensions and the slowdown in China (see Chart 5.2). In the region's labour markets, small reductions were only visible in the unemployment rates in Brazil and Mexico, although their respective starting points were very different (see Chart 5.3). Lastly, credit to the private sector in real terms contracted in the main economies (see Chart 5.4).

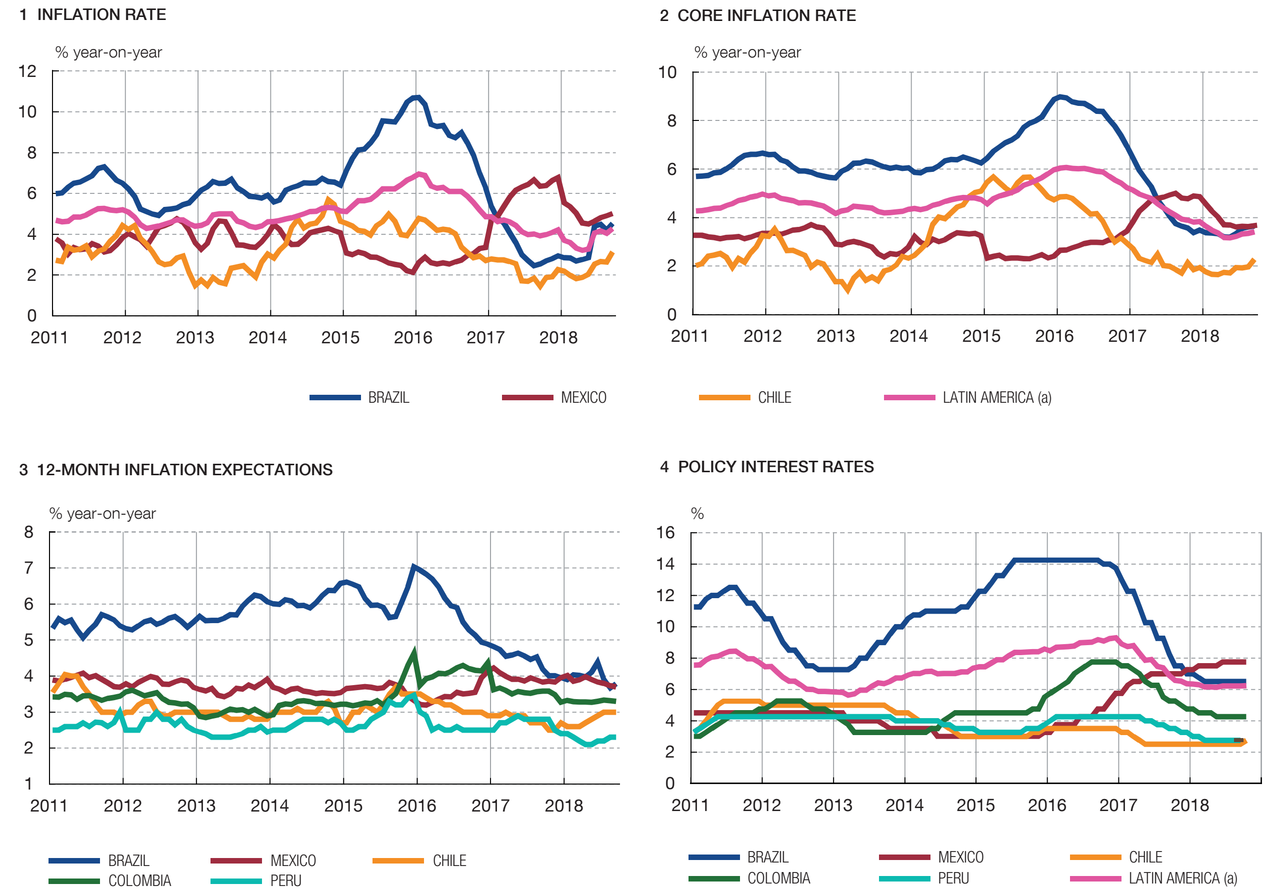
INFLATION AND ECONOMIC POLICIES

After the lows reached in the early months of the year, inflation has begun to rise gradually (see Chart 6.1) as a result of higher energy prices, the closing of output gaps and, to a lesser degree, currency depreciations and their pass-through to final prices. In Chile, Colombia and Peru, inflation stands within central bank target ranges and inflationary pressure from currency depreciations is low. In Brazil, inflation has increased to a greater extent due to the (temporary) effect of the lorry drivers' strike, although no second-round effects are expected.

## GRADUAL RISE IN INFLATION EXCEPT IN ARGENTINA, WHERE STRONG INFLATIONARY PRESSURES ARE DISCERNIBLE. WITH THE EXCEPTION OF ARGENTINA, THE REGION'S CENTRAL BANKS MADE FEW POLICY INTEREST RATE MOVEMENTS

CHART 6

Inflation has begun to rise gradually in Brazil, Chile, Colombia and Peru (as a result of higher energy prices, the closing of output gaps, currency depreciations and other idiosyncratic factors), while core inflation and inflation expectations rose only slightly. In Mexico, inflation remained above the target range and did not decline as expected and, in Argentina, year-on-year inflation stood at 40.5% in September, mainly as a result of the depreciation of the peso and the reduction in transport subsidies. Except in Argentina, there have only been small movements in the policy interest rates set by central banks in the region.




SOURCE: Datastream.

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

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Core inflation rose only slightly (see Chart 6.2) and expectations for end-2018 are consistent with the fulfilment of the inflation targets (see Table 2). The exceptions to this behaviour are Mexico, where inflation (and the expectations for 2018) remain above the target range, and Argentina, where year-on-year inflation stood at 40.5% in September, mainly as a result of the depreciation of the peso and the reduction in transport subsidies (see the analytical article on Argentina which accompanies this report).

Against this backdrop of greater uncertainty, tighter financial conditions and inflation under control – except for Argentina[7] – there have been few monetary policy movements by the region's central banks since April. Colombia's central bank cut the policy interest rate by 25 bp (to 4.25%) in April and Mexico's increased it by the same amount (to 7.75%) in June, continuing in both cases with the monetary cycles initiated in previous months. At end-October Chile's central bank raised the policy interest rate by 25 bp (to 2.75%), thus

7 Argentina's central bank raised key policy rates from 27.25%, their level at end-April, to 60% in August.

**INFLATION**
**Year-on-year rates of change**

**TABLE 2**

| | 2017 | | | 2018 | | 2019 |
|---|---|---|---|---|---|---|
| Country | Target | December | Fulfillment | September | Expectations (a) | Expectations (a) |
| Argentina | - (b) | 24.8 | No | 40.5 | 45.3 | 27.4 |
| Brazil (c) | 4,5 ± 1,5 | 2.9 | No | 4.5 | 4.3 | 4.2 |
| Mexico | 3 ± 1 | 6.8 | No | 5.0 | 4.6 | 3.7 |
| Chile | 3 ± 1 | 2.3 | Yes | 3.1 | 3.0 | 3.2 |
| Colombia | 3 ± 1 | 4.1 | No | 3.2 | 3.3 | 3.3 |
| Peru | 1 - 3 | 1.4 | Yes | 1.2 | 2.3 | 2.5 |

SOURCES: Datastream, national statistics and Consensus Forecasts.

**a** October 2018 Consensus Forecasts for the end of the year.
**b** In Argentina the monetary policy framework based on inflation targets was suspended and changed temporarily to a monetary policy based on growth restrictions on the monetary base (ceiling of 0% month-on-month for the monetary base until June 2019 – except some positive growth in December 2018 and June 2019 for seasonal reasons – or until inflation and inflation expectations have a clear downward path and of 1% month-on-month in the second half of-2019).
**c** Brazil's inflation target is 4.25% ±1.5 for 2019 and 4.00 % ±1.5 for 2020.

beginning a monetary tightening cycle which is expected to spread over the coming months to Colombia and Peru, given the closing of production gaps; these economies would thus join the group of emerging economies in Asia and Eastern Europe which have already commenced monetary tightening. In the case of Brazil, the expected commencement of the cycle of rate rises will be linked to developments of the real and their inflationary impact, since the production gap continues to be markedly negative and no second-round effects are expected from the lorry drivers' strike. According to the conventional Taylor rules,[8] monetary policy maintains an expansionary bias in Chile and Peru and a contractionary bias in Brazil and Colombia. In Mexico the next policy interest rate movements will be adopted depending on developments in inflation expectations. In Argentina, as part of the agreement renegotiated with the IMF, the central bank has abandoned the inflation target as the nominal anchor of the economy and has chosen to set a zero growth target for the monetary base, so that its strategy to reduce inflation regains credibility. Similarly, currency bands were set (which are modified on a daily basis following a given rule) within which the central bank will not intervene in exchange rate markets.

In the realm of fiscal policy (Chart 7), Brazil continues to show sizeable imbalances and the government deficit is expected to reach 8% of GDP by end-2018 (with an interest burden of 7 pp) and the public debt ratio to stand at around 80% of GDP. The approval of the pension reform is essential in order to be able to meet the limit on public spending set for the next few years, although doubts remain about the scope of the plans that may be implemented by the president-elect. In Argentina, a sharp fiscal adjustment is projected for the period 2018-20, with a zero primary balance target in 2019 and a positive primary balance target in 2020. Public debt will stand above 80% of GDP in 2018, an increase of approximately 30 pp in the year, due to the valuation effect of the foreign currency debt (which represents a high percentage of the total), arising from the depreciation of the peso. Nevertheless, with the fiscal adjustment and high nominal GDP growth it is expected to decrease over coming years. In other countries in the region there have been no major changes in fiscal balances, although the fiscal scope for stimulus, if needed, is low. Chile and Colombia will present their respective proposals for fiscal reform over the next few months, which are geared towards encouraging investment.

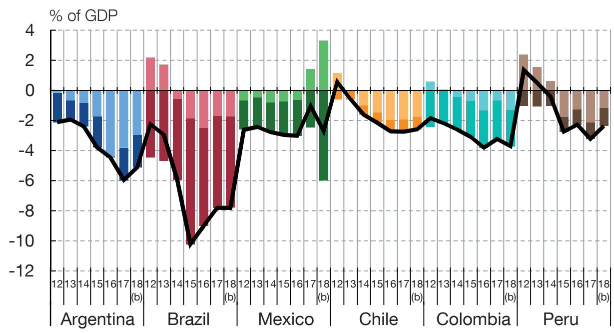
8 See the section "Natural interest rates and the monetary policy stance in Latin America", in the "Report on the Latin American economy. Second half of 2017", *Economic Bulletin* 4/2007.

MOST SUBSTANTIAL FISCAL IMBALANCES IN ARGENTINA AND BRAZIL. THE INCREASE IN PUBLIC DEBT CONTINUES IN PRACTICALLY THE ENTIRE REGION

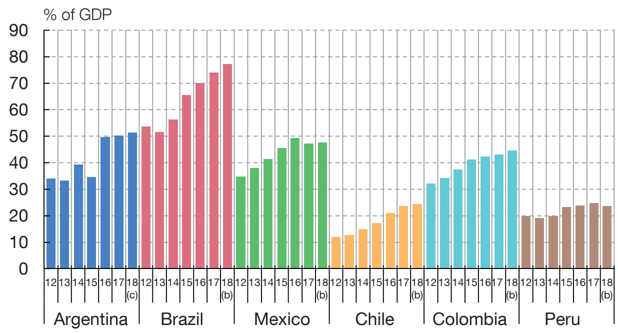
CHART 7

Significant government deficits exist in Argentina and Brazil. There are no substantial changes in the fiscal balances for the remainder of the countries. Increases in public debt as a percentage of GDP were recorded in almost all of the countries in the region.

1 GOVERNMENT SURPLUS (+) OR DEFICIT (-) (a)




2 PUBLIC DEBT




SOURCE: Datastream.

**a** Light colour, primary deficit; dark colour, interest burden.
**b** 2018 Q2.
**c** 2018 Q1.

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OUTLOOK

Growth projections for the region have been revised markedly downwards with respect to the previous half-yearly report: by 1.1 pp in 2018 to 1.5% and by 0.7 pp in 2019 to 2.2%, according to the consensus (see Chart 1). These revisions are due to Argentina, where negative growth is expected in both years, and Brazil, especially on account of the weakness in the first half of 2018; by contrast, the outlook for Chile, Colombia and Peru has been revised upwards. In Mexico, projections were revised downwards somewhat and expected growth holds slightly above 2%. The region's potential growth remains low – reflecting lean productivity, limited spending on infrastructures and scant returns on education – and insufficient for driving the region's convergence towards higher income levels.

The balance of risks is tilted downwards. The tightening of global financial conditions has already had particularly negative effects in Argentina, that could heighten and spread to other countries like Brazil, which is very vulnerable on account of its fiscal situation. A sharper depreciation of the currencies could lead to inflationary pressure and result in procyclical fiscal and monetary policies and in a contraction of the investment of those companies with high foreign debt. In the area of trade, following the preliminary agreement entered into by the United States, Canada and Mexico, trade tensions could spread to the region via two main channels: i) a further tightening of financial conditions, and ii) lower global growth, including a reduction of commodity prices on which the region is highly reliant. As for internal risks, those inherent to the implementation of the agreement between the IMF and the Argentinian government are worth noting as well as those to be faced by Brazil's new government, given the unfavourable outlook for this economy; even if a reformist agenda and a fiscal adjustment are prioritised, their approval by Parliament seems complex.

6.11.2018.

After holding the federal funds rate close to zero (in the target range 0%-0.25%) since December 2008 and implementing several asset purchase programmes in order to increase the expansionary stance of its monetary policy, in December 2015 the United States Federal Reserve decided to start the process of normalising monetary policy, raising the target federal funds range by 25 basis points (bp). Since then, it has raised this rate on several occasions by 25 bp, to reach the current range of 2%-2.25%, and since October 2017 it has been gradually reducing the size of its balance sheet. The financial markets have factored in a continuation of the process of official interest rate rises for the coming quarters, although at a slower pace than that projected by the Federal Open Market Committee,[1] the Federal Reserve Committee that takes the monetary policy decisions.

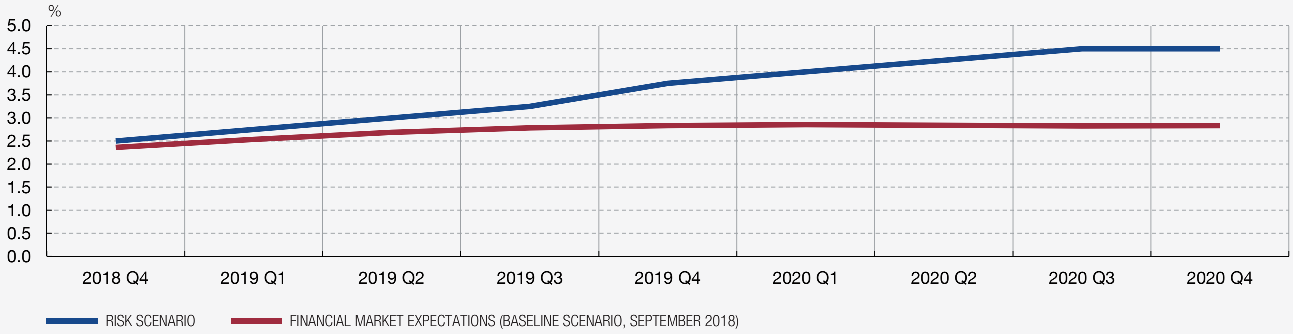
Against this backdrop, the appreciation of the US dollar and the rise in US government bond yields since the beginning of 2018 have prompted a tightening in the financial conditions faced by emerging market economies. This box assesses the potential impact of a more abrupt than expected normalisation of monetary policy in the United States on the financial markets of a series of emerging market economies (Brazil, Chile and Mexico in Latin America, and South Korea, Indonesia and China in Asia).

Theoretically, the tightening of financial conditions in the United States could spread to the rest of the world via two channels: the trade channel, based on the response of US imports to exchange rate movements (with the related effect on consumption and investment), and the financial channel, linked to the transmission of the higher US interest rates to the rest of the world (global financial cycle) and the depreciation of other currencies, which

1 https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20180926.pdf.

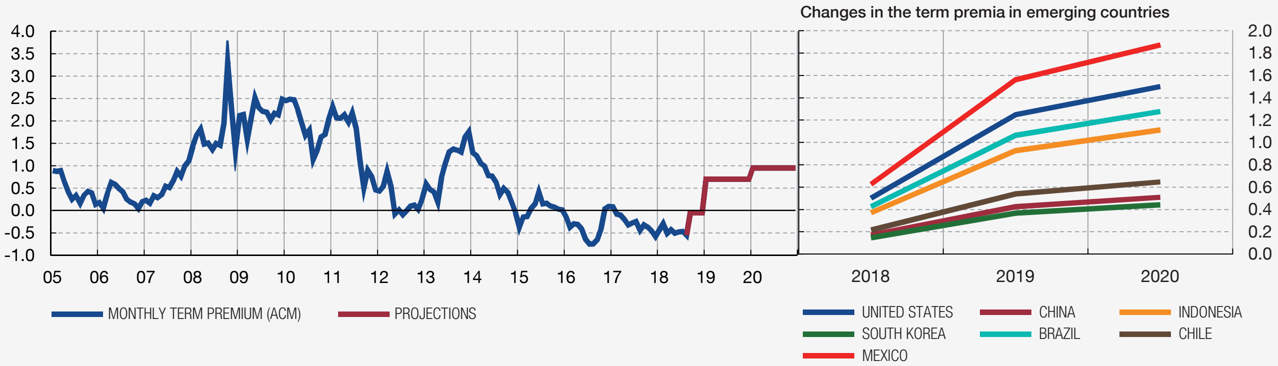
The baseline scenario includes the path of the US federal funds rates discounted by the financial markets in September 2018 and the risk scenario considered is for the federal funds rates to rise more quickly, unexpectedly and more in line with the pattern seen in past episodes of monetary policy normalisation conducted by the Federal Reserve.

Chart 1
FEDERAL FUNDS RATES IN THE UNITED STATES




Under the risk scenario, the assumption is made that the term premium on ten-year US government bond yields will rise in the coming years to stand closer to its historical average. In line with the elasticities estimated in empirical studies, the transmission of this increase in the US term premium to emerging market economies depends on their macroeconmic fundamentals.

Chart 2
UNITED STATES TERM PREMIUM




SOURCES: Banco de España calculations, Datastream, New York Federal Reserve, and Borrallo et al (2016).

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would lead to a deterioration in the balance sheets of agents that have built up debt denominated in US dollars but which obtain their revenues in local currency. There was a marked rise in US dollar-denominated debt during the period in which the Federal Reserve held US federal funds rates at very low levels, while expanding its balance sheet.

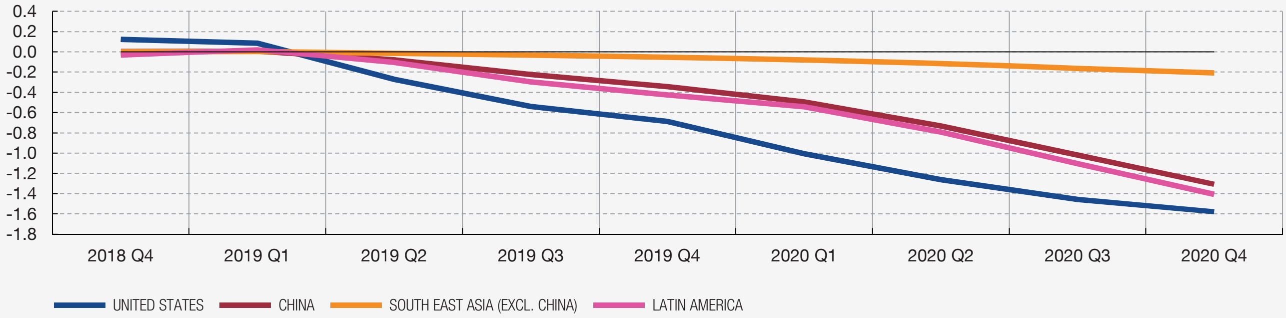
The National Institute Global Econometric Model (NiGEM) can be used to simulate the global impact of a faster than expected monetary policy tightening in the United States. The baseline scenario includes the path of US federal funds rates discounted by the financial markets in September 2018 (see Chart 1). The risk scenario considered is one in which, unexpectedly, the federal funds rates rise more quickly, so that they stand at 4.5% at the end of 2020, i.e. around 165 bp above the level discounted in the financial markets for that date, and more in line with the pattern seen during past episodes of monetary policy normalisation conducted by the Federal Reserve. In addition, this risk scenario is based on the assumption that the term premium on ten-year US government bond yields will stand at around 100 bp at the end of 2020, up from its level of -50 bp in September 2018[2] (an increase of 50 bp in 2018, 75 bp in 2019 and 25 bp in 2020) as shown in Chart 2. The empirical literature suggests that, faced with an unexpected rate hike by the Federal Reserve, the policy rates of the emerging market economies increase, on average, ten times more than the federal funds rate.[3] According to the elasticities estimated

2 See https://www.newyorkfed.org/research/data_indicators/term_premia.html for the calculation of the term premium in the US yield curve.

3 See, for example, B. Mackowiak, (2007), "External shocks, US monetary policy and macroeconomic fluctuations in emerging markets," *Journal of Monetary Economics,* Elsevier, Vol. 54(8), pp. 2512-2520, which estimates this relationship for a sample of emerging market economies. However, in previous episodes the central banks in Latin America reacted more strongly than those in Asia. For this reason, the negative impacts on the GDP of Latin America (Asia) could be greater (smaller) than those obtained in our simulations.

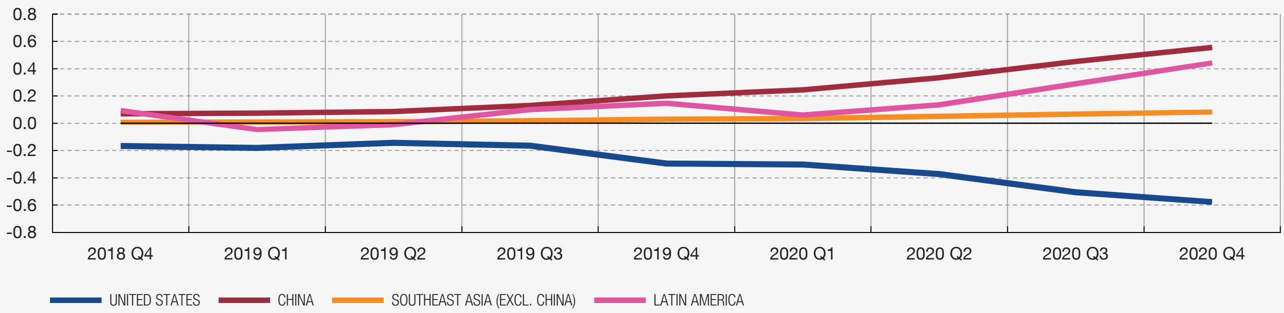
Under the risk scenario, GDP growth in the United States and in emerging market economies is lower, with the difference being greater with respect to the baseline scenario in the Latin American countries and China than in the rest of Asia. For the Latin American countries in the sample, this is explained by the larger increase in the term premium, which causes a steeper drop in investment.

Chart 3
GROSS DOMESTIC PRODUCT




Under the risk scenario, the US dollar appreciates more in response to greater tightening of US monetary policy. The current account of the United States deteriorates, while the external balance of the emerging market economies improves, with Latin America and China seeing a stronger improvement.

Chart 4
CURRENT ACCOUNT BALANCE




SOURCES: Banco de España calculations, Datastream, New York Federal Reserve, and Borrallo et al (2016).

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by Borrallo et al. (2016),[4] the extent to which the increase in the US term premium is transmitted to emerging market economies depends on their macroeconomic fundamentals (see Chart 2).[5]

The results of the simulation can be seen in Charts 3 and 4. As the US dollar appreciates in response to the monetary policy tightening in the United States, the US current account deteriorates, while the external balance of the emerging market economies improves,[6] to a greater degree in the Latin American countries than in the Asian countries, where the external balance is smaller if China is excluded. Although external demand makes a larger contribution to GDP growth in the emerging market economies, under the risk scenario, economic activity is reduced, as the decline in growth is stronger in the Latin American countries (-1.3 pp at the end of the reference period) and China (-1.1 pp) than in the rest of Asia. The simulations thus suggest that, if the monetary policy normalisation in the United States were more abrupt than the normalisation anticipated by the markets, it would have a somewhat larger negative effect on the Latin American countries than on the Asian countries. In the simulations, this result is explained by the higher increase in the term premium in the Latin American countries, which results in a steeper drop in investment. The better fundamentals of the Asian economies and the availability of larger buffers, such as international reserves, make them less vulnerable to a tightening in global financial conditions.

4 F. Borrallo, I. Hernando and J. Vallés (2016), "Los efectos en América Latina de las políticas monetarias no convencionales de Estados Unidos", *Monetaria,* Jul.-Dec., pp. 297-347, CEMLA.

5 The transmission elasticities of the US term premium to emerging economies are calculated using as explanatory variables the economies´ inflation, international reserves as a percentage of GDP and five-year sovereign CDS spreads. The sample was updated to include data up to the end of 2017.

6 The baseline scenario includes the increases in US tariffs on imports from China.