HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

Introduction

One year after the onset of the turmoil on international financial markets, the impact is being acutely felt on Latin American markets, which had hitherto proven notably resilient, and on those of the other emerging economies (see Chart 1 regarding stock exchanges).

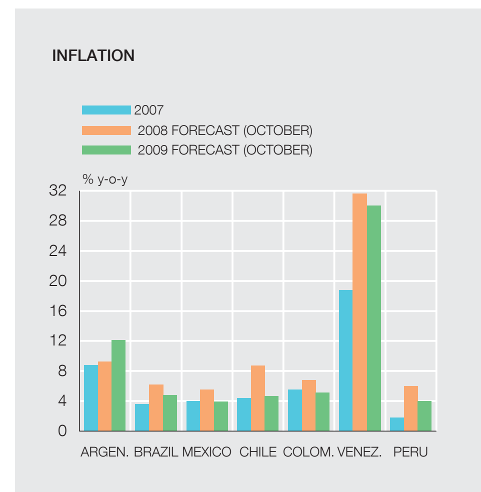
At the start of the summer the relatively moderate correction was associated with the deterioration in inflation expectations and with the growing weakness of activity in the advanced economies beyond the United States. However, the heightening of global financial tensions in September has ultimately prompted sharp capital outflows with a profound impact on asset prices in the area. The source of this falling off of capital flows is the process of deleveraging and search for liquidity that financial systems are experiencing across the globe, and not so much the fundamentals of the Latin American economies. The latter have generally remained relatively robust, although the reduction in the current account surplus marks a significant qualitative change in this respect. However, a prolonged period of financial stress inevitably erodes fundamentals, no matter how solid they are. Accordingly, the intensity of the recent deterioration in financial conditions may entail, if it is not shortly put behind, a turning point in the financial and growth outlook for 2009, and even for the end of the current year. The higher-frequency indicators for Q3, though their evidence is still partial, appeared to point to some weakening in industrial activity. Nonetheless, some demand indicators held at relatively robust rates to July.

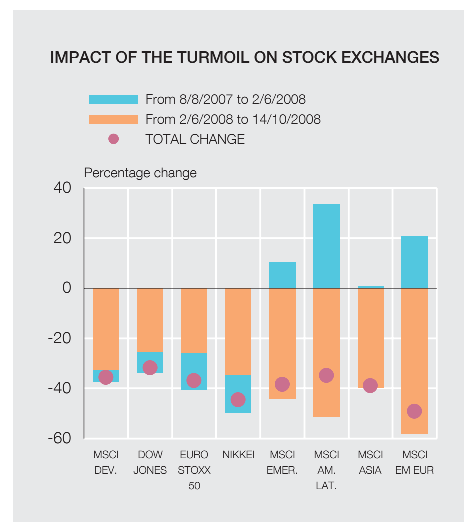
Indeed, with year-on-year growth exceeding 5% in the first half of 2008, based on the strength of domestic demand, the Latin American economy continued showing signs of notable dynamism, despite the slowdown in the world economy (see Chart 1 and Table 1). This did not prevent some easing from the extraordinary growth rates posted in 2007 being seen in several countries (especially in Mexico, Colombia and Venezuela, and also to some extent in Argentina). In each country the moderation was due to different reasons, but the outcome was essentially the same: the move towards growth rates that might be considered closer to potential, following the strong absorption of domestic demand of the last five years. By contrast, in countries such as Brazil and Peru, growth in the first half of the year was even higher than that in 2007. Consequently, there were no signs during the first half of the year of a slowdown on the scale of those recorded in the industrialised economies, although there was an increase in the dispersion of growth rate across countries compared with the relatively uniform upturn of recent years.

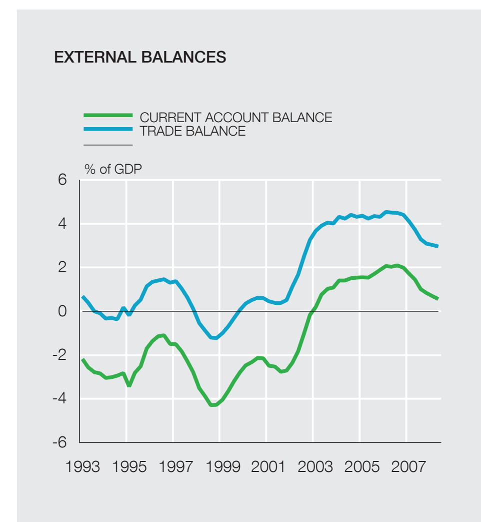
Inflation rose appreciably, posting year-on-year growth rates of 8.6% on average for the seven main economies in the region in the summer months, marking a five-year high. Unlike in 2007, this rise meant some upward pressure on core inflation and on inflation forecasts, and, in some countries, second-round effects, which heightened concern over a potential disanchoring of price expectations (see Chart 1). Against this background, monetary policies tended to tighten notably between April and September. Further, this tightening was largely conducted through the raising of interest rates, unlike in previous months when alternative instruments such as the raising of reserve requirements or capital controls were also used. Significantly, the lesser upward pressure on exchange rates in recent months may have helped circumvent one of the main obstacles to the application of more rigorous monetary policies in many countries. This may explain why countries such as Brazil, Chile, Mexico and Peru raised their reference rates in the past six months by between 75 pp and 250 pp, set against the maintenance or even decline in rates in some cases in

LATIN AMERICA: GROWTH AND INFLATION
Year-on-year change

CHART 1







SOURCES: National statistics, Consensus Forecast and Datastream.

a. Seven biggest economies

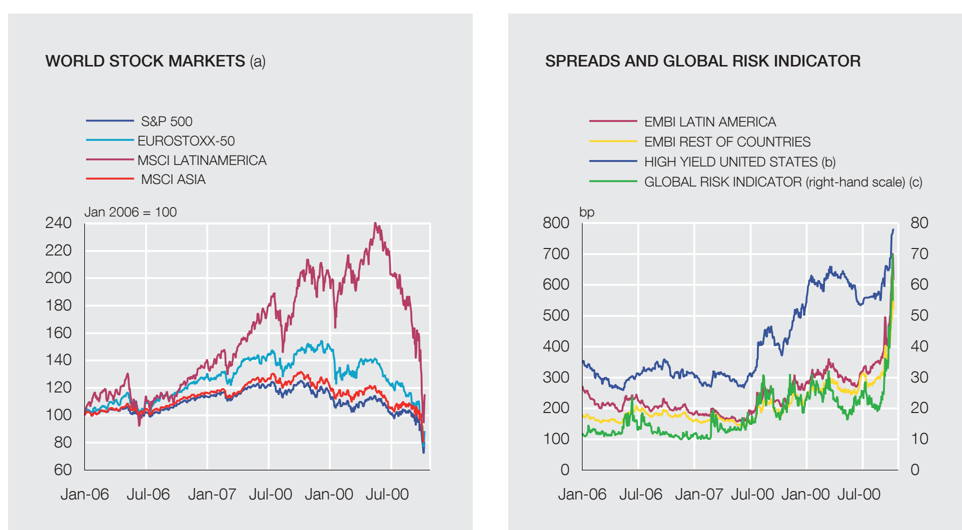
2007.[1] That said, real interest rates held at relatively low levels in many countries, and inflation will probably lie outside target at the end of the year in most of the countries with inflation targets, perhaps with the sole exception of Brazil.

The economic outlook for the coming months points to an easing of growth in Latin America, with much sharper downside risks than six months ago. This is mainly due to three reasons. First, the positive shock to the terms of trade arising from the increase in commodities prices that boosted growth in the region as from 2002 has begun to wane, in line with the recent correction on international commodities markets. Second, the tightening of monetary conditions should contribute to containing growth in domestic demand, which in some countries has been far above potential, and to softening inflationary pressures in the medium-term (see Chart 1). And adding to these two factors as a fundamental constraint has been the heightening of international financial tensions throughout September, which on this occasion have im-

1. Colombia is in some respects an exception, since the cycle of interest rate rises began earlier, in 2006.

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Basis points and indices

CHART 2



SOURCES: Bureau of Economic Analysis, Eurostat, Bloomberg and JP Morgan.

a. Indices in dollars.
b. B1-rated bond.
c. Implicit CBOE options volatility.

pacted Latin America full on. Indeed, the deterioration seen in the main financial indicators in the region since the summer, on a par with the general trend in other emerging markets, may ultimately have a substantial effect on confidence and real activity, intensifying the symptoms of cyclical change, and influencing considerably the economic policy responses in Latin America in the coming months.

Economic and financial developments

EXTERNAL ENVIRONMENT

Global economic and financial developments remained marked over the past six months by the persistence and subsequent heightening of the tensions on international financial markets. During Q2, the economic slowdown that had already manifest itself in the United States spread with unexpected intensity towards other advanced economies, in particular Europe – including the United Kingdom – and Japan. Against the backdrop of continuing upward pressure on inflation rates, this development tended to complicate economic policy management, which to some extent contributed to explaining the different monetary policy responses observed. Thus, the Federal Reserve lowered its official interest rate once again in late April, to 2%, while the European Central Bank raised its rate to 4.25% in July, and the Bank of Japan held its rate unchanged. These three central banks, along with others, carried out a co-ordinated interest rate cut of 50 bp in October, further to a serious deterioration in the financial situation. US long-term yields increased initially relative to the lows reached in March, but they stood once again at around 3.50% in September, following the announcement of the public intervention of two US government-sponsored mortgage agencies and the bankruptcy of the investment bank Lehman Brothers, both of which circumstances preceded the heightening of financial instability at the global level. These developments particularly affected internationals stock markets, which posted heavy losses in September and which have accumulated falls of over 25% in the last six months (see Chart 2).

Towards the summer a considerable deterioration in market sentiment was seen in the emerging economies. Initially, this could be attributed to the perception that inflationary risks may be greater in this group of countries, and to the fact that their decoupling capacity would

be very limited in the event of a global economic slowdown that were to prove more pronounced and persistent than expected. However, it was in September, when there was a fundamental change in the development and extension of the crisis, that the emerging financial markets were affected particularly adversely, mainly those whose fundamentals are viewed as less sound or more dependent on external financing. As a result, and unlike what had occurred since the start of the turmoil, the performance of emerging stock markets was considerably worse than other international markets, with sharper losses (see Charts 1 and 2), while sovereign spreads tended to widen, reaching five-year highs. Currency movements were mixed, although the depreciating trend against the dollar became generalised as the instability on international markets worsened. Of note in this respect were the Korean, Brazilian, Chilean and Indian currencies, which posted double-figure depreciations over the past six months. In terms of regions, movements in sovereign spreads were fairly uniform, although the widening of the Latin American spread proved slightly higher given the forceful increase in the Argentine and Venezuelan spreads. Eastern European stock markets were most affected by the turmoil, posting losses of around 50% for the period, dragged down by Russia.

Against this background, growth forecasts for the emerging economies began to be revised downwards, thereby incorporating the influence of the deterioration in instability in September. Economic growth in key countries such as China remained robust, albeit slightly down on end-2007. And this, in a setting of heightening global financial risks, prompted the first official interest rate cuts for six years in China.

The other key determinant of global economic and financial developments in the past six months was oil prices. After peaking in early July at around $145 per barrel, oil underwent a significant downward correction of more than 60%, against the backdrop of the recovery in the exchange rate to the dollar. This correction came about in parallel with the downward revision of the growth prospects of the world economy, and heightened in September, making for generalised falls in the prices of other commodities (mainly metals, and to a lesser extent foodstuffs). Given the composition of Latin American exports, this change in trend is another basic conditioning factor of the growth and inflation outlook for the region in the coming months, and to some extent also of how financial conditions will evolve (see Box 1).

ACTIVITY AND DEMAND

The growth rate of activity in Latin America remained very dynamic in the first half of the year. Attesting to this were the year-on-year growth rates of 5.1% and 5.4% in Q1 and Q2, respectively, only somewhat lower than the average growth in the second half of 2007 (see Chart 3 and Table 1). Nonetheless, the quarter-on-quarter growth rates portrayed a somewhat more erratic picture and perhaps qualify the impression of strength given by the year-on-year rates. Thus, growth in Q1 was only 0.2% in seasonally adjusted quarter-on-quarter terms, followed by 1.3% in Q2, entailing, on average, growth around half that recorded in the second half of 2007.

Domestic demand continued to be the main engine of growth, contributing 7.6 pp, while the contribution of external demand was negative once again, albeit only moderately so (–2.2 pp) (see Chart 3). These developments highlight a somewhat more balanced composition than that observed in the closing quarters of 2007, with the contribution by domestic demand to growth around 1 pp less, and a slight containment of the negative contribution of external demand. Country by country, the major South American economies (Brazil and Argentina) accounted, as in the second half of 2007, for more than 3 pp of regional GDP growth, while the contribution of Mexico once again declined to 0.8 pp in Q2, with Peru's contribution rising to 0.5 pp. In this respect, the easing off in growth in Mexico, Argentina, Venezuela and, espe-

From the onset of the international financial turbulence (in July 2007) until last summer, the performance of the emerging markets was notably resilient in practically the whole range of financial assets (exchange rates, bonds and stock market). Particularly sound in this respect was the performance of Latin America and, in the case of the stock market, this resilience led the Latin American markets to record rises of up to 40% in a representative index such as the MSCI Latin America (see Chart 2 of main text), much higher than in the Asian or emerging European markets and contrasting with the practically uninterrupted downward trend of the US stock market. The tables were turned, however, when the deepening of the crisis in the US and its spread to the emerging markets from September led the Latin American indices to perform worse in relative terms, falling by more (45%) in this period than those in Asia, eastern Europe and the US.

This box analyses one of the reasons why the Latin American stock market may have acted differently: the behaviour of commodity prices. Latin America is the prime example of an emerging region engaged in the production and export of these goods, including fuel (together with the Middle East) and metals and food. Primary-sector firms can thus be expected to be strongly represented in the stock market and productive structure of these countries. The assets issued by these firms may also be considered to constitute an optimum investment in a situation of commodity price inflation, insofar as they at least protect the value of the investment in real terms. Also, from a theoretical standpoint, in a setting of high commodity prices, the net present value of these firms' assets and expected profits would exceed that of other firms and the replacement cost of their capital (Tobin's q), and vice versa, if the commodity price fell.

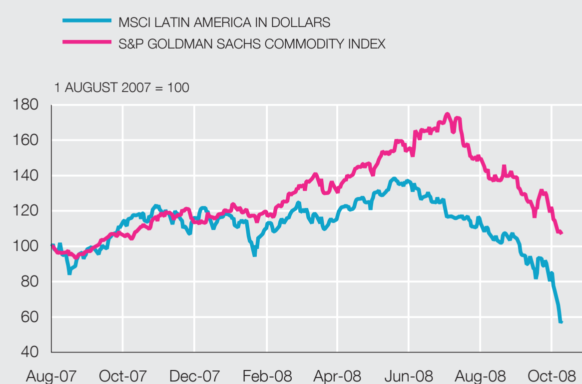
Panel 1 shows a high correlation between the MSCI Latin America index and a representative commodity price index, namely the Goldman Sachs Commodity Index (GSCI). While the latter held on its upward trend between August 2007 and June 2008, the Latin American stock exchanges rose in general terms. From July, the downturn in commodity prices was accompanied by a similar slump in the region's stock market indices. Panel 2 shows that the correlation coefficient of the changes between these two indices has increased notably in the last few years and reached historical highs in the last month.

To estimate the effect of primary-sector firms on the total return of the region's stock exchanges, the individual prices of each firm on each stock exchange and their weights in stock exchange capitalisation were used to construct two indices: one representing the performance of commodities firms and another excluding these firms from the overall index. For this purpose, commodities firms are broadly defined as those operating in mining, in oil and gas exploration and extraction, in food, beverages and tobacco, in iron and steel refining and in forestry products (e.g. paper and paper pulp). The stock exchange weights of these firms depend on the ownership structure of the natural resources of each country. This is important because the commodity exporters in some countries are State-owned and not listed on the stock exchange, such as Codelco (copper) in Chile, and PDVSA and PEMEX (oil) in Venezuela and Mexico, respectively. The accompanying table shows the weight of the primary-sector firms in Latin American stock exchange indices which, at an average of practically 40% of total capitalisation, is a much higher percentage than in other emerging economy stock exchanges.[1]

The table shows a marked contrast between the performance of the indices of primary-sector and other firms: thus, for example, from the onset of the turmoil until July this year, in Brazil the index of the primary-sector firms rose by 22%, while the rest of the stock market fell by 14.3% (see Panel 3).[2] For the aggregate of the seven main coun-

1. As a comparison, in countries such as Poland, which has an important agricultural sector, primary-sector firms account for around 20% of capitalisation, in India around 15% and in Indonesia around 25%. By contrast, in Russia they account for 62%. 2. It may be thought that the increase in the sub-index of commodity-related firms in Brazil is due exclusively to a "Petrobras effect", i.e. to a rise in the State company's share price as a result of the announcement of large new oil and gas deposits, which Petrobras would be expected to be in an advantageous position to exploit. However, although Petrobras has a weight of 15.4% in BOVESPA and of 29.9% in the commodity sub-index, the conclusions would be very similar if Petrobras were eliminated from the calculation.

1 LATIN AMERICAN STOCK MARKETS AND COMMODITY PRICES



2 LATIN AMERICAN STOCK MARKETS AND COMMODITY PRICES: CORRELATION COEFFICIENT

SOURCE: Datastream.

tries, the increase in the primary-sector index was 33.7%, against a fall of 2.5% in the rest. The only exception was Peru, for specific reasons.[3] In a symmetrical manner, the recent correction from July to October brought a fall in the commodity indices which was also larger than in the rest: 42%, against 33% for the aggregate of the area. The only exception in this case was Argentina.

In short, the evidence presented shows the predominant role that primary-sector firms have in most Latin American stock exchanges, including in the economies with greater productive and export diversification, such as Mexico or Brazil. This feature helps to explain the larger fluctuations in Latin American stock markets, both on the upside and on the downside, due to the parallel movement of commodity prices. In fact, if allowance is made for the performance of the stock market indices of primary-sector firms, Latin American stock market returns are much more in line with those of other emerging and developed markets (see Panel 4).

This evidence also illustrates the degree of dependence of Latin American economies on the commodity cycle in a way which differs from that of other more widely studied effects, such as the impact on growth, inflation, external accounts or public finances.

3. The decrease in the Peruvian stock market was due to the poor performance of copper companies, since copper prices fell significantly more than others in the latest phase of the turmoil.

1 STOCK EXCHANGE WEIGHTS

	Brazil	Mexico	Argentina	Colombia	Chile	Venezuela	Peru	LATAM-7 (a)
Commodity firms	**51.5**	13.4	37.8	26.8	20.5	8.0	**75.2**	38.7
Other	48.5	**86.6**	**62.2**	**73.2**	**79.5**	**92.0**	24.8	**61.3**

2 CHANGE IN INDICES (AUGUST 2007 TO JULY 2008) (a):

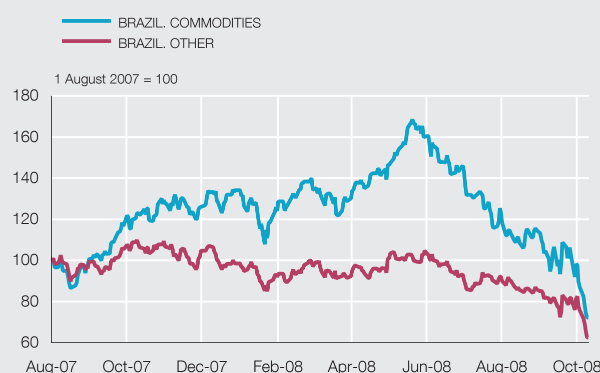
	Brazil	Mexico	Argentina	Colombia	Chile	Venezuela	Peru	LATAM-7 (a)
Commodity firms	**22.0**	**1.4**	**45.3**	**10.0**	**13.0**	-6.6	**-25.9**	**33.7**
Other	-14.3	-2.8	0.1	-17.0	-13.3	**-23.7**	-8.9	-2.5
Aggregate index	5.4	-2.2	14.1	-8.0	-8.3	-21.2	-21.9	12.3

3 CHANGE IN INDICES (JULY TO OCTOBER 2008) (a):

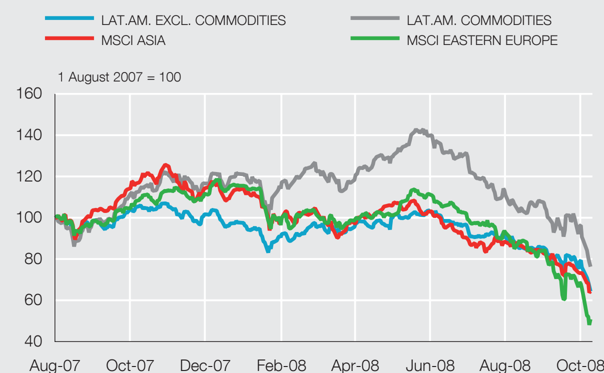
	Brazil	Mexico	Argentina	Colombia	Chile	Venezuela	Peru	LATAM-7 (a)
Commodity firms	**-50.6**	**-35.8**	-37.6	**-12.6**	**-41.7**	**22.1**	**-40.8**	**-42.0**
Other	-32.9	-19.9	**-46.4**	-10.2	-25.0	-9.7	-35.1	-33.5
Aggregate index	-44.1	-22.2	-42.3	-11.0	-28.9	-4.3	-39.3	-40.0

SOURCES: Bloomberg and Banco de España.

3 STOCK EXCHANGE INDICES (a)



4 EMERGING ECONOMY STOCK EXCHANGES (a)



SOURCES: National statistics, World Bank and Banco de España.

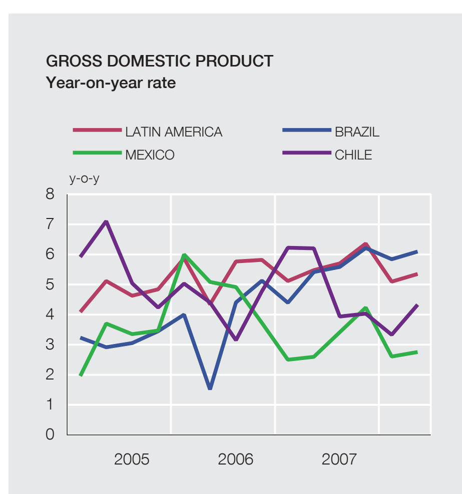
a. Indices in local currency.

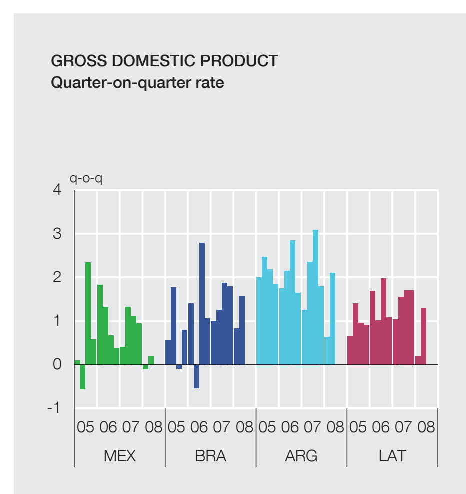
n the sample,

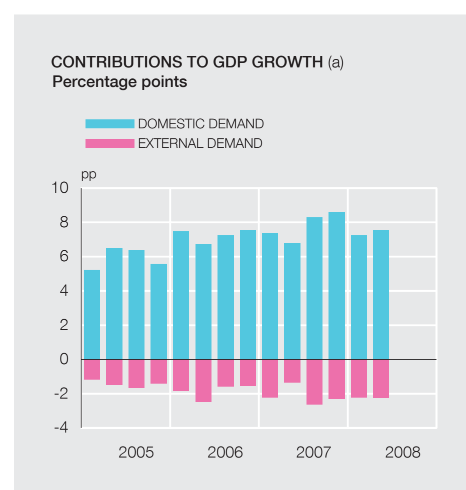
LATIN AMERICAN GDP

CHART 3

Year-on-year and quarter-on-quarter rates, and percentage points.







SOURCE: National statistics.

a. Aggregate of the seven main economies.

cially, Colombia should be set against the stability or, indeed, acceleration of the expansion in Brazil and Peru.

In terms of components, private consumption continued to post a robust growth rate of 5.9% in Q2 (see Chart 4). However, there was some deceleration compared with 2007 Q4, of a general nature across all countries with the exception of Peru. This slowdown explains practically all the moderation observed in the regional aggregate of domestic demand. This turnaround may have been influenced by the increase in inflation and its impact on real incomes, the rise in interest rates in some countries and the easing in the growth of credit to the private sector, along with other more country-specific factors. For example, in Mexico the pass-through of the slowdown in the US economy and the decline in remittances received from the United States may have been further factors behind the moderation of consumption. In contrast, another component that helps explain the course of consumption, namely the labour market, continued to trend in a generally satisfactory manner, with marked declines in the unemployment rates in the highest-growth countries (Brazil, to a historical low of 7.6% of the labour force, Argentina, Venezuela and Peru). In Chile, unemployment increased as a result of the rise in the labour force, since employ-

LATIN AMERICA: MAIN ECONOMIC INDICATORS

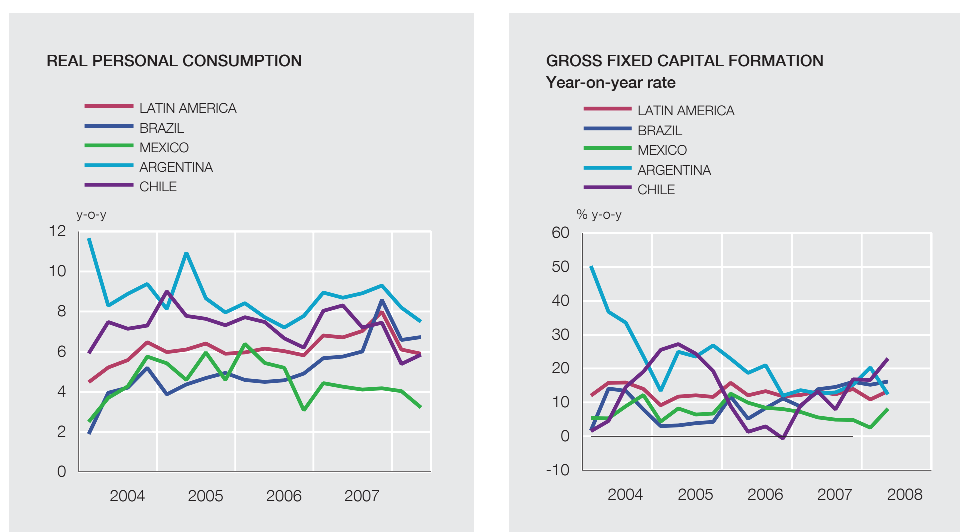
TABLE 1

	2005	2006	2007	2006		2007				2008		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	September
GDP (year-on-year rate)												
Latin America (a)	4.7	5.4	5.6	5.8	5.8	5.2	5.5	5.7	6.3	5.1	5.4	
Argentina	9.2	8.5	8.7	8.7	8.6	8.0	8.6	8.8	9.1	8.3	7.5	
Brazil	3.2	3.7	5.4	4.4	5.1	4.4	5.4	5.6	6.2	5.9	6.1	
Mexico	3.1	4.9	3.2	4.9	3.7	2.5	2.6	3.4	4.2	2.6	2.8	
Chile	5.6	4.3	5.1	3.2	4.8	6.2	6.2	3.9	4.0	3.3	4.3	
Colombia	5.7	6.8	7.7	7.6	7.8	8.5	8.0	6.5	8.0	4.5	3.7	
Venezuela	10.3	10.3	8.4	10.1	11.4	8.8	7.6	8.6	8.5	4.9	7.1	
Peru	6.7	7.6	9.0	9.2	8.1	8.8	8.1	8.9	9.8	9.7	10.9	
Uruguay	6.6	7.0	7.4	7.2	6.1	6.6	3.9	9.6	9.5	10.0	16.0	
CPI (year-on-year rate)												
Latin America (a)	6.4	5.2	5.4	5.0	4.8	4.9	5.3	5.4	5.9	6.6	7.7	8.6
Argentina	9.7	10.9	8.8	10.6	10.1	9.5	8.8	8.6	8.5	8.5	9.1	8.7
Brazil	6.9	4.2	3.6	3.8	3.1	3.0	3.3	4.0	4.3	4.6	5.6	6.3
Mexico	4.0	3.6	4.0	3.5	4.1	4.1	4.0	4.0	3.8	3.9	4.9	5.5
Chile	3.1	3.4	4.4	3.5	2.2	2.7	2.9	4.8	7.2	8.0	8.9	9.2
Colombia	5.0	4.3	5.5	4.6	4.3	5.2	6.2	5.3	5.4	6.1	6.4	7.6
Venezuela	16.0	13.6	18.8	14.6	16.2	19.0	19.5	16.2	20.0	26.3	31.0	36.0
Peru	1.6	2.0	1.8	1.8	1.5	0.4	0.8	2.4	3.5	4.8	5.5	6.2
Uruguay	4.7	6.4	8.1	6.6	6.2	7.0	8.1	8.7	8.6	7.7	7.6	7.5
BUDGET BALANCE (% of GDP) (b)												
Latin America (a)	-1.0	-0.7	-0.5	-0.4	-0.7	-0.5	-0.2	-0.2	-0.2	0.0	-0.3	
Argentina	1.8	1.8	1.1	1.8	1.8	1.5	1.6	1.7	1.1	1.5	1.6	
Brazil	-2.8	-2.9	-2.2	-3.1	-2.9	-2.6	-2.1	-2.2	-2.2	-1.6	-1.9	
Mexico	-0.1	0.1	0.0	0.4	0.1	0.7	0.4	0.1	0.0	0.0	-0.2	
Chile	4.7	8.0	8.7	7.9	8.0	7.9	8.6	8.7	8.7	9.2	7.2	
Colombia	-5.0	-3.7	-3.3	1.8	-3.7	-3.2	-2.1	-2.4	-2.8	-2.3	-2.6	
Venezuela	2.0	0.0	—	-3.7	-1.5	-1.3	1.2	0.9	3.0	—	—	
Peru	-0.7	1.4	1.1	1.0	1.4	1.5	1.2	1.7	1.8	2.3	2.6	
Uruguay	-0.8	-0.6	-0.3	-0.6	-0.6	-0.8	0.5	1.0	0.0	1.1	-0.4	
PUBLIC DEBT (% of GDP)												
Latin America (a)	41.0	39.1	36.0	39.0	38.7	38.1	37.4	33.9	33.7	32.3	31.3	
Argentina	70.7	64.2	55.5	59.9	59.8	61.5	59.1	55.8	55.5	52.4	50.6	
Brazil	46.5	44.7	42.8	45.0	44.7	44.7	43.9	43.2	42.7	41.2	40.5	
Mexico	22.4	23.2	24.1	23.9	23.2	23.3	23.9	21.2	21.1	21.1	20.7	
Chile	6.8	5.3	5.5	5.4	5.3	5.2	5.1	4.4	4.1	3.6	3.9	
Colombia	46.6	44.8	—	45.6	44.8	42.7	42.2	35.6	35.9	35.3	—	
Venezuela	48.2	41.9	30.1	40.0	41.9	31.7	29.9	21.2	22.7	17.4	15.9	
Peru	37.8	32.7	29.3	33.1	32.7	30.8	29.6	31.4	29.7	27.6	25.3	
Uruguay	83.8	70.9	—	75.5	70.9	66.4	71.6	72.9	70.5	74.0	76.0	
CURRENT ACCOUNT BALANCE (% of GDP) (b)												
Latin America (a)	1.9	2.0	0.9	2.1	2.0	1.7	1.5	1.1	0.9	0.7	0.5	
Argentina	2.9	3.6	2.7	3.2	3.6	3.5	3.3	2.8	2.7	2.7	2.0	
Brazil	1.6	1.3	0.1	1.3	1.3	1.1	1.1	0.6	0.1	-0.7	-1.2	
Mexico	-0.6	-0.2	-0.6	-0.2	-0.2	-0.5	-0.7	-0.7	-0.6	-0.5	-0.5	
Chile	1.2	4.7	4.4	4.6	4.7	5.9	5.7	5.0	4.4	2.7	0.5	
Colombia	-1.3	-1.9	-2.9	-1.5	-1.9	-2.5	-2.8	-3.0	-2.9	-2.3	-2.2	
Venezuela	17.7	14.7	8.8	16.9	14.7	12.0	10.0	8.8	8.8	11.1	15.0	
Peru	1.4	3.0	1.4	2.4	3.0	3.2	3.0	2.1	1.4	0.4	-1.2	
Uruguay	0.3	-2.1	-1.0	-1.0	-2.2	-1.3	-0.7	-1.1	-1.0	-1.1	-4.6	
EXTERNAL DEBT (% of GDP)												
Latin America (a)	26.5	22.4	21.6	23.2	23.1	22.8	22.9	22.4	21.6	—	—	
Argentina	59.1	47.5	47.3	49.1	47.5	50.6	50.8	49.2	47.6	46.2	43.4	
Brazil	19.2	16.1	14.7	15.4	16.2	16.4	16.4	15.9	14.7	14.2	13.4	
Mexico	15.4	13.4	12.6	15.3	13.4	13.8	13.3	11.5	11.0	—	—	
Chile	33.5	32.0	34.0	33.1	32.0	32.3	33.0	33.9	34.0	33.5	34.8	
Colombia	31.3	29.5	26.0	28.2	26.5	24.9	25.5	25.3	25.9	21.8	—	
Venezuela	28.3	26.9	24.4	27.4	26.5	25.0	24.3	24.1	24.4	23.6	23.9	
Peru	35.3	28.2	28.7	29.3	28.2	28.9	29.5	29.7	29.8	30.4	30.4	
Uruguay	68.6	54.6	—	59.0	54.6	50.3	54.7	55.2	52.8	50.6	46.8	

SOURCE: National statistics.

a. Aggregate of the eight countries represented, except Uruguay.
b. Four-quarter moving average.

PRIVATE CONSUMPTION AND INVESTMENT CHART 4
Year-on-year rate



SOURCE: National statistics.

a. Seven biggest economies

ment grew at a high rate; consequently, only in Mexico did the labour market perform more sluggishly.

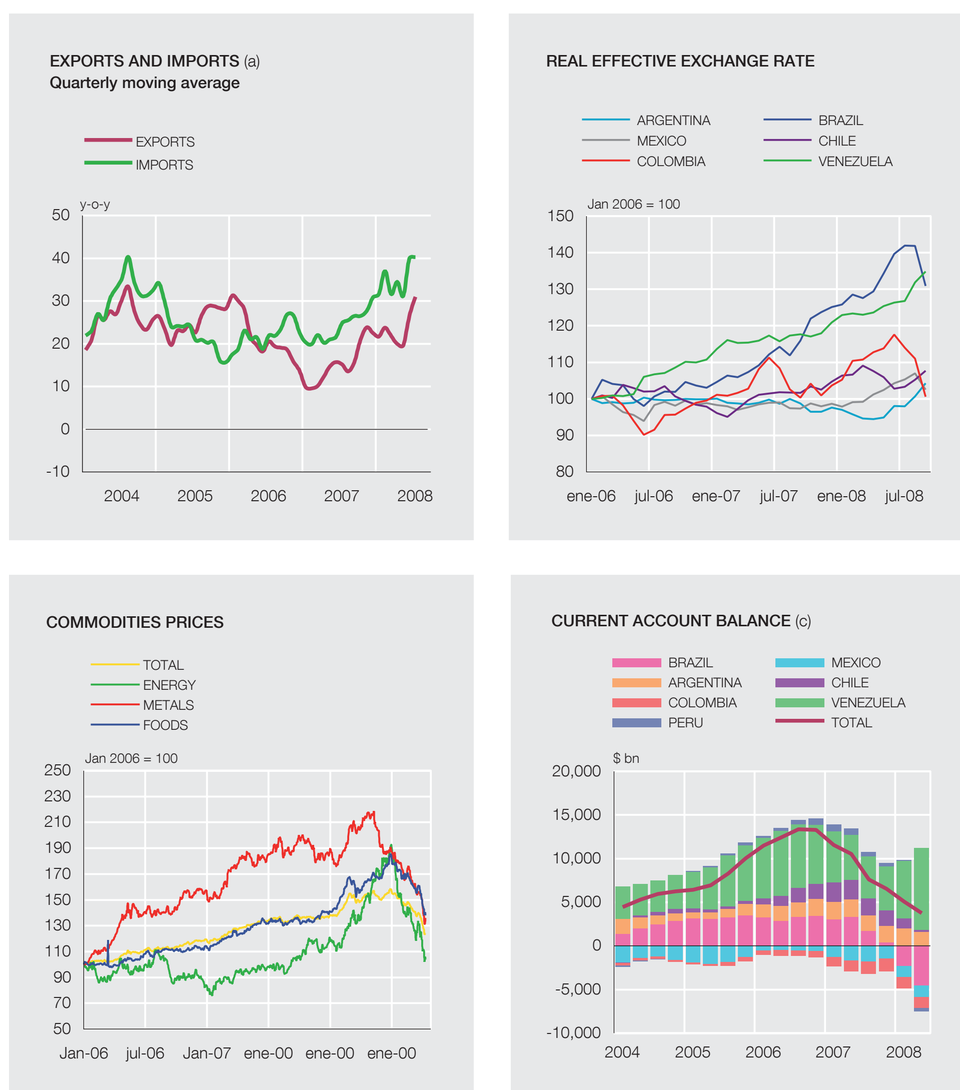
Conversely, both government consumption and gross capital formation grew at very similar rates in Latin America as a whole to those in 2007 Q4. Indeed, gross capital formation grew forcefully once again in 2008 Q2 (13.4% year-on-year), after a relatively weaker performance in Q1, and was once again the most dynamic component of GDP and that responsible for the rise in the growth rates of Mexico, Chile and Venezuela that quarter. In Peru, investment grew at a record rate of over 35% year-on-year. Overall, then, the behaviour of investment continued to be favourable, unaffected to date by the external deterioration.

Finally, external demand contributed negatively to growth by somewhat over 2 pp, without posting a further deterioration compared with the second half of 2007. On National Accounts data, imports grew at a year-on-year rate of 15.4% in Q1 and 18% in Q2, reflecting the strength of domestic demand, while exports eased off considerably in Q1 to a year-on-year rate of 2.8%, offset in part by the Q2 figure (4.5%). This pick-up in exports was somewhat surprising, given the spread of the slowdown in growth to many of the developed economies.

Against this background, the external accounts held on a similar trend to that in 2007, when there was an appreciable reduction in the region's trade and current surplus. After five years of surplus, the region's current account practically resumed a balanced footing, despite the fact that the trade balance retained a sizeable surplus of 3% of GDP. Indeed, if we excluded the Argentine and Venezuelan current account surpluses, the region's current account balance would be in deficit (see Chart 5). Pivotal to this change has been the performance of the external sector in Brazil, which posted a current deficit of $11 billion – somewhat higher than 1% of GDP – as a result of the strength of domestic demand. As commodities prices held at very high levels to July, the value of exports for the region as a whole continued to grow forcefully (26% year-on-year), while overall regional imports quickened to a year-on-year rate of 42%, amid strong domestic demand and the appreciation of exchange rates (see Chart 5). Against this backdrop, the downward trend recently witnessed in the prices of the region's main com-

EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year changes, indices, percentage of GDP and billions of US dollars

CHART 5



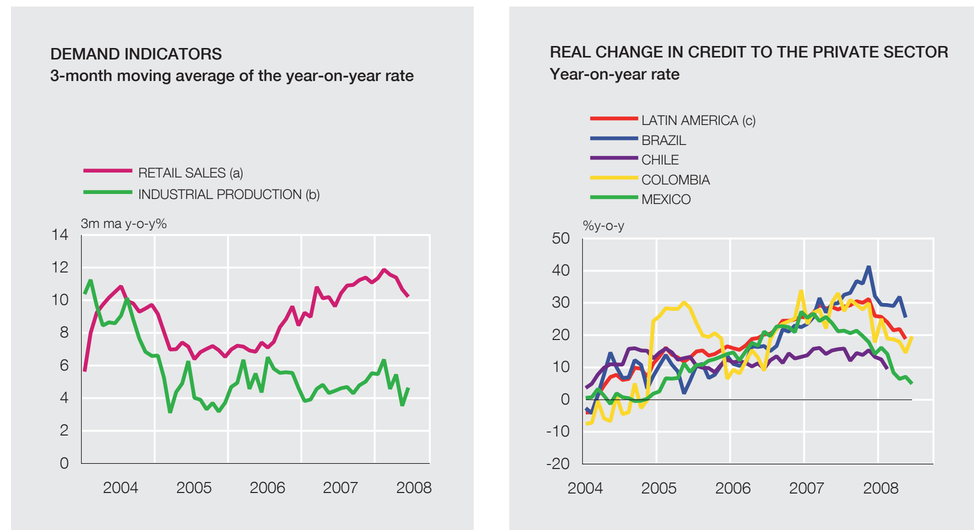
SOURCE: National statistics and Banco de España.

a. Customs data in dollars.
b. Aggregate of the seven biggeste economies.
c. Four-quarter moving average.

modities exports, to a two-year low in some cases, might herald a further deterioration in trade and current-account balances. And that, given the lesser availability of capital globally, might act as a constraint on growth for some countries.

The higher-frequency indicators for Q3 provide but partial evidence so far, as they run only to August at best. These figures point to a weakening of industrial activity in Argentina, Chile, Mexico and Brazil (in this latter country the August figure might be affected by certain temporary factors). This greater sluggishness might be associated with the diminished dynamism of the demand for exports, but also with the tightening of domestic financing conditions (see Chart 6). In this respect, the growth of credit to the private sector is discernibly moderating (see Chart 6), although it remains at a relatively high rate of 20% year-on-year in real terms at the regional level (and at a very high rate in Brazil and Peru). The demand indicators have continued to show appreciable robustness, growing at a rate of 10% year-on-year for the region as a whole to July (see Chart 6), although they too are slowing.

SUPPLY, DEMAND AND PRIVATE-SECTOR CREDIT INDICATORS CHART 6
Year-on-year rate and its 3-month moving average



SOURCE: National statistics.

a. Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
b. Eight biggest economies
c. Seven biggest economies.

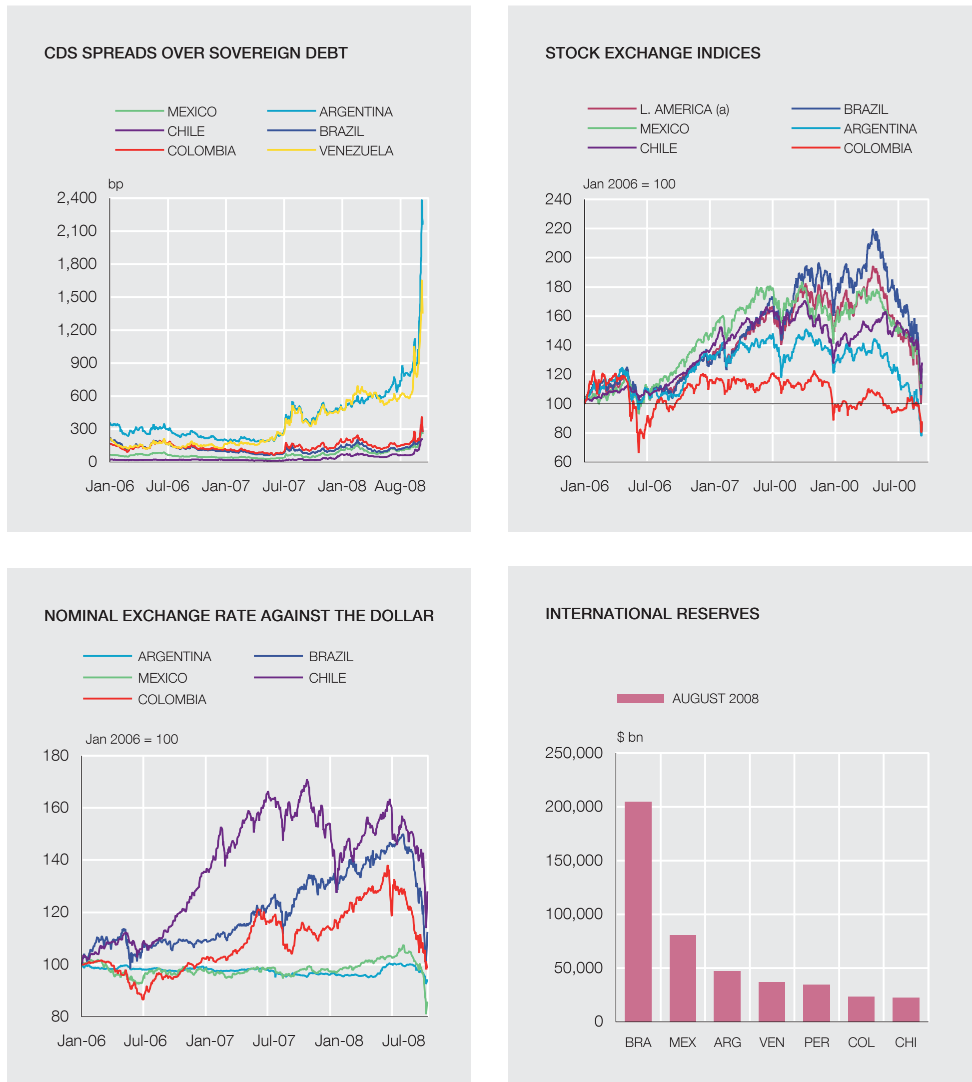
FINANCIAL MARKETS AND EXTERNAL FINANCING

Latin American financial markets showed two clearly differentiated phases over the last six months. From April to June they broadly moved on the path observed in previous quarters, i.e. a favourable stock market performance, appreciating exchange rates which continued to bear in some countries on the monetary policy response (Brazil, Chile and Peru) and a build-up of reserves (Brazil, Chile, Colombia and Peru), and stable sovereign risk premia moving around low levels, similar to those recorded at the start of the turmoil in August 2007. The exceptions to this general trend were Argentina, where the spread held continuously high, and, to a lesser extent, Venezuela (see Chart 7).

From June, however, the change in sentiment vis-à-vis the emerging markets had a particularly adverse effect on the Latin American market as a whole. Their differential behaviour relative to the other emerging economies (which had been more favourable in the previous period, and more negative in recent months) may be related to their status as commodities exporters, as is analysed in Box 1. Stock markets posted most sizeable declines, sovereign spreads widened to a three-year high (of around 600 bp, measured by the EMBI spread) and there was an across-the-board depreciation of exchange rates.

These trends intensified in September as a result of the worsening international crisis. Overall, there have been declines of up to 40% (and even higher, from the pre-summer highs) in the past six months on several of the main stock exchanges (Brazil, Mexico and Argentina), of 45% in the case of Peru, and on a somewhat more moderate scale in Chile and Colombia. The appreciation of exchange rates in previous months tended mostly to be corrected, and they depreciated by around 30% in Brazil, and by 25% in Chile and Colombia. The Mexican peso depreciated very sharply in October (making for a 20% fall since April), which led the Bank of Mexico to intervene selling reserves. The Peruvian sol depreciated somewhat less (by around 10%) and the Argentine peso fell by 2%, supported by the sale of central bank reserves to withstand the decline in the demand for pesos. Sovereign debt spreads, measured both by the EMBI and by CDSs (credit default swaps) on sovereign debt, widened considerably, especially in the cases of Argentina, Venezuela (both above 1,250 bp) and Ecuador, whose economic and financial fundamentals are

CDS SPREADS OVER SOVEREIGN DEBT AND STOCK MARKETS CHART 7
Basis points and indices



SOURCE: Datastream.

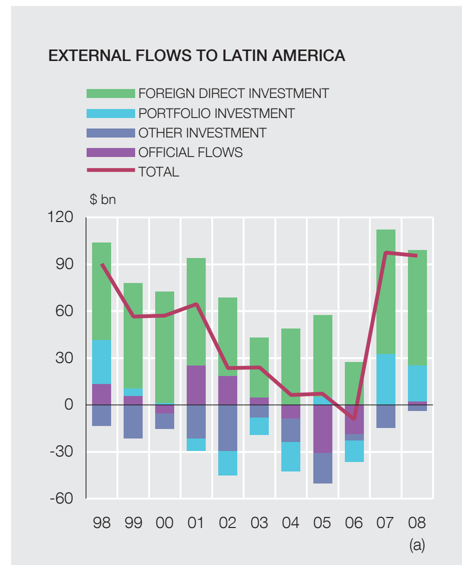
a. MSCI Latin America Index, in local currency.

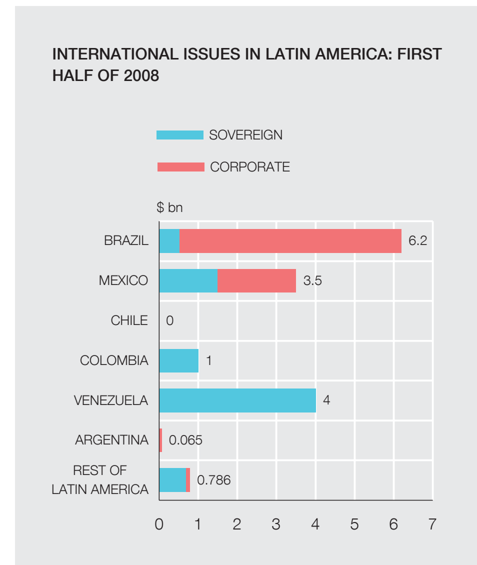
perceived as less sound. Meanwhile, the widening of such spreads in Chile, Mexico, Brazil and Colombia was more moderate in relative terms, albeit significant, since in many cases spreads doubled compared with the levels six months earlier (see Chart 7).

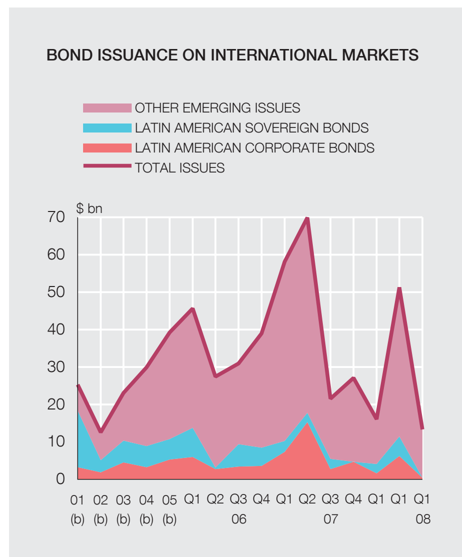
The heightening of the international financial crisis, the recent increase in risk aversion and their confluence with the turnaround in commodities prices place Latin American financial markets at a much more complicated and uncertain juncture than at the start of the crisis, when these markets were in a relatively favourable position. On one hand, the widening on sovereign spreads entails an appreciable rise in the cost of financing in dollars, especially in certain countries; and this rise also has a corollary in financing in local currency, with the increase in official interest rates and the upward trend in long-term interest rates. On the other, certain higher-frequency data appear to highlight a relatively significant capital outflow since the summer, although private net capital flows over the year as a whole may hold at a high level (see Chart 8), somewhat down on 2007. Market access was assured during

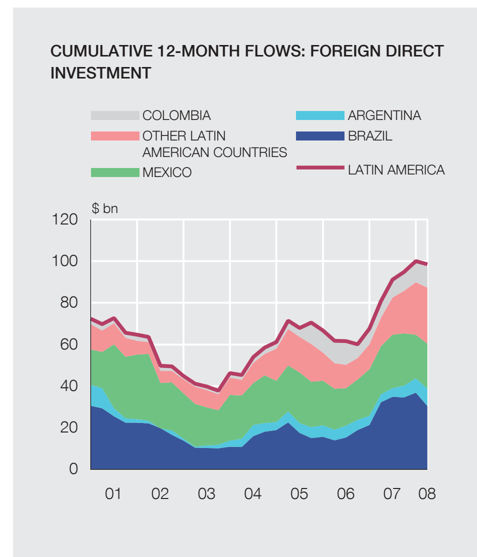
EXTERNAL CAPITAL FLOWS
$ bn

CHART 8









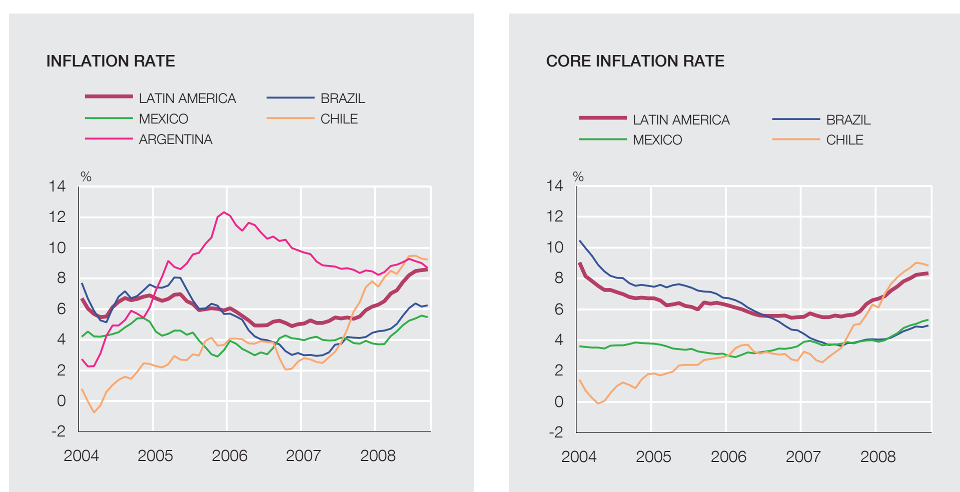
SOURCES: JP Morgan, IMF and national statistics.

a. 2008: estimate.
b. Quarterly average.
c. Figures for July and estimate for August and September.

the first half of the year, as shown by the volume of issues both by public and private issuers. But the decline in net portfolio flows, particularly in countries such as Brazil, and the widespread decline in financial asset prices (stock markets, bonds and exchange rates) evidence the change in sentiment from the summer, which might especially affect those countries with the weakest fundamentals. In this respect, the instability on markets has already necessitated certain changes to domestic public debt management strategies, such as the repurchase of debt by Argentina, the amendment of the Brazilian Treasury's Annual Plan (which foresees an increase in issues at a floating interest rate at the expense of those at a fixed interest rate) and cancellations of international issues in several countries in the September-October period. Along the same lines, many countries have recently introduced exceptional measures aimed at providing greater liquidity to the markets, particularly in dollars, given the increase in the demand for this currency in local markets and the

INFLATION
Year-on-year rate of change

CHART 9



SOURCE: National statistics.

emergence of signs of stress in the interbank markets. These measures include most notably: dollar-sale operations by central banks to provide liquidity or to support the exchange rate (Argentina, Brazil, Peru and Mexico); the widening of the range of collateral that can be discounted at the central bank (Brazil); the suspension of the reserves accumulation mechanism and the setting in place of weekly currency swap auctions in Chile; the partial elimination of exchange controls or requirements in Colombia and Peru; changes to reserve requirement arrangements, and the opening of credit lines by public-sector banks to exporters drawing on reserves (Brazil). In any event, these measures are much less drastic than those applied by the advanced economies.

The Latin American economies still have basic strengths: firm domestic demand, healthy fiscal positions, flexible exchange rates in many countries with the capacity to absorb external shocks, a better debt structure than in the past and high reserves. Four countries have seen their credit ratings raised in the past six months (Brazil and Peru, to investment grade, Colombia and Uruguay), which corroborates their fiscal consolidation drives and should allow broader access to external financing. Indeed, only one country (Argentina) has seen its rating lowered. One very relevant factor of soundness in recent times had been the comfortable current-account position in the region as a whole, reflecting a relatively limited dependence on external financing. However, the speed with which the current surplus has declined over the past 18 months - despite commodities prices holding at very high levels – is a cause for caution, given the current diminished availability of external financing. High dependence on commodities prices and uncertainty over the inflation outlook are two of the main sources of vulnerability, in an external environment of marked risk aversion.

PRICES AND MACRO POLICIES

Inflation increased notably in the course of the last six months, standing at a year-on-year rate of over 8.5% on average for the seven main economies in the region, 3 pp up on average inflation in 2007 and marking a five-year high (see Chart 9). The upward trend in prices, which have been more notable in 2007 in Argentina, Venezuela, Colombia and Chile, ultimately spread to the other countries during 2008, with inflation rates in Brazil, Mexico and Peru increasing by more than 2 pp from March to September. As a result, inflation stood far outside its target bands in all countries in the region (with the exception of Brazil), whose central banks are pursuing explicit inflation targets. Indeed, as can be seen in Table 2, a return to back within the bands in the short run does not seem possible.

INFLATION
Year-on-year changes

TABLE 2

Country	2006	2007			2008	
	Fulfillment	Target	Fulfillment	December	Target	Expectations (a)
Brazil	Yes	4.5 ± 2.5	Yes	4.5%	4.5 ± 2	6.3%
Mexico	No	3 ± 1	Yes	3.8%	3 ± 1	5.6%
Chile	Yes	3 ± 1	No	7.8%	3 ± 1	8.5%
Colombia	Yes	4 ± 0.5	No	5.7%	3.5 to 4.5	7.0%
Peru	No (below)	2 ± 1	No	3.9%	2 ± 1	5.0%

SOURCE: National statistics.

a. Inflation expectations for 2008 from the reports of central banks and private institutions.

The rise in prices was attributable in part to the increase in food prices, since dearer energy prices made practically no contribution to the rise in consumer prices, largely because administered prices were involved and/or because of the existence of subsidies. But the other components also tended to rise moderately from end-2007, reflecting demand pressures, which contributed to pushing the different measures of core inflation upwards (see Box 2). Likewise, long-term inflation expectations, which had held relatively stable until the summer despite the deterioration in short-term expectations, trended upwards, as did wages in some countries, which heightened concern over a possible disanchoring of inflation expectations (see Chart 10).

The rise in inflation in Latin America has posed a particularly marked challenge for monetary policy.[2] Firstly, because the attainment of low inflation rates has been a relatively recent achievement and, therefore, the credibility of the monetary authorities and the anchoring of inflation expectations may be less firm than in countries with a longer track record of macroeconomic stability. Thus, with a sizeable gap opening up between targeted and actual inflation in many countries, the current situation is the first occasion on which the credibility of the explicit inflation target regimes established in recent years in countries such as Brazil, Chile, Colombia, Mexico and Peru is being put seriously to the test. And secondly, because, as theory predicts, the impact of the rise in commodities prices is more inflationary in the countries (such as the Latin American economies) that export these goods owing to the induced effect of the boost to demand. In this respect, the adjustment would require an appreciation of the real equilibrium exchange rate, one all the more sizable the more permanent the improvement in the terms of trade is perceived to be. This appreciation may take place through a nominal appreciation, or through an increase in inflation, alternatives on which the exchange rate policy adopted has a decisive influence.

Against this background, the monetary policy response of the different central banks in the region to the rise in inflation has been mixed and, moreover, it is difficult to consider it independently from the setting of financial turmoil and slowing growth in the US economy in which it has taken place, and from the easing of monetary policy in the United States. However, as a notable common feature, mention may be made of the fact that, following a limited monetary policy response during the second half of 2007, which led real interest rates to relatively low levels (albeit high in comparison with other emerging regions), monetary policies have tended to react more firmly in recent months. A case in point is the response by Brazil, which raised its official interest rate by 250 bp between April and October. But so too is that of Chile, whose

2. See López Urruchi, P., J.C. Berganza and E. Alberola (2008), " Commodities, inflation and monetary policy: a global perspective", *Economic Bulletin*, July, Banco de España, pp. 93-110.

In the last year and a half, inflation has become an increasingly important issue globally as it has been pushed significantly upward by the rises in international food and energy prices. Inflation excluding food and energy, however, has remained relatively more stable over this period, particularly in the advanced economies (see Panel 1). This index of inflation excluding food and energy coincides with what is known as the official measure of core inflation in some countries (United States), but differs from the corresponding official measures in many countries, in particular several Latin American ones.

It is not easy to define the concept of core inflation, as is apparent from the literature on the measurement of this variable. There is, however, broad agreement along two lines. The first is that core inflation should only capture the portion of the change in prices that is common to all components and exclude the changes in relative prices of goods and services. The second has to do with the permanent nature of the price rise, rather than how widespread it is, i.e. core inflation should be a good indicator of the change in the price level that is expected to persist over time and should therefore be useful in predicting total CPI. In any event, a measure of these characteristics is a significant indicator of monetary policy.

Given the significance of the concept of core inflation, this Box reviews it from a methodological perspective, concluding that the choice of its definition is not innocuous. A brief look at the properties that a good measure of core inflation should have, at the possible calculation methods and at international practice highlights how the use of different measures of core inflation can lead to divergences in assessment.

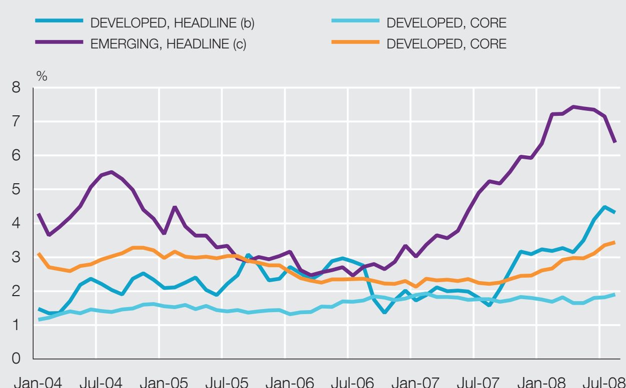
The properties which a good measure of core inflation should have include the following: a) rapidly available and easily understood by the public, b) credible in terms of quality of the measure and of transparency of the compilation process, c) less variable than headline inflation, d) unbiased and not departing from headline inflation over long periods of time and e) a good predictor of headline inflation. Based on these key properties, an extensive literature focuses on the study of the different methods of calculating core inflation, a non-exhaustive list of which includes the following: a) exclusion-based methods, which take total CPI as a starting point and omit certain components in constructing the core index: in some cases the same components (e.g. food and energy) are systematically omitted, and in others, the distribution of changes in the prices of components is used to determine which components are to be excluded (e.g. those undergoing extreme changes), resulting in a measure known as "limited influence estimator"; b) CPI re-weighting methods, which do not eliminate index components, but rather assign to each component a new weight which depends inversely on its variance; c) trend estimates, which use moving averages to extract the smoothing of the headline inflation series; and d) methods based on economic models which, together with the information provided by the inflation time series, take into account the information contributed by other variables (for example, production).

One of the most frequently used methods is that of exclusion. The accompanying table contains various examples of how core inflation measures are compiled at international level, giving special attention to Latin American countries. This table reveals a not insignificant degree of heterogeneity across the measures. Thus, for example, while most of the Latin American countries analysed exclude fuel and fruit and vegetables from core inflation, some also omit other unprocessed food, and yet others also exclude some processed foods. Heterogeneity also exists in other excluded components, which tend to be components with regulated prices.

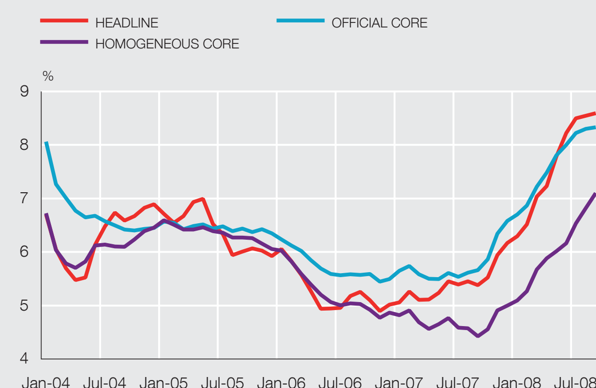
Given this significant heterogeneity, a measure of core inflation for a region as a whole which simply aggregates the various official indices may provide a distorted signal. Panel 2, which plots core inflation for the region obtained by aggregating the official core indices, shows that it seems to have moved in parallel with and, until recently, above headline inflation. However, if a more homogeneous core inflation measure is constructed which excludes, as far as possible, total food and energy from the total CPI, a significantly different picture is obtained, as follows. Core inflation tends to moderate in early 2007 and, despite its subsequent upward trend, in line with the worldwide trend, it remains below headline inflation.

In conclusion, if it is assumed that core inflation can act as an indicator of inflationary pressure or of medium-term inflation, the divergence

1 HEADLINE AND CORE INFLATION (a). DEVELOPED AND EMERGING COUNTRIES



2. HEADLINE AND CORE INFLATION. LATIN AMERICA (d)



of results means that there are different interpretations: inflationary pressure is higher in the heterogeneous measure, but in the homogeneous measure the recent deterioration contrasts more strongly with the downward trend seen in previous years. This would suggest that the underlying inflationary pressure in the Latin American economies as a whole is high. Similar conclusions were drawn in certain studies which emphasise that the definition of core inflation is not a simple task, that different measures of core inflation lead to different results and that the results may differ according to the country in question. This suggests that each country should assess possible alternative measures of core inflation, an approach which is now being investigated by various Latin American central banks.

	Food		Energy	Other regulated or seasonal prices
	Processed	Unprocessed		
Argentina (b)		• (Fruit and vegetables) (a)	• (Fuel and electricity)	Water and sanitary services, public passenger transport, vehicle operation and maintenance, post, telephone and accessories, outer clothing, tourist transport, and lodging and excursions
Brazil (c)	• (d)	• (d)	• (Fuel and electricity)	Water and sewage rates, property tax, telephone, health insurance, transport
Chile (e)		• (Fruit and vegetables)	• (Fuel)	
Colombia (f)		• (Perishable foodstuffs)	• (Fuel)	Public services
Mexico (g)		•	• (Fuel and electricity)	Telephone, water supply rights, bus service, toll road and parking charges, among others
Peru	• (h)	• (h)	• (Fuel)	Public services and transport
VENEZUELA		•		Goods prices and regulated services
UNITED STATES	•	•	•	
EURO AREA		•	•	
JAPAN		• (Fresh food)		

SOURCE: National statistics.

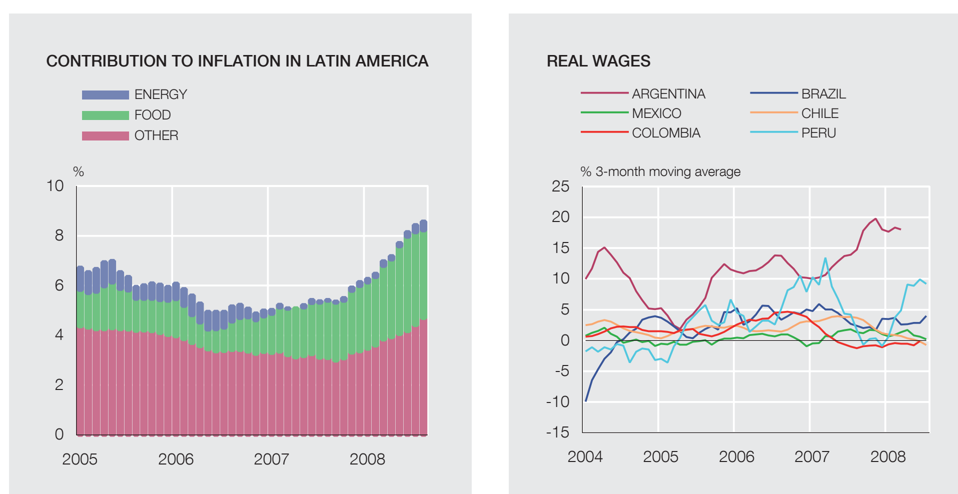
a. A dot in the table means that the core inflation measure excludes the stated component.
b. Argentina publishes a "rest of CPI" which is defined as the headline index less components with seasonal or regulated prices.
c. The Central Bank of Brazil provides other measures of core inflation apart from that which excludes the components specified in the table: a smoothed one and an unsmoothed one, using a symmetrically truncated average which excludes 20% of the components of the distribution.
d. Household food.
e. Along with the measure of core inflation included in the table for Chile (IPCX), there is another regularly used measure (IPCX1) which is calculated by excluding from the IPCX the prices of fresh meat and fish, regulated prices, indexed prices and financial services. Additionally, in the last few months, given the recent rise in international food and energy prices, the Central Bank of Chile has begun to use two other measures in its reports: the CPI excluding food and energy and the IPCX1 excluding food.
f. The Central Bank of Colombia provides various regularly supervised measures of core inflation, one which excludes the components specified in the table; one which excludes food; and one which excludes 20% of the distribution, with those components which showed the greatest price variability between January 1990 and April 1999. A fourth indicator is a measure which excludes food and regulated components.
g. Before January 2008, the measure of core inflation in Mexico excluded private education services.
h. Food with the highest monthly change in price in 1995-2008.

rate was raised by 200 bp, and that of Mexico and Peru, where the official rate increased by 75 bp between June and August. Colombia raised its reference rate by only 25 bp as it had largely anticipated the cycle of rises last year. This change in monetary policy stance may be attributed, in addition to the increase in inflation, to the fact that two of the main obstacles that had deterred central banks from applying stricter monetary policies over the last six months have been overcome: the fear of a strong adverse impact on growth derived from the global turmoil and a slowdown in the US economy, and the appreciation of exchange rates stemming

CONTRIBUTION TO INFLATION AND REAL WAGES

Year-on-year rate of change and its three-month moving average

CHART 10



SOURCES: National statistics and Datastream.

initially from the widening of interest rate spreads over the United States. The countries maintaining a fixed or quasi-fixed exchange rate against the dollar offered different monetary policy responses. Venezuela adopted several measures to reduce liquidity in the system, seeking in this way to reduce inflation. The Argentine central bank raised its reference market interest rate (the seven-day repo rate) by 200 bp, with the principal aim of supporting the demand for pesos, initially because of the influence of the agricultural dispute and subsequently in the face of the heightening of the international financial crisis. Both countries ran high inflation rates, which has proved conducive to the ongoing adjustment to a higher equilibrium exchange rate, due to the higher terms of trade, taking place via higher inflation.

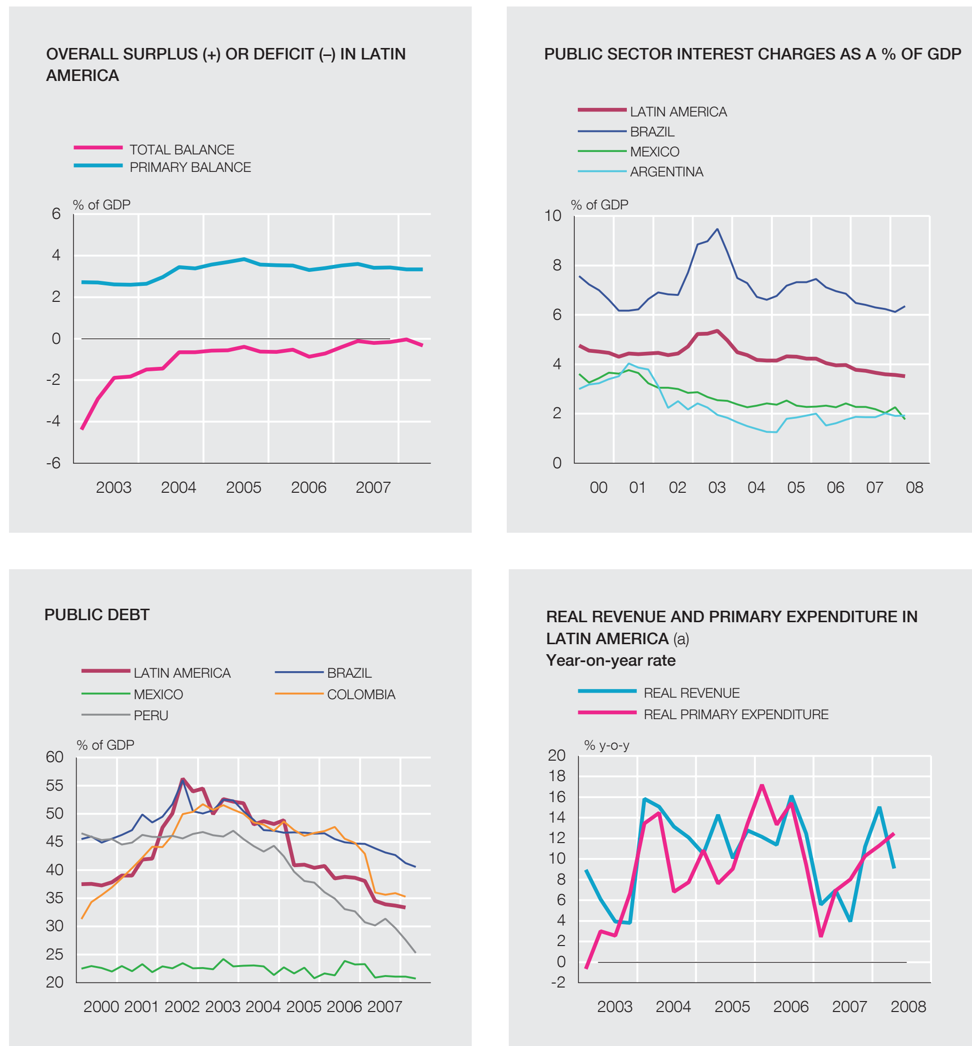
The external environment has, nonetheless, changed substantially since the summer and, following the worsening of the crisis in September in particular, the impact on domestic conditions has been marked. On one hand, the recent downward trend in oil and, above all, food commodities prices should help ensure that inflation does not continue accelerating as has hitherto been the case. However, several developments may hinder any immediate return by inflation to target, despite the tightening of monetary policies. These include most notably the upward trend in the various measures of core inflation during 2008, continuing demand pressures in several countries, the possibility that the pass-through of certain commodities prices to consumer prices is not yet fully complete owing to the habitual lags in the process (especially in emerging economies) and the recent depreciation of exchange rates.

Accordingly, and owing to the credibility test to which the monetary policy regimes in the region are being subjected, the coming months may continue to require rigorous monetary policies so as to avert second-round effects, although the impact of the economic and financial crisis is likely once more to influence policy responses decisively.

On the fiscal front, the total and primary budget balances in the region as a whole did not undergo significant changes in the opening months of 2008 compared with 2007 (see Chart 11), holding at levels close to zero and at 3% of GDP, respectively. However, mention should be made of the more volatile trend of revenue, which tended to ease off, while expenditure remained on a rising trend, with subsidies becoming a sizeable item in several countries. In this respect, there was a moderate deterioration in the primary balances of some countries (Mexico, Peru and Chile), in the first two as a consequence of the expan-

MAIN INDICATORS OF PUBLIC SECTOR PERFORMANCE
Year-on-year changes and percentage of GDP

CHART 11



SOURCE: National statistics.

a. Deflated by the CPI.

sion in expenditure, and in the third owing to the decline in mining-related revenue. In Argentina, by contrast, the primary surplus in 2008 to date was far higher than that in 2007, partly as a result of the bringing forward of future central bank profits and partly due to some moderation in spending compared with 2007, which was a presidential election year. In Brazil, meanwhile, the primary surplus increased to 4.4% of GDP (with a budget deficit of 1.9%), underpinned by the sound behaviour of revenue, and developments in Colombia were along similar lines. Overall, the performance of public finances in most Latin American countries may be said to have continued to be favourable, thanks to a very positive business cycle, the increase in commodities prices and, possibly, spending, which has at least not been as expansionary as in previous cycles, despite increasing in some countries in recent months. For 2009, budget forecasts for some countries (Chile and Peru) posit relatively tight spending, which is also the case to some extent for Mexico and Brazil. Generally, nonetheless, in a setting such as the present one, with greater uncertainty over growth and commodities prices, meeting revenue – and therefore deficit – targets might prove demanding, as it will be difficult for expenditure to show sufficient downward flexibility. In Mexico, the recent amendment of the draft budget includes a downward revision of the

growth forecasts for GDP and for revenue and expenditure, along with a more conservative assumption about oil prices.

TRADE INTEGRATION AND STRUCTURAL POLICIES

There have not been any notable changes in 2008 in respect of recent trends in trade integration. The most ambitious regional agreements in terms of goals – MERCOSUR and the CAN – made no significant progress. The US Congress deferred approval of the free trade agreement with Colombia until after the elections and, therefore, renewed until December the benefits of the preferential agreements (ATPDEA), while Chile and Peru entered into new bilateral trade liberalisation agreements (with Honduras, Panama and Australia in the first case, and with Canada and Singapore in the second). Finally, the Peruvian government initiated talks to achieve a trade agreement with China.

Turning to structural reforms, Chile announced the creation of a fund to finance investment in human capital, drawing on a portion of its copper export revenues. Brazil unveiled a plan for productive development and announced the setting up of a sovereign wealth fund using excess funds on the primary surplus, of around 0.5% of GDP. Conversely, Venezuela pushed forward its nationalisation programme: in the steel industry, with the acquisition of the biggest steelworks in South America, and in the cement sector, previously in Mexican hands. It is further negotiating the purchase of the subsidiary of Banco Santander in the country, Banco de Venezuela. Moreover, the government used legal powers to reinforce the public-sector control mechanisms of the economy. Finally, the new interventionist-leaning constitution in Ecuador was approved by referendum, and there will be a public consultation in Bolivia in December on the new and similarly interventionist *Carta Magna*.

ECONOMIC DEVELOPMENTS IN THE MAIN COUNTRIES

In *Brazil*, GDP held at a high year-on-year growth rate in the first half of the year, standing at 5.9% in Q1 and at 6.1% in Q2, both very similar to the second half of 2007, although in quarterly terms the rate slowed slightly. Regarding the composition of growth, there was an accentuation of the features observed in the previous six-month period, i.e. domestic demand quickened (to a year-on-year rate of over 8%) and the negative contribution of the external sector widened (to over 2 pp). The greater dynamism of domestic demand was attributable to the slight acceleration in investment (which grew at a rate of over 15%) and the notable acceleration in government consumption. The more negative contribution of external demand in this period was due to the worse performance of real exports, which posted negative year-on-year growth rates in Q1, in a setting in which real imports continued to register very high growth. One of the key features of the period under analysis is the adverse behaviour of inflation, which increased from 4.6% in March to 6.4% in July, although it eased off slightly – to 6.2% – in August. Although the increase in inflation was induced essentially by developments in food prices, it was fairly generalised, meaning that core inflation rose in parallel. As a result of this, there was a marked deterioration in short-term inflation expectations, less than in long-term expectations, which was corrected partially in the latest surveys. Against this backdrop, the central bank raised official interest rates at all its monetary policy meetings from April. The first two meetings saw rises of 50 bp, which climbed to 75 bp at the two following meetings, taking rates to 13.75%. Regarding fiscal policy, there was an increase in the primary surplus in the January-July period to 6%, considerably above the fiscal targets, and the use of part of this surplus to the recently established sovereign wealth fund was announced. Turning to the external sector, the data available to August show a further deterioration in the trend of the current account balance, which posted negative figures for the first time since 2002. This was largely the result of the reduction in the trade surplus, induced by the strong acceleration in imports. The current deficit was financed by more moderate financial inflows than in 2007, which even so continued to require a considerable build-up in reserves. Among the more positive aspects of recent months have been the discovery of big oil fields, which might turn

Brazil into a major oil exporter, and its credit rating, which was enhanced to investment grade by Standard & Poor's and by Fitch in May and June. However, financial conditions worsened notably from September, making for a very strong depreciation in the real against the dollar, increases in dollar and local currency interest rates, and falls on equity markets. This prompted the authorities to launch a substantial range of measures to alleviate pressures and provide for greater liquidity.

In *Mexico*, growth slowed strongly in the first half of 2008 given that GDP grew by only 2.6% in Q1 and by 2.8% in Q2, around 1 pp below growth in the second half of 2007. The weakness of growth is more readily discernible in the quarter-on-quarter rates of change, which stood at –0.1% and 0.2%, respectively. Both private and government consumption slowed during the second half of the year, while the growth rate of investment declined strongly in the first half (from 4.8% to 2.6%), recovering thereafter to 8.1%, the highest rate since 2006 Q3. Imports grew during the period at a higher rate than in 2007, while exports slowed slightly. That led to external demand subtracting, in both quarters, 1.1 pp from growth. Despite sluggish activity, inflation increased at a sustained rate, standing in August at 5.6%, 1.6 pp above the upper limit of the central bank's target band. Core inflation stood at 5.2%, its highest level since December 2001. These trends have fed through to inflation expectations and to the wage negotiations concluded in July. In this setting, the Mexican central bank raised official rates on three occasions (by 25 bp on each), at its June, July and August meetings, to 8.25%. Further, the government approved several measures to contain the rise in food prices. As regards the external sector, the current account deficit doubled in the first two quarters of 2008 (to 0.5% of GDP), despite the substantial improvement in the trade balance (the rise in exports doubled that in imports) and the increase in tourist receipts. The explanation lies in the decline in remittances and, especially, in the repatriation of dividends. The notable increase in exports stems from the performance of oil, machinery and motor vehicle exports, and greater diversification outside the United States. Public finances worsened slightly in the period under analysis: in annualised terms, the deficit in the period to the end of Q2 is expected to be 0.2 pp of GDP, set against the balanced budget achieved in 2007. On the revenue side, the performance of oil revenue was sound as was, under the non-oil heading, that of revenue levied by the IETU, a flat business tax introduced in the tax reform approved last year. On the expenditure side, there was a notable increase under social development and direct physical investment. Public debt continued to decline as a percentage of GDP, as the Treasury maintained its active debt management policy, undertaking several repo and swap operations and issuing foreign/domestic debt exchange warrants. As to structural reforms, the government submitted to Parliament plans to reform the energy sector in a manner compatible with the Constitution, and legislation was approved to reduce the tax burden on the State-owned oil company PEMEX. The heightening of pressures on international markets also affected Mexican financial markets, and the peso depreciated strongly. The government amended the budget, adjusting expenditure and revenue to more conservative growth and oil prices forecasts for 2009.

In *Argentina*, the figures for economic activity in Q2 are distorted by the mobilisation of the agricultural sector, in relation to the mooted tax on exports (which was finally not approved), since exports of agricultural products fell and the activity of certain sectors was intermittent. On National Accounts data, GDP slowed slightly in Q1 (to a year-on-year rate of 8.3%) and somewhat more markedly in Q2 (7.5%), set against the figure of 8.9% in the second half of 2007. Of note was the greater negative contribution of external demand, while domestic demand continued to grow at around 10.5%, although there was a notable build-up of stocks of agricultural products in Q2, for the aforementioned reasons. The problems in the agricultural sector also impacted forcefully the trade balance figures, which makes their assessment difficult. However, there were high growth rates both in exports (linked to the favourable trend of

prices) and imports (given the notable increase in imported amounts linked to the favourable course of domestic demand). The balance of payments evidenced net outflows of over $5 billion from the non-financial private sector. The official inflation figures show it to be stable at around a year-on-year rate of 9%, according to the new CPI released by the Argentine Statistics Institute. Public finances show a bigger surplus than in the same period a year earlier, linked in part to some easing in public spending, but also to the fact that revenues include bigger amounts brought forward on future central bank profits. In this period there was a bigger rise in sovereign spreads in relative terms than in other emerging countries, a difference which has been exacerbated in the past month. Against this background, the central bank sold some $3.5 billion in reserves in the past months in order to stabilise the exchange rate of the peso and to curb the increase in the demand for dollars. In September, as a sign of willingness to pay, the authorities began to repurchase government bonds and announced that they would repay in full the debt with the Paris Club with a charge to the Central Bank's reserves. Further, as a mechanism for obtaining fresh financing on international financial markets, an intention was expressed to re-open debt swaps for those creditors who did not avail themselves of the process in 2005. However, the heightening of financial pressures in recent weeks has led the government to reconsider its debt repayment decision, and this will probably also influence the degree of acceptance of the swap arrangement, having worsened the initial conditions.

In *Chile*, GDP in the first half of 2008 grew somewhat less than in the previous six months, but on an upward quarterly trajectory (3.3% year-on-year in Q1 and 4.3% in Q2). Of note once again was the dynamism of domestic demand, which grew by 11% in Q2, due among other factors to the strength of investment, especially in machinery and equipment. Conversely, the negative contribution of external demand continued growing, up to 7.1 pp, as a result of the weakness of exports and the continuing strength of imports, especially of investment goods. The trade surplus fell relative to the same period in 2007, since lower volume exports (especially in the mining sector) were compounded by a deterioration in the terms of trade. That pushed the current account balance into deficit in Q2, reversing the sign of previous quarters. There was also a reduction in the budget surplus as a result of a decline in copper-related revenue, given the lower quality of the copper extracted from the main mines. The inflation outlook worsened drastically in the period under analysis, not only because headline inflation continued to increase, moving even further from the inflation target to stand at 9.3% in August, but also because food and energy price rises spread to other goods and because inflation expectations have increased. The central bank response was to sharply tighten monetary policy with four consecutive 50 bp increases in official interest rates at its meetings from June to September, taking the official rate up to 8.25%. However, in October the central bank held the interest rate steady, although it continued to signal the persistence of inflationary risks against the background of the sharp deterioration in financial markets. During the period under study, the nominal exchange rate against the dollar depreciated; this followed the start-up of a programme for the purchase of international reserves by the central bank, but further influences were the deterioration in the terms of trade, the adverse economic activity and inflation figures, and the international financial instability. This trend was exacerbated by the heightening of the international financial crisis, whereby the central bank decided to interrupt the international reserves purchase programme in September, earlier than initially scheduled, and the government took a series of measures to provide more liquidity.

The pace of activity slowed most notably in *Colombia* in the first half of the year, with year-on-year growth of 4.1% and 3.7% in Q1 and Q2, far down on the figure of 8.8% recorded in 2007 Q4. The explanation for this slowdown in growth was the strong reduction in domestic

demand, and particularly in investment, since consumption decelerated more moderately. Inflation continued rising, standing at 7.9% in August, mainly as a result of food prices, since the increase was much more moderate in the case of other goods. This setting of inflation increases and widespread signs of economic slowing (the result in part of the tightening of monetary policy in previous quarters) involved a trade-off for the central bank, which increased official interest rates moderately by 25 bp in late July, taking them to 10%. The current account balance posted a smaller deficit in the first half of the year than in the same period of 2007 (a reduction of 29%, standing at 2.2% of GDP), chiefly as a result of the improvement in the trade balance (due in part to the effect of actual commodities prices) and the rise in migrants' remittances, and despite the increase in the repatriation of dividends. Foreign direct investment flows grew by 27% in the period under study to around 5% of GDP. At the start of the period the exchange rate moved on a persistent appreciating trend, which led the government to introduce further restrictions on financial inflows, in an attempt to deter short-term inflows. It also led the central bank to increase the amount of its daily dollar purchases (up to 20 million). Nonetheless, the depreciating trend of the peso from the end of Q2, which steepened in mid-September coinciding with the deterioration in the market situation, led the authorities to eliminate in part the measures introduced to restrict portfolio financial inflows and to amend its policy of interventions in the foreign exchange market, aimed at mitigating this trend.

Peru posted the highest growth rate in the region in the first half of 2008. Indeed, growth quickened in Q2 (10.9%, against 9.7% in Q1) thanks to the strength of domestic demand, where investment quickened notably. Further to this buoyancy of domestic demand and to the increases in import prices, inflation continued to rise, standing at 6.3% in August, the highest year-on-year rate since September 1998. To tackle this inflation rise and in an attempt to avoid second-round effects, the central bank continued tightening its official interest rate (four 25 bp rises in the period under analysis, to 6.50%) and continued raising (on two occasions) its reserve requirement. The rising pressures on the sol reversed following the central bank's increase to the reserve requirement on sol-denominated deposits by non-residents and became selling pressures with the deterioration of the terms of trade and of the financial situation. That has led the central bank to intervene on the foreign exchange market selling dollars in recent weeks, in addition to other measures aimed at providing liquidity and dollars, and to interrupt the process of interest rate rises. Public finances maintain the same characteristics as in previous quarters, i.e. a budget surplus and high growth rates of non-tax revenue (royalties and fees) and of capital expenses.

In the first half of the year, growth in *Venezuela* slowed strongly compared with the second half of 2007, evidencing very different behaviour, moreover, in the two quarters. In Q1 the year-on-year rate declined to 4.9% (with a strong fall in quarter-on-quarter terms) owing to the collapse in investments and the slowdown in private consumption, and despite the notable reduction in the negative contribution of external demand. In Q2, the year-on-year growth rate increased to 7.1% as a result of something of a recovery in investment (albeit without resuming the rates recorded over the last cycle) and of the lesser negative contribution of external demand, mainly because of moderating imports. Inflation continued to rise, increasing to 34.5% in August. Consequently, the authorities attempted to reduce the liquidity in the system in order to narrow the spread between the official exchange rate and the attendant parallel rate through a series of measures: the elimination of the tax on financial transactions, settlement obligations in respect of structured notes, the issuance of bolivar bonds payable in dollars, the announcement of a possible repurchase of foreign debt, etc. Also to be included in the inflation-combating drive is the containment of public spending, which grew below the increase in revenue and in inflation. Regarding the external sector, and unlike the

other countries in the region, there was an improvement in the current account balance, linked to the trade balance, in view of the rise in oil exports (due to the increase in price, not in volume, which fell) and the easing in imports in the face of the diminished buoyancy of consumption and investment. A new tax on oil export gains was also approved, and further progress was made on the nationalisation programme. From September, the international financial instability prompted a very considerable widening of sovereign spreads in Venezuela, up to levels of 1,300 bp.

11.10.2008.