Introduction

The decline in global demand, which dragged down commodity prices, and the impact of the credit crunch, which spread to the emerging economies from mid-September, have brought growth in the Latin American economies grinding to a halt, interrupting one of the longest-lasting expansions (2002-2008) in their recent history. With a significant degree of synchronisation, activity in most of the Latin American economies posted negative quarterly rates in Q4, giving rise to a reduction in year-on-year growth from 5% in Q3 to 1% (see Table 1). In 2008 as a whole, GDP growth was 4.2%, a rate which, while the lowest for the past four years, reflects the buoyancy the Latin American economy enjoyed during the first three quarters of the year. However, more indicative of the current economic pulse is the convergence of the growth forecasts for 2009 towards negative rates, entailing a downward revision of more than 4 pp on the forecasts proffered just six months back (see Chart 1). This adjustment is not very different from that experienced by the other emerging regions (it is similar to that in Asia excluding China and India, and somewhat less than that in eastern Europe); but, seen in perspective, it contrasts with the resilience shown by activity in Latin America during the first year of the global financial turmoil.

Against this background, there has been a prompt economic policy response to the deterioration in the economic situation, with the dual aim of softening the adverse effects on activity arising from the credit crunch (see Box 1) and using all the available room for manoeuvre in respect of the countercyclical response. Significantly, most of the countries started from a favourable economic and financial situation, the outcome not only of the external environment but also of the macroeconomic stabilisation drive of recent years. This sound starting position meant that economic policies could offer some response, despite the difficulties of the global setting, which is in notable contrast to similar situations in the past. Exchange rate flexibility, the sizeable volume of reserves, the improved fiscal position and the reduction of financial vulnerabilities were the key props that provided for greater leeway. Although the economic policy response has not been sufficient to avert a far-reaching real and financial adjustment (similar to that in the other regions), arguably it has helped mitigate its effect.

It should be highlighted, in any event, that the channels through which the crisis has been transmitted to the various countries differ in terms of their relative significance, and that the room for manoeuvre has not been equal in all of them. Both circumstances help explain both the appreciable differences regarding the scale of the fiscal policy response and the growing convergence in the monetary policy area, as is analysed in section 4. Indeed, in many countries – though not in all – the reduction in financial vulnerabilities attained in recent years has provided for a more flexible use of the exchange rate as an initial external shock absorber, eliminating what was a significant constraint on monetary policy in the past and allowing it to bear the weight of many of the countercyclical policies in this period (see Chart 1). Conversely, the fiscal policy response (see Box 2) may have been limited by two types of constraints: on one hand, the fall in revenue and the decline in the primary surplus in some countries; and on the other, the external financial constraint, heightened by risk aversion, and which may hold in the medium term owing to the increase in bond (public or publicly backed) issues in the advanced countries.

Inflation, which was a constant concern in the first half of 2008, has become a secondary preoccupation in the last six months, since the weakness of demand and the fall in commodity prices have begun – slowly – to exert influence in moderating it and, more importantly, in tempering inflation expectations (see Chart 1). That said, consumer prices (which grew by

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

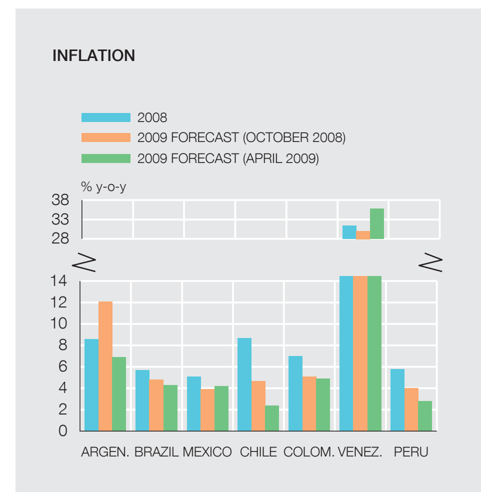
	2006	2007	2008	2007				2008				
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate)												
Latin America (a)	5.6	5.7	4.2	5.2	5.5	5.7	6.3	5.2	5.5	5.0	1.0	
Argentina	8.5	8.7	7.0	8.0	8.6	8.8	9.1	8.5	7.8	6.9	4.9	
Brazil	3.7	5.4	5.1	4.4	5.4	5.6	6.2	6.1	6.2	6.8	1.3	
Mexico	4.9	3.2	1.3	2.5	2.6	3.4	4.2	2.6	2.9	1.7	-1.6	
Chile	4.6	4.7	3.2	5.9	5.5	3.6	3.8	3.4	4.6	4.6	0.2	
Colombia	6.9	7.5	2.5	8.5	8.0	6.5	8.0	4.1	3.9	2.9	-0.7	
Venezuela	10.3	8.4	4.8	8.8	7.6	8.6	8.5	5.0	7.3	4.1	3.2	
Peru	7.6	9.0	9.8	8.8	8.1	8.9	9.8	10.3	11.7	10.7	6.7	
Uruguay	7.0	7.8	12.1	6.6	3.9	9.6	9.5	9.8	16.0	13.2	9.5	
CPI (year-on-year rate)												
Latin America (a)	5.2	5.4	7.9	4.9	5.3	5.4	5.9	6.6	7.7	8.5	8.5	7.4
Argentina	10.9	8.8	8.6	9.5	8.8	8.6	8.5	8.5	9.1	8.9	7.8	6.3
Brazil	4.2	3.6	5.7	3.0	3.3	4.0	4.3	4.6	5.6	6.3	6.2	5.6
Mexico	3.6	4.0	5.1	4.1	4.0	4.0	3.8	3.9	4.9	5.5	6.2	6.0
Chile	3.4	4.4	8.7	2.7	2.9	4.8	7.2	8.0	8.9	9.3	8.6	5.0
Colombia	4.3	5.5	7.0	5.2	6.2	5.3	5.4	6.1	6.4	7.7	7.8	6.1
Venezuela	13.6	18.8	31.4	19.0	19.5	16.2	20.0	26.3	31.0	34.6	33.4	28.5
Peru	2.0	1.8	5.8	0.4	0.8	2.4	3.5	4.8	5.5	6.1	6.6	4.8
Uruguay	6.4	8.1	7.9	7.0	8.1	8.7	8.6	7.7	7.6	7.6	8.6	7.5
BUDGET BALANCE (% of GDP) (b)												
Latin America (a)	-0.7	-0.5	-0.3	-0.5	-0.2	-0.2	-0.2	0.0	-0.3	-0.1	-0.3	
Argentina	1.8	1.1	1.4	1.5	1.6	1.7	1.1	1.5	1.6	1.9	1.4	
Brazil	-2.9	-2.2	-1.6	-2.6	-2.1	-2.2	-2.2	-1.6	-1.8	-1.3	-1.6	
Mexico	0.1	0.0	-0.1	0.7	0.4	0.1	0.0	0.0	-0.3	0.0	-0.1	
Chile	8.0	8.7	5.0	7.9	8.6	8.7	8.7	9.2	7.2	6.1	5.0	
Colombia	-3.7	-3.3	-1.7	-3.2	-2.1	-2.4	-2.8	-2.2	-2.5	-2.4	-1.7	
Venezuela	0.0	3.0	—	-1.3	1.2	0.9	3.0	—	—	—	—	
Peru	1.4	1.1	2.2	1.5	1.2	1.7	1.8	2.3	3.1	2.1	2.2	
Uruguay	-0.6	-0.3	-1.5	-0.8	0.5	1.0	0.0	1.1	-0.3	-1.1	-1.5	
PUBLIC DEBT (% of GDP)												
Latin America (a)	39.1	33.7	29.9	38.1	37.4	33.9	33.7	31.7	31.0	29.6	29.9	
Argentina	64.2	55.5	44.6	61.5	59.1	55.8	55.5	52.4	50.5	46.0	44.6	
Brazil	44.7	42.7	35.8	44.7	43.9	43.2	42.7	40.8	40.1	37.8	35.8	
Mexico	23.2	21.1	24.5	23.3	23.9	21.2	21.1	21.0	20.7	20.8	24.5	
Chile	5.3	4.1	5.2	5.2	5.1	4.4	4.1	3.6	3.9	4.5	5.2	
Colombia	44.8	32.9	33.4	42.7	42.2	35.6	32.9	32.6	32.5	32.7	33.4	
Venezuela	41.9	22.7	13.5	31.7	29.9	21.2	22.7	20.9	13.6	12.6	13.5	
Peru	32.7	29.7	24.1	30.8	29.6	31.4	29.7	27.6	25.3	23.9	24.1	
Uruguay	70.9	70.5	57.8	62.6	67.6	68.7	70.6	70.1	68.1	62.5	57.5	
CURRENT ACCOUNT BALANCE (% of GDP) (b)												
Latin America (a)	2.0	0.8	-0.4	1.7	1.5	1.1	0.9	0.7	0.5	0.4	-0.4	
Argentina	3.6	2.7	2.3	3.5	3.3	2.8	2.7	2.8	2.0	2.8	2.3	
Brazil	1.3	0.1	-1.8	1.1	1.1	0.6	0.1	-0.6	-1.1	-1.5	-1.8	
Mexico	-0.2	-0.6	-1.4	-0.5	-0.7	-0.7	-0.6	-0.5	-0.5	-0.9	-1.4	
Chile	4.7	4.4	-2.0	5.9	5.7	5.0	4.4	3.1	1.9	0.0	-2.0	
Colombia	-1.8	-2.8	-2.8	-2.5	-2.8	-3.0	-2.9	-2.2	-2.1	-2.1	-2.8	
Venezuela	14.7	8.8	14.3	12.0	10.0	8.8	8.8	11.5	14.7	17.8	14.3	
Peru	3.0	1.4	-3.3	3.2	3.0	2.1	1.4	0.3	-1.2	-2.2	-3.3	
Uruguay	-2.0	-0.3	-3.9	-1.3	-0.7	-1.1	-1.0	-0.3	-3.2	-3.3	-3.9	
EXTERNAL DEBT (% of GDP)												
Latin America (a)	22.4	21.6	—	22.8	22.9	22.4	21.6	19.9	19.1	18.3	—	
Argentina	47.5	47.3	39.1	50.6	50.8	49.2	47.6	46.6	44.6	40.7	39.1	
Brazil	16.1	14.7	—	16.4	16.4	15.9	14.7	14.1	13.3	12.8	—	
Mexico	13.4	12.6		13.8	13.3	11.5	11.0	12.1	11.6	11.3	—	
Chile	32.0	34.0	37.6	32.3	33.0	33.9	34.0	33.4	35.1	37.5	37.6	
Colombia	29.5	26.0	—	24.9	25.5	25.3	25.9	18.9	19.0	19.1	—	
Venezuela	26.9	24.4	—	25.0	24.3	24.1	24.4	25.0	23.9	21.3	19.6	
Peru	28.2	28.7	27.1	28.9	29.5	29.7	29.8	31.6	30.1	28.2	27.1	
Uruguay	54.6	52.8	—	50.3	54.7	55.2	52.8	51.2	47.7	43.9	—	

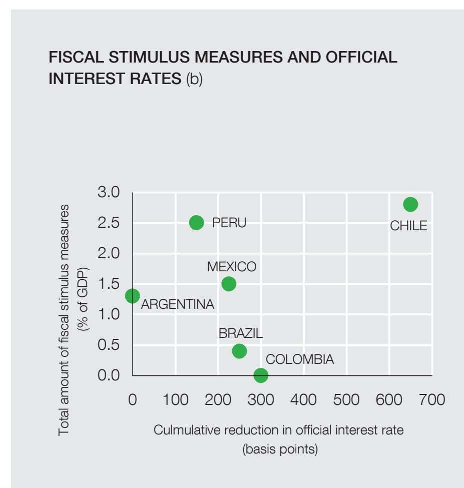
SOURCE: National statistics.

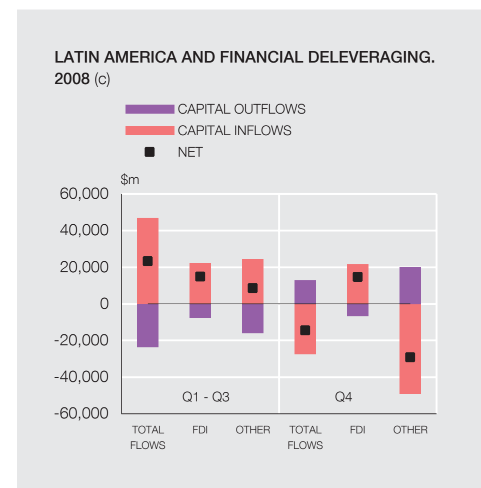
a. Aggregate of the eight countries represented, except Uruguay.
b. Four-quarter moving average.

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

CHART 1







SOURCES: National statistics, G20, Consensus Forecats, Datastream and Banco de España.

a. Seven biggest economies.
b. G20 data for Argentina, Brazil and Mexico. National statistics for the rest.
c. A plus sign (+) denotes positive inflows. A negative sign (-) denotes positive outflows.

7.4% across the region in March 2009 compared with a year earlier) continued to show notable downward stickiness, more so than in other advanced and emerging economies, and the depreciation in exchange rates since September may slow the ongoing moderation of inflation rates.

In sum, neither the reduction in financial vulnerabilities nor limited net borrowing have afforded sufficient protection for the Latin American economies from the effects of an international financial crisis that has entailed a strong reduction in external demand, credit restrictions and an across-the-board fall in confidence (see Chart 1). In this setting, some of the region's traditional difficulties at times of financial volatility – such as access to external financing – have reappeared, and certain latent vulnerabilities during the boom period – such as the structural fragility of public finances – have resurfaced. However, so far no country has seen problems in its financial system of the scale and nature of those experienced in the industrialised countries. The question is whether the economic policy response will be sufficient or not – and whether any leeway is available – to stave off the risk of financial crisis. Against this background, the extension of bilateral and multilateral financial support may prove a key factor in restoring confidence.

CHANNELS OF TRANSMISSION OF THE FINANCIAL CRISIS TO LATIN AMERICA AND ECONOMIC POLICY RESPONSES

BOX 1

The financial crisis originating in the United States impacted Latin America following several years of extraordinarily favourable external conditions, in which the region was the recipient of sizeable financial flows from the rest of the world. This box analyses the channels of transmission of the crisis to Latin America and the economic policy responses adopted.[1]

After a first year in which the financial turmoil had a limited impact on Latin America, the international financial crisis that began in mid-September was felt with great intensity, through the start of a severe process of deleveraging. Initially and particularly virulently, this process affected the countries with a greater degree of financial integration, such as Chile, Mexico and, especially, Brazil. As Chart 1 shows, the withdrawal of short-term foreign capital in Brazil from October amounted to $32 billion. In Mexico, the related amount was $8.1 billion. That prompted a depreciation of these countries' currencies from their 2008 peak of around 40% against the dollar. In Argentina, the downward trend of the currency was more moderate, but non-financial private-sector capital outflows stepped up (almost $9 billion in the second half of 2008), and there was a concurrent increase in the proportion of dollar deposits to almost 19% of the total, compared with 14% in early September.

Thus, as a result of deleveraging and of the habitual funding markets (foreign credit lines, currency swaps) drying up, the period in particular from October to November saw an appreciable rise in the cost of financing in dollars for local financial intermediaries and a significant credit restriction in this currency, with a particular impact on trade financing. The effects of this restriction were exacerbated by the habitual increase in the public's preference for the dollar as a safe-haven currency, and – on this occasion – by specific factors such as the reversal of foreign exchange derivatives transactions by certain non-financial corporations, which experienced heavy losses (Mexico, Brazil), and uncertainty over the capacity of local banks to refinance their foreign credit lines (Chile, Mexico).

In this situation, central banks took a wide range of measures, aimed chiefly at the following objectives: to mitigate the depreciation of their currencies; to ease liquidity pressures and the credit restriction on dollars; and to counter the tightening of financing conditions in local currency.

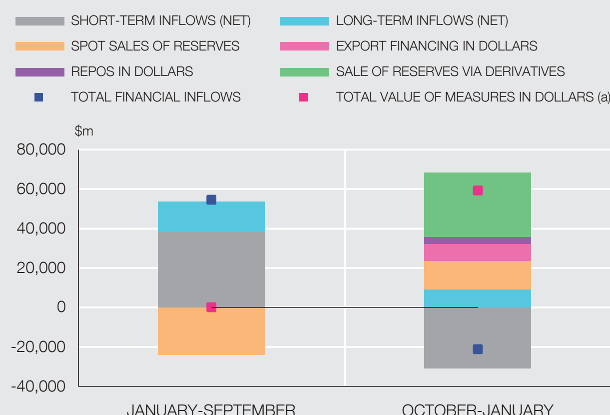
To mitigate the volatility of exchange rates, most central banks intervened selling reserves. In Brazil and Mexico, these sales totalled $15 billion and $19 billion, respectively, on the spot market, while intervention involving exchange rate swaps in Brazil amounted to $32 billion (see panel 2). A greater relative effort to sustain the currency was apparent in Peru, where the degree of exchange-rate flexibility is limited by the high level of financial dollarisation.

There were most considerable measures to increase liquidity in dollars in Brazil, where the central bank injected dollars into the interbank markets and conducted tenders of this currency to provide credit to the export sector and banking system. A mechanism – which has not yet been used – was also designed to provide for the refinancing of corporate-sector foreign-currency-denominated liabilities for an amount of up to $43 billion. In other countries financial inflows were encouraged by the reduction of foreign currency reserve requirements (Peru) and the elimination of taxes on financial inflows (Colombia). The Argentine and Chilean central banks also extended loans in dollars to commercial banks to facilitate foreign trade financing.

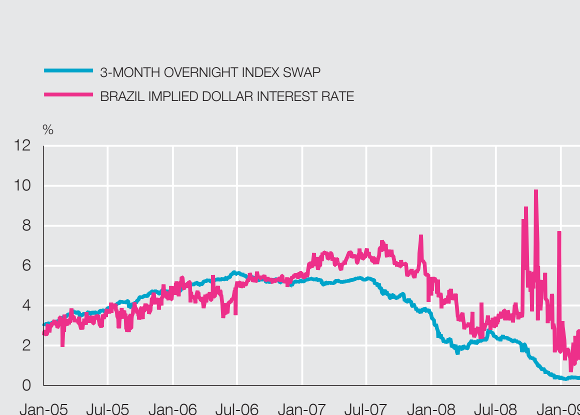
Overall, in respect of the measures aimed at alleviating local-currency funding difficulties, Brazil was also the most active country, given that a more severe risk of credit restriction was perceptible and there was greater room for manoeuvre. Reductions in bank reserve requirements have freed around 40% of the resources immobilised before the start of the crisis, equivalent to more than

1. An extensive country-by-country review of these measures can be found in: The reactions of Latin American and Caribbean governments to the international crisis: an overview of policy measures up to February 2009, ECLAC, 2009.

1 BRAZIL: FINANCIAL CRISIS, FINANCIAL FLOWS AND RESERVES



2 DOLLAR INTEREST RATES IN BRAZIL



SOURCES: Bloomberg and Banco Central do Brasil

a. The total value of measures in dollars includes repos in dollars, export financing in dollars, spot sales of reserves and sales of reserves via derivatives.

15% of banking system deposits, and changes have also been made to cash ratio arrangements to ease the transmission of liquidity in the interbank market. The authorities likewise attempted to support credit more directly, through injecting 100 billion reales (3% of GDP) into the public-sector development bank, and the approval of legislation allowing public-sector banks to acquire private banks. In Chile, the central bank allowed requirements in dollars to be covered by local currency. In Colombia bank reserve requirements were lowered, and the contractionary effect on liquidity of sales of reserves was offset by central bank public debt purchases, which were also resorted to in Chile. Argentina, Venezuela and Peru reduced reserve requirements in order to provide greater liquidity to the banking system. Mexico set in train a programme to increase short-term liquidity through interest rate swaps, the repurchase of government bonds and the extension of the eligible collateral for borrowing from the Bank of Mexico.

The measures adopted have met some of the objectives for which they were designed. Indeed, the use of international reserves has proved effective for addressing specific problems in foreign trade financing, for refinancing foreign-currency-denominated loans and for providing dollars to the financial system. Moreover, from a broader perspective, the fall-off in foreign financing has not resulted in a financial crisis in the region, which is a significant achievement. However, government intervention has not been able to counter more than partially the severe tightening of credit conditions, and in some countries it has not prevented a decline in credit, a situation which continues to worsen.

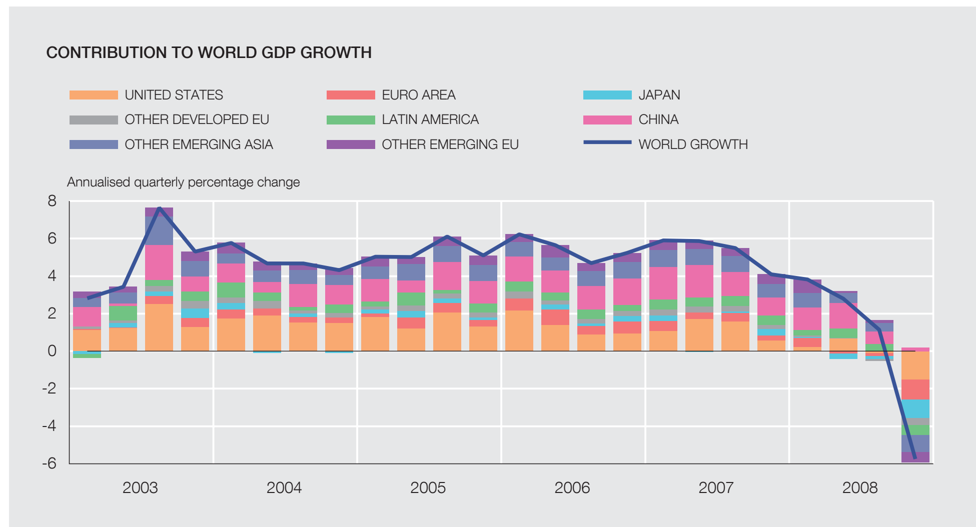
Economic and financial developments: external environment

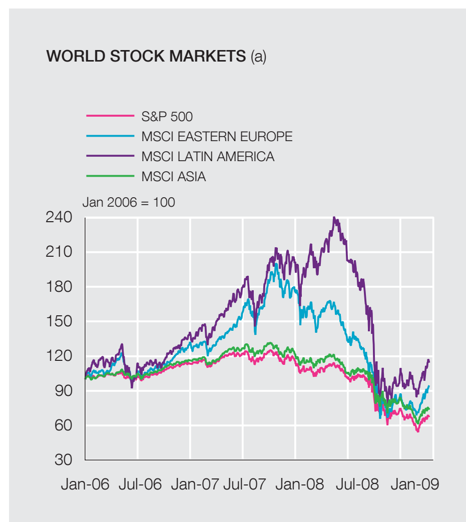
In the last two quarters of 2008 – especially in Q4 – and at the start of 2009 there was a rapid deterioration in the world economy, which moved into what may be characterised as a global recession. Following the bout of extreme tension that broke out on the international financial markets in mid-September, the world economy saw an unprecedented collapse in activity and trade as a result of the impact of the financial crisis (see Chart 2). The annualised quarterly rate of GDP fell by 6.3% in the United States, by around 6% in Europe and by almost 13% in Japan. In the main emerging countries there was also a strong correction in activity, though on occasions not as sharp as in the industrialised countries. In China, too, growth in Q4 was far lower than in the previous quarters, and the foreign trade indicators showed a significant contraction. In the Asian economies more open to trade, both exports and industrial production collapsed at double-digit rates, while in eastern Europe the risk of a regional financial crisis increased in light of the scale of their external imbalances. Against this backdrop, the growth outlook worsened globally, giving rise to a further strong decline in commodity prices from October, of 40% in the case of oil and of 25% in that of metals, this being a key factor for Latin America.

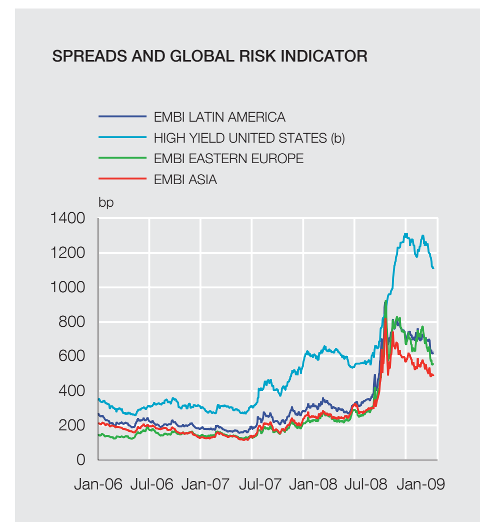
The situation required resolute monetary and fiscal policy measures, with sizeable cuts in official interest rates in the main developed and emerging economies. The Federal Reserve lowered its official interest rates on three occasions, from 2% to a range of 0%-0.25%, moving towards a non-conventional monetary policy framework that entailed a most substantial increase in its balance sheet and, moreover, the announced acquisition of long-term government debt for an amount of up to $300 billion, with the aim of facilitating the decline in interest rates. The ECB changed its policy stance and cut its official rate on five occasions, to 1.5%. And the Bank of Japan lowered its official rate to 0.10%. The flight to quality led US 10-year yields to fall to historical lows of 2% in late 2008, although they subsequently stood in a range of between 2.5% and 3%. Heightening risk aversion and the search for quality were also reflected on the foreign exchange markets, as highlighted by the clearly rising trend of the dollar against most of the emerging and developed countries' currencies, which was only interrupted significantly in March. In this respect and for much of the period, the dollar appreciated particularly sharply against some of the main eastern European currencies (the Polish zloty, the Hungarian forint and the Russian rouble). But currencies such as the Mexican peso, the Brazilian real or the Korean won have depreciated by more than 30% since the publication of the October half-yearly Latin American report.

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.

While recently there has been some stability, the financial markets are far from having returned to normal. This stability has largely been due to the swift application of support measures in the area of liquidity provision, recapitalisation, the providing of public guarantees and the purchase of troubled assets, which have contributed to sustaining the basic functions of the financial system, but have not restored agents' confidence. In the case of the emerging economies, an influential factor in stabilising the markets was the simultaneous announcements in late October by the Federal Reserve and the IMF, respectively, of a liquidity swap facility to Brazil, Mexico, South Korea and Singapore, and of a non-conditional short-term liquidity facility for countries with sound fundamentals and policies, which was later replaced in March by a more flexible facility (see Box 1). Sovereign spreads, measured by the EMBI+, have returned to levels around 650 bp after reaching 860 bp in late October, a six-year high, while stock markets hovered around minimum levels after the slump from July to October (see Chart 2). Region by region, the EMBI stood at very similar levels in Latin America, eastern Europe and Asia, although the increase was greater in eastern Europe, where the stock market performance was also relatively worse.

Activity and demand

The aggregate national accounts data for the region as a whole show the strong impact of the crisis on Latin America during 2008 Q4, when the economy grew by only 1% year-on-year, compared with 5% in Q3 (see Chart 3). Until then, the financial turmoil and the notable slowdown in the developed countries had only had a limited effect on the region. However Mexico and, to a lesser extent, Colombia, which were both ahead in the regional business cycle, had already experienced an appreciable slowdown in previous quarters, attributable essentially to the tightening of their monetary policies and to the subsequent decline in external demand. Nonetheless, there were abrupt and synchronised quarter-on-quarter declines in practically all countries in the region (–2.6% on aggregate) in 2008 Q4 (see Chart 3). At the end of the year, then, Chile was technically in recession according to the definition of two consecutive quarters of negative growth, and the rest (except Peru) were on the verge of recession. Brazil, whose growth accounted for more than 2.5 pp of the region's overall year-on-year growth to Q3, saw its contribution decline to only 0.5 pp, while Mexico's contribution was negative for this same amount. The region's very moderate year-on-year growth in Q4 was thus based on the contribution of Argentina, Peru and Venezuela.

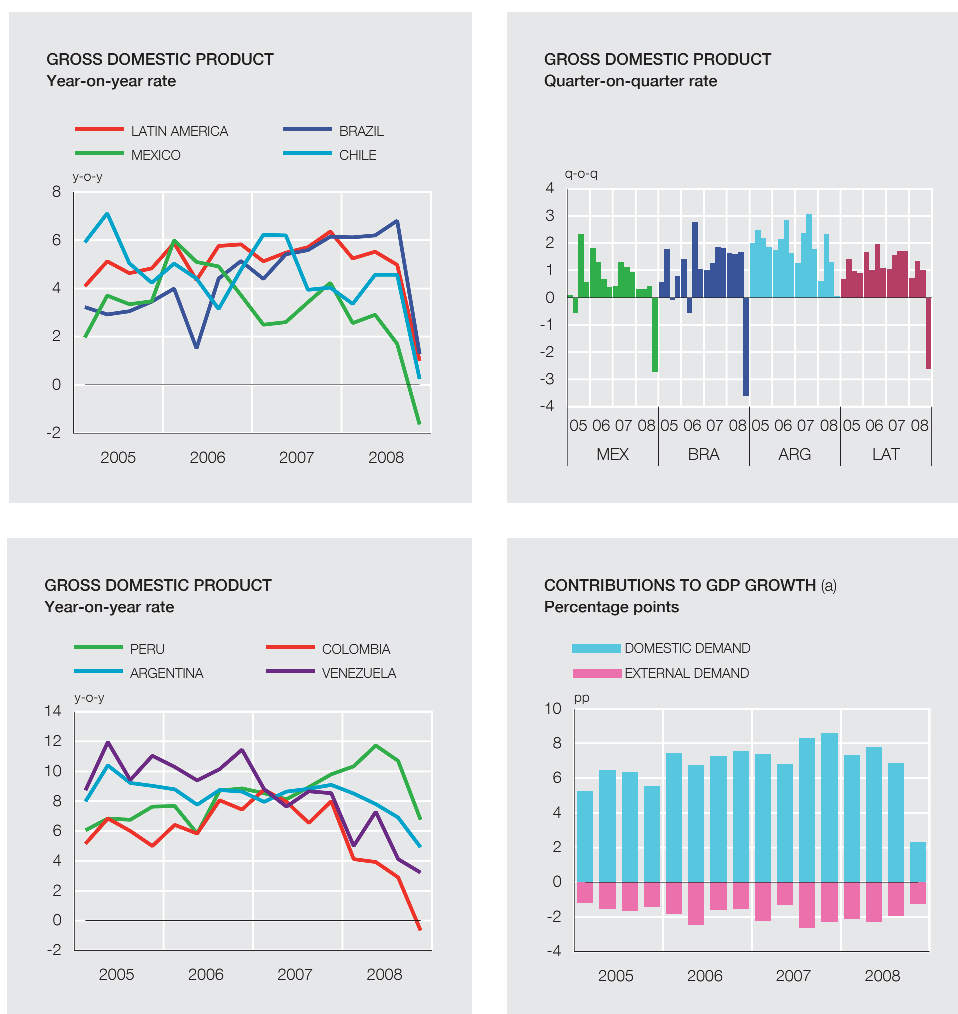
During the first year of turmoil, Latin America showed notable resilience. There was some consensus that this was based on very positive terms of trade, the reduction of financial vulnerabilities achieved in recent years and the reduced reliance on external financing, aspects which are interrelated to some extent. If this resilience was somewhat unexpected, so too was the abruptness of the current adjustment, which in some countries (Brazil and Peru) has entailed a decline in GDP growth of between 4 and 5 pp, in terms of the year-on-year rate, in only one quarter, and an even bigger fall in domestic demand. Conceivably, therefore, although the real channel was the dominant one for the transmission of the crisis from the start of the turbulence in most countries (including Argentina, Chile, Mexico, Peru and Colombia), its effect was slow and belated (in some cases a whole year) in filtering through to growth, owing to the soundness and to the inertia of domestic demand. However, from September, the sharp worsening in the international economic situation, the interaction of the financial transmission channel – through the credit crunch – with the real channel (in particular, the collapse of external demand and of commodity prices) and confidence effects have all resulted in a much more immediate and virulent impact on activity in only one quarter than in the whole of the previous year. It is illustrative here that the composition of GDP growth in the region in Q4, where the adjustment of domestic demand is on such a scale that it accounts for only 2.2 pp of year-on-year growth, compared with almost 7 pp in Q3 (see Chart 3). The negative contribution of external demand to growth was moderately corrected by the slowdown in imports (from 14.5% in Q3 to 2% in Q4), despite the strong decline in exports (–6.2% year-on-year), which is a further sign of the intensity of the adjustment.

Component by component, the biggest adjustment was in gross capital formation (which grew by 2.6% year-on-year, against 14.3% in Q3). This is the most cyclical component and is habitually affected most directly by changes in the availability and cost of financing. In addition, there was a fall in the price of commodities which, in the case of Latin America, are linked to a substantial portion of industrial investment (see Chart 4). This slowdown in investment was across the board, but particularly pronounced in the biggest South American economies (Argentina, Brazil and Chile), where this demand component had been more dynamic in recent years. However, perhaps the most salient development was the strong slowdown in private consumption (which increased by 1.7% year-on-year, compared with 5.3% in Q3), which was particularly evident in Mexico (posting negative rates), Brazil and Chile. The incipient deterioration in the labour market indicators, especially in Brazil and Mexico, the weakness of remittances flows, the change in the credit cycle, the worsening growth outlook and, in sum, the collapse of confidence are expected

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.

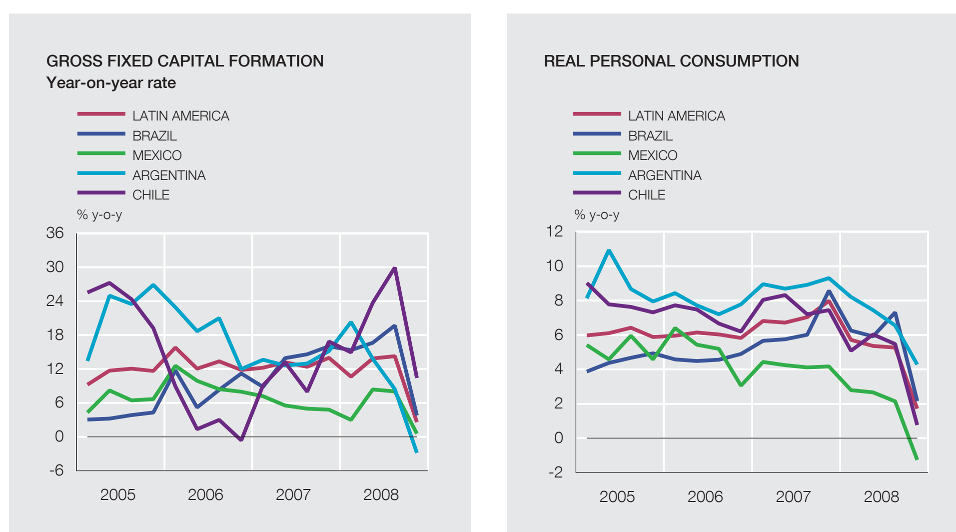
to make for an unfavourable outlook for consumption. Indeed, the higher-frequency indicators point to a possible intensification of the slowdown in 2009 Q1: industrial production was falling at a quarterly moving average rate of 10% in January, the biggest decline since 2002, while retail sales are slowing strongly and tax revenue is growing less than expected (see Chart 5).

This means that the factors which might a priori help mitigate the weakness of domestic demand (the expected fall in inflation, the cut in official interest rates, the restoring of credit thanks to public-sector backing and an expansionary fiscal policy stance) do not so far seem to be sufficient. Indeed, interest rates on credit have been raised in many countries (incorporating higher risk premia), credit to the private sector is slowing and new credit it is falling in the countries for which data are available (see Chart 5).

One key factor behind this deterioration in the economic outlook was the parallel collapse in imports and exports in the second half of the year. This was due, in part, to the decline in commodity prices from July (around 60%) and to the high component of import recycling business in the exports of several countries (Mexico, among others). Imports, which grew at a rate of close to 40% on average for the region in the first half of 2008, posted a negative rate of over

PRIVATE CONSUMPTION AND INVESTMENT
Year-on-year rate

CHART 4



SOURCE: National statistics.

a. Seven biggest economies.

10%, while exports underwent a turnaround from growth of 25% to a negative rate of –20% (see Chart 6). The scale of such rates is evocative of the slowdown in foreign trade in commercially more open areas, such as emerging Asia. Consequently, the negative contribution to growth of external demand fell, albeit only moderately; only in countries such as Venezuela (greatly affected by the decline in oil prices and more dependent on imports) and Argentina did the negative contribution of the external sector to growth increase. Against this background, the current surplus for the region as a whole has disappeared, following the declining trend in train since a peak was reached two years back. Chart 6 shows that the external position of all the countries is in deficit, except in Argentina and Venezuela.

Financial markets and external financing

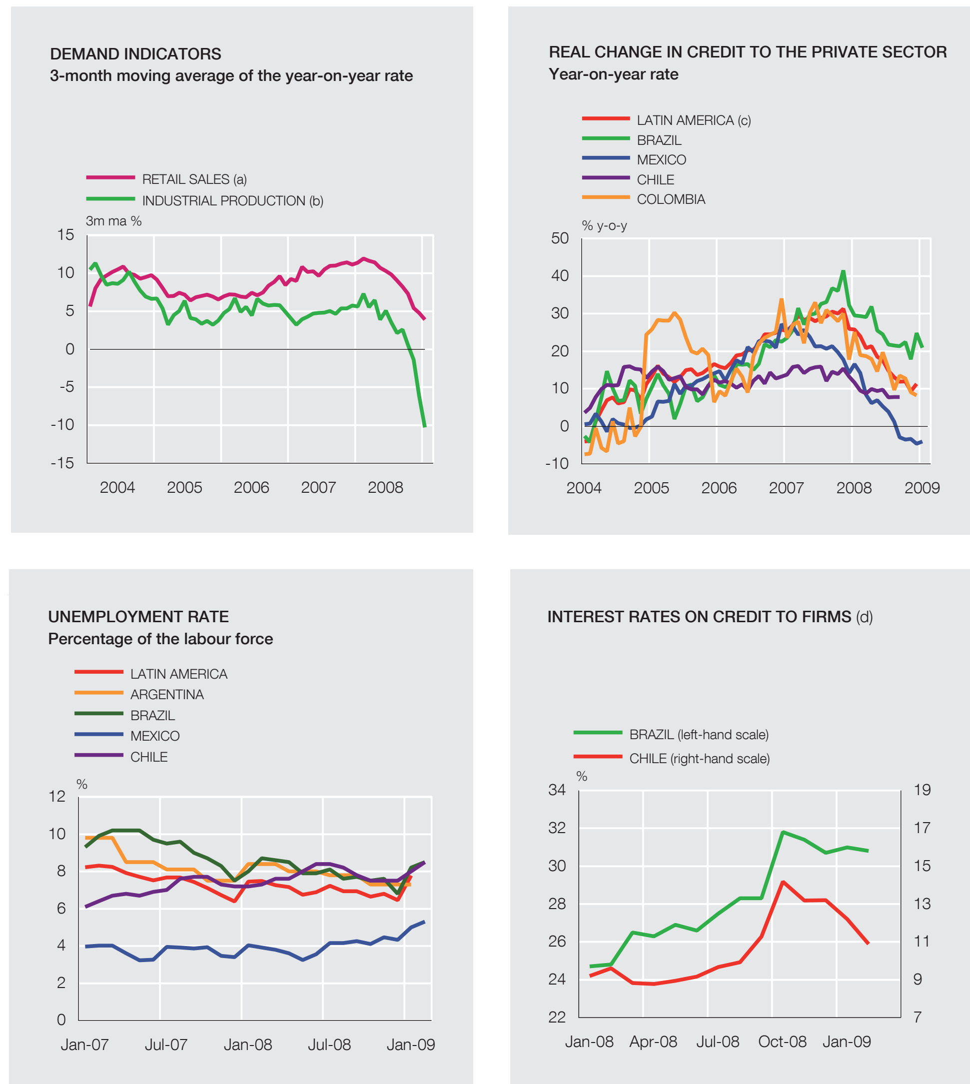
The global financial crisis in mid-September marked a key turning point for the region's financial markets. Although there had been a significant correction on stock markets and fixed-income markets since the summer, as a result of portfolio investment outflows, October and November saw bank flows and the usual funding sources practically dry up, along with a sizeable increase in the cost of bank and non-bank financing, and a sharp rise in the preference for the dollar. As Chart 1 shows, there was an abrupt reversal in Q4 in gross inflows in the region's four main economies (such inflows having amounted to more than $40 billion on average in the first three quarters of 2008). These turned into capital outflows of almost $30 billion, despite the more favourable and countercyclical behaviour of foreign direct investment, which partly offset the fall-off in "other flows" (around $50 billion).

In this setting, the currencies of the countries with the highest degree of financial integration (Brazil, Mexico and Chile) depreciated by close to 40% from their peak exchange rate in 2008 (see Chart 7). But their recent trajectory shows differentiated trends: the exchange rate of the Brazilian real has tended to stabilise, supported by central bank sales of reserves; the Chilean peso has appreciated (by 10% since mid-October); and the Mexican peso has fluctuated both ways, depreciating to mid-March (10%) and recovering thereafter. The downward movement was related to the vulnerability perceived in the Mexican economy owing to its ties to the United States and to doubts about its capacity to finance its current account deficit. Such doubts were alleviated from March further to the access to the IMF's new financing facility and to the Federal Reserve's swap facility. The Argentine peso, the exchange rate of which had held very stable since the start

DEMAND, CREDIT AND EMPLOYMENT INDICATORS

Year-on-year rates and their 3-month moving average and percentages

CHART 5



SOURCE: National statistics.

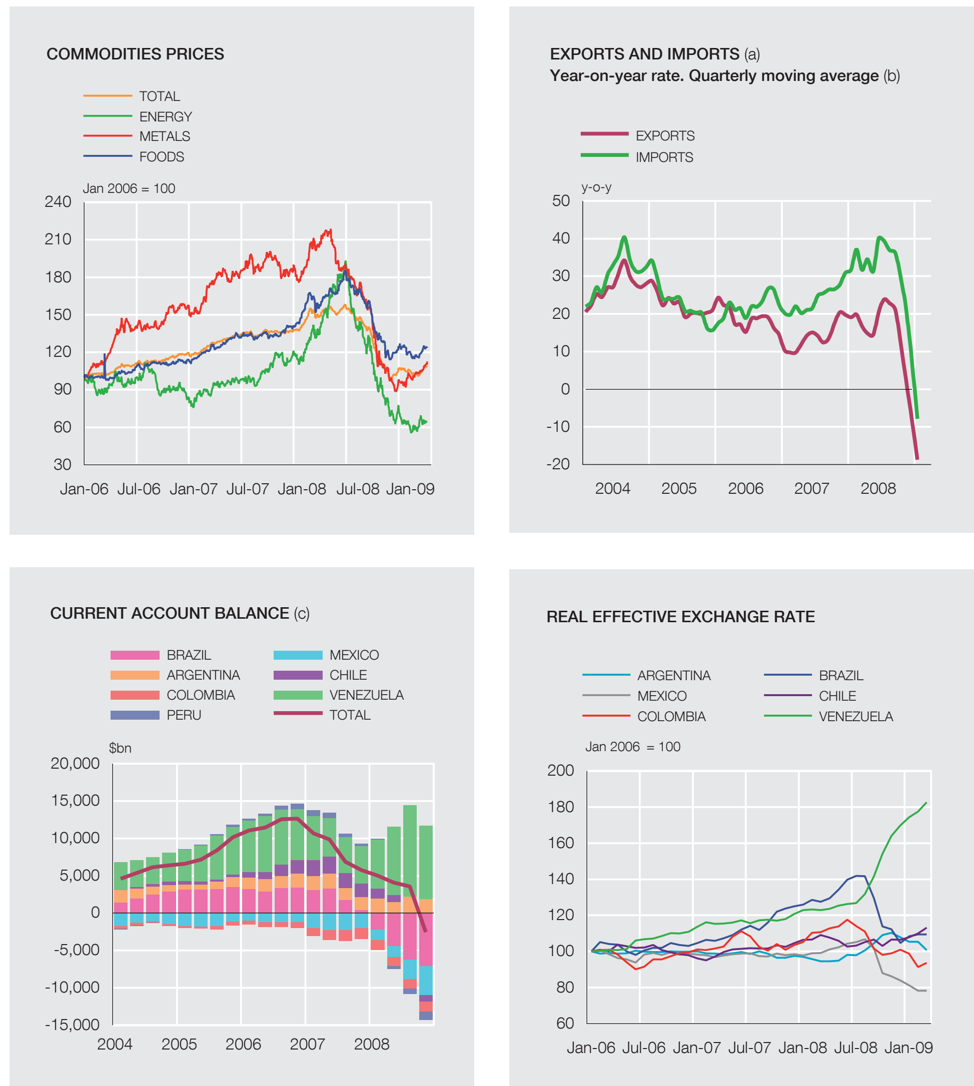
a. Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
b. Eight biggest economies.
c. Seven biggest economies.
d. Interest rates on credit to legal entities in Brazil; interest rates on trade credit in Chile.

of the turmoil, trended gradually downwards from October, recording a cumulative depreciation of 12%. The recent depreciation of exchange rates, measured in real effective terms (see Chart 6), shows a relatively generalised correction in the strong appreciation accumulated in the previous years, except in the case of the Venezuelan bolivar. In the case of the Mexican peso, a significant depreciation from the levels of three years earlier can be seen.

Sovereign spreads and implied CDS premia, after widening most substantially from mid-September to mid-October, have trended unevenly from country to country, highlighting some risk discrimination by the market. Thus, the sovereign spreads and CDS of Argentina and Venezuela have continued widening and reached a high, discounting a high probability of default. In the remaining countries, although CDS premia remained high, there has been some narrowing from the levels reached after the bankruptcy of Lehman Brothers, standing at around 300 bp in Brazil, Mexico, Peru and Colombia, and closer to 200 bp

EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rates of change, indices and billions of US dollars

CHART 6



SOURCES: National statistics and Banco de España.

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

in Chile, whose solvency was acknowledged with a further upgrading in March. In contrast, Argentina, Venezuela and Ecuador saw their ratings downgraded in this period (see Chart 7).

Finally, stock markets tended to stabilise and practically recover in full from late October, following the sharp declines (of around 40%) in the previous months. Hence, although volatility was marked, since October the main markets have picked up by around 15% in the cases of Brazil and Chile, but also in those of Venezuela and Peru. The Argentine, Colombian and Mexican markets held at levels closer to those in October.

Set against these developments, it is estimated that capital flows to Latin America in 2009 could fall most sharply: they would account for approximately one-third of net flows received in 2008 and eightfold less than in 2007, including a sizeable decline in foreign direct investment, habitually considered as the most stable source of financing (see Chart 8). Sovereign

and corporate issues fell significantly in the second half of 2008 and in early 2009. However, one positive aspect is that issuers such as Brazil, Mexico, Peru and Colombia have maintained access to international markets in this period, and they might already have met their financing needs for 2009 (and part of 2010 in some cases). The perception of greater refinancing risk has focused on private-sector issues, whose substantial maturities in dollars this year (see Chart 8) might have to be rolled over, in part, on local – and habitually narrower – debt markets, or through resort to bank credit. In any event, this refinancing risk is estimated to be somewhat less than in other emerging regions and might be partly alleviated by multilateral (IDB, IMF and WB) and bilateral financial support.

Prices and macroeconomic policies

Following the sizeable increase in headline and core inflation rates from early 2007, running through well into 2008 (up to a peak of 8.8% year-on-year in October in terms of the regional aggregate), both indices have begun to ease off in recent months (7.4% in March), albeit only moderately and with substantial differences from one country to another (see Chart 9). In Chile, the inflation rate fell appreciably, by more than 4 pp from October 2008 to 5% year-on-year in March, after five months of negative figures. At the other extreme, inflation in Venezuela has shown downward stickiness and stood at 28.5% year-on-year in March, only slightly below its 2008 peak. At an intermediate point are countries such as Mexico (6% in March) and Brazil (5.6%), where inflation has begun to ease only slowly, despite the intensity of the financial and real shock they underwent.

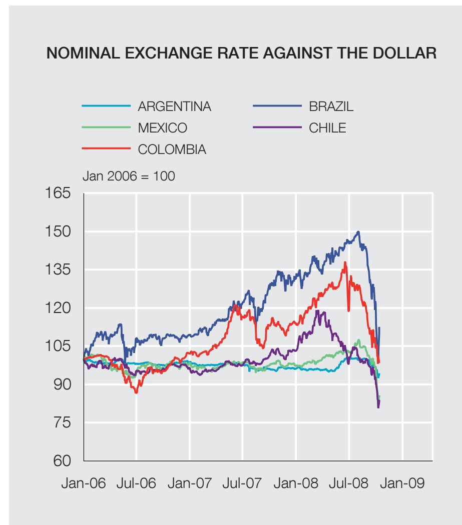
The fall in commodity prices is the main determinant of the easing in consumer prices in most of Latin America and, generally, worldwide, just as their acceleration in the previous phase was due to rising commodity prices. However, this easing off has been much more notable in the prices of energy than of food, which perhaps helps explain why the moderation in consumer prices has been slower in emerging economies, as in Latin America, where the weight of food in the CPI basket is greater and where the presence of energy consumption subsidies restricted the pass-through of the rise in oil prices to consumer prices (and now it should have prevented, in a symmetrical fashion, a clearer pass-through to a decline in the inflation rate) (see Chart 9). The existence of some market power in the setting of prices, as a determinant of their downward stickiness, has also been a concern in some countries.

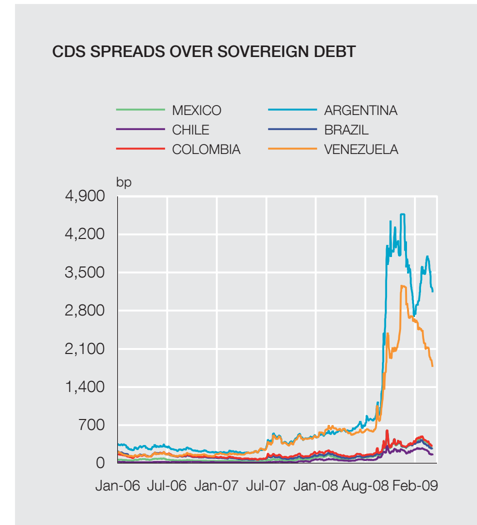
Notwithstanding, the deterioration in the terms of trade and the effect on aggregate demand in Latin America as a commodity-exporting region make for a significant change in the outlook for inflation in the coming months. In this respect, though there are risks arising from the existence of pass-through effects given the sharp depreciation in exchange rates in recent months, so far there have been no discernible pressures on import prices, production or the consumer prices of unprocessed food (the odd exception aside) that give credence to a clear concernin this connection. Conceivably, therefore, the moderate improvement in inflation expectations in recent months in most countries – that should be attributed, above all, to the deterioration in the growth outlook and to the forecast of extensive output gaps in the coming quarters – should restrict to some extent the upside risks to prices.

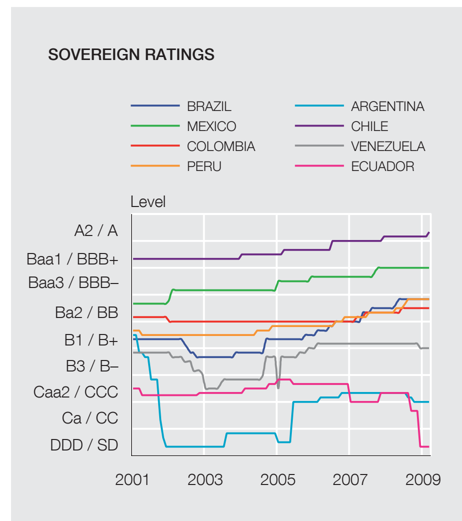
In terms of interest-rate cuts the monetary policy response was very cautious until the end of the year, in contrast to that in the developed countries, in a context in which the evidence of a turnaround in inflation was insufficient (see Table 2). However, monetary policy in recent months has been characterised by its use of a broader range of instruments than the interest rate. Accordingly, in order to analyse the effort in easing monetary conditions, it may prove misleading to focus exclusively on interest-rate movements. In particular, in October and November, when the exogenous contraction of monetary and credit conditions became more acute, most central banks in the region (notably Brazil, but the others too) set in train a wide range of measures in order to mobilise available resources to mitigate the effects of the

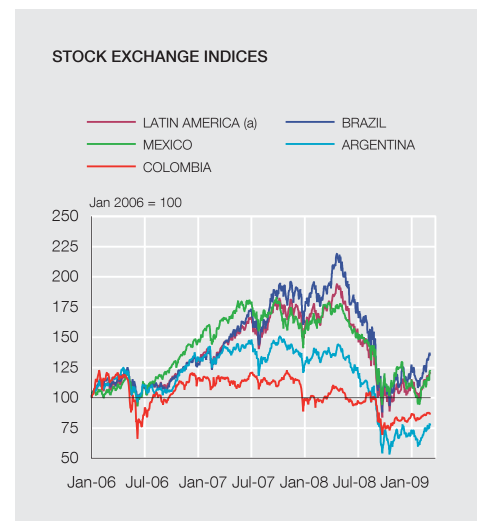
CDS SPREADS OVER SOVEREIGN DEBT, STOCK MARKETS, DOLLAR EXCHANGE RATE AND SOVEREIGN RATINGS
Basis points, indices and level

CHART 7









SOURCE: Datastream.

a. MSCI Latin America Index, in local currency.

credit contraction, with particular emphasis on facilitating the provision of dollars. Without intending to be exhaustive, Box 1 reviews some of these measures. In addition to the use of reserves to moderate exchange-rate volatility, central banks took measures in many different areas, supplemented in some cases by action by finance ministries. These included most notably: export credit (Brazil and Argentina); the refinancing of banking or corporate sector liabilities through the provision of dollars (Brazil, Mexico and Chile); the extension of local-currency-denominated liquidity provision, through the lowering of reserve requirements (Argentina, Brazil, Peru, Colombia and Venezuela); broadening the range of collateral acceptable to the central bank (Mexico and Argentina); and the financial reinforcement of public-sector banks to promote credit (Brazil and Chile).

The cycle of official interest rate reductions in the region began only in December, when Colombia made its first cut (of 50 bp, to 9.50%), two months after the concerted reduction in interest rates by the Federal Reserve, the ECB and the Bank of Japan in October. Chile was next, with an unexpectedly strong cut of 100 bp in January. And Mexico and Brazil

EXTERNAL CAPITAL FLOWS AND REFINANCING
Billions of US dollars and percentage

CHART 8

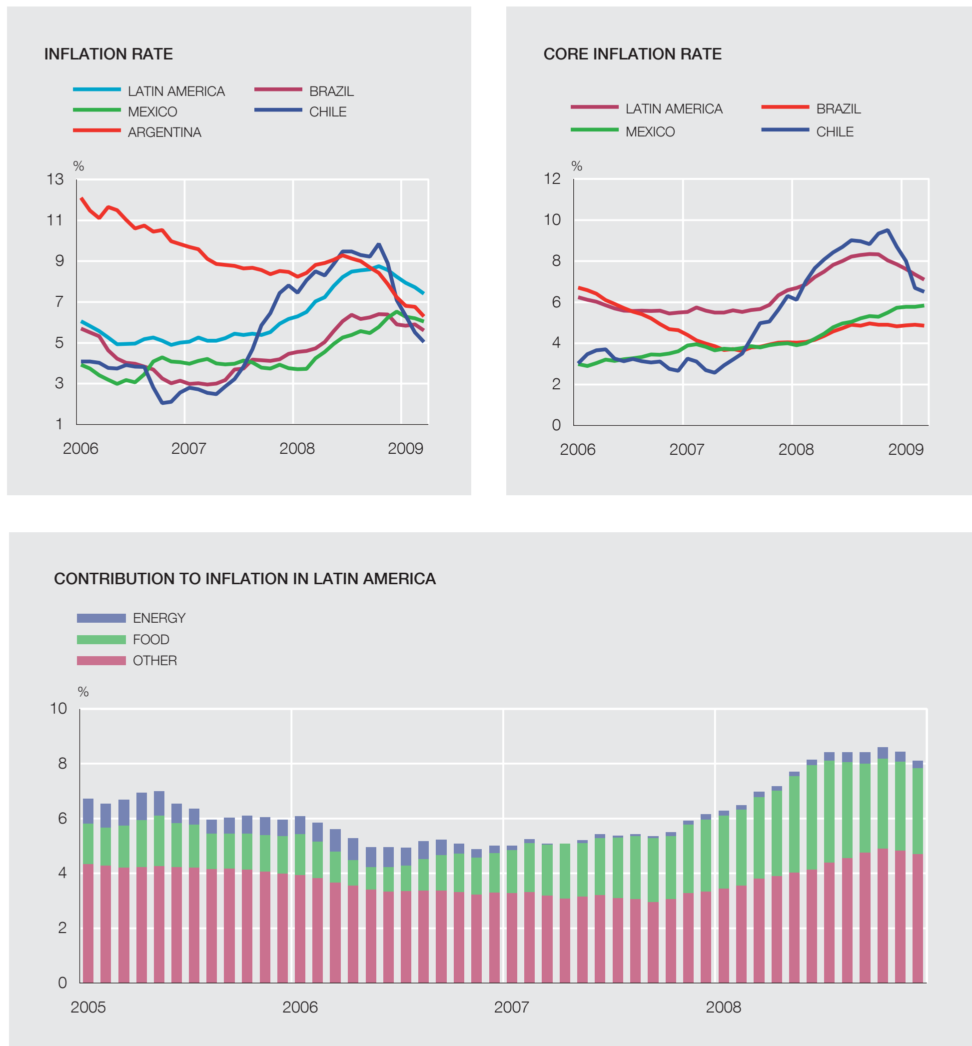
SOURCES: JP Morgan, IMF (GFSR) and national statistics.

a. 2009: Estimate.
b. IMF estimates for short-term private-sector and public debt issued in 2008 and long-term debt repayments in 2009.

followed suit, with cuts of 50 bp to 7.75% and 100 bp in February, respectively. Further cuts ensued, meaning that the cumulative decline to mid-April amounted to 650 bp in Chile and 250 bp in Brazil (in both cases entailing a complete reversal of the cycle of rises initiated in 2008 and, despite this, expectations remain on the downside), 300 bp in Colombia, 225 bp in Mexico and 150 bp in Peru. In this respect, it is worth highlighting the convergence ultimately seen among the countries pursuing inflation targets (firstly with Chile and Brazil, and after with Colombia, Mexico and Peru), as they have moved towards an acceleration of the cycle of interest-rate cuts as a monetary policy response, as opposed to a more gradualist approach, although in all cases inflation has stood to date above or in the upper range of the inflation targets (see Table 2). In this sense, Mexico and Peru, which appeared to have opted for a more gradual management of official interest rate cuts, changed their strategy. Mexico made a second cut of only 25 bp, but then took a surprise step with a third cut of 75 bp in March and a further 75 bp in April. Peru made a 100 bp cut in April, in light of the signs of the slowdown intensifying. Finally, in the countries not pursu-

INFLATION
Year-on-year rates of change

CHART 9



SOURCES: National statistics and Banco de España.

ing inflation targets (Argentina and Venezuela), monetary policy was steered by different considerations. The Argentine central bank held its interest rates unchanged despite some decline in the official measurement of inflation, although it implemented measures for greater liquidity provision, while the Bank of Venezuela shaved 2 pp off its reserve requirement in local currency and its regulated lending and deposit interest rates.

On the fiscal policy front, the key feature was the announcement of a series of relatively expansionary fiscal packages, as analysed in Box 2. In this respect, although revenue declined strongly in most countries at the start of the year, the fiscal indicators (fiscal balances, debt ratios, interest burden) continued to evidence until end-2008 a relatively favourable position. Nonetheless, the cyclical slowdown and the announced fiscal responses augur a clear deteriorating trend during 2009.

Other economic policies

During the second half of 2008 and the opening months of 2009, there was no substantial headway in structural reform, against a background in which policy measures were conditioned by the immediate response to the crisis. Brazil set up a sovereign wealth fund, equivalent to around 0.5% of GDP, which will be used to contain potential crises, to finance Brazilian

INFLATION TABLE 2
Year-on-year rates of change

Country	2007	2008			2009	
	Fulfillment	Target	Fulfillment	December	Target	Expectations (a)
Brazil	Yes	4.5 ±	Yes	5.9	4.5 ±	4.42
Mexic	Yes	3 ± 1	No	6.5	3 ± 1	4.05
Chile	No	3 ± 1	No	7.1	3 ± 1	2
Colombia	No	3.5 a 4.5	No	7.7	4.5 a 5.5	5
Peru	No	2 ± 1	No	6.7	2 ± 1	3

SOURCE: National statistics.

a. Inflation expectations for 2009 from the reports of central banks and private institutions.

companies' operations abroad and to guarantee government investments. In Venezuela, the nationalisation programme continued in the rice distribution sector, and fuel distribution in the country was granted on an exclusive basis to the State oil company. In Argentina the private management companies of pension funds were nationalised, with their resources being transferred to Social Security Funds. In Bolivia the new constitution, backing greater State intervention in the economy, was approved by referendum.

Trade integration processes were also affected by the new global economic context. In MERCOSUR, three of the four members announced the possible application of pre-import licences, or of measures protecting local industry. If implemented, such measures could reduce trade within the group. On the positive side, an initiative was launched for trade between Brazil and Argentina to be conducted in local currency. On 1 February, the Free Trade Agreement between Peru and the United States came into force, while Bolivia forwent the US trade preference arrangements granted under the ATPDEA programme.

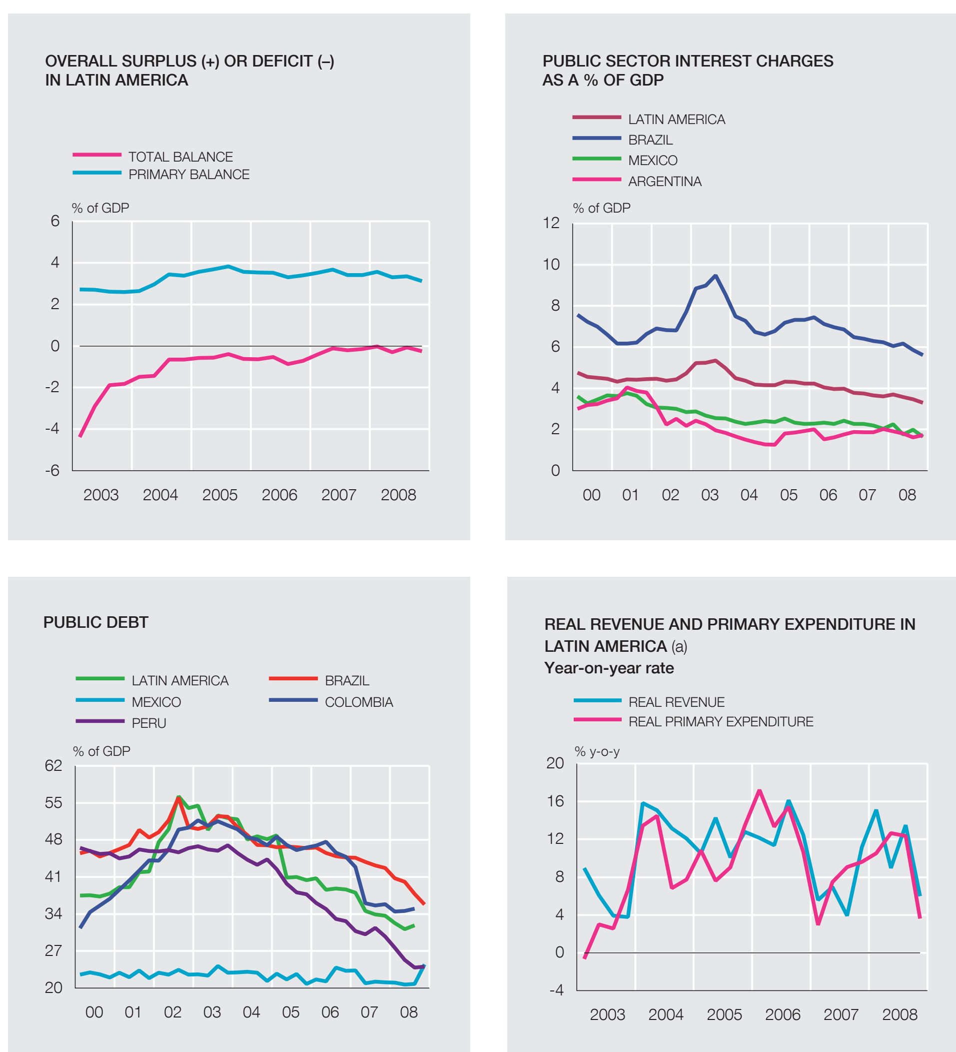
One particularly important area for international economic policy in recent months has been the G20 meetings, of which Argentina, Brazil and Mexico are part, and in which Spain has also participated. This forum has seen headway in international reform and cooperation, and means the region can better convey its interests at a time of difficulty such as the present. Its participation has contributed to the adoption of certain proposals conducive to the interests of the emerging economies, such as the increase in the IMF's financial capacity by up to $750 billion, the provision of funds for the reactivation of trade financing via multilateral banks and the creation of a new, more flexible lending facility, which Mexico and Colombia have already requested. Brazil and Peru have likewise acknowledged that they consider this facility useful, but have stated they do not intend to use it for the moment.

Countries

The Brazilian economy sustained a high growth rate in 2008 Q3 (6.8% year-on-year), but was severely affected by the deterioration in the international financial setting from mid-September. The economy contracted 3.6% in quarter-on-quarter terms in 2008 Q4, which entailed a notable decline in its year-on-year growth rate to 1.8%. However, growth for 2008 as a whole was 5.1%. The slowdown was principally due to domestic demand, the contribution of which to growth fell to only 3.2 pp from 9.2 pp in Q3, and particularly to investment (3.8% year-on-year, against 20% the previous quarter). Private consumption was also impacted, its year-on-year growth rate dipping to 2.2%, from 7.3% in Q3. Conversely, the negative contribution of external demand to growth fell slightly (to –1.8 pp from –2.4 pp of GDP in Q3), but there was a strong fall in exports (–7%) and a notable slowdown in imports (7.6%, against 22.8% in Q3). Against this background, the indicators for 2009 Q1 point to a continuation of the recession

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

CHART 10

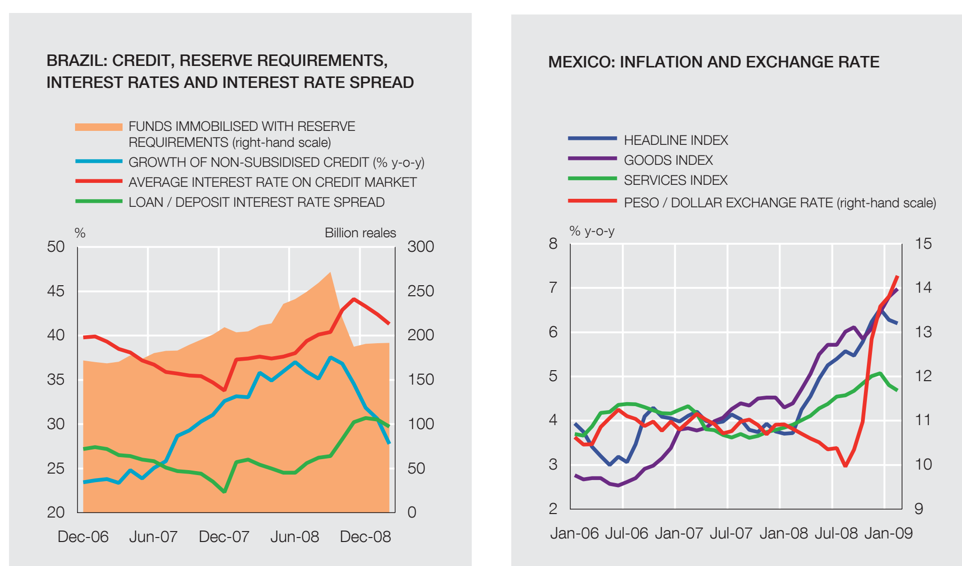


SOURCE: National statistics.

a. Deflated by the CPI.

and show clear signs of deterioration in the labour market. Along with diminished external demand, the chief impact of the crisis for the Brazilian economy has stemmed from the higher cost of and restricted access to credit, in particular to companies and for export (see Chart 11). Accordingly, the central bank intervened promptly, tempering the volatility of the exchange rate and providing liquidity in dollars and in local currency through various mechanisms. The measures adopted averted the collapse of credit to the export sector, although they were not sufficient to prevent a strong increase in the cost of financing and a reduction in the financial resources available. Turning to the external sector, the ongoing deterioration of the current account continued, with a worsening of the trade balance which, in part, was mitigated by the improvement in the income balance. There were also financial outflows from mid-September which led the central bank to intervene using substantial sales of reserves. Inflation remained high throughout the second half of 2008, close to the upper ceiling of the central bank's target (4.5% +/–2%), as a result of domestic demand pressures and food prices, although inflation expectations have tended to ease and to move closer to the mid-point of the range (4.5%). Consequently the central bank, despite the fact the inflation figures do not indicate a clear downward trend, opted to cut interest rates by 100 bp at its January meeting and by 150 bp at its March meeting, placing them at 11.25%. As regards fiscal policy, the year 2008 closed

BRAZIL AND MEXICO CHART 11



SOURCES: Central banks of Brazil and Mexico.

with a surplus of 4.1% of GDP, higher than the target of 3.8% of GDP. In January, however, some deterioration in public finances was discerned. This is due in part to lower revenue, and partly to agreed increases in current expenditure. Unlike in other countries in the region, Brazil has not announced a large-scale fiscal plan, despite having selectively cut taxes and reduced its primary surplus target to 2.5% (see Box 2).

Activity in Mexico slowed strongly in the second half of 2008, given that GDP growth averaged zero in year-on-year terms, against 2.7% in the previous half-year period. In Q4 there was a strong adjustment in activity. GDP fell by 2.7% in quarter-on-quarter terms (7% year-on-year) owing to the contraction in private consumption (–1.3% year-on-year). International trade also felt the impact of the crisis, since exports fell at a year-on-year rate of 8.8%, and imports by 7.7%. Inflation increased by more than 2 pp during the second half of 2008 to 6.5% in December, a six-year high and 2.5 pp above the Bank of Mexico's maximum range. This was chiefly as a result of food price developments (see Chart 11), although second-round effects were also evident since the core inflation rate rose from 5.1% to 5.7% on a year earlier. Between January and March inflation declined slightly, although the rate (6.1%) is still far higher than target. In this setting, inflation expectations, measured by the Bank of Mexico's monthly survey, trended upwards, to over 4% (the upper limit of the target corridor) for 2009 and 2010. These indicators, combined with the notable depreciation of the peso, posed a monetary policy dilemma, in a setting in which activity and the international environment were worsening substantially. At the four monetary policy meetings held in 2009, official interest rate cuts were announced: 50 bp in January, 25 bp in February and 75 bp in March and April, to 6%, which appears to highlight the growing weight that the output gap has had in the authorities' reaction function. The measures taken, along with the agreement by pension funds to invest only in domestic securities in 2009, the possibility of access to the IMF's new flexible facility ($47 billion) and the announcement by the Federal Reserve of a liquidity swap facility, have been conducive to a considerable recovery by the exchange rate since mid-March. Regarding the external sector, the current-account deficit widened notably in the second half of the year, standing at 1.4% of GDP in 2008. This was due to the deterioration in the trade balance, arising in turn from a collapse in exports (led by fuel and automobiles), which had been relatively robust during the first nine months of the year. The adverse trend of remittances prompted a strong decline in transfers, while inward foreign

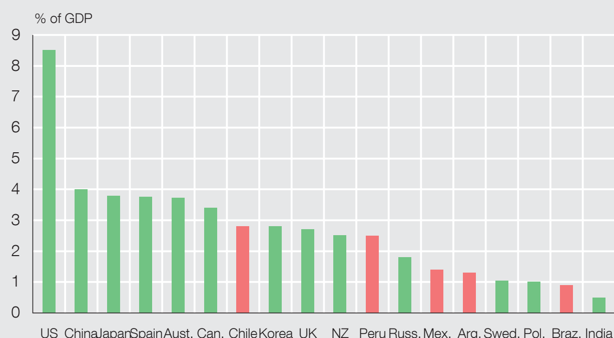
Latin American governments have responded to the global crisis not only with monetary and foreign exchange policy measures (see Box 1), but also with the implementation of fiscal plans, many of which contain measures involving financing to strategic sectors. This box seeks to examine three facets of this response: relative to the response provided by other economies; from a historical perspective; and across the other countries in the region. In addition, a summary of the main measures adopted in several of the region's economies is given.

Firstly, from an international perspective, the size of the fiscal packages announced in Latin America, measured as a percentage of GDP, is significantly below that observed in other regions (1.3% in average weighted terms for the five economies represented) (see accompanying panel), although in international comparisons such as this it is difficult to apply uniform concepts. Likewise, they are, on average, below the IMF's broad recommendation that fiscal expansions equivalent to 2% of GDP be implemented in those countries with the capacity to do so, although there are significant cross-country differences. For example, the amounts relating to the plans of two very open economies highly dependent on revenue from commodities (such as Chile and Peru) are above both the average and this recommendation. In this respect, one difference between the plans announced in Latin America and those of other countries is that the former focus their efforts on the current year (2009), while in the latter countries – especially in the developed economies – the announced stimulus is usually apportioned out over several years. In terms of composition, the measures announced in Latin America appear, by comparison, to have more features supportive of domestic consumption and to include a sizeable proportion of measures geared to financing companies and exporters (normally through the reinforcement of public-sector banks). This may be due, on one hand, to the general absence of automatic stabilisers in the region and, on the other, to the consideration of the export sector as strategic in most countries.

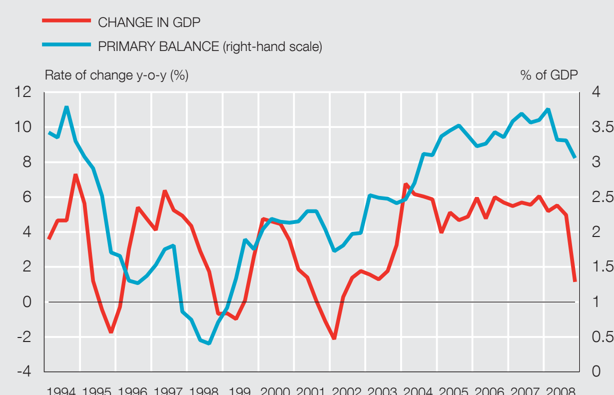
Secondly, from a time perspective, this is the first time that countries in the region are facing a crisis with some capacity to implement a countercyclical fiscal policy. As the accompanying panel shows, fiscal

1. Enrique Alberola and José Manuel Montero (2006), Debt Sustainability and Procyclical Fiscal Policies in Latin America, Documentos de Trabajo, no. 0611, Banco de España.

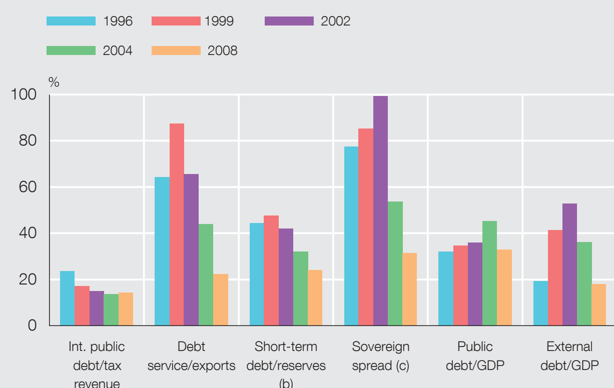
1 VOLUME OF FISCAL PACKAGES (a)



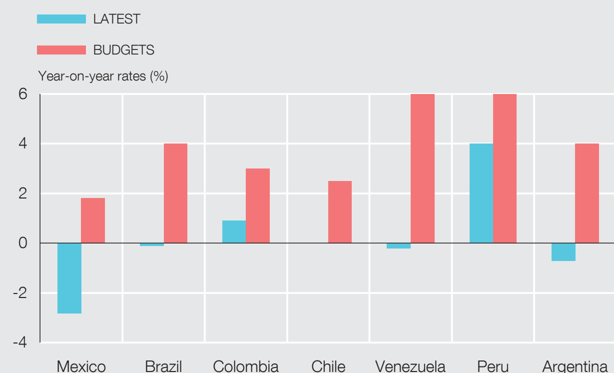
2 FISCAL STIMULUS IN LATIN AMERICA



3 VULNERABILITY INDICATORS



4 GROWTH FORECASTS



SOURCES: Banco de España and national statistics.

a. As % of GDP. Includes packages announced and/or approved, irrespective of the timing. Excludes all financial support measures.
b. Excluding Argentina.
c. In standardised bp.

policies, proxied by the primary balance as a percentage of GDP, have tended to be procyclical in the region. Following the Asian and Russian crisis (1998), or during the more recent phase of instability (2001-2002), the public-sector primary balance increased or held stable, denoting that fiscal policy was unable to exert a countercyclical effect, as a result of the high financial and fiscal vulnerability.[1] However, growth in the past cycle and the stabilisation policies pursued in the region in recent years have made for a more favourable starting position, reflected in lower external and public-sector vulnerability, which provides some leeway to pursue an expansionary policy in the current circumstances. The foregoing would also allow readier access to both domestic and external financing under relatively more favourable conditions, as the recent sovereign issues on international markets by Brazil, Mexico, Colombia and Peru would show.

In this respect, and from a regional perspective, the fiscal response of the Latin American countries to the crisis is far from uniform. Possibly, this diversity depends both on the intensity and nature of the shock each country has undergone and on the headroom for and limits to current borrowing capacity. Against this background, Chile is the only country which has been able to put a forceful countercyclical fiscal policy into practice, resorting to the prior saving in its Economic and Social Stabilisation Fund, which had accumulated up to 12% of GDP. As the accompanying table indicates, the announced plan in Chile would amount to $5.9 billion (3.6% of GDP), of which 2.8% of GDP might be considered fiscal policy in the strictest sense (tax cuts, spending on investment and transfers, and capitalisation of the State copper company, Codelco). The rest of the package comprises measures offering financial support to SMEs and exporters, and capitalisation of the State Bank. The programme is funded drawing on accumulated saving, although bond issues have also been authorised under the 2009 budget.

A similar case would be that of Peru, although its countercyclical responsiveness is considered to be somewhat less. A fiscal stimulus plan for approximately $3,850 million (3.4% of GDP) has been announced. It focuses on an increase in public spending (2.5% of GDP), although some measures were already included in the 2009 budget. Funding would be based partly on access to multilateral loans.

In Mexico, the room for manoeuvre is more limited owing to the lack of public-sector saving. But Mexico's access to international markets and to multilateral loans has enabled it to provide for fiscal stimulus on a considerable scale (1.4% of GDP). Mexico set out two plans: the first in October (the first plan submitted by an emerging economy) and the second at the beginning of the year, the main measures of which are an increase in public spending on infrastructure, a freeze on or reduction in energy charges, and an increase in public-sector employment.

Argentina has announced an expansionary fiscal policy ($3.5 billion, 1.3% of GDP). The fiscal package consists essentially of a public spending impulse (investment in infrastructure). In light of the lack of access to international markets, almost half the necessary funding would be from fixed-term deposits that had been held by the AFJP (the management companies of retirement and pension funds) – and which are now administered by Social Security Funds – and from the rollover of fixed-term funds and bills held by Social Security Funds.

Brazil and Colombia are two of the countries that have submitted more limited fiscal packages. This may be related to greater fiscal vulnerability, given their higher public debt and financial costs, and in Brazil's case with the fact that the credit restriction is the main problem facing it. Indeed, Brazil is the country in the region which has put forward the smallest stimulus in terms of GDP (excluding Ecuador), equivalent to 0.9% of GDP. However, Brazil has deployed sizeable resources to support the BNDES (National Development Bank) – 3.5% of GDP – and has recently reduced its primary surplus target for 2009 to 2.5% of GDP. To offset the effect of the fiscal package, the Treasury has announced a freeze on primary spending at 1.2% of GDP.

MAIN FISCAL AND FINANCIAL MEASURES IN LATIN AMERICA

	CHILE	PERU	MEXICO	ARGENTINA	BRAZIL
FISCAL PACKAGE AS % OF GDP	2.8%	2.5%	1.4%	1.3%	0.9%
TAX CUTS	- Financial transactions - Income tax - Corporate income tax	- Fuel tax - Customs duties	- Petrol prices frozen - Gas and electricity prices cut	- Sectoral tax - Income tax	- Financial transactions - Production taxes - Income tax
EXPENDITURE AND TRANSFERS	- Infrastructure - Housing - Social assistance - Sectoral subsidies	- Construction - Public investment - Social assistance	- Infrastructure - Temporary public employment - Energy subsidies - Social assistance	- Infrastructures	- Primary expenditure frozen at 1.2% of GDP
FINANCIAL SUPPORT	- Corporate capitalisation (CODELCO) - Recapitalisation BancoEstado - SMEs, exporters, housing	- SMEs and exporters	- Housing - Development bank - Pension funds (possibility of early withdrawal of funds)	- Tourism - Public transport	- Recapitalisation of public banking sector (3.5% of GDP) - Public banking sector support for sectors
FISCAL PACKAGE + FINANCIAL SUPPORT AS % OF GDP	3.6%	3.4%	—	—	4.5%

Finally, Venezuela acted chiefly to restrict the loss of revenue arising from the fall in oil prices, to uphold the public stimulus policy that sustained activity in 2008. In this respect, announcements have been made on a rise in the VAT rate, a 6.7% cut in administration expenses and a public-sector investment plan totalling $225 billion between 2009 and 2013 (11% of GDP each year), which is expected to be funded by international reserves and by a significant increase in domestic government debt issues.

In sum, most of the Latin American countries have been able to withstand the decline in activity with significant fiscal stimuli. That said, such stimuli have, on average, been on a lesser scale than in other emerging and developed economies, meaning that their fiscal policy might be moderately countercyclical in 2009, an unprecedented occurrence in the region. Nonetheless, beyond this initial reaction, the fiscal position is subject to notable limitations and risks. On one hand, there is a possibility that tax revenue has been overestimated in the budget, given the current economic slowdown. In this respect, the accompanying panel shows the difference between the growth forecasts in the respective budgets and the latest consensus forecasts released by analysts: there are notable differences in the cases of Mexico, Venezuela (exacerbated, moreover, by the projection of a $60 per barrel oil price, far above the present market price) and Brazil (the elasticity of whose revenue to the cycle is very high). On the other hand, from the standpoint of financing, the difficulties of global financial markets and the avalanche of issues by the industrialised countries to fund their own fiscal and financial plans might restrict the access of these countries to financing. Conversely, the IMF's new financial facilities may offer some support in this setting.

direct investment in the second half of the year fell by half. Public finances were virtually in balance (–0.1%) and the government devised two fiscal stimulus plans, which overall might be equivalent to 1.4% of GDP (see Box 2).

In Argentina the economy grew by 7% in 2008, the sixth consecutive year of growth. However, there was a significant slowdown during the year, especially in the final quarter, with growth running at a quarterly rate of –0.3% (and at an annual rate of 4.9%). There was a notable loss of momentum in investment, although private consumption also slowed. The negative contribution of external demand to growth increased once again in Q4, albeit without reaching the amount recorded in previous quarters. The volume of both exports and imports declined in that quarter. During 2008, the current account balance posted a surplus of 2.3% of GDP, only marginally below the related figure in 2007. The trade surplus widened by 21%, but was offset by a bigger deficit in the other items. Official measurement of the CPI revealed an easing of inflation during the year. The calculations by provinces or by private institutions indicate a similar moderating profile, but with higher inflation rates. Turning to public finances, the growth rate of tax revenue moderated in Q4 owing to the slowdown in activity and, especially, to the fall in agricultural commodity prices. Until Q4, the favourable trend of such prices (and the sale of stocks built up during the agricultural dispute) contributed to sustaining the government's primary surplus, despite the considerable increase in public spending, which was largely due to transfers to the private sector to contain prices in sectors such as energy, transport and food. To ease the redemptions and interest relating to public debt maturing in the period 2009-2011, the government carried out a debt conversion enabling capital maturities to be extended to 2014. The government further reformed retirement arrangements, eliminating the private pension system and transferring funds to the public pay-as-you-go system; a portion of these funds is being used by the government to reactivate credit to the private sector. The effects of the international crisis on Argentina were essentially manifest in a reduction in export prices, in a marked decline in share and bond prices (which had already been influenced by domestic uncertainty) and in the diminished supply of credit (even though an economy with relatively low levels of credit is involved here). In turn, the global financial crisis halted the government's plans to regain access to foreign credit by means of the cancellation of the Paris Club debt and the reopening of the government bond exchange programme launched in 2005. The government adopted several measures to face the crisis, including most notably the approval of legislation to promote the repatriation of funds held by residents abroad, the

reduction of labour costs and a fiscal package focusing chiefly on investment in public works and equivalent to close to 2% of GDP (see Box 2). The central bank entered into a currency swap agreement with the Central Bank of China for an amount of 38 billion pesos, which will be in force for three years.

In Chile, the economy moved into recession in the second half of 2008, with negative quarter-on-quarter growth rates of 0.8% and 2.1% in Q3 and Q4, respectively. The authorities reacted to this situation with a forceful fiscal and monetary expansion. In Q4, year-on-year growth was scarcely 0.2%. This was the result of the collapse in domestic demand, which declined from double-digit growth to contraction at the end of the year, owing to the slump in private consumption and investment in machinery and equipment. Exports declined strongly and imports posted negative year-on-year growth rates, albeit on a lesser scale. The outcome was the emergence of trade deficits in the last two quarters of 2008, against the background of the worsening terms of trade and a current account deficit (around 2% of GDP in 2008), despite lower outflows in respect of factor income. The budget surplus trended in parallel with production and the price of copper, leading it to post a surplus of 5.2% of GDP in 2008, but in Q4 the budget surplus was zero. A high budget deficit is projected for 2009, since it is expected these trends will continue and – thanks to Chile's capacity to pursue a countercyclical fiscal policy – that a fiscal plan will be implemented for an amount close to 3% of GDP (see Box 2). This plan has been supplemented in recent weeks by measures to stimulate credit. Inflation was on the verge of 10% in year-on-year terms, far exceeding the central bank target (3%), but there was a turnaround from November, with notable declines in the year-on-year rate (which stood at 5% in March). The central bank reacted to the fall in inflation and to the decline in activity with greater-than-expected cuts in official interest rates, for a total of 650 bp at four meetings, placing the official interest rate at 2.25%. Finally, in this difficult global setting, it was most notable that Moody's should upgrade Chile's sovereign debt rating from A2 to A1, citing the economy's resilience in the face of external shocks and the solvency of its public sector.

In Colombia, the slowdown in the economy continued during 2008 Q3, with growth of 2.9% year-on-year. The deceleration steepened in Q4, and there was a contraction of 0.7%. The financial crisis had a notable impact on the country's financial conditions, giving rise to financial outflows and a strong depreciation in the currency. Although the central bank had eliminated the taxes it had introduced on short-term capital inflows and sold moderate amounts ($500 million in total) of reserves to control exchange rate volatility, the peso depreciated. Despite the slowdown in domestic demand, inflation remained high and above the central bank target in the second half of 2008, ending the year above 7% (the target was in the 3.5%-4.5% range). In any event, the gradual convergence of inflation expectations and core inflation towards the central bank target (5% +/–0.5%), in conjunction with the lower growth outlook, enabled the central bank to initiate a cycle of interest-rate cuts which, after two 50 bp cuts and one 100 bp reduction, placed the official rate at 8%. On the fiscal front, Colombia's reaction was much more limited than that of its neighbours (see Box 2), probably due to its worse public finances position. However, the authorities ensured the financing of Colombia's external debt for the current year (partly through market issues, and partly through multilateral agencies) and undertook a debt conversion that lengthened the attendant maturities, which has eased the risks in this field.

In Peru, activity slowed in 2008 Q4 to 6.8% compared with the same period a year earlier. Nonetheless, growth for 2008 as a whole was 9.8%, the highest rate in the region. The slowdown in Q4 was essentially due to the deceleration in domestic demand, since the negative contribution of the external sector held at around 3 pp, as in previous quarters. As regards the external accounts, the current account ran a deficit of 3.3% of GDP in 2008, compared with the surplus of 1.1% in 2007. The deficit was the result of the progressive deterioration in the

trade balance, which recorded a deficit in Q4 for the first time since the beginning of 2002, owing to the slowdown in exports, the relative strength of imports and the deterioration in the terms of trade. And this despite the partial offsetting effect of lower profits at foreign companies, which repatriated fewer funds abroad. The rise in inflation continued in the second half of 2008, and this variable ended the year far above the central bank target, and began to ease only in early 2009. To face the international financial crisis, the central bank adopted a series of measures to increase liquidity in the financial system. Nonetheless, the Peruvian currency has depreciated gradually against the dollar in recent months. Moreover, at its meetings in February and March, the central bank cut its official interest rates by 25 bp, but the related cut in April was for 100 bp, to 5%. The budget surplus in 2008 was 2.1% of GDP, against 3.1% in 2007. In an attempt to withstand the slowdown in activity, a fiscal plan equivalent to around 2.5% of GDP (see Box 2) was approved.

In the second half of the year, Venezuela posted average growth of 3.7% year-on-year (4.1% and 3.2% in Q3 in Q4, respectively), marking a notable slowdown in growth in the first half of the year, weighed down by the collapse of oil prices. The current account posted a deficit of $4.5 billion in 2008 Q4, the biggest deficit in the time series, as a result of the fall in exports to one-third of their value. As to public finances, the growth of spending quickened substantially from Q2 and once again outpaced revenue. Despite the announcement of highly ambitious investment plans (see Box 2), it appears fiscal policy may be restricted in 2009, with a 6.7% cut in spending and a 3 pp rise in VAT. On the price front, the inflation rate reached 36% in October 2008, falling progressively thereafter to 28.5% in March. The price of food and beverages accounts for a large portion of these high rates. The abrupt deterioration in the current account balance and the fiscal policy stance underscore the fiscal dependence on oil in this economy and the difficulties it faces in the current circumstances.

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