Report on the Latin American economy. First half of 2011

Introduction

Latin America recorded aggregate growth of 6.3% in 2010,[1] the highest rate in the decade, exceeding by nearly two percentage points (pp) the average for the expansionary five-year period preceding the crisis. As in that expansionary phase, growth in the region was based on the vigour of domestic demand, which was again driven by the same, at least partially correlated, external factors. The first of these is the upward cycle in commodity prices, which benefits South American economies specialised in the export of these products by improving their terms of trade. This specialisation explains a large part of the divergence between the slower recovery of Mexico, integrated commercially and financially with the United States, and the dynamism shown by Argentina, Peru, Brazil and Chile (see Chart 1), which trade more with Asia and are more specialised (to varying degrees) in commodity trade. The second dynamism-enhancing factor is the large inflow of international financing into the region, reflected in favourable conditions of market access for both the public and the private sector, which has helped to drive the recovery of credit. In this respect, it should be noted that financing conditions have scarcely been affected in the last six months, except for a certain increase in risk premia and for the partial (and temporary) reversal of some capital flows due to the tensions associated with the European crisis, the socio-political instability in the north of Africa and the Middle East and the earthquake in Japan. This demonstrates Latin America's deep-seated resilience.

To the momentum provided by these external factors should be added the effect of a combination of economic policies which, although they have begun to turn towards the withdrawal of the stimuli provided during the crisis, have not been overly restrictive in any country. This has given rise to a highly expansionary macroeconomic performance in 2010 and the early months of 2011.

Thus, against the background of strongly growing economies and of a fresh upward trend in commodity prices from the end of 2010, inflation has begun to predominate amongst the economic policy concerns of the Latin American authorities in several of the countries with inflation targets. The average inflation rate of the region rose to more than 6.5% at the beginning of 2011, practically 1 pp above that at the end-2009 and in some countries approaching the ceiling of the target bands (see Chart 1). Additionally, some of this rise has fed through to expectations. Thus, although the rise in prices has been driven mainly by higher food prices, signs of demand pressure have been perceived in various economies, now that the output gaps which opened during the crisis have been closed.

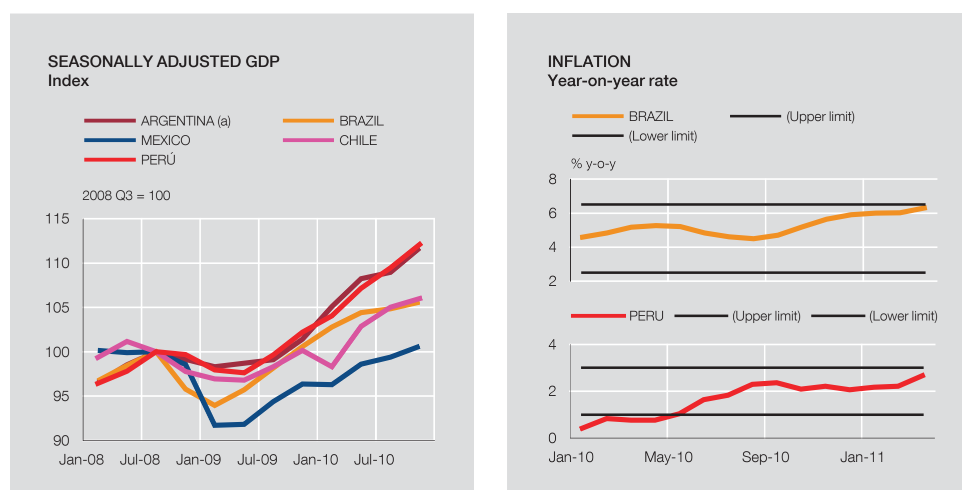
Monetary policy has continued to confront the dilemma of how to contain inflationary pressures before they end up disanchoring expectations and at the same time prevent the monetary tightening from further spurring capital inflows and exchange rate appreciation. In this situation, the reversal of the more volatile capital flows between January and March 2011, associated with the portfolio restructuring which prompted the improved outlook for the American economy, mitigated the dilemma at least temporarily and gave the authorities more room to tighten monetary policies. Four of the five central banks in the region which have inflation targets raised their official rates at that time, following the pause or slowdown in the cyclical rises in the closing months of 2010.

Against this background, the recent economic developments pose some uncertainties. Particularly noteworthy is the notable divergence between the stagnation of industrial production

1. This is the weighted average growth rate of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela, the countries on whose data this report is based.

SEASONALLY ADJUSTED GDP AND INFLATION
Index and year-on-year rate

CHART 1



SOURCES: National statistics and Datastream

a. Analysts consider that Argentinean GDP growth in 2008 and 2009 was considerably lower than the official figures. This discrepancy seems to have diminished in 2010.

in various countries since 2010 Q2 and the strength of the consumption indicators. In a setting of strong commodity price rises like the present one, and of across-the-board exchange rate appreciation (the Brazilian real and the Chilean peso are among the currencies which have appreciated most since 2009, these being, in general, the currencies of commodity exporting countries), it may be asked whether the current trend towards more moderate growth reflects a shift towards more sustainable rates or whether, by contrast, it may be a symptom of loss of competitiveness or "Dutch disease".

Despite these overarching doubts, the short-term prospects for Latin America remain favourable. In 2011 growth may moderate towards rates more compatible with potential growth, reflecting the closure of the output gap and the progressive tightening of policies. The main short-term risks include higher oil prices, the still fragile European situation and the possibility of overheating of some economies in the region. This latter risk will be more serious if economic policies do not respond quickly enough, giving rise to a disanchoring of inflation expectations or to greater fragility of the external accounts. The recent oil price rise will have an uneven impact on the region, with Chile being the potentially most prejudiced country in terms of growth and inflation due to its greater energy dependence; by contrast, Venezuela is the most favoured country because its exports consist almost entirely of oil. In terms of trade exposure, Latin America's exports to North Africa and the Middle East represent a small fraction of its total exports, as do its exports to Japan (around 5% of total exports). Exports to the euro area are significant (more than 12% in aggregate, although they vary widely across exporting countries), but not those to the countries most affected by the crisis (around 3% of total exports). For this reason, a significant direct impact through the trade channel is not to be expected, nor has there been one through the financial channel.

Meanwhile, the firming of the global economic recovery, particularly in the United States, may moderate capital inflows into Latin America, thereby helping make monetary policy management easier, as noted above. However, this may involve a certain risk of reversal of capital flows, although, given the region's fundamentals, this does not seem likely. In the medium term, the main risks derive, first, from the possibility of a disorderly adjustment in interest rates in the United States (due to the eventual withdrawal of monetary stimuli or to the deterioration of the

fiscal situation in that country), which, if sharp, could prompt a significant reversal of capital flows; and, second, from a strong deceleration of growth in Asia, given the region's dependence on it. These risks underline the need to take advantage of the current expansionary phase of the cycle in Latin America to rebuild the policy margins eroded during the crisis and strengthen the capacity to absorb capital inflows, insofar as they are permanent.

Economic and financial developments: external environment

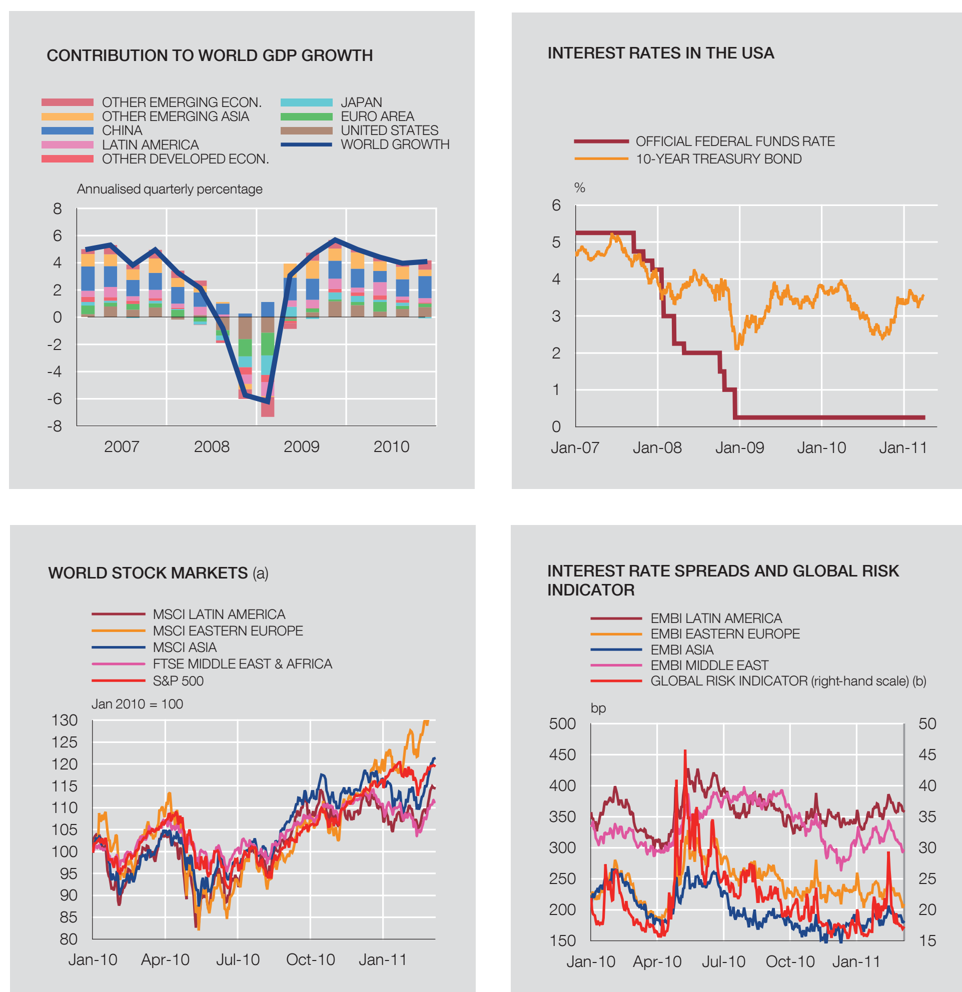
Following a moderate slowdown in mid-2010, global economic activity rose somewhat in 2010 Q4. The introduction of new expansionary monetary and fiscal measures in United States contributed to put the global recovery on a firmer footing, despite the re-emergence of sovereign tensions in the euro area, this time linked to the fragility of the Irish banking system. Thus, against a background of prolonged dynamism of the emerging countries, the US economy picked up slightly in the last quarter of the year. However, some European economies, both in the euro area and, above all, the United Kingdom, continued to show signs of weakness. The latest indicators for the developed economies point to a continuation of the recovery despite the persistence of the sovereign crisis in the euro area, the geopolitical tensions in the Arab countries (which are exacerbating the upward trend in oil prices) and the Japanese earthquake with its grave consequences. In the United States, the job creation and industrial production figures seem to evidence a firmer pattern, although the delicate fiscal situation continues to be a significant source of uncertainty.

The emerging economies continued to show considerable dynamism, especially in emerging Asia, which recorded year-on-year growth of 8.5% in the fourth quarter. Hence these economies continued to account for a substantial part of global growth (see Chart 2). Some of them showed signs of overheating, against a background in which commodity prices continued the upward trend initiated in mid-2010. The rises were particularly sharp in crude oil as a result of the instability of some of the main producers, which added to the pressure exerted by the robust demand, and the price of Brent oil topped $120 per barrel at the beginning of April, compared with $80 per barrel at the end of September.

Against this backdrop, the international financial markets showed uneven behaviour across regions in 2010 Q4, within a global trend towards normalisation. The United States saw stock market gains and falling risk premia on debt securities, in a setting of improved economic prospects. By contrast, the euro area suffered a fresh outbreak of tensions in the sovereign debt markets owing to the Irish crisis, which was reflected in broader spreads on government securities in the countries farthest from the euro area core countries. In the early months of 2011, the international financial markets were increasingly affected by the tensions in the Arab countries and, to a greater extent, by the earthquake in Japan and its grave consequences. However, despite these events, which caused volatility to surge, there was a moderately positive trend in the markets, underpinned by the good growth prospects.

In the area of monetary policy, official interest rates held near to zero in the advanced economies. In addition, following the signs of weakness in activity in mid-2010, the authorities of Japan and, in particular, of the United States stepped up the quantitative stimuli in the last part of 2010. Subsequently, against a background of firmer recovery and expectations of rising inflation, the markets began to discount earlier rises in official rates, particularly in the United Kingdom and the euro area. In fact, the ECB raised its policy interest rate by 25 basis points (bp) to 1.25% on 7 April. In the case of the Bank of England, the markets expect the upturn to start in spring. In this respect, the increasingly imminent withdrawal of the extraordinary stimuli in the advanced economies represents a certain risk to the recovery, which in some of these countries is still fragile. Further, the improved growth outlook in late 2010 prompted rises in the yields on long-term debt in the United States, which increased by around 100 bp in Q4 to nearly 3.5%, fluctuating around this level in 2011 to date (see Chart 2). In the foreign exchange markets, the sharp depreciation of the

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS CHART 2
Annualised quarterly rate, percentage, basis points and indices



SOURCES: National statistics and Datastream

a. Indices in dollars.
b. VIX.

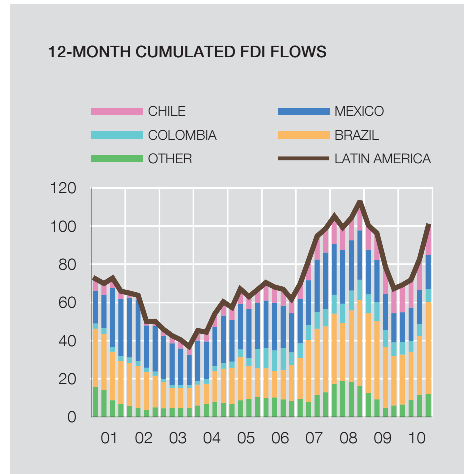
dollar from March 2010 reversed in the closing stages of the year. Also noteworthy was the upward pressure on the yen following the earthquake, which triggered a coordinated intervention by the G7 to halt this movement, which was successful. Emerging markets performed favourably in the period, in line with the perception of strength of these economies (see Chart 2).

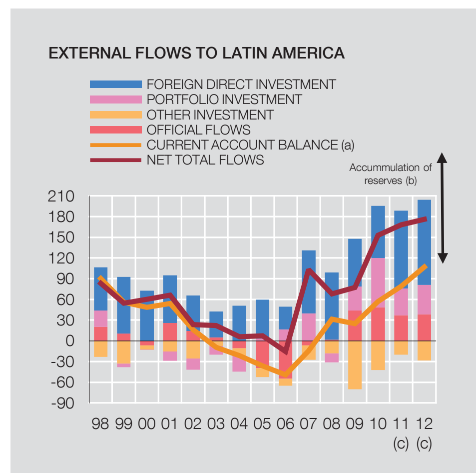
Financial markets and external financing

In the last six months the Latin American financial markets have gone through two clearly differentiated phases. In the first, which lasted until end-2010, the indirect effects of the monetary relaxation in the United States and the favourable growth prospects in the emerging economies continued to dominate. This gave rise to fairly widespread rises in stock markets and to the stabilisation of sovereign spreads near their historical lows, this tendency only being interrupted by sporadic temporary rises in volatility due to external events (such as the Irish crisis in November). Exchange rates tended to stabilise after appreciating in the preceding months, and in some countries this stabilisation was associated with the imposition of capital controls or an increase in interventions to purchase reserves. Notably in 2010 the volume of capital inflows reached that recorded before the crisis and, in certain specific segments, amply exceeded it (portfolio investment, $95 billion in year-on-year terms; see Chart 3). Foreign direct investment, which had tended to lag behind portfolio flows in the initial quarters of the recovery, recovered strongly in 2010 H2, reaching $100 billion in year-on-year terms. Also, a considerable number of sovereign and corporate

EXTERNAL CAPITAL FLOWS AND FINANCING
$ bn and %

CHART 3





SOURCES: JP Morgan, IMF and national statistics.

a. A positive sign denotes a current account deficit.
b. Difference between investment flows and the current account deficit (-).
c. WEO forecasts (April 2011) for 2011-2012.

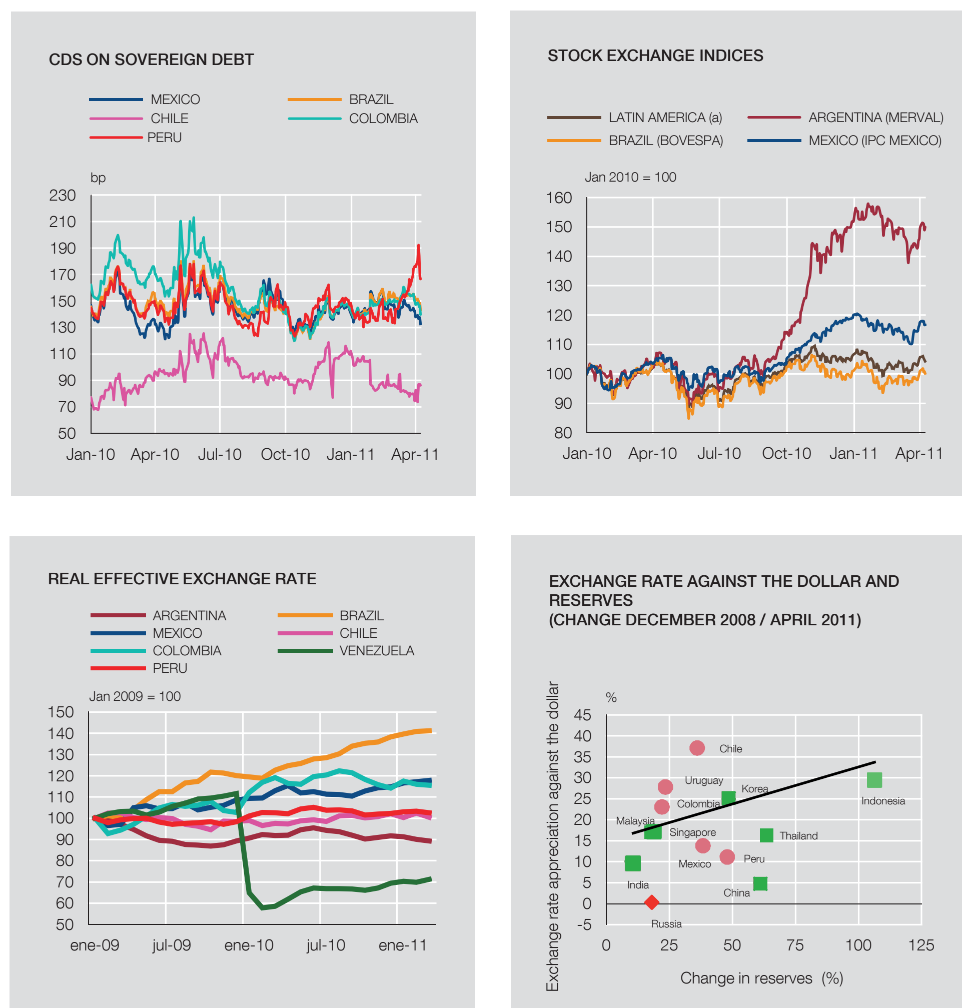
issues were launched on the international markets, mainly by primary sector firms, particularly in Brazil and Venezuela, followed by banks, especially in Brazil and Colombia. The gross capital flows into the region reached a historical high (more than $250 billion), and the region's relative share of the total flows to emerging economies increased significantly, a trend which will foreseeably continue in the following years according to the latest IMF projections.[2]

This first phase was followed, between January and March, by a period of higher volatility in the Latin American financial markets, in a setting of apparent rebalancing of international portfolios towards the developed markets, particularly the United States, given the confirmation of improved growth prospects. The higher volatility derived from events in the Middle East and the Japanese earthquake affected the Latin American markets moderately, principally the higher risk ones (Argentina and Venezuela) and those with a higher exposure to Japanese investors (Brazil and Mexico, whose currencies depreciated sharply in the week following the earthquake). Against this background, the stock market indices fell and the sovereign spread widened. In the local-currency debt markets, yields rose also because of the upward trend in inflation and the sharper pace of

2. The gross capital flows to Latin America in 2010 accounted for 27% of the flows to emerging economies, behind Asia (45%) and ahead of eastern Europe (9%). This percentage is 10 pp higher than Latin America's average level for the decade.

CDSs ON SOVEREIGN DEBT, STOCK MARKETS, REER, EXCHANGE RATE AGAINST THE DOLLAR AND RESERVES
Basis points, indices and percentage change

CHART 4



SOURCES: Datastream and JP Morgan.

a. MSCI Latin America Index in local currency.

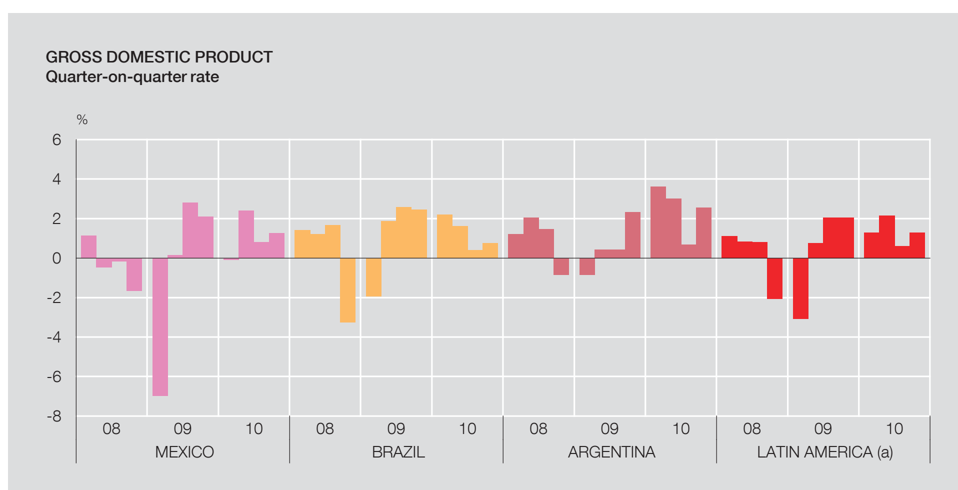
official interest rate rises in some countries. However, in April these trends began to reverse again and exchange rates came under renewed upward pressure, reflecting new capital inflows.

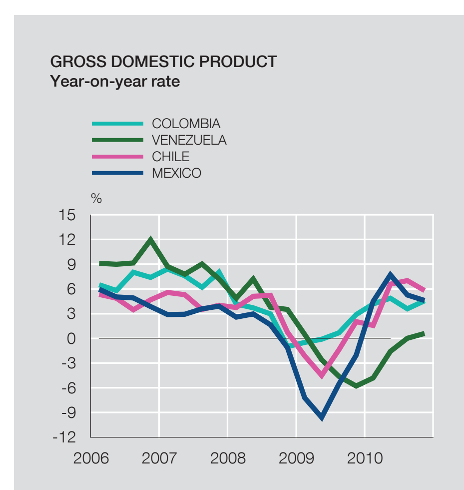
In the total period analysed, i.e. from October 2010 to April 2011, the sovereign spread, as measured by the regional EMBI, moved in a relatively narrow range, between 350 bp and 290 bp, showing decreases in most countries. These were particularly notable in Argentina (154 bp), Venezuela (156 bp) and Ecuador (276 bp), owing in this case to the improvement in the sovereign rating in February. CDSs performed in a similar fashion (see Chart 4). The opposite happened in the Peruvian financial markets, where volatility rose and risk premia widened at the beginning of April against a backdrop dominated by the presidential elections. As for the stock markets, the local-currency Latin American MSCI regional index remained practically steady in the review period, compared with moderate rises in emerging Asia, the Middle East and Africa, and sharper ones in emerging Europe. By country, between October and April there were moderate falls in the indices of Brazil, Chile and Colombia and sharp rises in Peru (13.4%), Mexico (11.2%) and Argentina (30%) (see Chart 4).

The capital inflows in the period continued putting upward pressure on exchange rates. The six-month review period saw appreciations against the dollar of nearly 6% in Brazil and Mexico,

LATIN AMERICAN GDP
Year-on-year and quarter-on-quarter rates

CHART 5





SOURCE: National statistics.

a. Aggregate of the seven main economies.

mainly towards the end of the period. Also significant was the appreciation of the Colombian peso since the end of the year (by 12%). Thus the exchange rates of these currencies against the dollar standard levels similar to those of summer 2008, and significantly above the lows recorded during the crisis (in particular, 17% in Peru, 32% in Mexico, 43% in Colombia, 45% in Chile and 59% in Brazil). In real effective terms, exchange rates also continued appreciating, reaching, in the case of Brazil, a historical high (see Chart 4). The large capital inflows in late 2010 prompted interventions in the foreign exchange markets –both pre-announced (Mexico, Colombia and Chile from January) and discretionary– and the introduction of diverse capital control measures, which in most cases failed to prevent stronger appreciation than in other emerging economies (see Chart 4).

Activity and demand

The annual growth of 6.3% of the Latin American economy in 2010 is the result of rates above 7.5% in Argentina, Peru and Brazil and above 4% in Mexico, Chile and Colombia, which evidence the pervasive strength of the recovery in the region, although at varying paces (see Table 1 and the section on economic performance by country). However, just as activity was surprisingly high in 2010 H1, it was somewhat less than expected in H2. In particular, the year-on-year GDP growth rates of the region moderated to 6% and 5.3% in Q3 and Q4, respectively, around 1.5 pp below those in the first half of the year, while the quarterly rates were below 1%, compared with an average of 1.7% in H1 (see Chart 5).

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2008	2009	2010	2009				2010				
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate):												
Latin America (a)	4.3	-2.0	6.3	-2.9	-4.2	-2.6	1.7	5.9	7.9	6.0	5.3	
Argentina (b)	6.8	0.9	9.2	2.0	-0.8	-0.3	2.6	6.8	11.8	8.6	9.2	
Brazil	5.2	-0.6	7.5	-3.0	-2.8	-1.8	5.0	9.3	9.2	6.7	5.0	
Mexico	1.5	-6.1	5.5	-7.2	-9.6	-5.5	-2.0	4.5	7.7	5.3	4.6	
Chile	3.7	-1.7	5.2	-2.1	-4.5	-1.4	2.1	1.7	6.4	6.9	5.8	
Colombia (c)	3.5	1.5	4.3	-0.4	-0.1	0.8	2.9	4.2	4.9	3.6	4.6	
Venezuela	4.8	-3.3	-1.4	0.5	-2.6	-4.6	-5.8	-4.8	-1.6	0.0	0.6	
Peru	9.8	0.9	8.8	1.9	-1.2	-0.6	3.4	6.2	10.0	9.6	9.2	
Uruguay	8.6	2.6	8.5	2.6	1.1	2.8	4.7	9.6	10.5	7.7	6.5	
CPI (year-on-year rate):												
Latin America (a)	7.8	6.4	6.4	7.6	6.7	5.9	5.4	6.1	6.6	6.3	6.7	6.7
Argentina (b)	8.6	6.3	10.5	6.6	5.5	5.9	7.1	9.0	10.6	11.1	11.0	9.7
Brazil	5.7	4.9	5.0	5.8	5.2	4.4	4.2	4.9	5.1	4.6	5.6	6.3
Mexico	5.1	5.3	4.2	6.2	6.0	5.1	4.0	4.8	4.0	3.7	4.2	3.0
Chile	8.7	0.4	1.4	4.8	1.8	-1.9	-3.0	-0.3	1.2	2.2	2.5	3.4
Colombia	7.0	4.2	2.3	6.6	4.8	3.2	2.4	2.0	2.1	2.3	2.7	3.2
Venezuela	31.4	28.6	29.0	29.5	28.2	28.7	28.1	27.4	31.9	29.8	27.3	28.7
Peru	5.8	2.9	1.5	5.6	4.0	1.9	0.4	0.7	1.1	2.2	2.1	2.7
Uruguay	7.9	7.1	6.7	8.2	6.7	7.1	6.3	6.7	6.9	6.3	6.9	8.2
BUDGET BALANCE (% of GDP):												
Latin America (a) (d)	-0.5	-2.9	-2.2	-1.5	-2.0	-3.1	-2.8	-2.7	-2.5	-2.1	-2.2	
Argentina	1.4	-0.6	0.2	1.1	0.0	-1.0	-0.6	-0.8	-0.3	0.2	0.2	
Brazil	-2.0	-3.3	-2.6	-2.8	-3.1	-4.2	-3.3	-3.4	-3.3	-2.3	-2.6	
Mexico	-0.1	-2.3	-2.8	-1.4	-1.7	-2.3	-2.1	-1.8	-2.1	-2.4	-2.7	
Chile	5.0	-4.6	-0.3	1.3	-1.5	-3.9	-4.6	-3.9	-1.1	0.0	-0.3	
Colombia	-1.8	-3.8	-3.6	-2.7	-3.0	-3.2	-3.8	-3.4	-4.0	-3.6	-3.6	
Venezuela	-1.2	-5.1	-	-2.3	-2.8	-3.9	-5.1	-4.8	-3.8	-3.5	-	
Peru	2.2	-1.8	0.0	1.4	0.1	-0.7	-1.8	-1.3	-1.0	-0.3	0.0	
Uruguay	-1.5	-1.7	-1.1	-2.1	-2.2	-2.2	-1.7	-1.9	-1.1	-1.1	-1.1	
PUBLIC DEBT (% of GDP):												
Latin America (a)	30.7	34.7	33.7	31.4	33.1	34.5	34.2	34.1	33.1	33.4	32.9	
Argentina	44.7	47.9	44.6	48.8	43.9	46.4	45.8	47.9	40.5	43.3	41.3	
Brazil	38.5	42.8	40.4	39.3	41.5	43.3	42.8	41.9	40.9	40.3	40.4	
Mexico	24.3	28.0	27.4	27.0	27.2	27.5	26.3	27.7	27.5	27.3	25.9	
Chile	5.2	6.2	9.2	5.0	4.9	5.8	6.1	6.9	7.5	8.7	9.2	
Colombia	33.2	34.7	34.8	36.8	35.2	33.6	35.1	34.3	35.1	34.7	34.8	
Venezuela	13.6	22.6	28.4	13.5	18.1	20.4	22.6	19.0	22.4	26.1	28.4	
Peru	24.2	27.3	23.9	24.8	26.1	27.2	27.3	25.5	24.2	23.7	23.9	
Uruguay	52.9	69.8	57.4	56.7	60.5	67.3	69.1	65.7	59.0	58.4	57.3	
CURRENT ACCOUNT BALANCE (% of GDP):												
Latin America (a) (d)	-0.6	-0.3	-0.7	-0.7	-0.7	-0.7	-0.2	-0.1	-0.4	-0.6	-0.7	
Argentina	2.0	3.6	1.0	2.3	3.2	3.5	3.4	3.0	2.1	1.4	0.9	
Brazil	-1.7	-1.5	-2.3	-1.5	-1.2	-1.2	-1.5	-1.8	-2.2	-2.4	-2.3	
Mexico	-1.5	-0.7	-0.5	-1.9	-1.5	-1.4	-0.6	-0.4	-0.4	-0.3	-0.5	
Chile	-1.9	1.6	1.9	-2.0	-1.4	0.7	2.6	2.4	1.8	1.6	1.9	
Colombia	-2.8	-2.2	-3.1	-3.3	-3.0	-2.7	-2.1	-2.1	-2.2	-2.8	-3.1	
Venezuela	12.0	2.6	6.1	7.6	2.9	-0.6	2.6	6.0	6.8	6.3	6.1	
Peru	-4.2	0.2	-1.5	-3.3	-2.4	-1.0	0.2	0.0	-0.2	-0.9	-1.5	
Uruguay	-4.7	0.7	-0.4	-3.8	-1.1	-0.2	0.5	0.5	0.7	0.8	-0.4	
EXTERNAL DEBT (% of GDP):												
Latin America (a)	17.5	20.6	20.7	18.7	19.6	20.8	19.8	19.7	19.2	20.3	20.5	
Argentina	38.3	37.9	34.9	43.6	37.9	39.2	36.3	36.9	32.4	34.7	32.3	
Brazil	12.0	12.4	12.2	12.2	13.3	14.0	12.2	11.9	12.0	12.3	12.2	
Mexico	11.5	18.5	18.2	19.2	17.3	17.0	16.8	17.9	17.4	17.7	18.2	
Chile	38.0	45.9	42.3	40.0	42.1	45.3	45.0	42.8	42.8	43.2	42.2	
Colombia	19.1	22.7	22.6	19.9	19.7	21.9	22.9	18.8	19.4	21.6	22.6	
Venezuela	19.4	22.6	42.7	18.8	18.6	21.4	22.6	23.8	26.9	35.0	42.7	
Peru	27.3	28.1	26.1	27.7	28.2	28.6	28.1	27.3	25.4	26.6	26.1	
Uruguay	38.5	44.9	36.2	39.2	40.9	45.4	44.5	40.7	36.8	36.4	36.2	

SOURCE: National statistics.

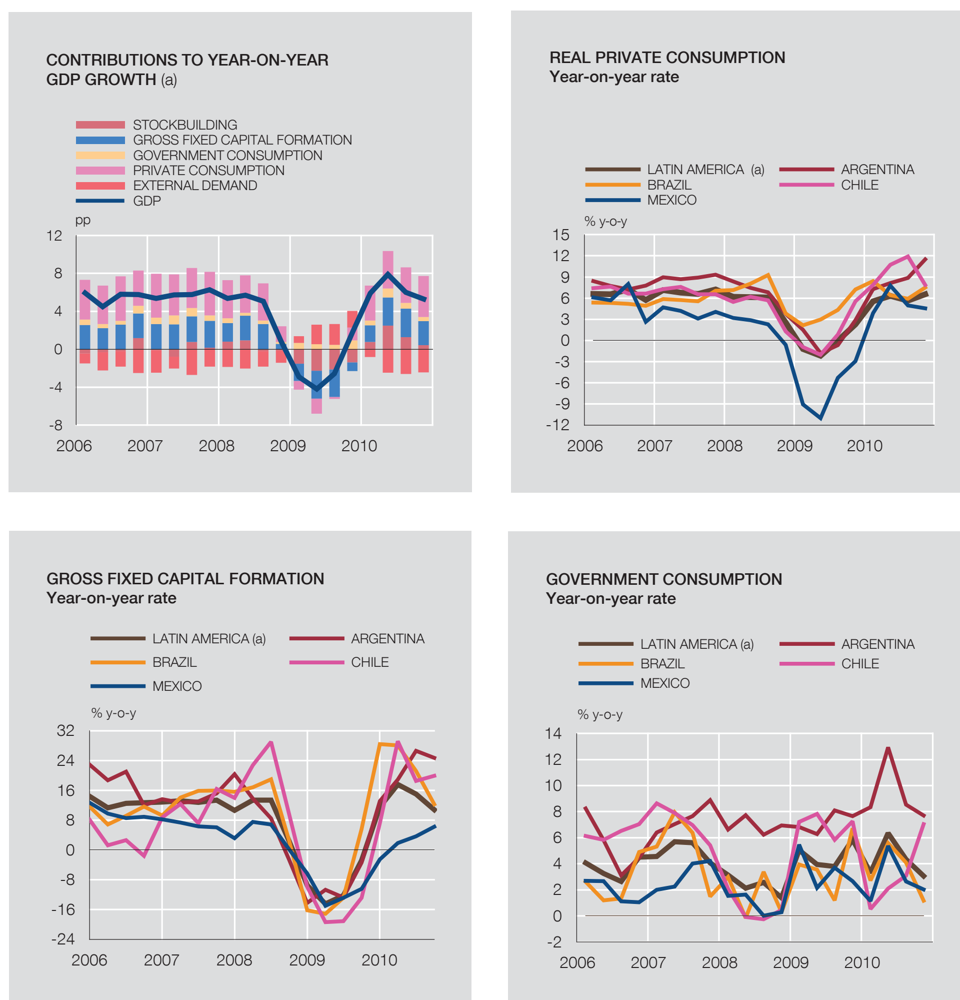
a. Aggregate of the eight countries represented, except Uruguay.

b. Private analysts consider that Argentinean GDP growth in 2008 and 2009 was considerably lower than the official figures, although this discrepancy decreased in 2010. They also consider that the inflation figures have been notably higher than the official ones since 2007 onwards.

c. Seasonally adjusted.

d. Four-quarter moving average.

PRIVATE CONSUMPTION, GOVERNMENT CONSUMPTION AND INVESTMENT CHART 6
Year-on-year rates and percentage points



SOURCE: National statistics.

a. Seven biggest economies.

This moderation was particularly notable in Brazil, as a result of the marked slowdown in investment, and to a lesser extent in Mexico, where it was due to a base effect. Indeed, the quarterly growth rates in Q3 and Q4 in Mexico were high, being well above those of Brazil. In the other countries, activity held firm, even tending to rise in Argentina and Colombia in the last quarter of the year, against a background of strong growth in domestic demand. Venezuela recorded, for the first time since the beginning of the crisis, positive year-on-year growth in Q4, which represented a lag of one year with respect to the rest of the region and did not prevent GDP from falling in 2010 as a whole.

Growth continued to be based on the buoyancy of domestic demand, which contributed 7.7 pp to GDP growth in Q4, while external demand remained relatively steady in its negative contribution to growth (2.4 pp) (see Chart 6). Private consumption remained notably strong. However, unlike in the first half of the year, there was a certain moderation in gross capital formation and a lower contribution from the inventory cycle.

Thus, in the aggregate of the region, the growth rate of gross capital formation moderated to 11.8% year-on-year from 16.5% in the second quarter (see Chart 6), with significant differences between countries. On the one hand, investment accelerated in Argentina and Mexico. In the

latter country, the growth rate of investment increased particularly in construction and agriculture, since manufacturing, which had been the driving force of the recovery in 2009, tended to moderate, perhaps indicating a certain replacement of the most-lagged sectors in the cycle and a possible shift of growth towards domestic demand. On the other hand, Brazil saw a sharp slowdown in gross capital formation from rates above 28% year-on-year in H1 to rates of 12% at the end of the year, in line with the recent performance of the industrial sector. This development was particularly marked in the capital goods sector, which contracted in Q3. Given that financing conditions and the investment outlook have remained favourable, and that foreign direct investment has recovered to levels close to its historical highs, the slowdown of the industrial sector is difficult to explain, against a background of widespread robustness of demand. In these circumstances, the exchange rate –which in real effective terms has been very high in countries such as Brazil or Colombia– may have contributed to the moderation of investment (see Box 1).

Private consumption, by contrast, held at robust growth rates in the aggregate of the region, around 6.5% in Q4 (see Chart 6), in line with the favourable performance of the labour market, which continued to perform better than in previous recoveries. Unemployment rates fell to levels similar to or lower than those before the crisis in the main South American countries (see Chart 7). In Brazil, this indicator moved through successive historical lows to stand at 5.3% in December; in Argentina it stood at 7.3% and in Chile and Peru decreased rapidly to approach the low before the crisis. Meanwhile, in Mexico, although the labour market situation improved in the six-month review period, it continued to be more fragile, which, along with the slow recovery of remittances due to the weakness of the American labour market, tended to hinder the recovery of private consumption. In the countries where the labour market was firmer, wage growth generally adjusted to that of inflation. In Mexico are, by contrast, wages decreased moderately in nominal terms. Against this background, consumer confidence indicators remained at very high levels and credit to the private sector tended to take off (see Chart 7). In Brazil and Peru, credit expanded again at rates above 20% year-on-year in real terms, prompting the introduction of macroprudential measures and restrictions in some segments, while in Mexico it recouped positive growth rates after two years of contraction or stagnation, and in the other countries it seems to be growing at rates in accordance with the position in the cycle.

Turning to the external sector, real imports grew rapidly (at year-on-year rates above 23% in the region as a whole in 2010 Q4), while real exports posted growth rates around 11%. Despite the high growth elasticity of imports, the increase in the terms of trade (20% in the region in 2010) has continued to allow the trade balance of the region to remain in appreciable surplus (2% of regional GDP). In fact, the seven countries on which this report focuses recorded trade surpluses in 2010, although in most cases the contribution of price changes exceeded that of the volumes traded. In this respect, it should be noted that in 2007 the trade surplus was more than twice the current one, and that, if the current surplus were adjusted for a level of commodity prices in line with the long-term historical level, the trade balance would show a deficit of around 1% of the GDP of the region (see Chart 7).

The region registered an aggregate current deficit of -0.7% of GDP in 2010 with notable differences between countries (see Chart 8). In some countries, including Brazil, there was a notable deterioration, particularly due to the behaviour of the services balance, which may be related to the strength of the exchange rate. The rapid accumulation of reserves which continued in this period in the whole of the region shows that the financing of the current account deficit has not posed a problem (see Chart 8). However, in some countries, despite the recent recovery of direct investment flows, the financing structure continued to be more dependent on other flows considered to be less stable, and, in fact, in some countries this investment does not cover the current deficit.

COMMODITY PRICES AND EXCHANGE RATE APPRECIATION: ARE THERE SIGNS OF DUTCH DISEASE IN LATIN AMERICA?

BOX 1

Latin America has traditionally been a commodity exporting region, a feature which has become more noticeable in the past decade (Chart 1) as a result of the growth in demand for these products by the Asian developing economies, particularly China. This growth has been reflected in an upward trend in commodity prices since 2003, which has sharply increased the region's terms of trade (the ratio of export prices to import prices). Thus the last seven years have seen cumulative increases of 14% in Mexico, 25% in Brazil, 28% in Argentina, 55% in Peru, 60% in Colombia, 110% in Chile and 353% in Venezuela, and it has stood at record highs since the 1990s in most countries (see Chart 1).

Higher terms of trade benefit the region in numerous ways. These include improved income, which boosts demand and activity; higher public revenue; improved external balance, as the increase in nominal exports tends to offset the increase in imports derived from the strong growth of domestic demand; and the attraction of capital flows, whether in the form of direct investment in the primary sector or in other forms, due to the general improvement in growth prospects. However, the increase in the terms of trade may also bring unfavourable economic effects. For example, the expansion induced by it tends to generate inflation and may increase the volatility of the business cycle, since commodity prices are usually less stable than those of manufactures or services, and may even give rise to a deterioration in institutional quality.[1] Finally, the increase in the terms of trade may give rise to so-called "Dutch disease", which is analysed in this box.

The term "Dutch disease" was coined by *The Economist* in 1977 to describe the recession in the Dutch manufacturing sector following the discovery of large gas reserves in the North Sea, and describes the loss of competitiveness of a country's tradable sector derived from the effects of exploitation of natural resources with a high world demand. The consequent improvement in the terms of trade generates an inflow of foreign exchange from exports and simultaneously an expansion of demand which leads to an appreciation of the real exchange rate, either through nominal appreciation or through increased inflation, and gives rise to a deterioration in relative prices between tradable goods (except commodities) and non-tradables (particularly services). Moreover, when the relative profitability of investment in the primary sector versus in the non-tradable sector increases, resources tend to be diverted to those sectors and, depending on the degree of flexibility of the factor markets, upward pressure is put on wages and on the return on capital in the economy as a whole, further prejudicing the competitiveness of the sectors subject to international competition. In the medium term, the increase in the value of the primary sector exports may not offset the decrease in the exports of other sectors (particularly if the volume of commodity exports is not very price elastic, as in the case of non-renewable resources or those requiring long-term investment, such as oil, gas or mining). This situation, along with the fact that part of the increase in national income passes through to imports, may end up worsening the external balance.

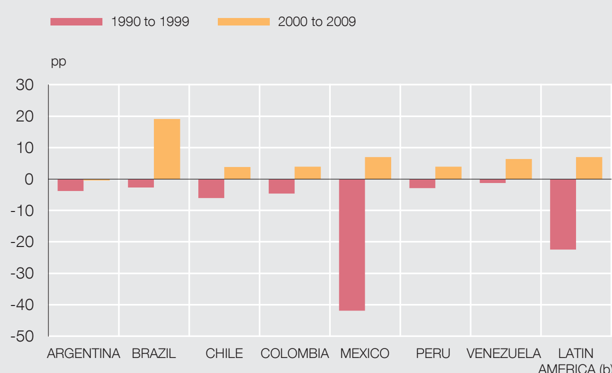
Is there evidence of the presence of this type of phenomenon in the region? Chart 2 shows some indicators which allow this possibility to be evaluated. First, there seems to be a correlation between the behaviour of the terms of trade and that of real effective exchange

1. See, among others, A. Gelb et al (1988), Oil Windfalls: Blessing or Curse? World Bank, Oxford University Press, and Jeffrey D. Sachs and Andrew M. Warner (2001), "The curse of natural resources", *European Economic Review*, vol. 45.

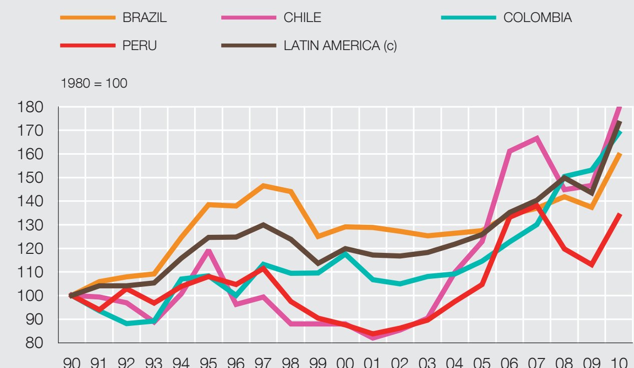
EXPORT STRUCTURE AND TERMS OF TRADE

CHART 1

CHANGE IN THE PERCENTAGE OF COMMODITY-RELATED EXPORTS (a)



TERMS OF TRADE



SOURCES: World Bank and national sources.

a. Percentage points. Comprising food, agricultural commodities, fuels and metals.
b. Includes central America and the Caribbean.
c. Seven largest economies.

rates in the region,[2] especially in Brazil, although also in Mexico, Colombia and Chile.[3] In some countries, the real effective exchange rate stood, like the terms of trade, at a historical high.[4] Furthermore, as shown by the chart, from 2010 Q2 various Latin American countries have experienced an appreciable disassociation between supply indicators, such as industrial production (stagnant since summer 2010) and demand indicators, such as retail sales, which continue to grow strongly.

As shown by the sectoral disaggregation in the middle left-hand panel of Chart 2, the primary sectors of certain countries (boosted by commodity prices), the most strongly consumption-oriented services sectors (boosted by domestic demand growth) and other non-tradable goods sectors, such as construction, have led growth in the latest expansionary phase, while the manufacturing sectors have lagged. These trends are most noticeable in the case of Brazil, where average GDP growth between 2007 and 2010 (4.5%), driven by telecommunications, trade and mining, is much higher than that of the manufacturing sector (2.7%). However, similar kinds of development occur in Chile, Colombia and Venezuela. Peru is an exception, since its industry unrelated to the primary sector has grown at a very similar rate to that of the average of the other sectors and of GDP.

Additional evidence would be provided by a shift of resources to more profitable sectors following an increase in the terms of trade. In this respect, the ratio between employment in industry and in services has decreased sharply in various countries in the region (Brazil, Peru and Colombia), although this decrease was not because of a fall in employment in industry, but rather because of a much higher rise in employment in services.[5]

Further, the bottom panels of Chart 2 show that commodity exports have grown strongly in volume in most countries of the region (except oil in Mexico and Venezuela, the production of which has been declining for some time), in clear contrast to the volume of manufacturing exports, which either fell year-on-year throughout 2010 or slowed sharply (except in Peru and, to a lesser extent, Chile), perhaps indicating that manufactured goods exports are being crowded out by commodity exports.[6] Finally, the current account balance deteriorated during 2010, as is natural in economies with high demand growth and imports growing faster than exports. However, these developments were not attributable to the goods balance, whose surplus increased, but rather to the services balance (more than half of the deterioration), reflecting the increase in national income, and to the income balance, which seems to reflect a higher repatriation of dividends of the firms exploiting the region's resources (see Chart 11 of the main text for the case of Brazil).

In short, although the evidence is not conclusive and the picture is complicated by some structural characteristics of the countries,[7] certain signs point to some negative effects of the exchange rate appreciation on the competitiveness and performance of other sectors exposed to international competition, such as the fall in the volume of manufacturing exports in some countries at a time of buoyant commodity exports and sharp exchange rate appreciation, the weaker recovery of employment in manufactures compared with other sectors more tightly linked to domestic demand and, above all, the stagnation of industrial production despite the boom in demand.

However, to be able to speak of Dutch disease in the strict sense, it would be necessary to demonstrate that what dominates real exchange rate behaviour is the improvement in the terms of trade derived from the commodity price boom. And this is difficult to prove because another factor (strong capital inflows) has recently been influencing the trend of real exchange rate depreciation in the region. Thus the correlation between capital inflows and real exchange rate appreciation is very high for Brazil, Mexico and Colombia, as seen in Chart 3. However, it can be argued that some countries' capital inflows are partly induced by the commodity boom itself, insofar as this tends to attract capital into the commodity sectors or, indirectly, to improve growth prospects. Thus a high correlation between terms of trade and capital inflows is discernible in the recent period, above all in Brazil and Peru (see Chart 3). Therefore, although capital inflows hinder recognition of the symptoms of Dutch disease in Latin America, they may constitute an additional channel through which the improvement in the terms of trade negatively affects the competitiveness of non-primary exports in these countries.

Given the prospects of ongoing growth in demand, particularly that from Asia, it is likely that commodity prices will remain high and hence that the direct investment flows associated with the primary sector will also be significant, as compared with more

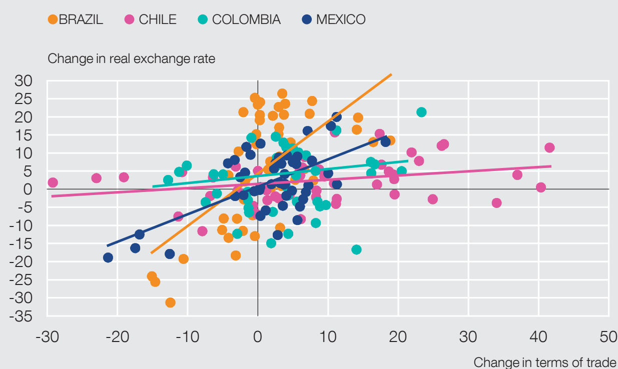
2. Most of the calculations in this box exclude Argentina and Venezuela because they use the exchange rate as a monetary policy instrument, which means that the relationship between the terms of trade and the exchange rate is of little use for our purposes. In other cases, the calculations exclude Mexico, given that it is the country with the lowest proportion of commodities in its exports, and given that the development of its industry is more closely linked to the US cycle and to relative wages than to the real exchange rate. **3.** In the case of Chile, the low correlation between the terms of trade and the real exchange rate is because a large part of the income gains derived from higher commodity prices are accumulated in the Sovereign Wealth Fund (*Fondo de Riqueza Soberano*), which short-circuits the transmission of higher export income to the nominal exchange rate. **4.** The correlation should be established within the framework of an empirical model which takes into account, in addition, other drivers of appreciation, such as growth, public expenditure, remittances and capital flows. In this respect, López, Molina and Bussolo (2007) consider that, in a wide sample of emerging economies, a 1% increase in the terms of trade would generate an appreciation of 0.3% in the real exchange rate, with the ratios being significant in most cases. **5.** 58% in services against 29% in industry between 2005 and 2010 in Peru, or 21% against 4% in Brazil.

6. The case of Chile may be special because it has entered into a multitude of free trade agreements which enable it to take advantage of niche markets in each case, which may lessen somewhat the influence of the exchange rate on the competitiveness of industry. The use of this strategy, albeit from a more recent date, has also been embraced by Peru. **7.** For example, Brazil is a country whose openness to trade measured as imports and exports in proportion to GDP is very low, and furthermore its manufactures are relatively diversified.

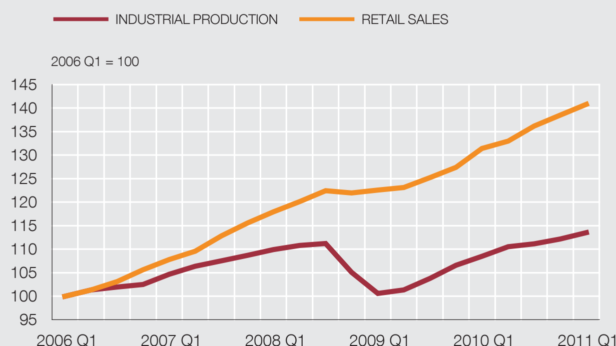
POSSIBLE SIGNS OF DUTCH DISEASE

CHART 2

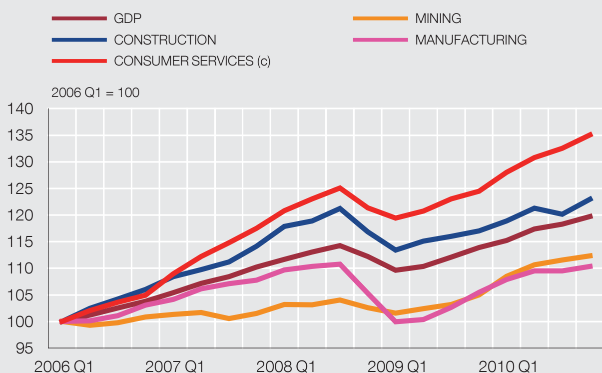
LATIN AMERICA: TERMS OF TRADE AND REAL EFFECTIVE EXCHANGE RATE (a)



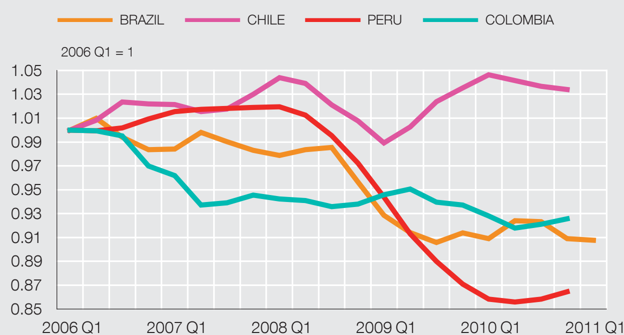
INDUSTRIAL PRODUCTION AND RETAIL SALES (b)



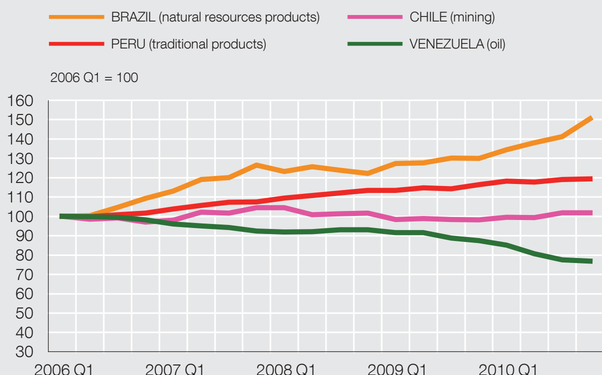
LATIN AMERICA (b)**: SECTORAL GDP**



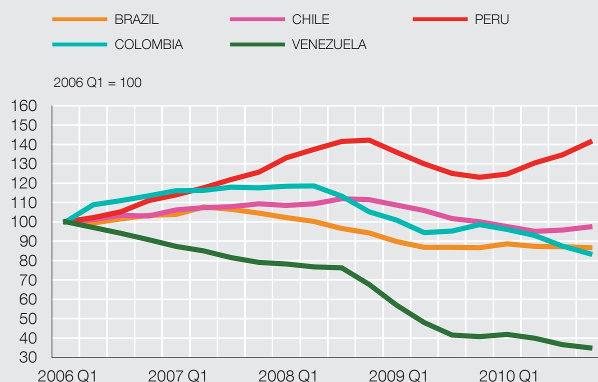
LATIN AMERICA: RATIO OF INDUSTRIAL EMPLOYMENT TO SERVICES EMPLOYMENT



LATIN AMERICA: COMMODITY EXPORTS (VOLUME)



LATIN AMERICA: EXPORTS (VOLUME) EXCLUDING COMMODITIES



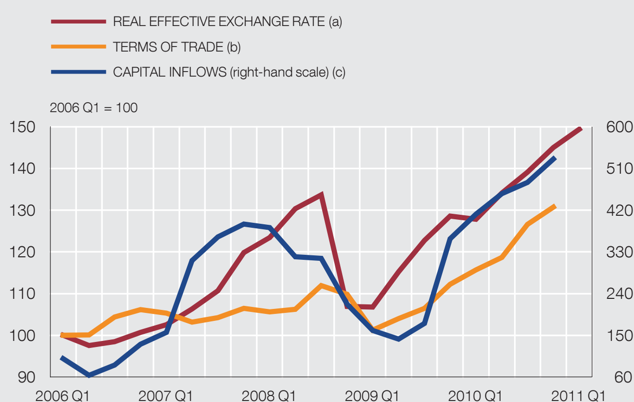
SOURCES: National sources.

a. Year-on-year change between 1999 and 2010.
b. Seven largest economies.
c. Trade, telecommunications and financial services.

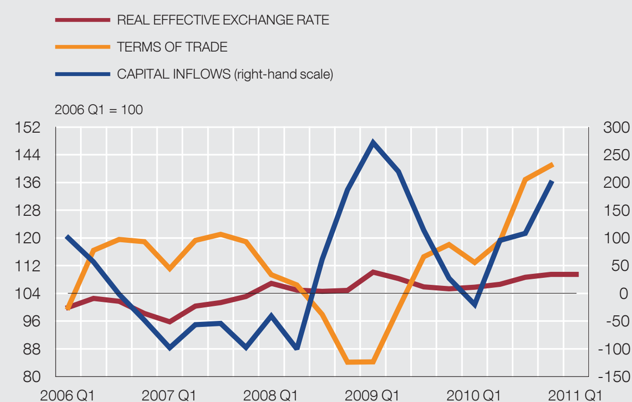
volatile and less persistent behaviour of other flows. This would strengthen the trends of an increasing primary-sector presence in the export structure and of a structurally higher real exchange rate. To counteract the competitive difficulties of their non-primary industries, the Latin American countries should consider structural policies designed to improve industrial productivity. Particularly significant in this respect are the proposals that a part of the wealth generated by natural resources should be created or accumulated in sovereign wealth funds (Chile, Colombia and Peru) and the recommendation to develop national sectors complementing the exploitation of natural resources, which generate externalities for the rest of the economy, such as the implementation of new technologies and longer-term policies to improve educational standards and physical and human capital. At times like the present, characterised by trend appreciation of real exchange rates and sharply increasing demand, it seems advisable to make use of the exchange rate flexibility to prevent real appreciation from occurring through the mechanism of rising inflation. Therefore, policies designed to prevent overreaction of the nominal exchange rate derived from capital flow cycles, such as foreign exchange intervention or the imposition of capital controls, should be carefully calibrated.

EXCHANGE RATES, CAPITAL FLOWS AND TERMS OF TRADE CHART 3

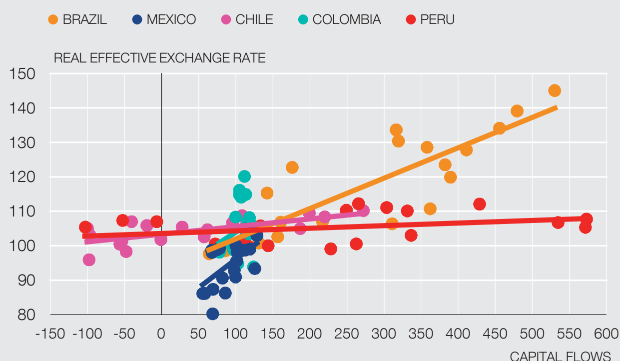
BRAZIL



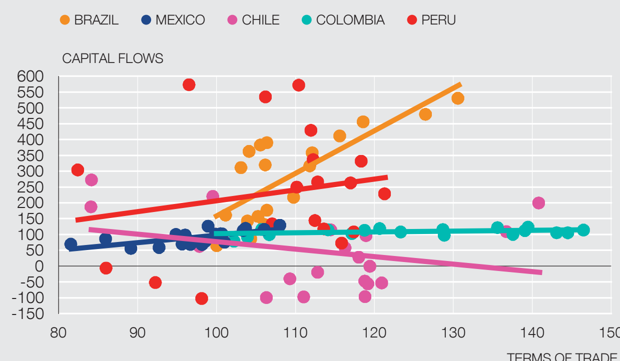
CHILE



REAL EXCHANGE RATE AND CAPITAL FLOWS (2006 Q1 = 100)



CAPITAL FLOWS AND TERMS OF TRADE (2006 Q1 = 100)

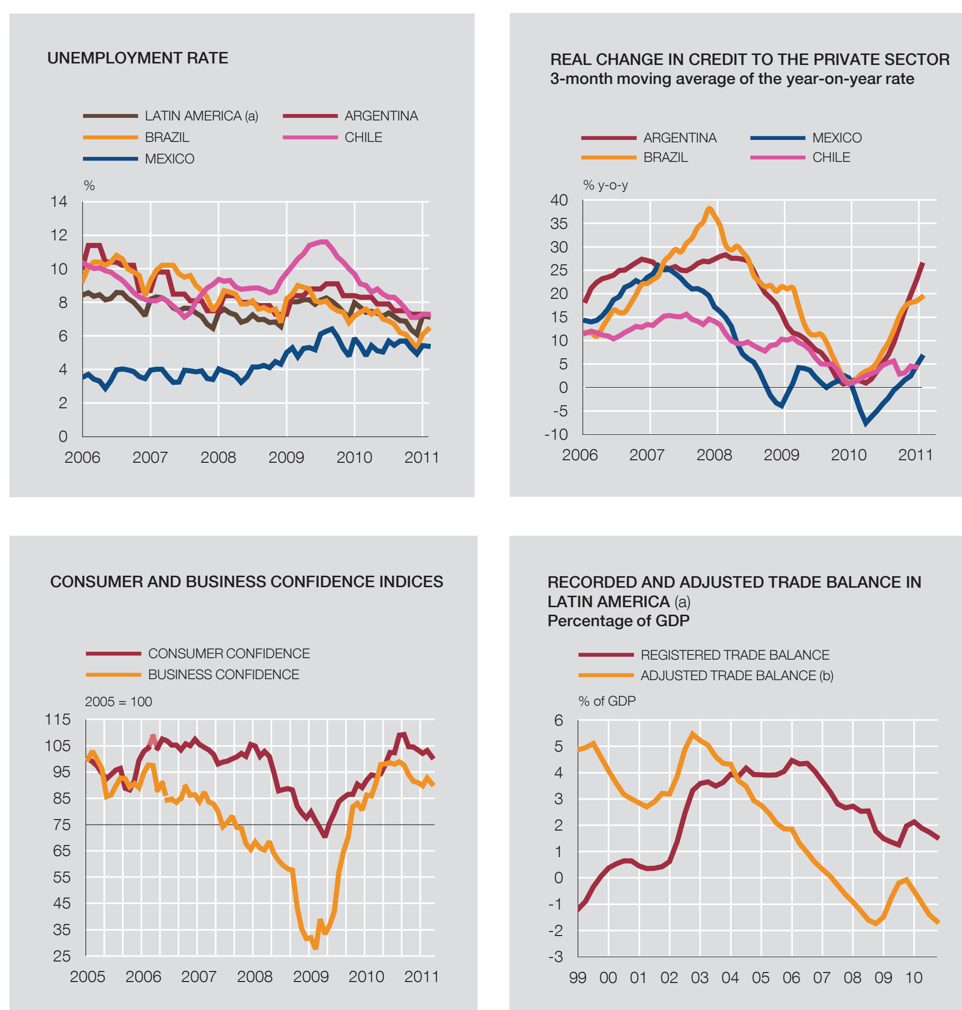


SOURCES: National sources.

a. Base 100 in 2006 Q1.
b. Base 100 in 2006 Q1.
c. Sum of portfolio and direct investment inflows, base 100 in 2006 Q1.

EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Three-month moving average of the year-on-year rate, and percentage

CHART 7



SOURCE: National statistics.

a. Seven biggest economies.
b. Estimate of the trade balance setting export and import prices at their average from 1990 to 2007.

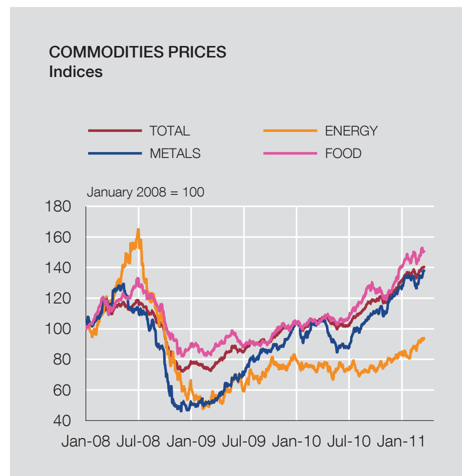
Prices and macroeconomic policies

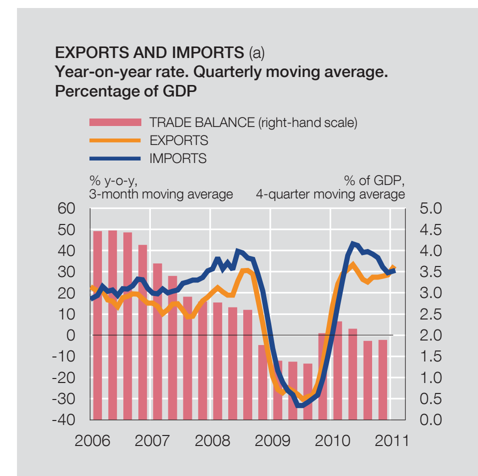
One of the main changes in the macroeconomic performance of Latin America in the last six months has been the rise in inflation, which is approaching rates of 6.5% year-on-year in the regional aggregate (see Chart 9). This increase is largely explained by the performance of Brazil, where the year-on-year rate reached 6.3% in March, in the upper half of the target band. In Peru, Chile and Colombia, price rises were more moderate, reaching rates of 2.7%, 3.4% and 3.2%, respectively, although in all of them inflation expectations have trended upwards (see Table 2). Only in Mexico did inflation decrease to 3% (in the middle of the target band), thanks to the disappearance of the base effect of the VAT rise in early 2010, favoured by the persistence of a certain output gap and the strengthening trend of the exchange rate in recent months. At the opposite extreme, Argentina and Venezuela continued recording very high inflation (around 10% and 29%, respectively). In Argentina, private analysts' estimates are above 20% and there is a certain concern about a possible price and wage rise spiral.

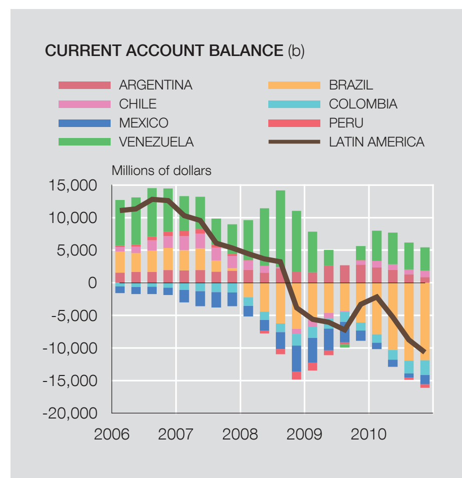
Until mid-2010, consumer prices performed favourably in the five countries with inflation targets (against a background in which output gaps had not yet closed), although risks associated with

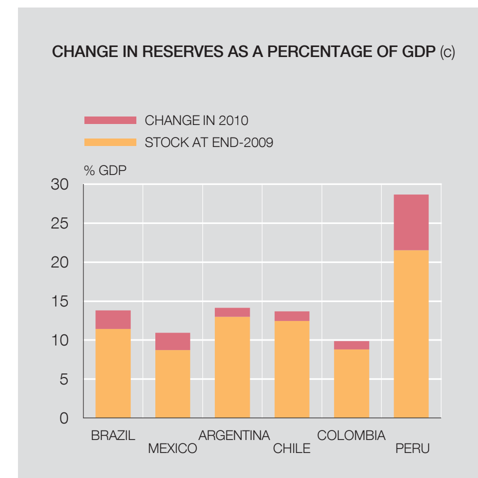
EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rates of change, indices and billions of US dollars

CHART 8









SOURCES: National statistics, central banks and Banco de España.

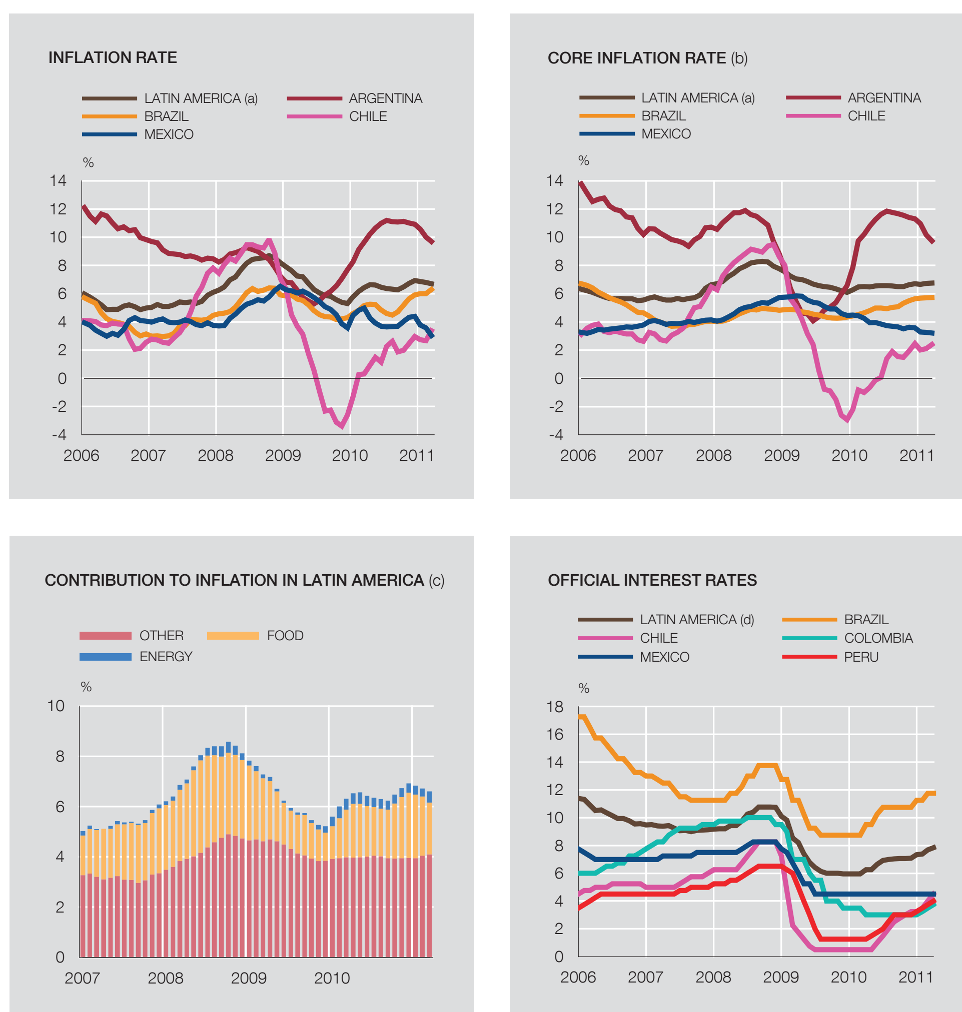
a. Customs data in dollars, aggregate of the seven biggest economies.
b. Four-quarter moving average.
c. Change in reserves in 2009 and 2010 as a percentage of 2010 GDP.

commodity (particularly food) price rises were already apparent in the international markets. Given the high share of food in the consumer basket of Latin American countries, the acceleration of food prices in international markets from September (by more than 40%) prompted a rise in inflation in all countries. Also, there is a risk that the recent energy price rise will reinforce this trend, not so much by its direct effect (which in many countries is lessened by petrol consumption subsidies and by its lower weight in the CPI basket), but by its impact on food prices.

The main risk of pass-through of food and other commodity price rises to consumer prices (illustrated in Chart 9) is in the appearance of second-round affects, with a labour market near to full employment and possibilities of overheating in various countries. However, for the time being these effects have not been observed (indeed, core inflation has risen more moderately than overall inflation) and monetary policies seem to be responding more firmly in recent months, at least in some countries. However, as a recent comparison, it should be remembered that in 2008 food price rises pushed overall inflation towards rates of 8% year-on-year in the region as a whole and that core inflation was not far behind it.

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

CHART 9



SOURCES: National statistics and Banco de España.

a. Aggregate of the seven main economies.
b. Official measures.
c. Banco de España calculations stripping out the food and energy indices from the overall index.
d. Weighted average of the official rates of the five countries with inflation targets.

Against this background, four of the five countries with inflation targets have continued or commenced the cycle of official interest rate rises in the last six months (see Chart 9 and Box 2). The capital inflow which took place between September and November 2010 temporarily interrupted the interest rate rises in Brazil and Peru during the closing months of 2010 and moderated them in Chile. After a four-month pause, the central bank of Brazil again raised the official interest rate in January, against a background of lower pressure from capital inflows, setting it at 12.00% in April, which amounted to a cumulative rise of 275 bp from the beginning of the upturn. This rise, which is moderate in historical terms, was accompanied by a wide range of macroprudential and capital control measures designed to contain credit growth, evidencing a change in the focus of monetary policy instrumentation. This, together with the exchange rate appreciation of nearly 20% in real effective terms since the beginning of 2010, amounts to a notable tightening of monetary conditions in Brazil. However, real interest rates continue to be 2 pp below those in 2008 and there was another injection of funds into public sector banks at the beginning of 2011, which might reactivate public credit following the moderation in late 2010.

INFLATION
Year-on-year rates of change

TABLE 2

Country	2010			2011		2012	
	Target	Dec-10	Fulfillment	Target	Expectations (a)	Target	Expectations (a)
Brazil	4.5 ± 2	5.9	Yes	4.5 ± 2	6.0	4.5 ± 2	4.9
Mexico	3 ± 1	4.4	No	3 ± 1	3.8	3 ± 1	3.8
Chile	3 ± 1	3.0	Yes	3 ± 1	4.3	3 ± 1	3.4
Colombia	3 ± 1	3.2	Yes	3 ± 1	3.7	3 ± 1	3.6
Peru	2 ± 1	2.1	Yes	2 ± 1	3.1	2 ± 1	2.5

SOURCES: National statistics and Consensus Forecasts.

a. April 2011 Consensus Forecasts for the end of the year.

In Chile there was also a certain slowdown in the pace of official interest rate rises at the end of 2010, against a background of exchange rate strength, which gave rise to the announcement of a $12 billion reserve accumulation programme to contain the appreciation of the peso and strengthen the international liquidity position (up to 17% of GDP). However in March, amidst lower exchange pressures, Chile surprised the markets with a rise of 50 bp in the official interest rate, larger than expected, to 4%, followed by another 50 bp in April, intended to correct the disanchoring of inflation expectations in recent months. In Peru, the official interest rate stood at 4% in April, representing a cumulative increase of 275 bp in the current cycle, while the foreign currency reserves held to meet external obligations due in less than two years and the bank reserve ratio increased considerably. In Colombia, the upward cycle in monetary policy began in 2011, with three rises of 25 bp in February, March and April, signalling the beginning of normalisation of interest rates, consistent with the gradual recovery of the economy and the rising trend in inflation. Finally, only Mexico among the countries with a inflation target held official interest rates steady (at 4.5%). Despite the official interest rate rises, in the five countries with inflation targets as a whole the weighted average interest rate remained around 3 pp below the level at the beginning of 2008 (see Chart 9).

In Argentina monetary policy has not reacted to the progressive increase in inflation since mid-2009 (M2, which is the target, continued growing at high rates); rather, the government has reimposed price controls and prohibited some agricultural exports. Nor did monetary policy respond to the higher inflation in Venezuela, where the interest rate ceilings on loans and deposits remained unchanged.

Most notable in the fiscal area in 2010 was the stabilisation of both primary and total public balances at regional level following the improvement in H1 (see Chart 10). Despite the limited progress in the recovery of a more restrictive fiscal stance and although primary expenditure continued growing strongly in real terms (see Chart 10), the public finances ended 2010 with a primary surplus and a moderate reduction in the budget deficit at regional level. As an exception, the Mexican public finances showed a certain deterioration with respect to 2009, due mainly to the increase in pension expenditure and despite the higher growth of the economy. The fiscal projections for 2011 foresee some changes in the region as a whole. Brazil announced a significant cut in budgeted expenditure in 2011 (by 1.2% of GDP), in order to rein in the rate of growth of the economy and the inflationary pressure. Although the measure has value as signalling mechanism, its restrictive nature is not absolutely clear, since the final expenditure in 2011 will be higher than that in 2010. Chile and Peru have also recently announced reductions in budgeted public expenditure of around 0.4%-0.3% of GDP for 2011, respectively.

Since the beginning of the 1980s there have been significant changes in the institutional design and monetary policy conduct of central banks at global level. In Latin America these changes arrived later, in the 1990s, but were more radical, since they enabled the region to leave behind a regime of high monetary instability. This Box describes the changes undergone by the Latin American central banks in the past two decades and their main achievements, making special mention of the efficient management at the height of the global financial crisis, and also looks at the challenges going ahead.[1]

For decades the role of Latin American central banks was largely subordinated to the financing needs of the public sector. This gave rise to numerous and recurring bouts of high inflation, and even hyperinflation, which had increasing costs in terms of growth and revenue distribution. In the early 1990s, owing to the broad social consensus in favour of greater price stability, increased independence was granted to central banks, price stability was set as their primary objective and lending to government was prohibited or limited in amount. These reforms were supplemented by other institutional changes to facilitate the task of monetary policy. Such changes included most notably lesser fiscal laxity and improved regulation and supervision of banking systems, which arose also as a response to the recurring banking crises in the region in the preceding decades. In some cases exchange rates and monetary aggregates were progressively abandoned as nominal anchors and replaced by monetary regimes based on direct inflation targets as a mechanism for fixing expectations. Although the region remains highly heterogeneous with regard to monetary policy regimes, five central banks adopted inflation targets between 1999 and 2002 (Brazil, Chile, Colombia, Mexico and Peru), while Argentina adopted a monetary aggregate as its target,[2] Venezuela retains a fixed exchange rate and other countries, such as Ecuador, have formally replaced their currency by the dollar. In any event, a characteristic of the Latin American inflation target regimes on which this Box particularly focuses is that they have continued considering the exchange rate as a significant policy variable, a conviction which has led them to intervene in the foreign exchange markets to, among other things, limit exchange rate volatility.

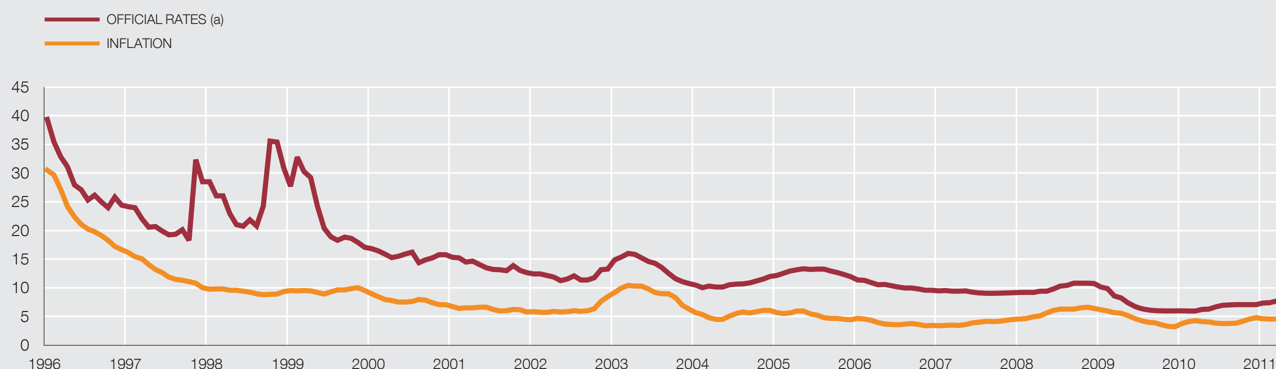
Thanks to their improved institutional design and greater level of independence, central banks, particularly those with inflation targets, helped Latin America to achieve greater macroeconomic stability and greater monetary policy credibility. This helped the region to participate in the prolonged expansionary phase of the world economy in the first few years of the new century, against a background of relative price stability, despite their past history of notable financial volatility and currency depreciation. Indeed, although there is some disagreement in this respect, most studies in the empirical literature find that countries with inflation targets have reduced the level and volatility of inflation and enjoy generally more stable activity.[3]

More recently, the Latin American economies have found a way to manage significant shocks more successfully than in the past. These shocks include the food and fuel price rises in 2007/2008 and, subsequently, the impact of the global financial crisis, which in Latin America took the form of a short recession followed by a strong recovery. In this respect, it was the first time that use could be made of a counter-cyclical mone-

1. This Box takes as its main reference a conference held last December at the Banco de España. The conference was given by Klaus Schmidt-Hebbel (Universidad Católica de Chile) on the occasion of the V High Level Seminar of the Eurosystem and the Latin American central banks. The Box also includes the discussions which followed the conference and those in the seminar. See Documentos Ocasionales No. 1102 of the Banco de España, “Central Banking in Latin America: Changes, Achievements, Challenges”. The articles cited in this Box and which are also listed in the bibliography given here are not referenced in their full form.

2. Nevertheless, in practice it also treats the exchange rate of the peso against the dollar as a nominal anchor. **3.** There is controversy over the effectiveness of inflation target regimes in reducing the level and volatility of inflation and the volatility of production, depending largely on the econometric method used. Thus Mishkin y Schmidt-Hebbel (2007) find evidence of this improvement in efficiency, while S. Lin and H. Ye (2009), «Does Inflation Targeting Make a Difference in Developing Countries?», Journal of Development Economics, 89, pp. 118-123, find it for emerging countries as a whole, although with a great heterogeneity among them depending on the characteristics of the country. Finally, R. Brito and B. Bystedt (2010), “Inflation Targeting in Emerging Countries: Panel Evidence”, Journal of Development Economics, 91, pp. 198-210, do not find these effects to be significant.

INFLATION AND OFFICIAL RATES



SOURCES: Datastream and national sources.

a. Five countries with inflation targets: Brazil, Mexico, Chile, Colombia and Peru.

tary policy, which managed to significantly reduce interest rates when conditions so required thanks to the greater exchange rate flexibility. Comparison of the drivers of the two most recent recessions in the region, i.e. those in 1998-1999 (linked to the Asian crisis) and 2008-2009 (linked to the global financial crisis), reveals that opposite financial policy responses were followed in the two cases: in the first, the region's central banks had to raise official interest rates to defend the fixed exchange rate; in the second, the central banks with inflation targets reduced them. The result was that in the first recession real interest rates increased much more than in the second and that the negative effect of real interest rates on growth was insignificant in the second [Corbo and Schmidt-Hebbel (2010)].

Furthermore, in the recent crisis non-conventional policy responses could be used, such as the reduction of reserve ratios, the granting of liquidity in local currency and foreign currency,[4] or the relaxation of collateral requirements, all of which were important in mitigating its impact on the financial system. Also, interventions in the exchange markets to moderate downward pressure on currencies helped to cushion the impact of the crisis. In this respect the region's central banks applied the inflation target regimes flexibly during the period of financial stress, and interventions were more effective in mitigating exchange rate volatility than under other monetary policy approaches.[5]

Having passed this crucial test for monetary policy credibility, the Latin American central banks now face a significant number of challenges, some of them shared with other central banks. Notable among them are the reform of supervision and regulation following the crisis, the integration of macroprudential regulation with more conventional monetary policy instruments, and the analysis of the implications of asset prices and financial frictions for monetary policy. They also share common challenges with the central banks which have inflation targets, such as improving transparency and communication, deciding on the advisability of adopting an overall or core inflation target, etc, or choosing whether or not to raise inflation targets as a means of tackling the problem posed by the official interest rate floor, an issue which is particularly controversial in a region where monetary policies have probably not yet reached maximum credibility.

Moreover, the characteristic features of Latin America entail some specific challenges. Latin American countries are highly sensitive to external shocks, since the region is relatively open both commercially and financially, an exporter of commodities whose prices are set on the international markets and the recipient of capital flows which by their very nature are volatile. Thus in recent years many of the region's central banks have periodically faced a monetary policy dilemma. This dilemma comes about when an upturn in inflation, partly derived from improved terms of trade due to commodity price rises, would make it advisable to raise interest rates, but there is a fear that such interest rate rises may trigger exchange rate appreciation and excessive and destabilising capital inflows, in a setting in which the exchange rate is already relatively high. For this reason, some of the region's central banks (Brazil, Colombia and Peru) have opted to raise reserve ratios, among other measures, so that monetary policy is more restrictive but does not attract capital flows.

To cope with this monetary policy dilemma, some governments and central banks in the region have also adopted other measures as the economic recovery and financial stability have progressively returned to the region. These measures (see accompanying table) are designed to moderate capital inflows or facilitate capital outflows and, in some cases, can be considered full-fledged capital controls. However, they are temporary measures to mitigate real exchange rate appreciation which, in a situation of economic boom and commodity price rises, tends to follow an upward trend. To prevent such an exchange rate adjustment, recourse must be had to fundamentals, in particular by means of an increase in domestic saving, specifically that of the public sector. This situation calls for fiscal policies of a more counter-cyclical nature, reinforced, where appropriate, by fiscal rules (for example, saving what is considered to be the temporary component of a commodity price rise in sovereign wealth funds) to ensure that the various policies are consistent. Meanwhile, maintaining the anti-inflationary credibility of central banks is probably the best contribution to resolving these dilemmas and to fostering an environment of monetary stability conducive to growth.

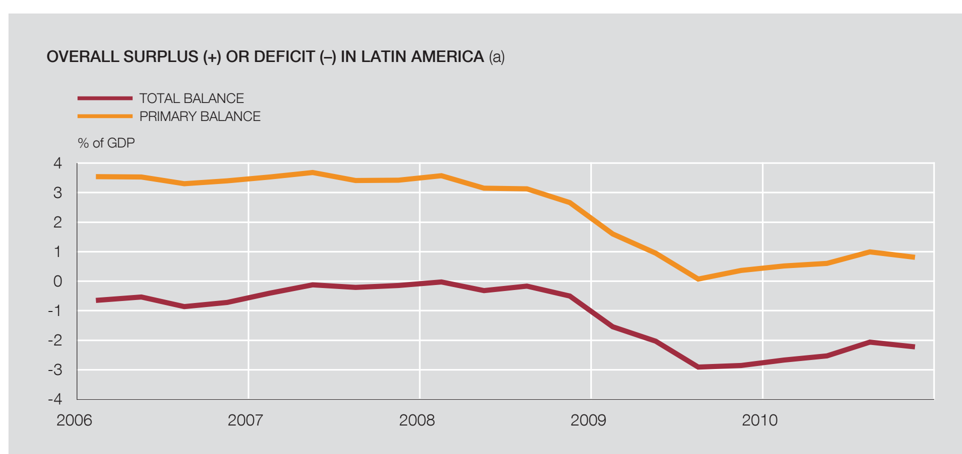
4. Thanks to the international reserves accumulated, to the swap facilities with the Federal Reserve (Brazil and Mexico) and to the FCL credit lines with the IMF (Colombia and Mexico). **5.** Berganza and C. Broto (2011), Flexible Inflation Targets, Forex Interventions and Exchange Rate Volatility in Emerging Countries, Documentos de Trabajo No. 1105, Banco de España.

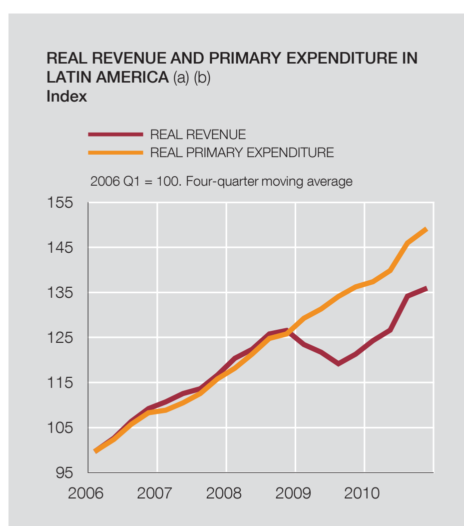
MEASURE	DESCRIPTION	COUNTRY (implementation date in brackets)
Restrictions on financial flows (capital controls)	Taxes on financial inflows	Brazil (Oct-10, Mar-11, Apr-11)
Liberalisation of financial flows	Liberalisation of capital outflows	Chile (Nov-10), Peru (various)
Macroprudential measures	Higher capital ratio	Brazil (Dec-10)
	Higher reserve ratio	Brazil (Dec-10), Peru (various)
	Tax on credit to natural persons	Brazil (Apr-11)
	Higher reserve ratio for deposits denominated in foreign currency	Peru (Jul, Sep and Oct-10)
	Limit on short position in foreign currency of banks	Brazil (Jan-11), Peru (Feb-11)

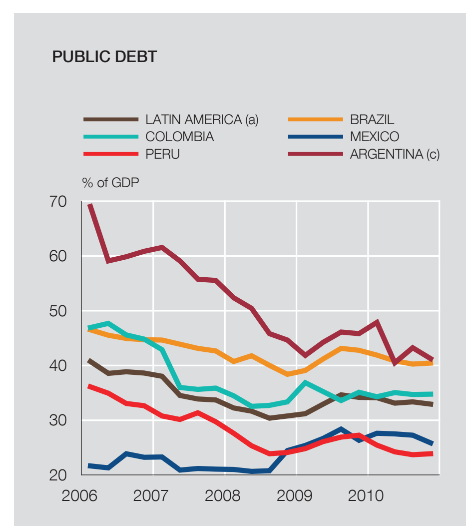
SOURCE: Banco de España.

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and index

CHART 10







SOURCE: National statistics.

a. Seven biggest economies.
b. Deflated by the CPI.
c. Excludes untendered debt in the debt swap offers of 2005 and 2010.

Trade integration processes and structural policies

Following the boost received in mid-2010 with the signature of the common customs code, Mercosur made headway in institutional matters (agreements on the drafting of investment guarantees and anti-monopoly laws, among others) and in its process of increasingly greater openness to trade. To achieve this, it signed an agreement to grant reciprocal tariff preferences with G20 countries (Korea, India and Indonesia) and with certain major customers for its products (Egypt), as well as Cuba, Malaysia and Morocco. The Senate of Paraguay delayed once again the admission of Venezuela to the block, and the European Union notified that the agreement with Mercosur would not be concluded this year because of the difficulties in agricultural issues.

In April the withdrawal of Venezuela from the CAN (*Comunidad Andina de Naciones* – Andean Community of Nations) will become effective, so this country and Colombia began conversations to enter into a treaty under which the treatment of bilateral trade would continue as it has to date. Another two members of the Andean Community (Peru and Colombia) took further steps in their strategy to reorient their trade towards the Pacific basin through bilateral treaties. Thus the free trade agreement between Korea and Peru came into force and the latter country entered into an agreement with Japan, announced its intention to negotiate with India and unilaterally reduced the average tariff.

Colombia intends to enter into a treaty with Korea in June 2011 and has initiated conversations with Turkey, while it expects the US Congress to approve the free trade treaty between the two countries. In February the renewal of the ATPDA[3] tariff preferences with Colombia expired. Mexico and Peru entered into a free trade agreement, and Chile did so with Malaysia and began conversations with Indonesia. Finally, Mexico and the United States resolved the problem of the suspension of an agreement to provide Mexican transport services within the framework of the North American Free Trade Treaty (NAFTA), whereby Mexico suspended the tariffs that it had announced by way of reprisal in summer 2010. Mexico and Brazil announced their intention to reach an agreement on economic integration that will enable each of them to complement its industrial sector.

In the area of structural reform, Chile announced the gradual implementation of a mechanism to shorten export administrative processes and some privatisations of public service companies and the creation of a Financial Stability Board. In Mexico, the opposition senators tabled a fiscal reform project (which may be a sign of future initiatives in this field) including a tax on certain foodstuffs at the general VAT rate. In Venezuela, the executive branch maintained its policy of expropriations and approved, in the final stage of the legislature, the Banking Law, which paves the way for nationalisation of the sector and includes provisions which raise the discretionary powers of the public sector to manage lending and financial system assets.

Economic developments by country

In *Brazil*, GDP grew by 0.7% quarter-on-quarter in 2010 Q4, representing a pick-up with respect to the preceding quarter. However, in the second half of the year activity lost dynamism sharply, as indicated by the year-on-year rates, which moderated to 5% in Q4, compared with average growth of 7.5% in 2010. The slowdown in activity came about because of the moderation of investment and, to a lesser extent, of public consumption, which led to slower growth of domestic demand (6.7% in Q4, against 10% in the previous quarters). By contrast, private consumption showed even greater momentum. The negative contribution of external demand decreased in Q4 to 1.7 pp, after having exceeded 3 pp in the preceding quarters, as a result of the slowdown in imports (which nevertheless grew at a rate of 25%). The most frequent indicators for 2011 Q4 continued to signal the strength of domestic demand and of its drivers, particularly the labour market, where the unemployment rate stood at a historical low. By contrast, industrial production, like that of other countries in the region, recorded a less positive performance in 2010 H2, although there was a certain recovery in the opening months of 2011. The strength of activity is contributing to an upturn in inflation which after several months of consecutive increases reached 6.3% in March 2011, close to the upper range of the central bank's target (4.5%, with bands of +/-2%). The inflation expectations have also trended upwards, and for 2012 they are a few tenths of a percentage point above the central bank target. One of the pillars of domestic demand, namely bank credit, continued to expand, growing around 20% in real terms in January, with a slowdown in public credit (to 27% in January) and an increase in private credit (to 17%). Against this background, the central bank, after having held the official interest rate unchanged since July 2010, resumed interest rate rises in its January, March and April meetings, with increases of 50 bp in the first two meetings and 25 bp in the third, to bring the interest rate to 12%. Similarly, in December it adopted diverse macroprudential measures (such as changes in the bank reserve ratio and in capital ratios) to subdue the expansion of credit, and strengthened these measures and capital controls again in April amidst renewed upward pressure on the real.[4] In the fiscal policy arena, the consolidated public sector primary surplus in 2010 as a whole was 2.8% of GDP,

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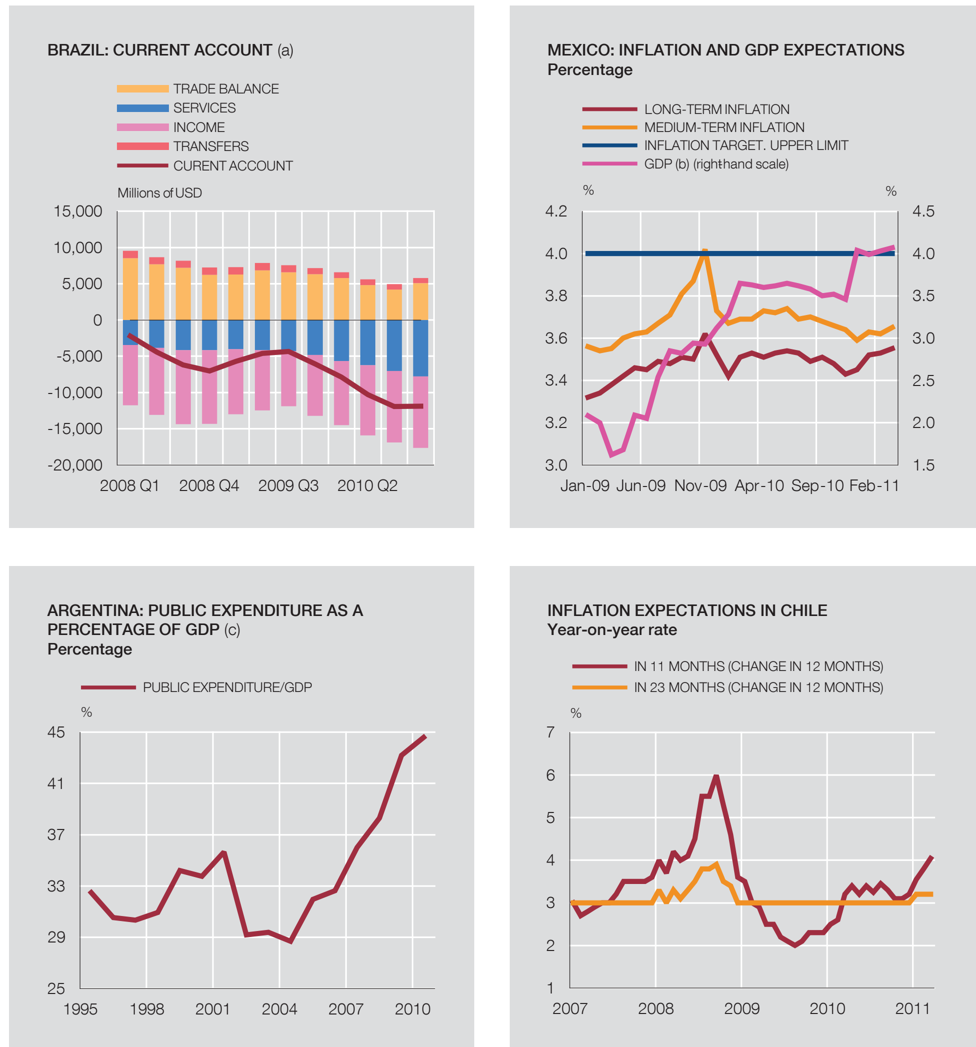
3. Andean Trade Promotion and Drug Act. **4.** Among other things, the following actions were taken: the reserve ratio was raised by an amount which it was considered would reverse the expansion of liquidity seen in 2008; an increase in the capital ratio for personal loans with maturities of more than two years was announced and an obligatory deposit of 60% imposed on dollar-denominated short cash positions for resident banks; and the tax on transactions with non-residents (6%) was extended successively so that in practice it applies to any transaction with a maturity of less than two years involving loans or bonds and this tax was raised to 3% for loans to individuals.

which was below the target of 3.3% of GDP but above that of the previous year. However, this result was achieved with significant extraordinary revenue from the sale of oilfield exploitation rights. The total budget balance was in deficit (2.6% of GDP). The government expressed its intention to pursue an anti-cyclical fiscal policy to help subdue inflation, and announced that it would reduce expenditure by 50 billion reais (equivalent to 1.2% of GDP) with respect to that budgeted for 2011, which does not entail any spending cuts with respect to the previous year. Additionally, the legislative arm has approved the government's proposal to increase the minimum wage by 7% in nominal terms, a measure which will also help to moderate current expenditure in 2011 and, consequently, ease inflationary pressure. By contrast, it was announced that 55 billion reais would be contributed to the development bank BNDES by the Treasury (compared with the 110 billion reais provided in 2010), which, along with the funds obtained from traditional sources, means that this year the BNDES will have very nearly the same amount as in 2010 for financing its programmes. In the external sector, there was a significant deterioration in the current account balance, mainly as a result of the worsening of the income and services balance, although the trade surplus also decreased as a result of the strength of imports (see Chart 11). The financial account includes high financial inflows, including most notably significant foreign direct investment inflows, which have led some analysts to suggest that this may stem from a certain strategy to circumvent the capital controls introduced in October. Against this background, the central bank has maintained its policy of building up reserves, which amounted to $317 billion at the end of March. Together with these purchases in the spot market, the central bank started to intervene in the derivatives market. Finally, in April Fitch raised its credit rating for Brazil by one level above the threshold investment grade, on the basis of the improvement in its fundamentals and policies.

In 2010 H2 the year-on-year rate of activity in *Mexico* slowed with respect to Q2, but the high pace of growth continued, with quarter-on-quarter rates of change in GDP of 0.8% of 1.3%, respectively, in Q3 and Q4. Growth in 2010 as a whole was 5.5%, of which approximately 3 pp stem from a statistical carryover effect. In any event, in Q4 GDP reached its level before the crisis, although the output gap continued to be negative. On the demand side, private consumption slowed in H2, while investment, particularly that by the private sector, continued in the opposite direction, although its growth rate held somewhat below that in the other economies of the region (except Venezuela). The contribution from inventories was very small, in contrast to their high contribution in H1. External demand contributed negatively to growth (by 0.3 pp) in Q4, for the first time since 2008 Q3. The data for 2011 seem to indicate a gradual improvement in the pace of growth. As regards the labour market, there was a certain improvement in the conditions and quality of employment in the closing months of 2010, which, however, does not recoup the ground lost during the crisis. The inflation rate, which had reached 4.4% in October as a result of the rising food prices, tended to converge towards 3% in March, since the base effect which in 2010 entailed an increase in some tax rates had ceased to act. Core inflation stands at 3.2%. The negative output gap and the recent appreciation of the currency have contributed to an ongoing favourable outlook for inflation, which is also reflected in the persistence of the inflation expectations for both 2011 and 2012. Against this background, the Bank of Mexico held official rates at 4.5% (the level at which they have stood since July 2009). Credit for private consumption in real terms returned to year-on-year growth in 2010 Q4, despite the continuing fall in credit cards. In 2010 the current deficit represented 0.5% of GDP, a level very similar to that recorded in 2009. However, in Q4 there was a notable worsening as a result of the sharp increase in dividend repatriation. Notable in the financial account were the portfolio investment inflows in 2010 Q4 (3.5% of GDP), particularly for the purchase of government securities in the money market. In view of the extraordinary rise in portfolio investment flows, the central bank held in place the mechanism designed to reduce volatility in currency appreciation and built reserves up to $122 billion (11.5% of GDP) by mid-March. In addition, the Mexican government renewed the flexible credit line with the

BRAZIL, MEXICO, ARGENTINA AND VENEZUELA

CHART 11



SOURCE: National statistics.

a. Four-quarter moving average.
b. One-year growth expectations.
c. Given the lack of provincial and municipal government data, it was assumed that growth was equal to that of the national government during that year.

IMF, but for a higher amount ($73 billion), thereby raising the available foreign currency funds to the average prevailing in the emerging countries. The public sector accounts worsened notably in H2, partly because of the larger contributions to public pensions, the total deficit standing at 2.8% of GDP. However, excluding the PEMEX investment, the government deficit would have been only 0.8% of GDP in 2010, compared with 0.2% in 2009. The government again arranged oil hedges for 2011 and, furthermore, made various issues in local currency and foreign currency which enabled it to pre-finance all external debt maturities until the presidential elections in mid-2012.

In 2010 Q4, the GDP of *Argentina* showed a notable pick-up (2.5% quarter-on-quarter), after the lull in Q3 (0.7%), as a result of the greater buoyancy of domestic demand, which grew by 12.3% year-on-year. The surge in private consumption was decisive in these developments, since investment slowed slightly in Q4, although it held at a high growth rate (nearly 25%), particularly in capital goods investment. Meanwhile, the contribution from external demand became much more negative (3.1 pp), due to the slowdown of exports, since imports decelerated

only slightly. In 2010 as a whole Argentine GDP growth was 9.2%. This strong growth allowed the unemployment rate to continue falling to stand near the level before the crisis. The most frequent indicators seem to show that the strong dynamism held during the first quarter of the year. In 2010 the current account showed a surplus of 1% of GDP compared with 3.6% in 2009, partly due to a decrease in the trade balance, which stood at 4% of GDP in 2010, against 6% in 2009, despite strong export growth. Another factor contributing to the decrease in the current surplus was the decline in current transfers, due mainly to the allotment of SDRs by the IMF in 2009 Q3 ($2,662 million). The financial account featured two positive factors. First, there was a notable decrease in capital outflows in 2010. Second, foreign direct investment showed a certain recovery to stand at 1.6% of GDP. International reserves held steady, since they were again used to make external public debt payments, a practice which will continue in 2011 for an amount around $7.5 billion. In 2010 the Argentine government recorded a primary surplus of 1.8% of GDP, compared with 1.5% in 2009, with growth of more than 30% in public revenue and expenditure. Thus the sharp increases in public expenditure by both the national and provincial governments in recent years has notably raised the proportion it represents of GDP (see Chart 11). Moreover, for 2011 the government has ample discretionary powers, since the budget which the government sent to Congress was rejected and, for reasons of necessity and urgency, the President approved decrees which broaden its scope of action. Inflation has been decreasing since October 2010 to stand at 10% in February. However, these rates are well below the private estimates and the official inflation in the provinces, and below the wage increases, which stand at nearly 27% year-on-year. Indeed, an IMF technical mission visited the country in order to create a new national price index. Year-on-year growth of the M2 monetary aggregate, targeted by the central bank, stood at nearly 30% and real interest rates continued to be negative, particularly if unofficial inflation measurements are taken into account. Meanwhile, the expansionary path of bank credit to the private sector quickened. The central bank continued to permit a gradual depreciation of the exchange rate against the dollar. In the review period, the Argentine government again opened the exchange facility for the holders of defaulted debt, although the offer was taken up by only some retail investors for small amounts, and the first contacts were held with the Club of Paris, with which the government is seeking to conclude an agreement before the presidential elections in October.

Although the earthquake in February 2010 delayed somewhat the recovery of economic activity in *Chile* following the global financial crisis, the pause was brief and strong growth was seen in the rest of the year (5.2% overall), despite a certain moderation in Q4 (quarter-on-quarter growth of 0.9%). This good performance was explained by the extraordinary dynamism of domestic demand, which grew by 16.8% in 2010 H2, with private consumption above 11.5% and private investment at nearly 20% (although investment in construction lagged somewhat behind). External demand made a negative contribution of more than 12 pp in the second half of the year, as a result of the weakness of exports and of the extraordinary strength of imports, with growth above 30%. However, the favourable trend in terms of trade allowed the trade balance to close 2010 with a surplus of nearly 8% of GDP and the current account balance to post a surplus equivalent to 1.9% of GDP, partly explained by higher current transfers (insurance indemnities to earthquake victims), which helped to offset the deficit of 7.7% of GDP in the income balance. Notable on the supply side was a certain weakness in the industrial sector. On a positive note, and unlike in the period following the Asian crisis, the labour market has recovered notably. The sharp growth of domestic demand, the closure of the output gaps and the rise in commodity prices at international level caused inflation to increase to 3.4% in March, above the central bank's target (3%), although core inflation measurements were lower. Contributing to this moderation was the appreciation of the peso against the dollar (nearly 10% in 2010 H2). However,

there was a certain disanchoring of inflation expectations, particularly shorter-term expectations in the past few months (see Chart 11). Against this background, the central bank raised the official interest rate in all monetary policy meetings from June 2010 (400 bp in total, to 4.5%), except that in January, when the monetary policy dilemma became most evident. This dilemma led the central bank to announce interventions in the foreign exchange market to purchase reserves ($12 billion in 2011). In this respect, to cope with the upward pressure on the currency, the number of non-resident institutions authorised to issue bonds on the local market was increased and the limit on investment abroad by pension funds was raised from 60% to 80%. Also, the government announced a reduction in budgeted public expenditure of 0.4% of GDP in 2011. In 2010 the government deficit amounted to 0.4% of GDP (4.5% in 2009), signifying a structural deficit of 2.1% of GDP (0.9% in 2009). This positive performance resulted from an increase in revenue of 28.4% in real terms (given the sound performance of copper revenues) and a rise in expenditure of 7%. In February the credit rating agency Fitch upgraded by one level its rating of Chilean sovereign debt denominated in foreign currency. The good outlook for investment in the Chilean economy was also reflected in the foreign direct investment received, which exceeded $15 billion in 2010 (equivalent to 7.5% of GDP).

In *Colombia* economic activity contracted by 0.5% quarter-on-quarter in Q3 and expanded by 1.9% in Q4, this latter quarter being notable for the strong performance of investment (with growth of 10.2% year-on-year), which, along with consumption growth of nearly 5%, explains the dynamism of domestic demand. However, the higher growth of the economy at the end of the year is basically explained by the lower negative contribution from the external sector (which trimmed 2.2 pp from growth), as a result of lower import growth and greater export dynamism. In 2010 as a whole, the economy grew by 4.3%. Additionally, there was a significant upward revision of the national accounts data from 2008, which in the case of GDP amounted to 0.8 pp in the growth rate for 2008 (lifting it to 3.5%) and 0.7 pp for 2009 (raising it to 1.5%). The higher-than-expected growth in Q4 and this upward revision resulted in a change in the estimates of the output gap and an improved understanding of the commencement of the cycle of official interest rate rises which began at the February meeting and continued in those of March and April (with three rises of 25 bp), against a background in which inflation, although progressively increasing, stood at 3.2% in March, only 0.2 pp above the central bank's inflation target. Both the public finances and the trade balance were similar in 2010 to those in 2009. In the external sector, the current account deficit in Q4, which reflected the income deficit, was amply covered by the financial inflows of long-term foreign investment (which were, however, smaller than in previous quarters) and of short-term foreign investment. To cope with the upward pressure on the peso, the central bank maintained its policy of accumulating reserves (20 million pesos daily) and announced that it would extend it to June. Meanwhile, in November it took diverse measures to reduce the inflow of dollars into the country and to increase demand by the private sector.[5] Notably Standard and Poor's upgraded to "investment grade" the credit rating of Colombian sovereign debt denominated in foreign currency. Finally, Colombia has indicated its intention to renew for two years the flexible credit line with the IMF which matures in May.

The GDP of *Peru* continued to grow rapidly in the second half of the year (3.1% and 2.4% quarter-on-quarter in Q3 and Q4, respectively). Year-on-year growth remained above 9% and the growth of domestic demand was noteworthy (14.2% in H2, although it slowed

5. Including, among other measures: non-monetarisation to pesos of dollar-denominated State funds received as dividends of the government corporation Ecopetrol and dollar-denominated debt issues already made; derogation of the income tax rebate for interest payments on external debt, except for financial or trade credit institutions; and reduction of import tariffs on a large number of intermediate and capital goods.

slightly in Q4). Notable within domestic demand was the strength of investment, which, although slowing, grew by 22.6% year-on-year in Q4. Also worthy of mention is the progressive pick-up in private consumption. The negative contribution of external demand in H2 was nearly 5 pp, which occurred because exports, although more dynamic, grew much more slowly than imports. In 2010 as a whole, GDP grew by 8.8% (0.9% in 2009), and the estimates indicate that the output gap seems to have closed. The inflation rate in recent months has held near the central bank's target of 2%, although the March figure represents a certain rise (2.7%). Against this background, in January the central bank resumed the cycle of official interest rate rises (four rises of 25 bp to a rate of 4% in April). Additionally, bank reserve requirements kept increasing. Also, the government announced two series of reductions in import tariffs, one temporary (in February) and one permanent (in January). Along the same lines, a draft law was approved to reduce the general sales tax by one percentage point to 18% and the financial transactions tax from 0.05% to 0.005%. In April the government announced cuts to the budgeted expenditure for 2011 by the equivalent of 0.3% of GDP and the consolidation of public sector saving in the stabilisation fund, which would double in 2011 (3.3% of GDP). In 2010, the non-financial public sector recorded a primary surplus (0.6% of GDP, compared with -0.6% in 2009) as a result of higher growth in revenue (up nearly 20%) than in expenditure (up 10.7%). In 2010 the current account showed a deficit equivalent to 1.5% of GDP (surplus of 0.2% in 2009). The trade surplus increased with respect to the previous year to stand at 4.4% of GDP (thanks to the increase of 18.2% in the terms of trade), but it was more than offset by the higher deficit in income account, linked to the profits of non-resident firms and to the deficit on the services account. Notable in the financial account is the fact that nearly 75% of capital inflows in 2010 were of a long-term nature (foreign direct investment or long-term loans). The exchange rate of the new sol against the dollar held steady at around 2.80, although in February the central bank made a series of discretionary dollar purchases to alleviate the upward pressure on the currency and in April it intervened for the opposite reason to moderate volatility in the run-up to the presidential elections.

In 2010 Q4 *Venezuela* recorded, for the first time since 2009 Q1, a positive year-on-year growth rate (0.6%). However, the quarterly rates show that activity contracted in H2 (GDP did not grow in Q3 and fell by 0.5% in Q4). In 2010 as a whole the fall in GDP was 1.4% (against a decrease of 3.3% in 2009). Notable in H2 was the negative contribution of external demand (6.6 pp), given the combined effect of a fall in exports and growth in imports, linked to the slightly positive growth of private consumption and, in particular, to the strength of public consumption. Domestic demand grew by nearly 6% year-on-year in H2, but did so basically through stockbuilding. The most frequent indicators show signs of a certain weakness of private consumption in early 2011, although consumer credit has shown positive year-on-year rates in recent months, albeit well below the inflation rate. The public sector posted higher nominal growth of revenue than of expenditure in 2010, which was reflected in a decrease in the financial and primary deficits. Prices continued to give cause for concern: since June the inflation rate has always held above 25% and is currently very near to 30%. The recent increase was mainly due to food price increases derived from international commodity price rises and from the unification of the exchange rate for preferential imports decreed in January (in a country where more than 90% of consumer goods are imported). In January the unification of the system of dual exchange rates, the nominal anchor of the economy, came into operation with the devaluation of the preferential rate applied to medicine, food, research equipment and external debt payments from 2.6 bolivares per dollar to 4.3 bolivares per dollar. Also, it was announced that transactions on the SITME (a parallel market organised by the central bank) will be carried out at a maximum rate of 5.3 bolivares per dollar, with the result that this market has become, in practice, the second official exchange

rate of the country. It should also be noted that in recent months the volume traded on this market has decreased substantially, which has increased the scarcity of foreign currency in the economy through official channels. The current account surplus stood in 2010 at nearly 7% of GDP, against 2.6% in 2009, this increase being explained by higher oil exports. Foreign direct investment amounted to $151 million in Q4, the first positive figure since 2008 Q3, although in the year as a whole there were outflows of $1.4 billion. The financial account (plus errors and omissions) showed a deficit of somewhat more than $22 billion (nearly 11% of GDP). All this resulted in a loss of international reserves slightly above $8 billion.

2.5.2011.