REPORT ON THE LATIN AMERICAN ECONOMY. SECOND HALF OF 2012

Introduction

Against an international backdrop of persistent strains in the euro area, growth in the Latin American economy continued to move on the gradually slowing path on which it had embarked in 2011, following a brief hiatus in Q1. Thus, GDP growth for the seven major economies in the region[1] averaged 2.6% in 2012 Q2 in year-on-year terms, almost 1 pp lower than at the close of 2011, representing the lowest growth since the exit from the crisis in 2009. In quarterly terms, the slowdown was seen mainly in Q2 (0.5%), since growth in Q1 (0.9%) was slightly better than that for the second half of 2011. These developments point to a regional "soft landing" scenario, with growth easing more than was expected at the beginning of the year, although moving similarly to that in other emerging economies, and centred especially on two countries, Argentina and Brazil (see Chart 1).

In these two economies, growth eased due mainly to the weakness of domestic demand, in particular of gross capital formation. In Brazil, weak investment in capital goods, in step with the prolonged sluggishness of the industrial sector, was attributable to structural factors and the delayed effects of the appreciation of the exchange rate. Meanwhile, in Argentina, investment in capital goods and construction has been affected in recent months by foreign exchange controls and restrictions on imports. Conversely, in the other countries the growth rates of GDP and domestic demand were notably sounder, but external demand weakened across the board, marking a significant difference on the previous year. These weak exports are a sign that the slowdown in the region's major trading partners, which brought about a marked deceleration in international trade (see Chart 1), the drop in the price of some of the main export commodities of countries in the region (oil and metals) and, to a lesser degree, the increase in volatility on financial markets, have had a considerable impact on economic developments in Latin America in recent months.

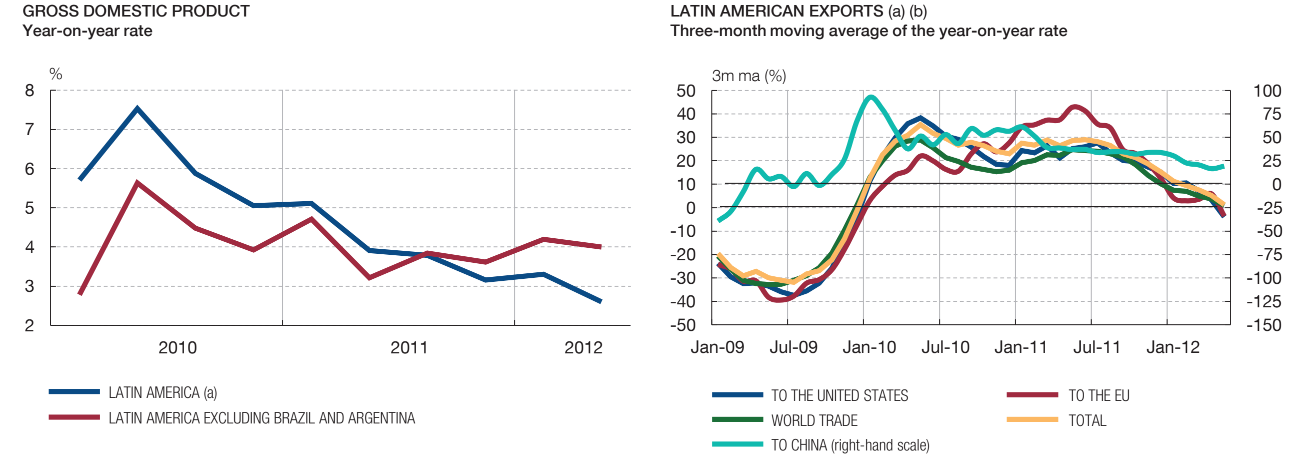
Conversely, consumer prices have scarcely changed in the past six months. Average inflation for the region stood in September at 6.2% year-on-year, unchanged on March, and displaying some downward stickiness despite the economic slowdown. Inflation expectations remained stable or even slightly on the upside in some countries, and in most countries with inflation targets they were in the upper limit of the tolerance band. In Brazil, inflation stabilised at above 5% year-on-year, 0.5 pp up on the official target, but that did not interrupt the pronounced cycle of cuts in benchmark interest rates, to a historical low of 7.25%, in a setting in which fiscal policy and other financial measures added fresh stimulus. Among the other countries, only Colombia joined the downward cycle in interest rates in July and August.

In short, although the economic fundamentals of most of the economies in the region remain relatively sound and domestic demand continues to be buoyant (with the odd notable exception such as Brazil and Argentina), the worsening external environment has significantly affected the region, especially via the trade channel. External risks have thus been a constant, although the most serious ones, relating to a possible spread of the euro area sovereign crisis to growth in the world economy (and indirectly to Latin America through the trade, financial and confidence channels), appeared to have slackened following the initiatives announced by the European authorities since the start of the summer. Meanwhile,

[1] Argentina, Brazil, Colombia, Chile, Mexico, Peru and Venezuela.

LATIN AMERICA: GDP AND EXPORTS
Year-on-year rate

CHART 1



SOURCES: Datastream, IMF and national statistics.

a Aggregate of the seven main economies.
b Latest data, May 2012.

the main central banks of the developed economies broadened their range of non-conventional measures to support growth, which should prove positive for the emerging economies – the Latin American countries among them - as a whole. That said, the measures might ultimately accentuate the monetary policy dilemmas in some of them. Accordingly, although the latest indicators point to some recovery, especially among the Latin American countries whose performance has recently been poor, economic policies are generally being pursued in a setting of high uncertainty over the global recovery; further, the fact a number of countries in the region are running current-account deficits means a note of caution is warranted (see Table 1).

External environment

In recent months, worldwide economic and financial developments have continued to be influenced by the unfolding of the sovereign debt crisis in the euro area. The worsening of the crisis in the spring, which was accompanied by a fairly geographically widespread slowdown in activity (see Chart 2), prompted a rise in risk aversion, which translated into further episodes of flight to quality and into stock market declines. Since the start of the summer, measures taken by the main developed economies' central banks have contributed to shaping a somewhat paradoxical international economic picture. While financial markets recovered substantially, on the back of the reduction in the risks of extreme events in the euro area and the increase in the appetite for risk against a background of ample liquidity, economic activity remained markedly weak, and the growth outlook for the global economy, including the emerging economies, was revised downwards.

In the developed countries, after economic activity picked up somewhat in 2012 Q1, an across-the-board slowdown was discernible, more sharply so in certain economies such as Japan, the euro area and the United Kingdom, but also in the United States, where the labour market began to show signs of weakness again. Against this backdrop, and with inflation rates tending to ease owing to the lesser pressure of commodities prices, the central banks decided mid-year to implement new measures. Of note was the action by the ECB, which cut its official interest rate to 0.75% in July and announced its commitment to act to eliminate redenomination risk in the euro area. In September it approved the introduction of Outright Monetary Transactions (OMTs), which envisage sovereign bond purchases in the short-term — with a residual maturity up to three years — on the secondary

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2009	2010	2011	2010		2011				2012		2012
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	September
GDP (year-on-year rate)												
Latin America (a)	-1.9	6.3	4.4	6.1	5.4	5.5	4.3	4.4	3.6	3.3	2.6	
Argentina (b)	0.9	9.2	8.9	8.6	9.2	9.9	9.1	9.3	7.3	5.2	0.0	
Brazil	-0.3	7.5	2.7	6.9	5.3	4.2	3.3	2.1	1.4	0.8	0.5	
Mexico	-6.2	5.5	3.9	5.4	4.4	4.4	3.1	4.3	3.9	4.5	4.1	
Chile	-1.0	6.1	6.0	7.7	6.7	9.9	6.3	3.7	4.5	5.3	5.5	
Colombia (c)	1.7	4.0	5.9	3.0	4.7	5.0	5.1	7.5	6.1	4.7	4.9	
Venezuela	-3.2	-1.5	4.2	-0.2	0.5	4.8	2.6	4.4	4.9	5.8	5.4	
Peru	0.9	8.8	6.9	9.6	9.2	8.8	6.9	6.7	5.5	6.0	6.1	
CPI (year-on-year rate)												
Latin America (a)	6.4	6.4	6.8	6.2	6.6	6.7	6.6	6.9	7.0	6.6	6.0	6.2
Argentina (b)	6.3	10.5	9.8	11.1	11.0	10.1	9.7	9.8	9.6	9.7	9.9	10.0
Brazil	4.9	5.0	6.6	4.6	5.6	6.1	6.6	7.1	6.7	5.8	5.0	5.3
Mexico	5.3	4.2	3.4	3.7	4.2	3.5	3.3	3.4	3.5	3.9	3.9	4.8
Chile	0.4	1.4	3.3	2.2	2.5	2.9	3.3	3.1	4.0	4.1	3.1	2.8
Colombia	4.2	2.3	3.4	2.3	2.7	3.3	3.0	3.5	3.9	3.5	3.3	3.1
Venezuela	28.6	29.0	27.2	29.8	27.3	29.1	24.6	26.5	28.5	25.1	22.3	19.1
Peru	2.9	1.5	3.4	2.2	2.1	2.4	3.1	3.5	4.5	4.2	4.1	3.7
Budget balance (% of GDP) (d)												
Latin America (a) (e)	-2.8	-2.2	-2.0	-2.0	-2.2	-1.8	-1.6	-1.7	-2.0	-2.1	-1.9	
Argentina	-0.6	0.2	-1.6	0.2	0.2	0.2	0.0	-0.4	-1.6	-1.9	-1.7	
Brazil	-3.3	-2.5	-2.6	-2.3	-2.5	-2.3	-2.1	-2.5	-2.6	-2.4	-2.6	
Mexico	-2.3	-2.9	-2.5	-2.4	-2.7	-2.8	-2.8	-2.6	-2.4	-2.7	-2.5	
Chile	-4.3	-0.3	1.5	0.0	-0.3	1.0	1.4	2.0	1.5	1.6	1.2	
Colombia	-3.8	-3.6	-2.1	-3.6	-3.5	-2.9	-1.5	-1.4	-2.1	-2.5	-1.0	
Venezuela	-5.1	-3.8	—	-3.5	-3.8	—	—	—	—	—	—	
Peru	-1.7	0.1	0.9	-0.3	0.1	0.4	0.3	0.9	0.9	1.3	2.4	
Public debt (% of GDP)												
Latin America (a)	34.5	33.4	32.1	33.5	33.1	33.0	32.9	32.3	32.1	31.3	—	
Argentina	47.9	44.6	40.1	46.1	44.6	44.8	42.9	40.8	40.2	—	—	
Brazil	42.1	39.2	36.5	39.4	39.2	38.9	38.6	36.3	36.4	36.5	35.1	
Mexico	28.0	27.5	26.5	27.3	26.1	27.1	26.9	27.6	26.5	28.2	28.1	
Chile	5.8	8.6	11.2	8.7	9.2	9.0	9.4	10.6	11.2	11.2	11.7	
Colombia	35.0	35.0	33.7	34.7	34.7	35.0	33.2	34.1	33.8	33.3	32.8	
Venezuela	22.6	28.1	25.1	25.9	28.1	25.1	31.5	34.7	36.6	33.5	—	
Peru	27.3	23.4	21.7	23.2	23.4	22.4	21.7	20.9	21.7	20.7	20.0	
Current account balance (% of GDP) (d)												
Latin America (a)	-0.3	-0.7	-0.8	-0.6	-0.8	-0.9	-0.8	-0.8	-0.9	-0.7	-0.9	
Argentina	3.6	0.8	0.0	1.3	0.7	0.6	0.2	0.0	0.0	0.1	0.1	
Brazil	-1.5	-2.2	-2.1	-2.3	-2.2	-2.2	-2.1	-2.0	-2.1	-2.0	-2.1	
Mexico	-0.6	-0.3	-0.8	0.0	-0.3	-0.5	-0.5	-0.9	-0.8	-0.6	-0.5	
Chile	2.0	1.5	-1.3	1.6	1.9	0.8	0.6	-0.4	-1.3	-1.6	-2.7	
Colombia	-2.1	-3.1	-3.0	-2.7	-3.1	-3.1	-3.2	-2.9	-3.0	-2.8	-3.1	
Venezuela	1.8	5.0	9.2	5.4	5.0	5.8	7.3	8.7	8.6	7.6	5.9	
Peru	0.2	-1.7	-1.3	-1.1	-1.7	-2.6	-2.9	-2.0	-1.9	-1.7	-2.0	
External debt (% of GDP)												
Latin America (a)	20.6	20.9	19.9	20.4	20.7	20.6	19.9	19.9	19.9	20.0	—	
Argentina	37.6	35.0	31.6	34.4	32.4	34.1	28.4	31.1	30.6	32.8	—	
Brazil	12.2	12.0	12.0	12.0	12.0	12.3	12.2	12.0	12.0	12.1	16.5	
Mexico	18.9	19.0	18.2	18.4	19.0	17.8	18.6	18.0	18.2	18.4	19.1	
Chile	42.1	40.1	40.3	40.8	39.9	39.8	39.8	38.6	39.5	39.3	39.8	
Colombia	22.7	22.4	22.8	21.5	22.5	20.6	20.9	21.7	22.8	20.6	20.5	
Venezuela	22.6	35.5	36.4	33.8	38.8	36.5	36.0	35.2	33.9	31.1	—	
Peru	28.1	26.1	24.4	26.6	26.4	28.1	27.9	27.6	26.9	28.5	28.6	

SOURCE: National statistics.

a Aggregate of the seven countries represented.
b Official figures.
c Seasonally adjusted.
d Four-quarter moving average.
e As from 2010 Q4, the budget balance aggregate does not include Venezuela.

market, in a discretionary manner, without quantitative limits and subject to strict conditionality, which will require the country whose bonds are purchased to have previously requested assistance from the European mechanisms. The European Council in June also contributed to alleviating tensions by committing itself to deepening integration, in particular by pushing forward the European banking union.

Likewise, the US Federal Reserve announced a major set of measures in September: the start of a new quantitative easing programme (QE3) based on purchases of MBSs from agencies for an unlimited amount and over an unlimited period of time, and the extension of its commitment to keep official rates at their current levels until mid-2015, explicitly signalling that this will be the case even if the recovery has started. The Bank of England approved a new six-month liquidity facility, it extended its asset purchase programme and, along with the British government, launched a scheme aimed at boosting lending to the non-financial private sector. Finally, the Bank of Japan expanded the volume of its asset purchase programme at its April and September meetings. In the fiscal domain, fiscal consolidation continued to be intense in the European economies most closely scrutinised by the markets, while doubts grew over the medium- and long-term sustainability of public finances in Japan and the United States. Nonetheless, in the United States the main risk in the short run is of the opposite sign: the automatic activation of substantial fiscal cuts at the end of this year (the so-called fiscal cliff) which, if no political agreement is reached to avoid it, will have an effect on growth equivalent to several percentage points of GDP.

During this period, activity continued to slow progressively in the emerging economies. This was notably the case in China and India, where the slowdown was sharper than expected. These developments arose, with some cross-regional differences, due to the lower contribution from external demand and, in some cases, to the gradual weakening of domestic demand. The deepening of the euro area crisis had a notable impact on emerging economies through the commercial channel; the impact was sharper in European emerging countries with closer commercial and financial ties to the euro area and in economies such as China with a higher degree of trade openness (see Chart 2). Inflation generally tended to ease in the period analysed, although in Q3 increases in energy and some food prices – in the latter case due to poor harvests in various regions – prompted a slight rise in inflation rates. In this setting, some banks continued with the cycle of interest rates cuts, although this trend was far from widespread and, rather, a cautious attitude prevailed which was reflected in leaving the monetary policy stance unchanged. In the same vein, the sharper-than-anticipated slowdown favoured the approval of fiscal stimulus packages in some cases – mainly China.

In this context, international financial markets were influenced by the worsening outlook for economic growth and the ongoing strains of the European sovereign debt crisis. However, the measures introduced during the summer by the main advanced economies' central banks contributed to stabilising financial markets. They triggered gains in most stock market indices, a decrease in volatility, a reduction in corporate bond risk premia, some improvement in the government debt markets of ailing European countries and a slight appreciation of the euro against the dollar. Commodities prices fluctuated somewhat and a pattern of declines predominated in Q2 which was corrected from end-June, especially in the case of oil and certain metals.

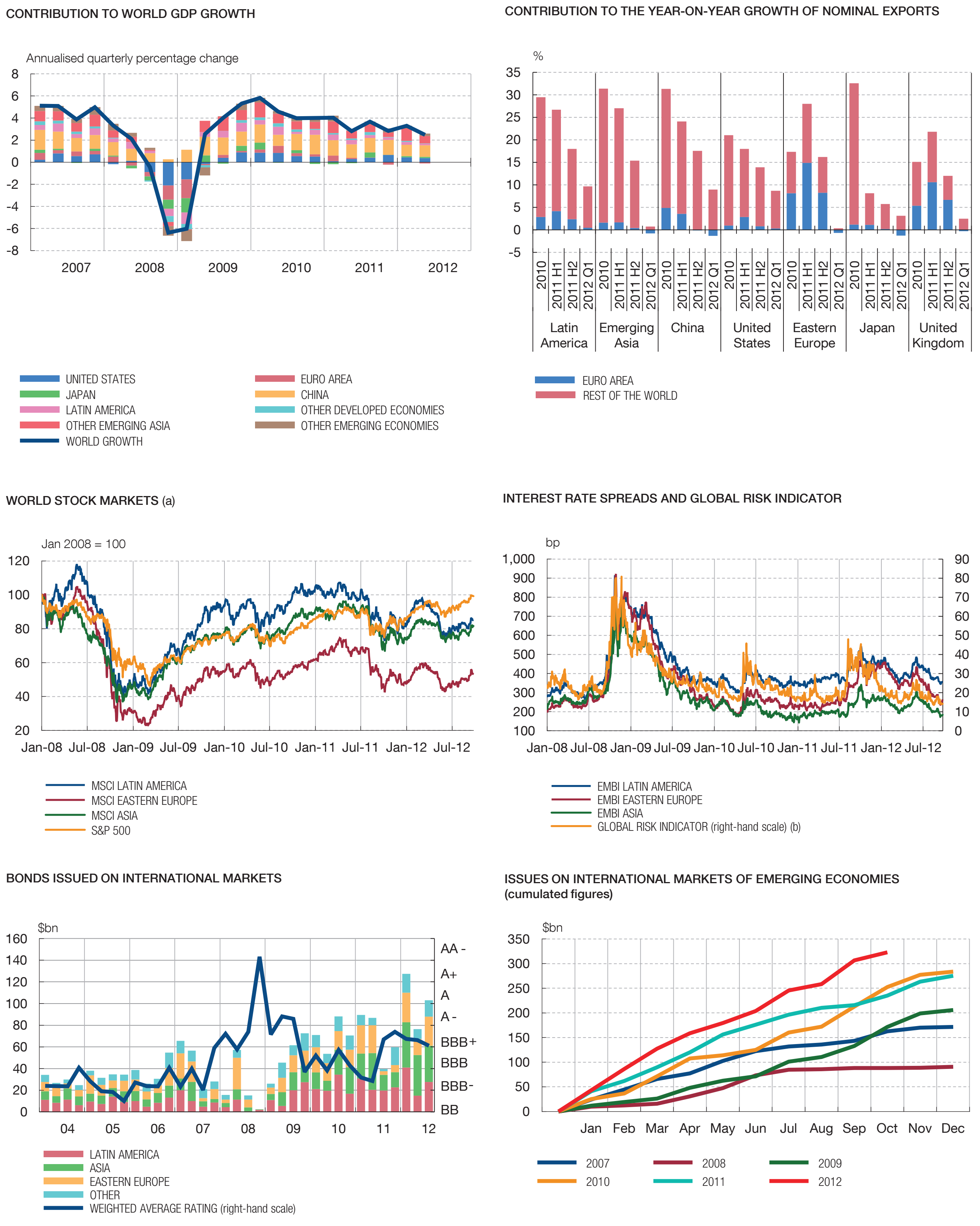
Financial markets and external financing

The recovery in financial markets in the early months of 2012, following the bout of instability in 2011 Q4 linked to uncertainty about the unfolding of the Greek crisis, did not firm. In 2012 Q2, emerging markets were once again affected by uncertainty concerning the

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS

CHART 2

Annualised quarterly rate, basis points, indices and billions of US dollars


CONTRIBUTION TO WORLD GDP GROWTH

CONTRIBUTION TO THE YEAR-ON-YEAR GROWTH OF NOMINAL EXPORTS

WORLD STOCK MARKETS (a)

INTEREST RATE SPREADS AND GLOBAL RISK INDICATOR

BONDS ISSUED ON INTERNATIONAL MARKETS

ISSUES ON INTERNATIONAL MARKETS OF EMERGING ECONOMIES (cumulated figures)

SOURCES: National statistics, Dealogic, EPFR and Datastream.

a Indices in dollars
b VIX Index.

sustainability of Spain and Italy's public debt and the future of the euro project. This was reflected both in terms of financial asset prices – with stock market declines, widening sovereign spreads and exchange rate depreciations – and in terms of volumes – capital outflows from stock markets and the lower pace of fixed-income issuance on international markets together with slightly tighter issuance conditions (see Chart 2). However, this episode of tension was relatively short-lived with the result that from end-May emerging markets began to pick up again and in some cases reached their pre-summer 2011 levels. Subsequently, as mentioned above, the monetary policy measures adopted in developed countries lent further support to these markets. Investors returned to the stock markets, especially to debt, and issuance on primary markets recovered, resulting in a higher volume being placed in emerging markets between January and October than in the same period in 2010, marking an all-time record (see Chart 2).

Developments in Latin American financial markets in the last six months paralleled those in other emerging markets and were determined to a greater degree by global factors than by country-specific events. Between April and May sovereign spreads as measured by the EMBI climbed by almost 100 bp and at the height of the tension stood at around 480 bp (Chart 2). The sovereign spreads of Argentina and Venezuela deteriorated most (widening by 275 bp and 260 bp, respectively). In the case of the former, they were affected by certain government measures to control supply and demand for dollars and, in the case of the latter, they were impacted by the uncertainty surrounding the presidential elections in October. In Chile, conversely, the widening of the spread was limited to 45 bp whereas in Brazil, Mexico, Colombia and Peru it was close to 65 bp.

Since Latin America's exposure to financial flows (direct investment and foreign banks' capital) from the countries impacted most by the euro crisis, particularly, Spain, is higher than that of other emerging regions, Latin American markets were expected to have been affected more directly and sharply than other markets (see Box 1). However, the reaction of sovereign spreads and stock markets was not more intense than that in other emerging economies and was more moderate than that in previous bouts of global tension (see Chart 3). This greater resilience has arisen, furthermore, against a backdrop of a poorer outlook for Latin America's main trading partners, notably China, and of continued low growth expectations in the United States, suggesting that it is the improvement in the region's own economic and financial fundamentals that is supporting this increased autonomy. In this setting the rating agencies' ratings have improved by one notch since the end of last year for the aggregate of Latin America, even taking into account Argentina and Venezuela. Five-year sovereign CDS appear to have an implied rating, obtained through a panel with all the available countries[2] in the A- category (see Chart 3), approximately three notches above that given by the agencies and, at certain points in 2012 Q2, even above the aggregate for the euro area.

Between April and March, the Latin American stock market posted a decline of more than 21%, measured in dollars, higher than that in Asia but slightly lower than that in Eastern Europe. Accordingly, the region's exchange rates depreciated sharply, especially those of the economies with higher interest rates and more liquid markets which enhance the appeal of carry trade operations, such as Mexico (-8.8%) and Brazil (-5.5%) (see Chart 3). The tensions in global financial markets were reflected in a sharp drop in total capital inflows into Latin America in 2012 Q2 (see Chart 4) to levels similar to those

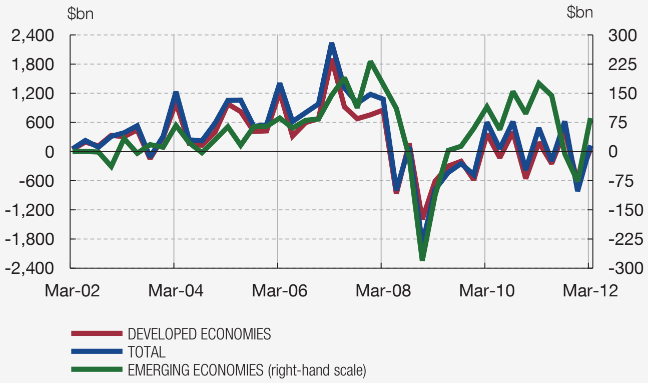
[2] Implied ratings calculated by exponential regression in respect of Standard and Poor's sovereign ratings transformed using the linear scale (21=AAA to 0=D/SD) and the listed premia for five-year sovereign CDS.

CROSS-BORDER BANK FLOWS TO LATIN AMERICA

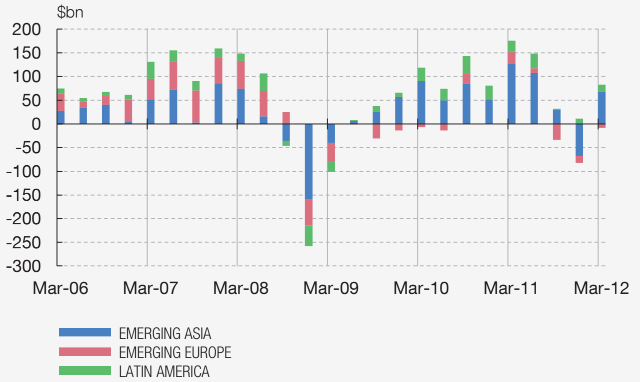
BOX 1

The world's main banking systems underwent strong international expansion in the years before the global economic and financial crisis of 2008. This process of internationalisation proceeded both directly through cross-border investment (hereafter "cross-border bank flows") and indirectly through expansion of local banking activity in the countries of destination. The bankruptcy of Lehman

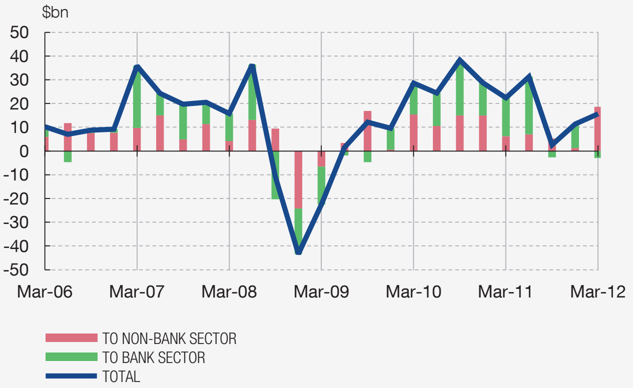
1 TOTAL CROSS-BORDER BANK FLOWS



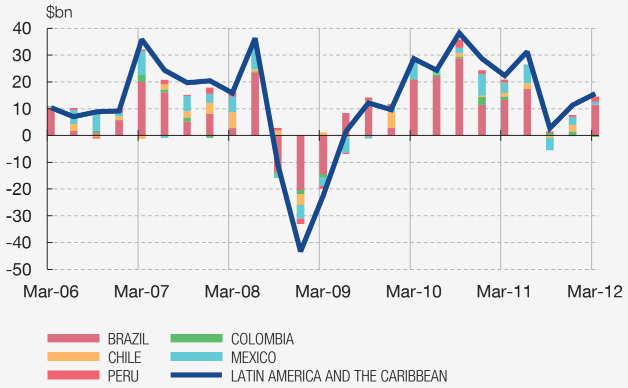
2 CROSS-BORDER BANK FLOWS TO EMERGING ECONOMIES, BY REGION



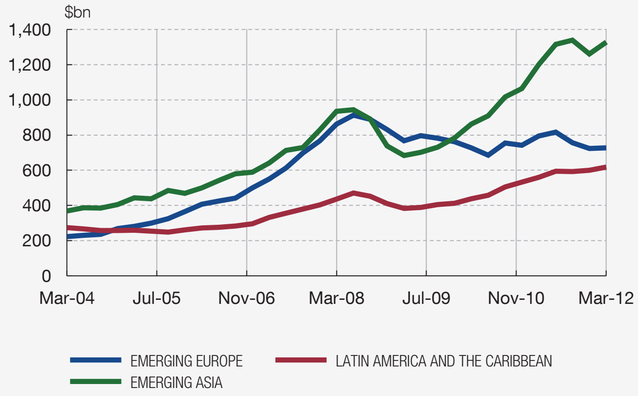
3 BANK FLOWS TO LATIN AMERICA, BY SECTOR OF DESTINATION



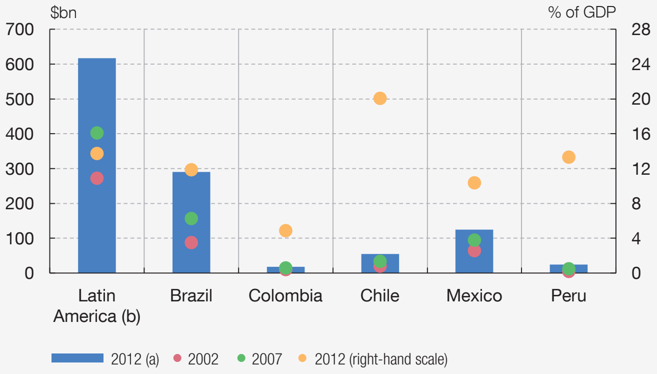
4 BANK FLOWS TO LATIN AMERICA, BY COUNTRY OF DESTINATION



5 CROSS-BORDER BANKING POSITIONS VIS-À-VIS EMERGING ECONOMIES



6 CROSS-BORDER BANKING POSITIONS VIS-À-VIS LATIN AMERICA



SOURCES: BIS Locational Statistics and IFM.

a Data up to 2012 Q1.
b Aggregate of Brazil, Colombia, Chile, Mexico and Peru.

Brothers suddenly interrupted this process, with a more notable impact on cross-border bank flows than on the local banking activity of foreign banks. Panel 1 shows that the successive bouts of financial instability since 2008 continue to have a significant negative impact on cross-border activity.

This Box describes cross-border bank flows to Latin America in recent years and compares them with those to other emerging regions, using the international banking statistics compiled by the Bank for International Settlements (BIS). The analysis is made with so-called Locational Banking Statistics (LBS), which are more appropriate for studying trends in international financial integration (because they focus on cross-border bank flows from the country of origin) than Consolidated Banking Statistics (CBS), also published by the BIS (which include both local exposure and the exposure through investments from the country of origin) and, accordingly, are more suitable for analysing the risks derived from such international expansion.[1]

In particular, LBS allow analysis of whether the deleveraging derived from the global financial crisis or, more recently, from the euro area sovereign debt crisis, is constraining cross-border funding. The analysis focuses in this case on emerging economies, particularly those in Latin America. This issue is important, among other reasons, because of its impact on the financial conditions in the countries receiving these flows.

The recovery of cross-border bank flows following the bankruptcy of Lehman Brothers has been irregular, with significant differences between the advanced and the emerging economies. On the one hand, as seen in Panel 1, bank flows to advanced economies have not recouped their levels prior to 2008. On the other, cross-border bank flows to the emerging economies as a whole rebounded strongly to levels above the previous highs, following the severe contraction between 2008 and 2009, although, as seen in Panel 2, regional composition changed significantly. Thus, flows to eastern Europe recorded a persistent contraction followed by an additional reduction from 2011 Q3, while emerging Asia and Latin America and the Caribbean recorded an upward trend, recouping and even exceeding the levels prior to 2008.

Recently these developments have been subject to significant fluctuations due to euro area instability, which has had a marked impact on emerging Asia. Note that in 2011 Q4 cross-border bank flows to this region showed a negative stock of around $70 billion, which contrasts with the strong inflows of previous quarters. Cross-border bank flows to Latin America and the Caribbean underwent smaller fluctuations than in other emerging areas, but exhibited qualitatively similar features. The breakdown by counterparty sector (see Panel 3) shows how cross-border bank flows to the banking sector showed the largest fluctuations in Latin America, a phenomenon similar to that seen in other regions.

The breakdown by country highlights the notable reversal of cross-border bank flows to Mexico in 2011 Q3 (see Panel 4), and the fall, smaller in absolute terms but highly significant, in Chile. In Brazil, a country financially integrated in the international markets, cross-border bank flows decreased in 2011 to become practically zero, and even posted a negative stock in 2011 Q4. Cross-border bank funding to the non-banking sector proved more resilient than that to the banking sector, although in 2011 Q4 it decreased in Brazil and Mexico.

These developments explain why cross-border bank positions (i.e. the volume of cross-border assets measured by LBS statistics) vis-à-vis Latin America and the Caribbean and vis-à-vis emerging Asia have tended to increase since the crisis, unlike in emerging Europe, where they have gradually decreased (see Panel 5). In any event, cross-border banking positions vis-à-vis Latin America continue to be smaller, measured in absolute terms, than the positions vis-à-vis other emerging regions. The breakdown by country also shows how the increase in international bank positions in Latin America has been practically across-the-board, reflecting the higher international financial integration. Panel 6 shows that in absolute terms the positions are larger in Brazil and Mexico, but that the relative positions, measured as a percentage of GDP, are more significant in Chile.

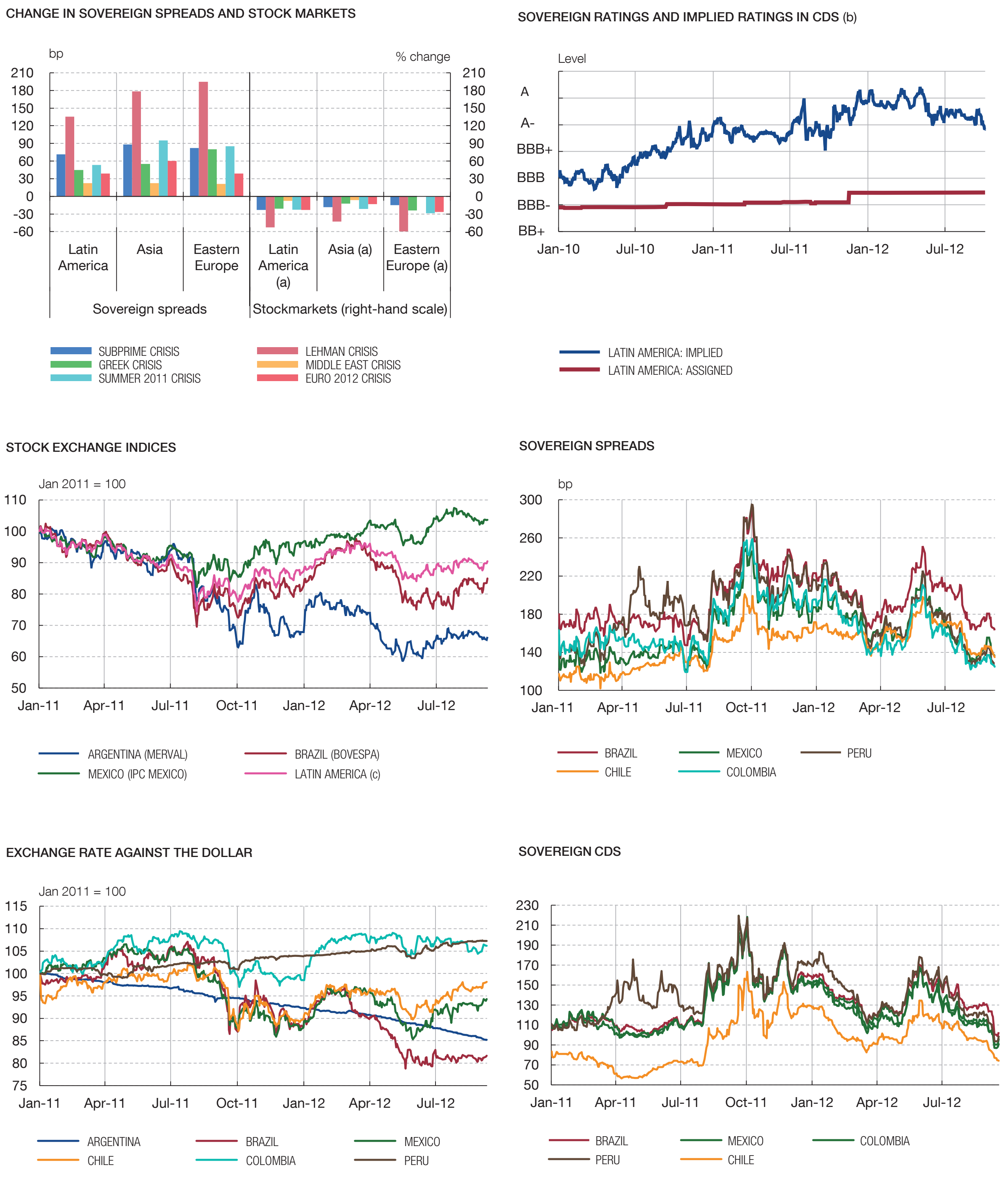
Overall, cross-border bank flows to Latin America have been more stable than those to the advanced economies or to other emerging regions. In Latin America, more than in other regions, foreign banks have operated through local banks, and this type of banking activity has been less affected by the crisis. These two circumstances may explain why, in regions like Latin America, the impact of the recurring bouts of financial instability on local financial conditions has been relatively slight to date.

[1] There are two reasons why Locational Banking Statistics are of more interest for analysing trends in international financial integration: (i) LBS include assets and liabilities of the banks resident in a country vis-à-vis the rest of the world, including vis-à-vis non-resident banks in the same group, while CBS are designed for studying the risks derived from the international expansion of banking systems and thus aggregate the international positions of the banks whose parent is located in a certain country with the positions of affiliates or subsidiaries located abroad, excluding the positions between them and their parents; and (ii) LBS, unlike CBS, show changes in exchange-rate value-adjusted positions, thus allowing a more accurate estimate of changes in cross-border bank flows by adjusting for this effect. For a detailed explanation of the banking statistics of the BIS and their various uses, see BIS, "Guide to the international financial statistics" (2009).

SOVEREIGN SPREADS, STOCK MARKETS, EXCHANGE RATE AGAINST THE DOLLAR AND SOVEREIGN RATINGS

CHART 3

Basis points, indices and percentage change



CHANGE IN SOVEREIGN SPREADS AND STOCK MARKETS

SOVEREIGN RATINGS AND IMPLIED RATINGS IN CDS (b)

STOCK EXCHANGE INDICES

SOVEREIGN SPREADS

EXCHANGE RATE AGAINST THE DOLLAR

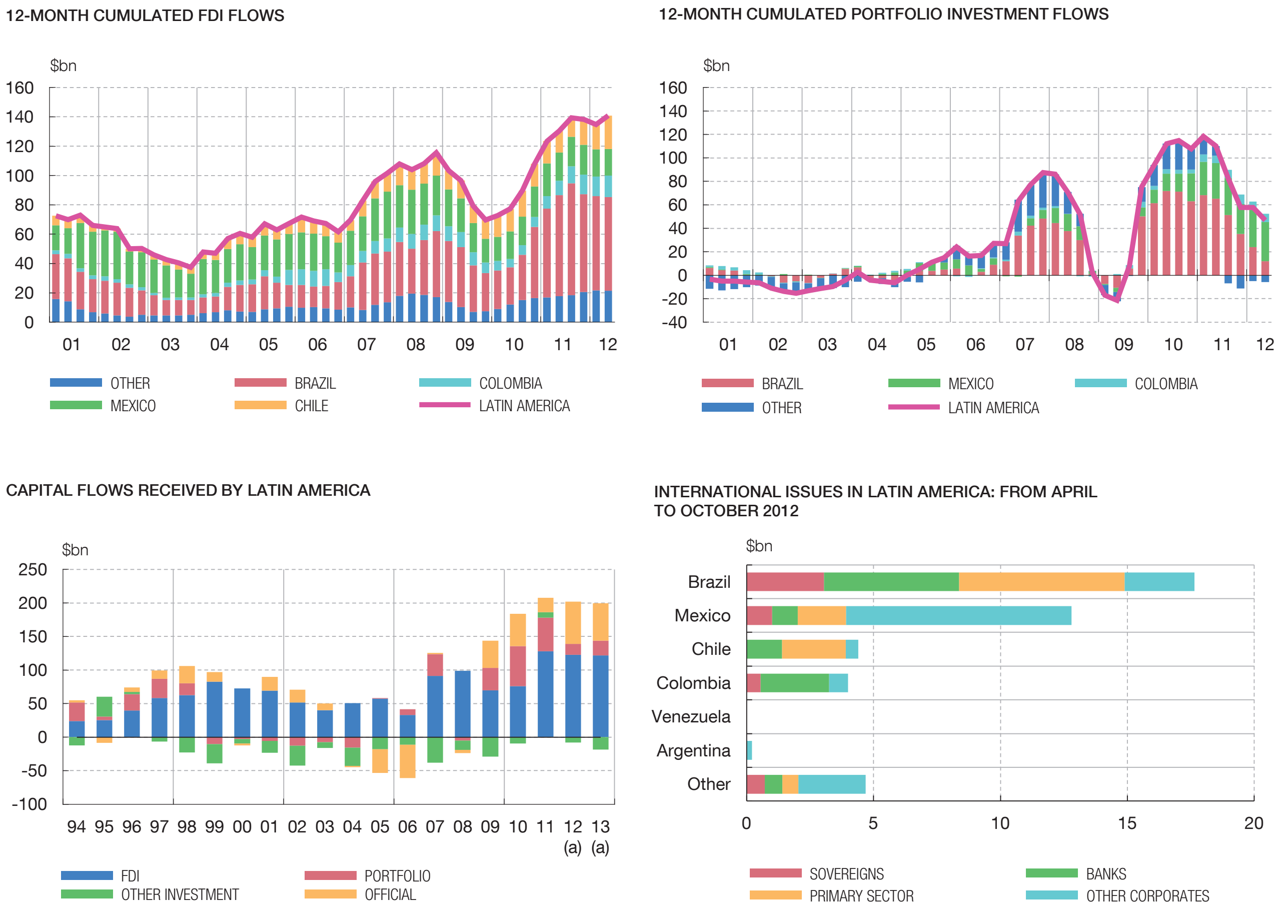
SOVEREIGN CDS

SOURCES: Datastream and JP Morgan.

a MSCI indices in local currency.
b Standard and Poor's scale. The implied ratings are derived from an exponential correlation between Standard and Poor's ratings and the five-year sovereign CDS.
c Latin American MSCI index in local currency.

EXTERNAL CAPITAL FLOWS AND FINANCING
Billions of US dollars

CHART 4



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

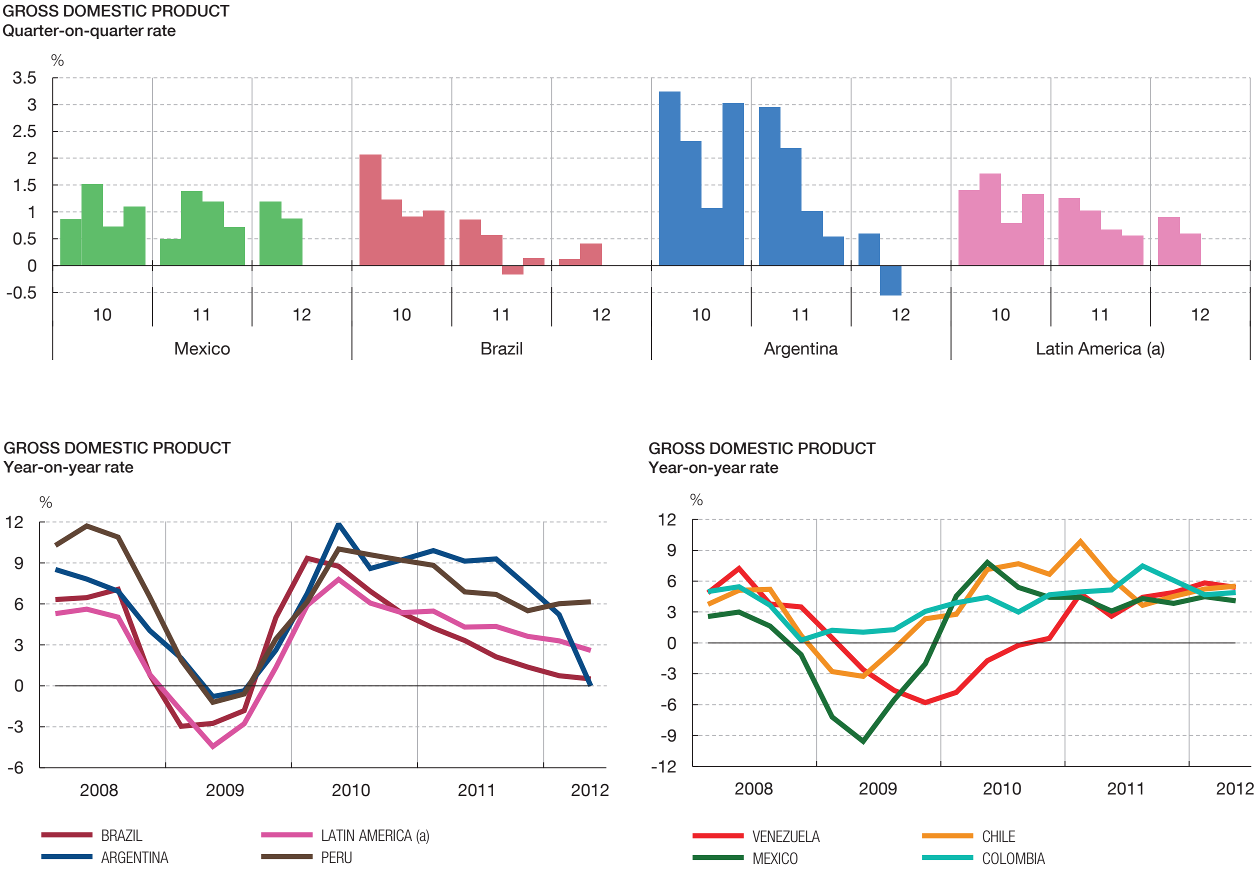
a IMF estimate.

at the beginning of 2009 (slightly less than $200 billion compared with more than $250 billion at the beginning of 2011). However, the breakdown of these inflows also changed very significantly since, while direct investment inflows held close to historical peaks (around $140 billion), portfolio investment flows fell back substantially to levels slightly below $50 billion (compared with $120 billion at the beginning of 2011). This moderation in portfolio inflows is accounted for by Brazil since portfolio investment inflows into Mexico remained very buoyant. Conversely, direct investment flows were very robust in most countries: Brazil ($56 billion), as well as Chile ($22 billion), Mexico and Colombia. Thus, direct investment inflows stood at 2.6% of regional GDP in Q2, higher than the aggregate current deficit.

From June the region's financial indicators improved significantly despite the backdrop of higher volatility. Sovereign spreads narrowed towards 350 bp, recovering their levels of prior to the turmoil in summer 2011, with sharper falls in the more stable countries, whereas the stock markets increased 14% in dollar terms, slightly more than Asia (10%). Also, fixed-income issuance improved on international markets, although Latin American issuers were less active than in 2012 Q1. Thus, in the six months analysed, issues amounting to more than $37 billion were placed (see Chart 4), compared with $41 billion in January-March, representing 23% of total emerging economies' issues compared with 32% in Q1. Brazil and Mexico continue to be the main issuers. In Mexico there is a high level of

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

CHART 5


GROSS DOMESTIC PRODUCT
Quarter-on-quarter rate

GROSS DOMESTIC PRODUCT
Year-on-year rate

GROSS DOMESTIC PRODUCT
Year-on-year rate

SOURCE: National statistics.

a Aggregate of the seven main economies.

concentration since only six firms have tapped the markets in this period —compared with ten in Brazil— and only one firm accounted for 54% of total issuance.

Following the depreciation of most Latin American currencies since March, the rise in capital inflows from June led exchange rates to recover their previous levels. The notable exception was the Brazilian real which has corrected part of its previous overvaluation, in a setting of worsening terms of trade and supported by measures taken by the Bank of Brazil, mainly the reduction of official interest rates against a backdrop in which it was possible to withdraw some of the controls used in the past to moderate capital inflows.

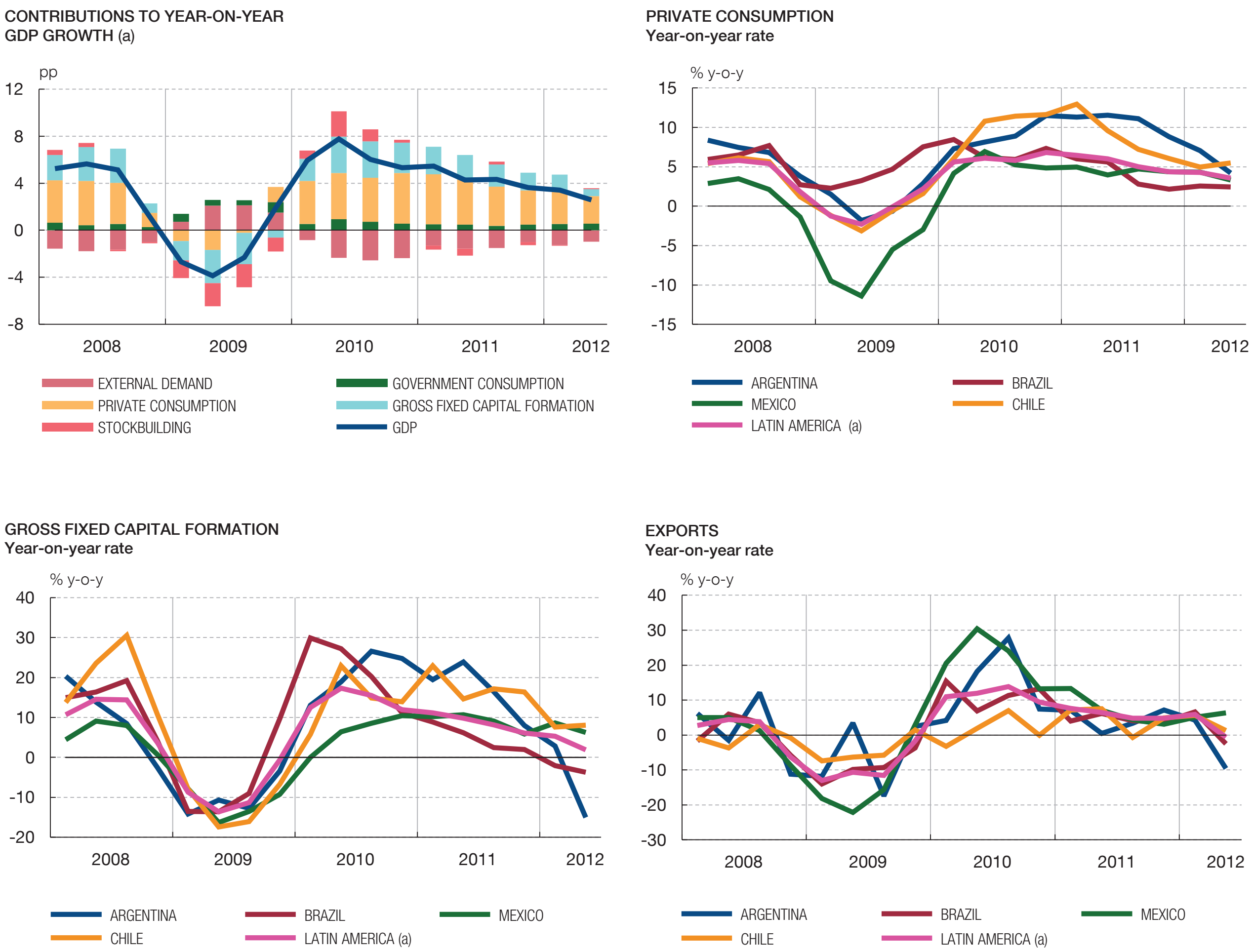
Activity and demand

Following Q1 when sound growth was confirmed in Latin America (averaging 0.9% quarter-on-quarter) the pace of expansion tended to moderate in Q2 to rates of 0.5%, while the year-on-year rate stood at 2.6%, down from 3.3% in Q1. This easing was influenced by activity in Brazil (0.5% year-on-year in Q2) and Argentina (0% year-on-year), since Mexico and Venezuela posted growth above 4% year-on-year in Q2, albeit slowing slightly with respect to Q1, whereas Chile, Colombia and Peru increased their pace of growth in Q2 with year-on-year rates of 5.5%, 4.9% and 6.1%, respectively (see Chart 5).

In terms of the regional average, domestic demand remained the main support for activity, contributing 3.2 pp to GDP growth in Q2 (see Chart 6). However, it was also the GDP component that slowed most (1 pp down on the previous quarter and 2 pp down on the average

BREAKDOWN OF GDP AND INVESTMENT
Year-on-year rates and percentage points

CHART 6



CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)

PRIVATE CONSUMPTION
Year-on-year rate

GROSS FIXED CAPITAL FORMATION
Year-on-year rate

EXPORTS
Year-on-year rate

SOURCES: National statistics and IMF.

a Aggregate of the seven main economies.

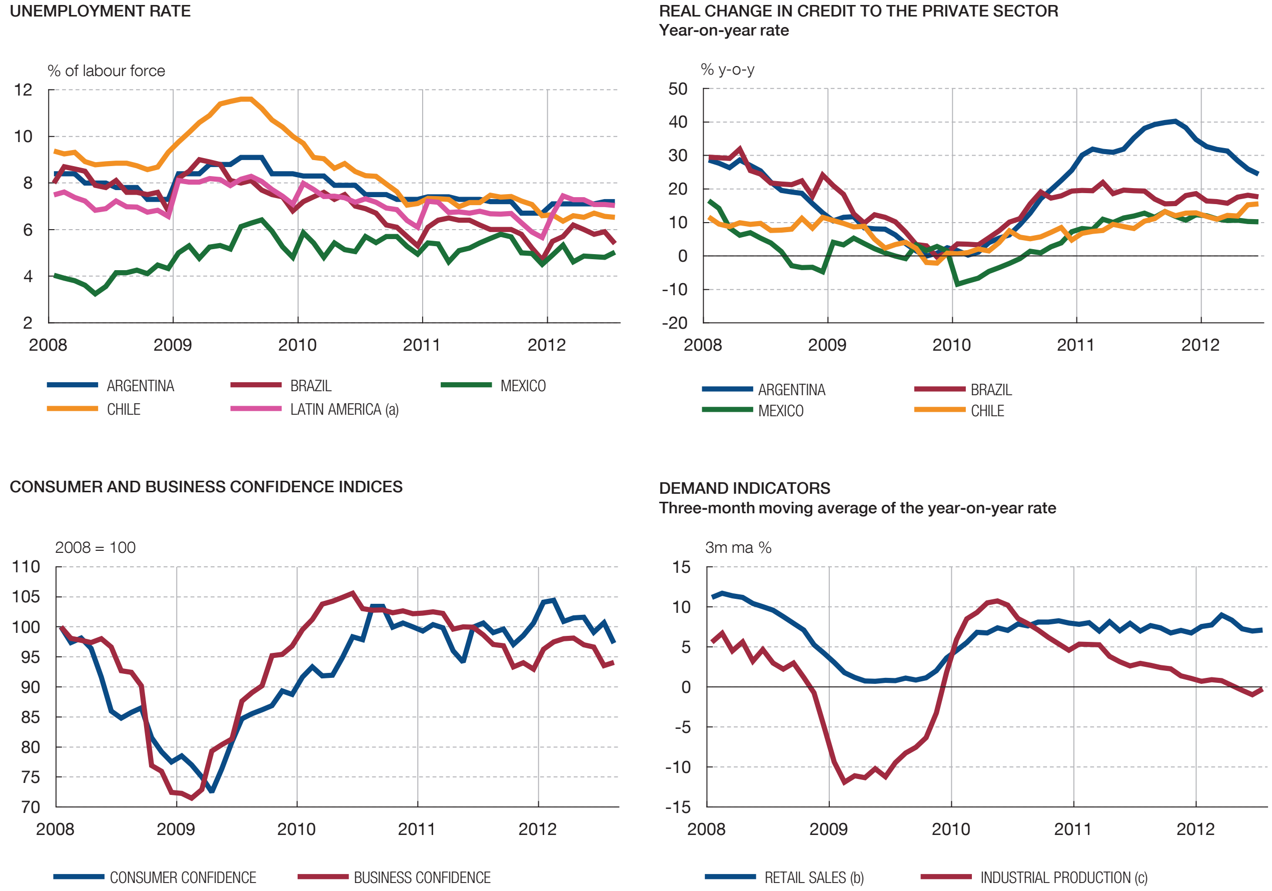
for 2011), mainly due to the weak performance of gross capital formation in several of the largest countries. By contrast, private consumption was more resilient and inventories contributed somewhat to growth, following two quarters of negative contributions.

Gross capital formation eased significantly at regional level and increased 1.9% year-on-year in Q2 (compared with 5% in Q1), the lowest rate since 2009. However, there was extensive cross-country disparity since in Colombia, Peru and Venezuela investment grew at year-on-year rates of more than 15%, while in Argentina it fell 15% and in Brazil it declined 3.5%. These differences correspond to different positions in the cycle and specific factors. In Colombia and Peru investment rose notably in a setting of expanding activity and a sharp increase in foreign direct investment. Conversely, in Brazil investment weakened because of the cyclical slowdown and the industrial sector's difficulties, partly due to the currency overvaluation, but also due to structural problems. In Argentina the strong contraction seems to be largely explained by the recently applied foreign exchange controls and restrictions on imports, while in Venezuela investment increased as a result of higher public spending and investment (housing programmes), in view of the elections. From the standpoint of financing investment, note that credit growth remained high – despite international financial instability – and that firms continued to have ample access to funding markets in most countries.

EMPLOYMENT, DEMAND AND CREDIT INDICATORS

CHART 7

Percentages, indices and three-month moving average of the year-on-year rate



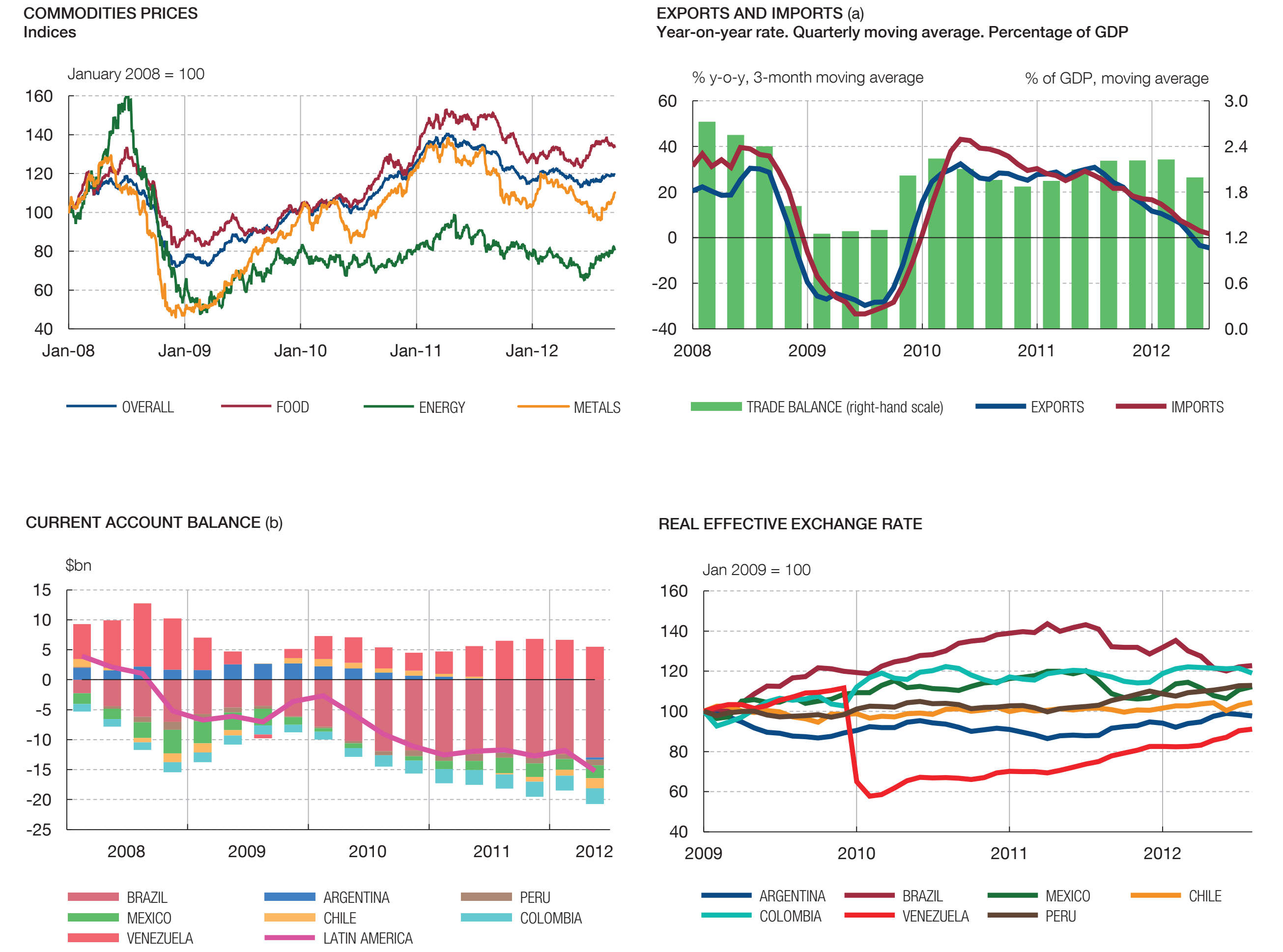
SOURCE: National statistics.

a Aggregate of the seven main economies.
b Aggregate of Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
c Aggregate of the eight main economies (the former plus Uruguay).

Private consumption showed greater resilience, although its growth moderated slightly to an average rate for the region of 3.4% year-on-year in Q2, in contrast with 4.2% in Q1 and rates of more than 5% in 2011. The slowdown centred mainly on two countries (Mexico and Argentina) since in the other countries growth rates remained similar to those of the previous year. Major determinants of the attendant developments here were the labour market situation, agents' confidence and credit, which continued to perform well in general, without many changes with respect to previous quarters. The average unemployment rate for the region held at similar levels to those in 2011, of around 7.6% of the labour force, close to the record lows (see Chart 7). In Brazil and Chile the labour market remained robust recording unemployment rates of around 6% and 6.5%, respectively, several points below those recorded in 2008, with some wage pressures. In Colombia and Peru the unemployment rate continued to move along a decelerating path, which shows the buoyant activity in both economies. In Mexico employment growth averaged 4.1% in the first half of the year, although the highest rise was in poor quality jobs, as has been the case since the crisis in 2008. Notwithstanding this, and the decline in the numbers unemployed, the unemployment rate stabilised around 5% which is still about 1 pp higher than before the crisis. In Argentina job creation fell in the last two quarters for the first time since the expansionary cycle in 2002 and the unemployment rate rose slightly to 7.2% in Q2.

EXTERNAL ACCOUNTS AND DETERMINANTS
Indices, year-on-year rates of change 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 main economies.
b Four-quarter moving average.

The negative contribution of external demand stood at 0.9 pp, similar to previous quarters, however, on this occasion it is explained by the slowdown of exports which posted a year-on-year rate of change of -0.6% in Q2 (compared with 6.2% in Q1). In previous quarters, the negative contribution of external demand had largely been in response to a strong increase in imports, in a setting of strong domestic demand and buoyant exports. This trend towards a slowdown of exports was widespread, Mexico being the main exception —its cycle is closely tied to the US industrial cycle— with export growth of 6.3% year-on-year in Q2.

The average nominal decline in the region's exports was -4% in year-on-year terms in July (see Chart 8), which means that the downward trend that began in the second half of 2011 was prolonged, after a year of growth rates of roughly 30%. The fall was sharper in value than in volume due to the drop in commodity prices in some countries in the first half of the year (mainly metal and energy prices which decreased by around 15%-20%) and due to the exchange rate depreciation in other countries. By destination, South America's exports to the EU, its main trading partner, fell 8.3% year-on-year to June and, by contrast, exports to the US grew 4.3% and those to China were up 7.8%, although they also slowed. In Mexico the slowdown arose from the contraction of fuel exports and, on the destination side, of exports to the US and Brazil due to the suspension of the Economic Complementation Agreements with Mexico. Foreign trade between Brazil and Argentina also weakened considerably as a result of the latter's import restrictions.

Since imports are highly correlated with exports, they also eased in recent months, albeit slightly less than exports. This resulted in a moderate reduction of the region's trade surplus to under 2% of GDP which is mainly explained by developments in Brazil, and in the commodities exporters, Chile and Peru. In Argentina the trade surplus widened substantially. In this setting the current deficit, measured as a percentage of regional GDP, held steady at around 1% of GDP but widened to slightly more than $55 billion and its distribution changed, with the result that all the region's largest economies (except Venezuela) are currently running a current account deficit (whereas at the beginning of the year only three countries did). The slowdown of economic growth has not changed this trend to date. The current deficit widened particularly quickly in Chile to 3% of GDP, despite continued high copper prices and positive terms of trade. This widening is associated with the robust investment process and the normalisation of the savings rate following the crisis.

The latest economic indicators show mixed signs. On one hand, the industrial sector seems to have bottomed out, judging by the recent recovery of industrial production, and is showing signs of picking up in Brazil and Argentina, two countries which had shown a weaker performance to date (see Chart 7). Contributory factors in the first case were the economic policy stimulus and the partial correction of the strong appreciation of the effective exchange rate of the Brazilian real in recent years, since it has depreciated by almost 20% over the last year (see Chart 8). On the other, indicators related to the external sector and to consumer and business confidence are on the downside in the other countries, partly reflecting uncertainty about the outlook for the global economy and weak external demand.

Prices and macroeconomic policies

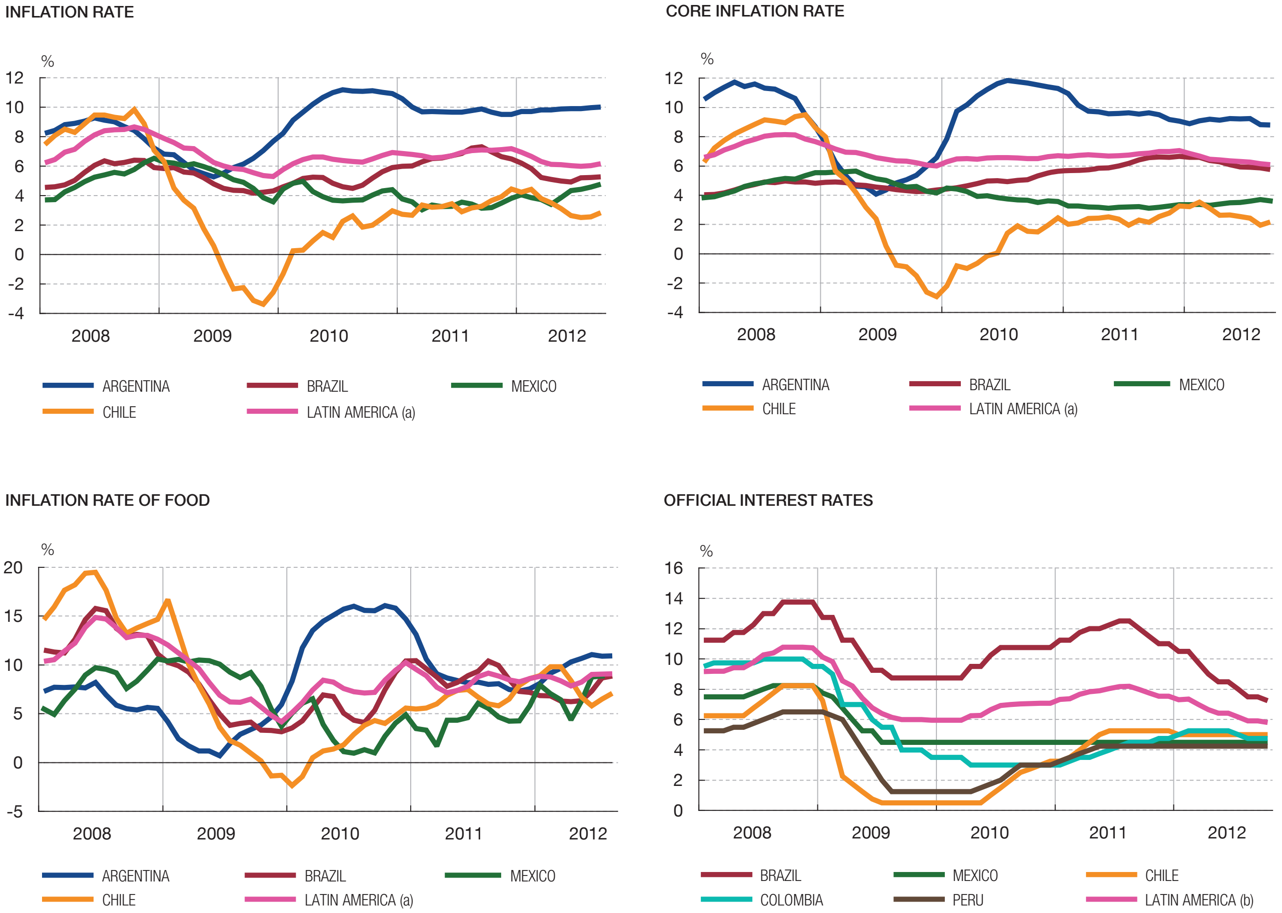
In Latin America as a whole, inflation experienced few changes in the last six months. The average inflation rate of the seven largest economies stood in September at 6.2% year-on-year, the same rate as in March (see Chart 9). Core inflation stood at 6.1%, only 0.3 pp lower than its levels of 2012 Q1, despite the significant slowdown in growth, which underlines some downward stickiness in prices, albeit with considerable cross-country differences. Thus, in Mexico inflation increased appreciably (to 4.8% in September, 0.9 pp up on March) which can be explained by an isolated supply shock arising from bird flu, that hardly affected core inflation or long-term inflation expectations. In the other countries, inflation stabilised (Brazil, 5.3% year-on-year) or posted a slight downward trend (Colombia and Peru, 3.1% and 3.7%, respectively, in September), underpinned by the moderation of food and energy prices, a trend which, nonetheless, has recently been interrupted. In Chile inflation slipped more notably to 2.8% year-on-year which is lower than the central bank's target, partly as a consequence of the appreciation of the exchange rate.

In Argentina and Venezuela inflation rates remained very high. Inflation in Argentina held at around 10% according to official figures (although private estimates indicate more than double this figure), a situation which has got worse on account of the monetary financing of the burgeoning government deficit. In Venezuela the growth rate of prices moderated somewhat, but still stands above 19%.

In this setting, the rise in food prices in Q3 (see Chart 9) caused some concern, given the high weight of this item in the consumption basket in several countries in the region.

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

CHART 9



INFLATION RATE

CORE INFLATION RATE

INFLATION RATE OF FOOD

OFFICIAL INTEREST RATES

SOURCES: National statistics and Banco de España.

a Aggregate of the seven main economies.
b Weighted average of the official rates of the five coutries with inflation targets (see Table 2).

INFLATION
Year-on-year rates of change

TABLE 2

	2011			2012		2013
Country	Target	December	Fulfillment	September	Expectations (a)	Expectations (a)
Brazil	4,5 ± 2	6,5	Yes	5.3	5.2	5.3
Mexico	3 ± 1	3,8	Yes	4.8	4.0	3.7
Chile	3 ± 1	4,4	No	2.8	2.2	3.1
Colombia	3 ± 1	3,7	Yes	3.1	3.1	3.1
Peru	2 ± 1	4,7	No	3.7	3.0	2.9

SOURCES: National statistics and Consensus Forecasts.

a September 2012 Consensus Forecasts for the end of the year.

The depreciation since the beginning of the year of several Latin American currencies and the labour market tightness in several countries constitute other risk factors. However, the fact that this rise has not been as widespread by product as that recorded in 2008, that energy prices have not increased to the same extent, and that the less buoyant setting has contributed to closing output gaps in some countries, indicates that pressures on food prices could feed through on this occasion to inflation rates and, especially, to inflation expectations to a smaller degree than they did at that time. In any event, this background contributes to explaining why the downward cycle in interest rates has not spread. Brazil's central bank has continued to cut its official interest rates heavily (by 525 bp since the beginning of the cycle to 7.25%); Colombia's central bank has lowered them by 25 bp on two occasions in July and August, to 4.75%. The other central banks in countries with inflation targets have adopted a wait-and-see stance and further action will depend to a large degree on developments in the external environment.

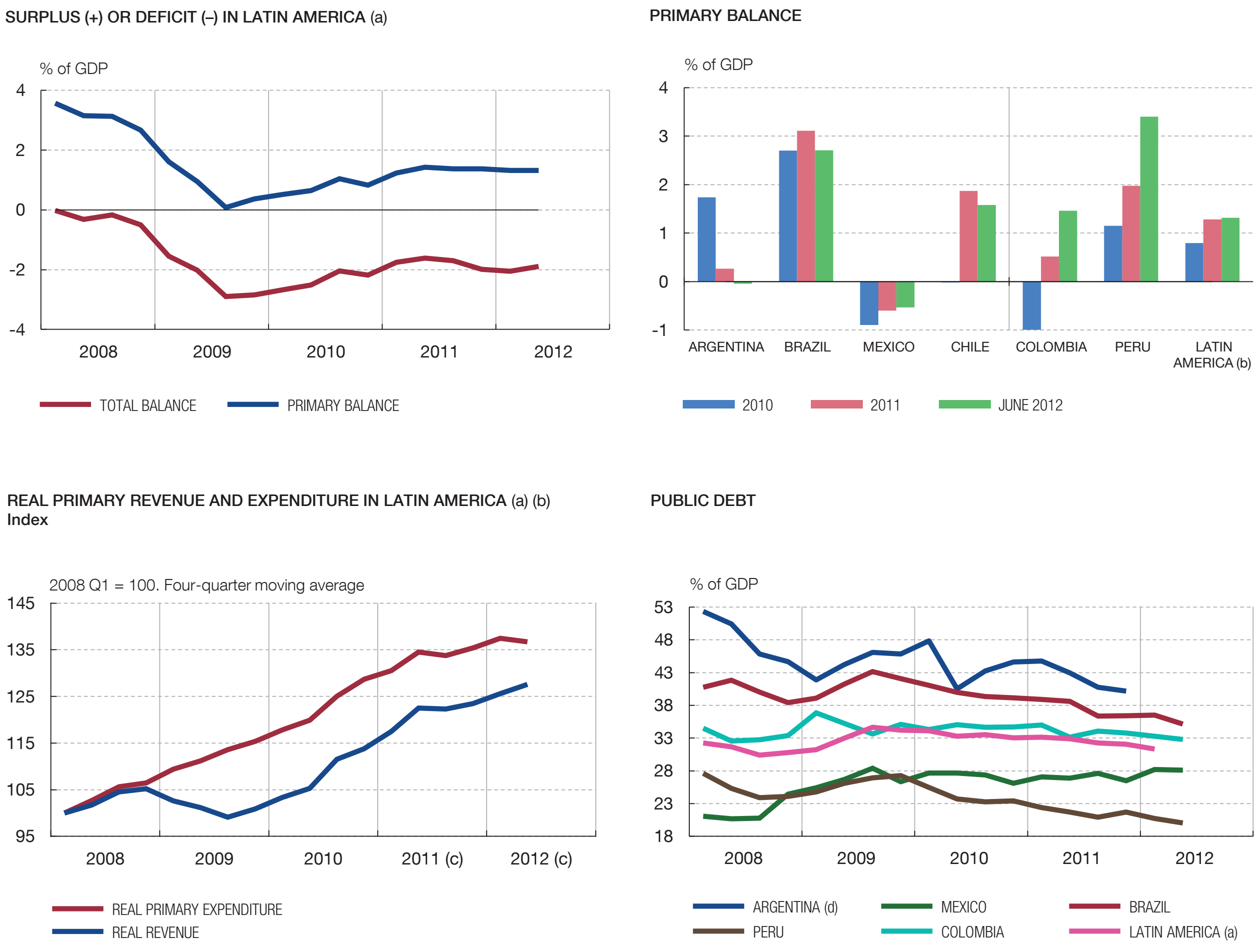
The stimulus measures were not restricted to conventional monetary policy in Brazil. A series of measures was also adopted to bring down the cost of credit, such as modifying the lower limit of savings deposits (considered a floor for official interest rates); an indirect reduction of the bank reserve requirement; a cut in the long-term interest rate on loans extended by the public bank to 5.5% and the abolition of the tax on financial transactions (IOF by its Portuguese acronym) for operations abroad with a maturity of more than two years. In Peru, by contrast, a series of restrictive measures were taken in this area such as raising the local and foreign currency bank reserve requirement in September and October in order to moderate the inflow of short-term capital and credit growth, although the requirements in respect of foreign trade transactions were reduced.

In the fiscal arena Brazil and Peru were the countries which announced most measures. In the former, various stimulus packages were approved, slightly shifting spending towards investment, although without changing the target of a primary surplus for 2012 or 2013 (3.1% of GDP). However, the outturn to August indicates a considerably lower primary surplus in 2012 of 2.5% of GDP. In the other countries the fiscal policy measures were less significant. The region's fiscal and primary balances hardly changed with respect to 2011, averaging around -2% of GDP for the former and around 1.5% for the latter (see Chart 10). Cross-country differences, however, were pronounced since, whereas in Brazil and Chile the primary surpluses fell and in Argentina there was a primary deficit (measured in cumulative four-quarter terms), in Colombia and Peru, as a result of the favourable performance of revenue, their primary surpluses rose noticeably. In this setting, the public debt/GDP ratios stabilised and in some countries continued their downward trend.

Finally, exchange rate policy has not had to face in this half-year period the upward pressures and dilemmas seen recurrently in 2008, 2010 and 2011, in a setting in which capital inflows have tended to moderate (especially portfolio inflows). Accordingly, in certain countries the active use of exchange controls and declines in interest rates seem to have had some effect on moderating the upward pressures. Furthermore, the international financial markets have experienced moments of high risk aversion which have also eased the pressure on and even triggered the depreciation of currencies. Nevertheless, the authorities of Peru and Colombia, for instance, have continued to intervene on foreign exchange markets when they have perceived that there is an overvaluation risk of their currencies (see Box 2). This possibility has even been weighed up in Chile due to the appreciation of the peso, although the authorities have reiterated that levels which would justify an intervention have not been breached. In Peru a new exchange rate intervention policy was announced which is geared at buying smaller amounts of dollars for a fixed

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and index

CHART 10



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

PRIMARY BALANCE

REAL PRIMARY REVENUE AND EXPENDITURE IN LATIN AMERICA (a) (b)
Index

PUBLIC DEBT

SOURCES: IMF and national statistics.

a Seven main economies.
b Deflated by the CPI.
c Aggregate excluding Venezuela.
d Excludes untendered debt in the debt swap offers of 2005 and 2010.

amount, irrespective of any appreciation of the new sol exchange rate, in order to introduce greater exchange rate volatility and to discourage speculation and indebtedness in dollars. Finally, in some countries such as Brazil, there seems to be lower tolerance of an appreciation of the exchange rate: following the depreciation of the real against the dollar over the year, the announcement of a third round of monetary easing by the Federal Reserve unleashed buying of dollars at certain thereshold levels of the exchange rate which are considerably lower than last year, and even prompted statements about the possible reintroduction of the tax on cross-border financial transactions in order to moderate speculative financial inflows. In the region as a whole, however, the build up of reserves in the last six months has been much more limited.

Integration processes and structural policies

The trade integration processes in the region continued to progress differently in the countries on the Pacific Rim, which continued to focus on foreign trade, and in Mercosur where the protectionist tensions between Argentina and Brazil heightened with the adoption of measures – although announced as temporary – that have restricted inter-regional trade. In addition to this problem, there were also fresh political tensions among the bloc’s members and progress on agreements with other actors in world trade was impossible.

ARE FOREIGN EXCHANGE INTERVENTIONS EFFECTIVE IN LATIN AMERICA? EVIDENCE FOR FOUR COUNTRIES IN THE REGION[1]

Foreign exchange interventions consist of foreign currency purchases or sales undertaken with the aim of influencing the level and/or volatility of the local currency. If a central bank considers that the exchange rate of its currency has deviated excessively from its equilibrium, it will buy (sell) a foreign currency during periods of upward (downward) pressures. Currently, practically all of these interventions, including those in Latin America, are sterilised through open market operations in order to eliminate their effect on the internal money supply. While unsterilised interventions have a direct impact on the exchange rate through the monetary channel, sterilised interventions have an impact through indirect channels, although there is still broad theoretical and empirical debate about these, both for developed and emerging countries.[2]

Thus, much of the empirical literature analysing this question reaches unfavourable conclusions about their degree of effectiveness: namely, the interventions are estimated not to have a significant influence on the exchange rate and even seemingly increase exchange rate volatility. However, this finding may be the result of a simultaneity problem inherent to the data since the interventions are a response to excessive exchange rate volatility and, consequently, the dates of both usually coincide. That is to say, concluding that greater volatility is the result of the intervention could be misleading.[3] This evidence contrasts with the widespread use of foreign exchange interventions by central banks. In fact, according to different surveys of central banks, the latter trust in the usefulness of these interventions for influencing the level and volatility of the exchange rate.

In addition to this lack of consensus is the fact that very few countries publish their daily interventions – the commonest frequency for this type of analysis. This explains why most empirical studies focus on a few economies: the United States, Japan and Australia. Conversely, studies which have analysed emerging market economies (EMEs) are more scarce, largely due to the lower availability of data, which are frequently considered confidential. Although the dissemination of this information is gradually increasing, only a few EMEs (mainly from Latin America) publish these figures with the aforementioned frequency.

Foreign exchange interventions in EMEs differ in nature from those of developed countries and, consequently, their effects could be different. Thus, this type of operations is more frequent in EMEs than in developed countries, even where the economies follow an inflation-targeting regime, although theoretically this regime should be linked to a freely floating exchange rate.[4] This flexible implementation of inflation targeting is very common in emerging economies given their vulnerability to abrupt movements in the exchange rate and, consequently, their exchange rate management is usually more active than in developed economies.[5] A priori, it could be thought that the effect of interventions on EMEs would have a bigger impact on the exchange rate than in developed economies, given the larger size of their interventions in relation to the foreign exchange trading volumes since they are less sophisticated markets than developed ones. However, the empirical studies for EMEs are not conclusive either.

The study on which this box is based analyses the effect of the interventions on foreign exchange levels and volatilities in the four economies in the region which publish their data daily – Chile, Colombia, Mexico and Peru – through various GARCH models. As a result of these models it is possible to take into account the volatility of the data in the estimation.[6] These four economies follow monetary policy systems based on the fulfilment of inflation targeting and constitute a representative sample of Latin America, although the main country in the region, Brazil,[7] is missing. Panel 1 shows bilateral exchange rates against the dollar of the Chilean peso, the Colombian peso, the Mexican peso and the Peruvian new sol, together with their corresponding daily interventions.

The Panel shows the varied characteristics of foreign exchange interventions in terms of frequency and size, which differ considerably by country. Thus, these intervention strategies range from purely discretionary ones (Peru), to the use of intervention rules (Chile and, recently, Mexico and Colombia), where the authorities publicly announce the amount of foreign currency to be bought or sold during a specific period, and where more frequent interventions of a smaller size than the ad hoc interventions seem to be involved.[8] This diversity of strategies employed by the EMEs contrasts with that of developed economies that currently perform interventions, such as Japan, where the tendency is to intervene discretionally and only under exceptional circumstances.

[1] Based on C. Broto (2012), The effectiveness of forex interventions in four Latin American countries, Documentos de Trabajo, No. 1226, Banco de España.

[2] Usually, three theoretical transmission channels of the effects of sterilised interventions are cited: the signalling channel, the portfolio-balance channel and the international coordination channel [see Sarno and Taylor (2001) for more details].

[3] Endogeneity problems are present in virtually all the empirical applications that analyse the effectiveness of foreign exchange interventions. Simultaneity problems are also behind some of the scantily intuitive results which are consistent with leaning against the wind strategies in which, for example, dollar purchases give rise to an appreciation of the exchange rate [Kim et al. (2000)].

[4] In principle, assuming that there is mobility of capital flows, an independent monetary policy cannot coexist with an exchange rate that is fixed or pegged to another currency through foreign exchange interventions (the policy dilemma of the impossible trinity).

[5] Berganza and Broto (2012).

[6] The main empirical contributions which study the impact of interventions on the exchange rate have used variants of the GARCH (Generalised Autoregressive Conditional Heteroskedasticity) models. See, for example, Domínguez (1998).

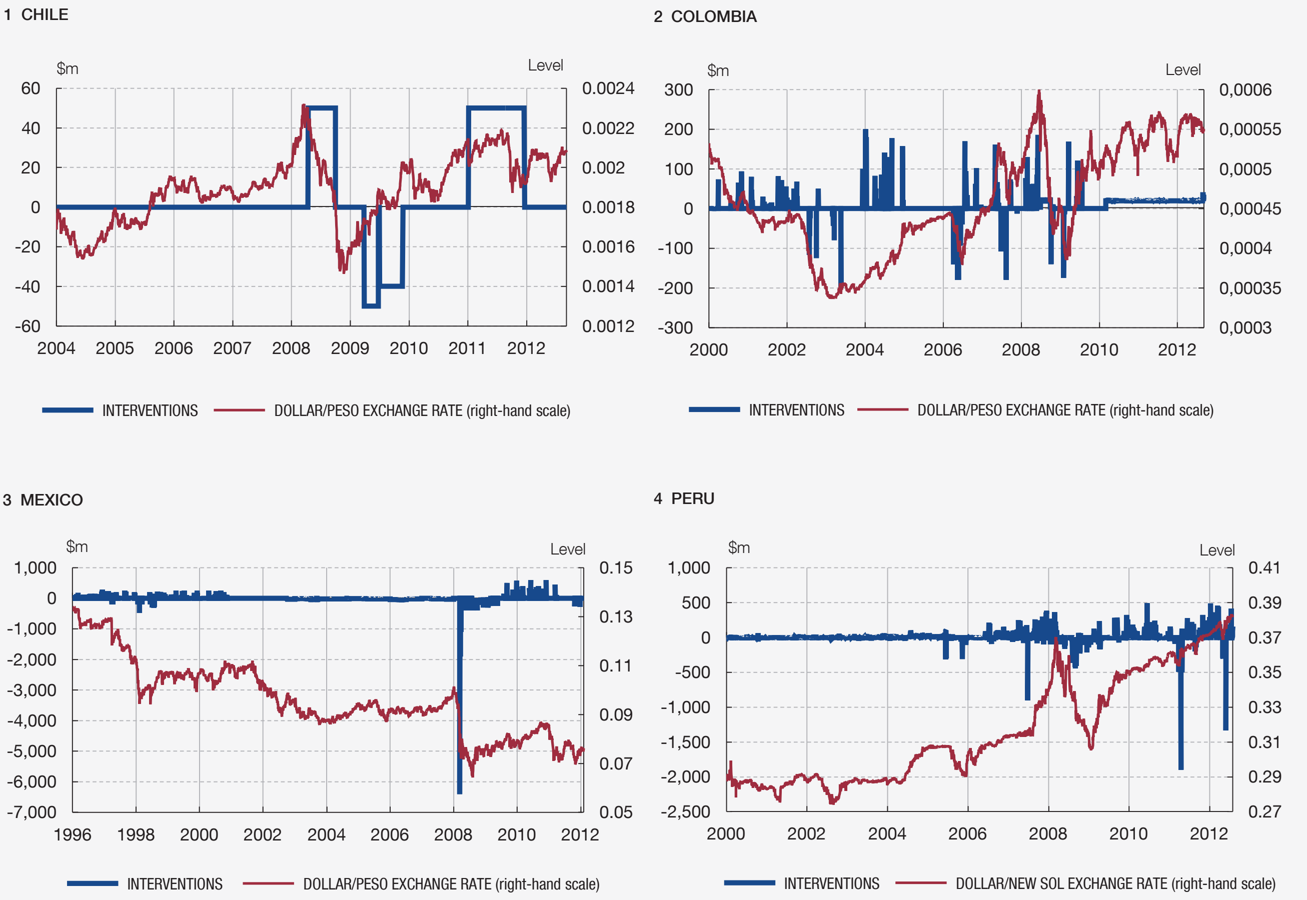
[7] Brazil is not included in the sample because daily data on its foreign exchange interventions are not available. They publish daily volumes of reserves, but the variation in international reserves is a poor approximation of the interventions [Adler and Tovar (2011)].

[8] There are two types of rules: those which aim to moderate exchange rate volatility (Colombia) and those which seek a mechanism to build up reserves (Chile). Mexico also uses the first type of rule with variation in the direction of the intervention (dollar purchases or sales on the spot market or via options). At present and since November 2011, a rule has been applied of buying up to $400 million daily if the peso depreciates by more than 2% daily against the dollar.

Another significant aspect is the possible asymmetrical effect of the interventions, namely, whether the magnitude of the impact of the foreign currency sales (negative interventions to avoid currency depreciation) on the level and volatility of the exchange rate is different to that of purchases (positive interventions with the aim of mitigating appreciation). This question had virtually not been analysed to date, however, following the outbreak of the global economic financial crisis in summer 2007, many central banks of EMEs implemented sales of reserves, of the opposite sign to those predominating prior to the crisis, which makes it easier to study this matter. Panel 1 shows that from the beginning of the period analysed, in Chile, Colombia and Peru interventions to purchase dollars have predominated, coinciding with the appreciation of their bilateral exchange rate against the dollar. Conversely, in Mexico dollar sales are more usual, given the depreciating trend of the Mexican peso and the central bank's strategy of smoothing market trends.

Several conclusions can be drawn from the empirical study. For instance, foreign exchange interventions seem to have asymmetrical effects, especially on exchange rate volatility. Furthermore, monitoring interventions based on their sign makes it easier to analyse the type of intervention, in terms of frequency and size, which is more effective. The results of the various estimations offer a clear pattern: on one hand, the size of the interventions does not seem to play an important role in reducing volatility or in achieving a specific exchange rate level. By contrast, isolated interventions or those which are the first following the adoption of a rule or in a series of interventions do seem to moderate exchange rate volatility in the four countries. The results for the level of the exchange rate are not as robust.

Since the four economies follow inflation targeting, this evidence suggests that the ad hoc interventions or the initial ones, following the creation of a rule, provide a signal to markets, irrespective of their size, and reduce exchange rate volatility. This result could be linked to the credibility of the inflation-targeting regime and offer further empirical support for the advantages of monetary policies instrumented through flexible inflation targeting. Additionally, these conclusions would support the empirical validity of the signalling channel in sterilised interventions, insofar as central banks would be indicating to the markets information about their future monetary policy or their outlook for the long-term equilibrium exchange rate.



1 CHILE

2 COLOMBIA

3 MEXICO

4 PERU

SOURCES: Datastream and national central banks.

a An increase (decrease) in the exchange rate indicates the appreciation (depreciation) of the local currency against the dollar. Foreign exchange interventions have a positive sign when they are dollar purchases and a negtive sign when they are dollar sales.

Thus, the Pacific Rim countries (Colombia, Peru, Chile and Mexico) created the Pacific Alliance in order to step up trade integration and to counter the protectionism of other blocs in the region, at the same time as they continued to sign or negotiate treaties such as that between Colombia and South Korea. Conversely, within Mercosur protectionist measures abounded such as new tariffs on capital goods imported by Argentina or various measures to protect local industry in Brazil, including, inter alia, the restriction of the automobile free-trade agreement with Mexico. At the summit held end-June the number of tariff items for which a temporary tariff increase was permitted for non-Mercosur products was raised from 100 to 200, although non-trade matters dominated the summit, in particular, Venezuela officially joining the trade bloc. No specific plans for opening up trade to other major players such as the European Union or China were made.

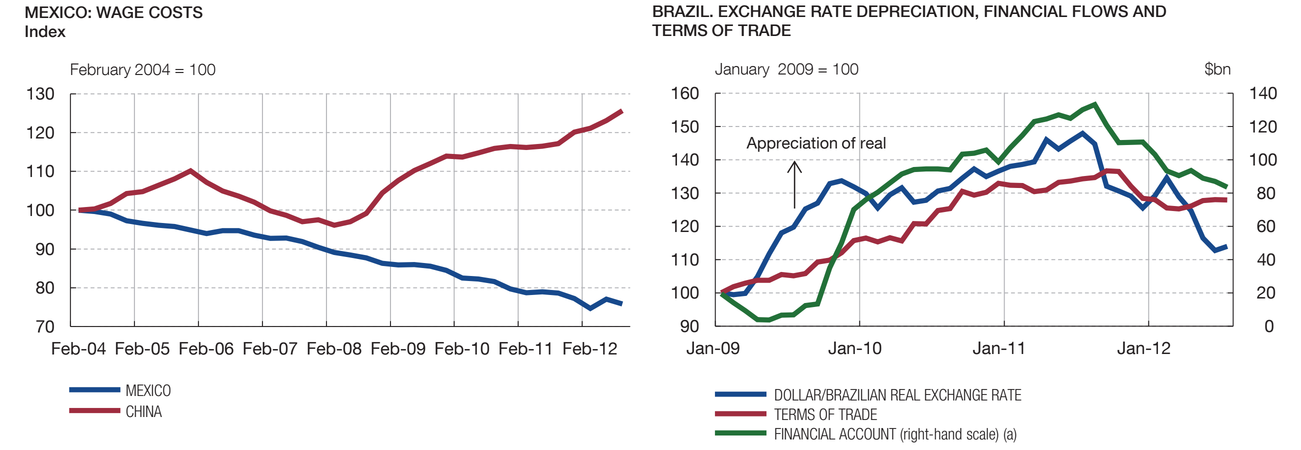
Turning to structural reforms, the new Mexican government suggested the possibility of implementing a labour reform (with unemployment benefit, regulation of temporary employment, reform of the role of trade unions and the introduction of a trial period in contracts), the universalisation of the social security system financed through taxes, an energy reform (opening up PEMEX to private investors while maintaining ownership and control of the company) and fiscal reform (broadening the VAT bases). Furthermore, the labour reform, proposed by the outgoing president of Mexico was approved, albeit with a smaller scope than was originally proposed. In Peru, the parliament approved the private pension system reform in order to increase current coverage of those contributing by 40% with the introduction of certain conditions for compulsory contributions (only 34% of employees are covered under these arrangements) and reduce the commissions charged by the employee pension fund managers. A tax reform was also approved which intends to raise tax revenue by 3 pp of GDP in five years, by abolishing certain tax allowances and reducing tax evasion. In Chile a tax reform was also approved with the aim of increasing tax revenue by reducing evasion, increasing corporate income tax, abolishing some allowances and eliminating legal loopholes which give risk to tax arbitrage. An increase in the tax on tobacco was also agreed, representing a further 0.2% of GDP to be used for improvements in education. Furthermore, half of household expenditure on education will be deductible. In Venezuela a new Labour Law was approved which increases labour costs and the payment of pensions and aims to reduce the shadow labour market. Lastly, the Bolivian government issued a decree for the expropriation of Transportadora de Electricidad, a subsidiary of the Spanish group Red Eléctrica, on the grounds of insufficient investment.

Economic developments by country

Economic activity in *Brazil* remained sluggish in the first half of the year, recovering more slowly than expected from the sharp slowdown recorded in the second half of 2011. GDP grew 0.4% quarter-on-quarter in 2012 Q2, after having expanded by 0.1% in Q1, and the year-on-year growth rate eased to 0.6% in Q2, down from 0.8% in Q1. This performance was once again explained by weak gross capital formation (-3.7% year-on-year), whereas private consumption continued to increase at a moderate pace (2.5%). The negative contribution of external demand stood at 0.5 pp, in line with previous quarters, the difference being that it was linked to a 3.9% contraction in exports in year-on-year terms. The lacklustre state of the economy stems from industrial weakness which is partly attributable to the delayed effect of the exchange rate appreciation in recent quarters, that despite having been corrected, could be weighing on competitiveness. Another factor that has had a negative impact on growth is lower external demand, partly linked to the restrictions imposed by Argentina and the weakness of the euro area. Factors such as rising household indebtedness could also have moderated growth of private consumption with respect to more robust growth recorded in prior years. In conjunction with this, growth is being limited by structural factors which include, most notably, the high cost of capital and the

MEXICO AND BRAZIL

CHART 11



MEXICO: WAGE COSTS
Index

BRAZIL. EXCHANGE RATE DEPRECIATION, FINANCIAL FLOWS AND TERMS OF TRADE

SOURCES: Banco Central de México, Banco Central de Brasil, Oxford Economics and Datastream.

a 12-month cumulated flows.

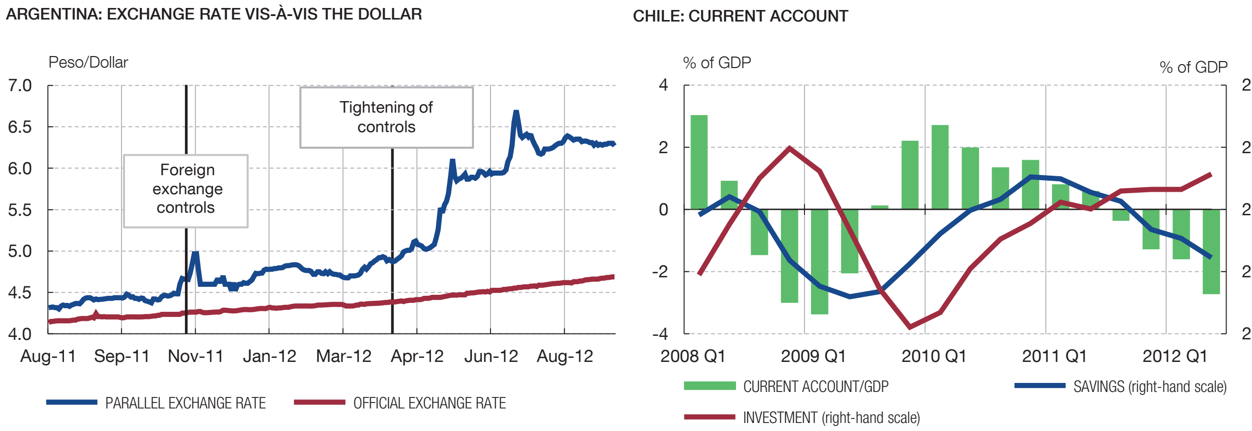
shortage of infrastructures. Activity indicators point to a slight recovery of the economy at the end of Q2, due to more buoyant retail sales and a slight pick-up in industrial production, underpinned by the considerable stimulus provided by economic policies. Inflation stood at 5.3% in year-on-year terms in September, practically unchanged relative to its level six months ago. Credit to the private sector posted high growth rates of 17% year-on-year to August, despite lower growth in recent months. The Brazilian real experienced the highest depreciating trend in the region during the last six months, moving within a range of 2-2.1 reales to the dollar, partly due to lower portfolio inflows (see Chart 11). In this setting, the central bank extended monetary easing, cutting official interest rates by a further 175 bp to 7.25%, which represents a reduction since the beginning of the downward cycle of 525 bp. The current account deficit held steady at around 2.2% of GDP. In the fiscal area, the primary surplus decreased over the six months to 2.5% of GDP in August, below the target set at 3.1% of GDP. This reduction in the surplus stems from lower-than-projected revenue —affected by the cyclical slowdown and lower extraordinary revenue— and the increase in spending (partly linked to the increase in the minimum wage which came into effect at the beginning of the year). The target of a primary surplus of 3.1% is maintained in the draft budget for 2013. Against a backdrop of a persistently weak industrial sector, certain tax relief and allowances were introduced or extended in order to boost the car industry and investment in capital goods. An infrastructure investment plan was announced, an area in which there is deemed to be a significant shortage. As a result of this 25-year plan, investments will be made in highways and railways amounting to 1.8% of GDP over the next five years; it will include resources from the public bank (BNDES), with private funding and tax allowances, and has been assessed positively since it is targeted at overcoming some of the structural limitations on Brazil's growth.

In *Mexico,* the economy performed better than expected in the first half of 2012, quickening slightly with respect to the previous half-year period. The higher buoyancy was especially noticeable in Q1 when GDP grew 1.2% quarter-on-quarter (4.5% year-on-year) and the pace of expansion moderated in Q2 (0.9% quarter-on-quarter and 4.1% year-on-year). By component, growth was supported by the robust increase in investment (7.5% in the first half of the year, as a whole), underpinned by government investment which grew 11.1% in the six-month period and offset a slight slowdown in private investment (6.6%), which nonetheless remained notably buoyant; conversely, private consumption moderated notably (3.8% in the six-month period, as a whole). Furthermore, exports grew by 6.3% year-on-year in Q2 which exceeded the growth rate of imports, generating a positive contribution from external demand. The higher frequency data indicate that the pace of growth in activity remained the same, with a higher contribution from industry and the external sector, and a slightly lower one from domestic demand. The external sector seems to be benefitting, among other factors, from a gradual narrowing of the wage-cost differential with respect to China, one of its main competitors in the US market (see Chart 11), although the gap is estimated to continue at around 25%. Private consumption was supported by fluid access to financing (consumer credit continues to expand at high rates in the region of 19% in real terms) and by the gradual improvement in the labour market, although mostly poor-quality jobs continue to be created. By contrast, the growth rate of remittances eased in the first half of the year and showed a negative year-on-year rate of change in July. Investment, as indicated above, held at high growth levels insofar as the cost of borrowing, both internally and externally, fell back and the rate of increase of credit quickened in the six-month period. Inflation rose strongly from April onwards, up from a rate of 3.4% to 4.8% in September, above the upper interval of the central bank's target range (3%±1%), owing to the shortage of certain foods due to isolated supply problems. Core inflation held at 3.6% and medium and long-term inflation expectations remain anchored at around 3.5%, although short-term inflation expectations rose further to the publication of official figures. Against this background, the central bank kept its official rate unchanged at 4.5%, where it has held since July 2009 and although in September the tone of its statement was more restrictive, a tightening of monetary conditions in coming quarters has not yet been discounted. The peso depreciated 10.2% between April and May, which activated on two occasions the dollar auctions that had been reintroduced in November 2011, and subsequently recovered to similar levels to those in March. In the fiscal realm, the deficit decreased to 2.5% of GDP (considering PEMEX's investment), from 2.7% at end-2011, due to the higher contribution of the state-owned petrol company to the budget. The current account balance posted a deficit of 0.5% of GDP in Q2 — lower than in previous quarters — as a result of the ongoing wide trade surplus. Capital inflows declined, particularly those related to carry trade operations. Finally, on 1 July presidential and parliamentary elections were held in Mexico which were won by the PRI. The first task for the new government, which came to power on 1 September, will be drawing up next year's budget for which no changes to taxes are expected.

Activity in *Argentina,* which had already lost momentum in the second half of 2011, slowed further over the first half of the year. Thus, in Q2 real GDP fell 0.8% quarter-on-quarter (following growth of 0.6% in Q1). In year-on-year terms, the economy recorded zero growth in Q2 (5.2% in Q1). Idiosyncratic factors have had a greater weight than external ones in the correction of activity. Accordingly, import restrictions have triggered a notable adjustment in purchases abroad (-14% year-on-year) and in gross capital formation (-15%), due to the effect of investment in capital goods, whereas foreign exchange controls, among other consequences, have cooled down the housing sector, a market with mostly dollar-denominated transactions. Consumption, by contrast, has held up as the main engine of growth. The private component increased 4.2% year-on-year in Q2 (10.7% in 2011) and government consumption rose 6.8% (10.9% in 2011). The contribution from external demand was positive despite the 9.5% decline in exports, which is partly attributable to the weakness of Brazil. The high frequency indicators show that the economy could have begun to stabilise. In fact, although restrictions remain on the currency market, other factors dampening growth are abating. Accordingly, certain import restrictions have been relaxed, a better harvest is expected (with high prices) and Brazil, its main trading partner, seems to have got back onto a more buoyant path. The current account once again re-

ARGENTINA AND CHILE

CHART 12



ARGENTINA: EXCHANGE RATE VIS-À-VIS THE DOLLAR

CHILE: CURRENT ACCOUNT

SOURCES: Banco Central de Argentina, Banco Central de Chile and Reuters.

corded a positive balance (after posting a deficit in the three previous months) due to the higher trade surplus – despite the increase in the energy deficit. Public finances have deteriorated substantially as a result of the increase in primary expenditure and the fall in tax revenue, with the government deficit standing at 1.9% of GDP in Q2 in annualised terms. As a result of the foregoing, public institutions, including pension fund administrators and the central bank, have become more reliant on the Treasury for financing. The attendant advances to the Treasury have reached their highest level since January 2003. Growing recourse to the central bank has contributed to perpetuating high inflation, of around 10% according to official figures (although private estimates indicate rates of more than 20%). Negative real interest rates together with a continuing overvalued exchange rate are behind the growing demand for dollars as a safe-haven asset and capital flight. Capital controls have been implemented in an attempt to contain capital flight. These measures have succeeded in stabilising the volume of international reserves, but they have prompted the re-emergence of the informal market on which the dollar is traded at a high premium – of around 35% with respect to the official exchange rate (see Chart 12). At the same time the withdrawal of dollar deposits has stepped up to more than $6.5 billion (45% of total dollar deposits) since the sale of dollars was regulated at the end of last year.

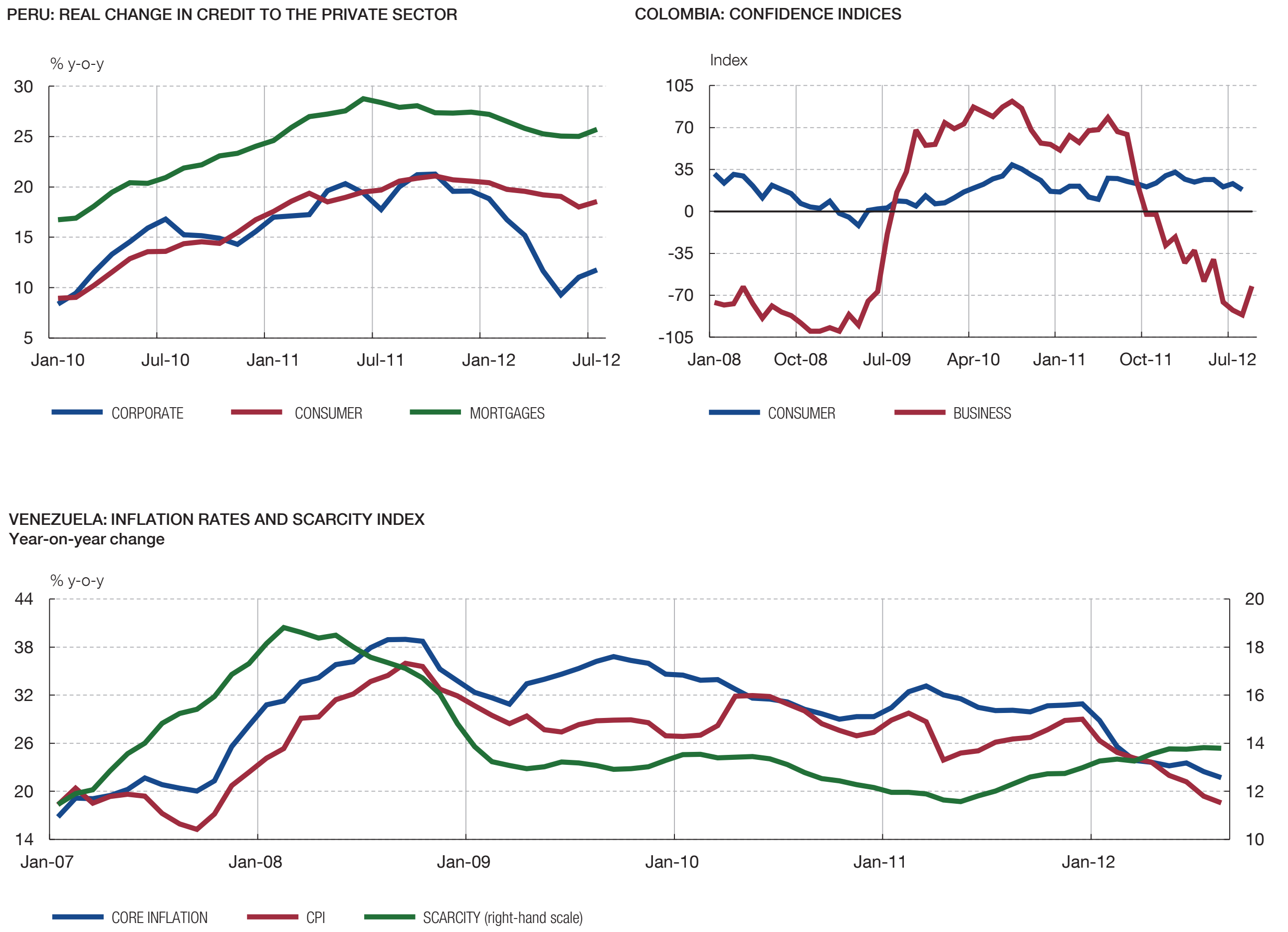
Economic activity in *Chile* was notably buoyant in the first half of 2012, exceeding expectations and showing high resilience to the deteriorating external environment and the see-sawing of global markets. Thus, GDP in 2012 Q2 posted quarter-on-quarter growth of 1.7% (5.5% year-on-year), which was even higher than in the previous quarter (1.3% quarter-on-quarter and 5.3% year-on-year). The expansion continues to be led by domestic demand which grew 7.2% in Q2, underpinned by the favourable performance of the labour market and the temporary effect of strong inventory building. Thus, the contribution of external demand, which was positive in Q1 (0.6 pp), turned negative once again in Q2 (1.8 pp), as a result in particular of the slowdown of exports, especially due to lower copper prices. The trade surplus fell by almost 67% in the nine months to end-September, due to a year-on-year decline in exports of 5.5% and an increase in imports of 4.3% which has widened the current account deficit, that stood at 2.7% of GDP in Q2 (see Chart 12). The high frequency indicators show that a slight slowdown has begun, especially in the investment component. Inflation has also been a favourable surprise throughout the year with a pronounced downward trend from rates of 4% in the early months of the year to 2.8% in September, although with a sharp contrast in the performance of tradeable and non-tradeable goods prices. The rise in the former fell back notably due to the adjustment of energy and food prices, and due to the appreciating trend of the peso, which despite bouts of volatility has strengthened by around 10% since the beginning of the year. Conversely, the rise in non-tradeable goods prices remained high with pressures linked to the tightness of the labour market (unemployment rate of 6.4% in the quarter June-August and growth of real salaries by around 3% in recent months). In the future, inflation could reverse its trend in view of the recent rise in international food prices, however, long-term inflation expectations remain anchored at 3%. In this context, the central bank has left the official interest rate unchanged at 5% since January, when it implemented a cut of 25 bp. The interest rate curve does not discount short-term declines. The rate of expansion of bank lending has decreased slightly, although it continues to grow by more than 10% in real terms. In the fiscal arena, the surplus built up in the first half of the year (2% of GDP) was slightly higher than projected due to the favourable performance of tax collection. Thus, although the stimulus applied in 2009 and 2010 has not been fully withdrawn, a structural deficit of 1.4% is projected to be reached before year-end, and the government's target is for it to be 1% in 2014. Faced with a worsening external scenario, Chile not only has some room to relax monetary and fiscal policies, but it also has more than $39 billion in dollar reserves and a sovereign wealth fund, which in August amounted to almost $15 billion, while the Pension Reserve Fund totalled more than $5.7 billion.

In *Colombia,* following robust buoyancy in 2011, economic activity slowed down notably throughout 2012 Q1, although it regained greater momentum in Q2. Thus, quarter-on-quarter growth was 1.6% in Q2 (0.3% in Q1), while the year-on-year rate stood at 4.9% in Q2 (4.7% in Q1). This performance is explained by developments in gross fixed investment, which during Q1 eased its year-on-year growth rate to 7.8%, while in Q2 it grew 15.5%, owing especially to the quickening pace of civil engineering works. Private consumption which had been growing strongly, supported by the gradual reduction of the unemployment rate, eased to 4.2% in Q2 due to less support from the labour market with an unemployment rate that has stabilised in recent months at 10.9%. Similarly, the contribution from external demand was negative after imports increased by 9.5% and exports fell 2%. The high frequency indicators point to a slight slowdown prompted by both external and local demand, especially in the manufacturing sector which also has been affected by the currency appreciation. In fact, business confidence has deteriorated continuously since the beginning of the year (see Chart 13). Inflation has gradually corrected from 3.6% in January to 3.1% in September. Furthermore, the real growth rate of credit decreased from 24% at the beginning of 2012 to less than 18%, which mitigates the associated risks. In this context, the central bank left official interest rates unchanged until its meetings in July and August, when it adopted cuts of 25 bp, leaving the official interest rate at 4.75% in September. Likewise, in order to control upward pressure on the Colombian peso, the central bank extended its daily dollar purchasing programme until March 2013, at the same time as the Public Treasury also began to make specific purchases. The central government's deficit continues to moderate as a result of the increase in tax revenue (especially, oil-related revenue), which is widening the primary surplus and, consequently, it has been possible to revise downwards the fiscal deficit projection for 2012 by 0.4 pp to 2.4%.

Although *Peru's* economy remains the most buoyant in the region, it has slowed slightly over the year. In Q2 GDP increased 1.4% quarter-on-quarter, below the rate of increase of 2.1% posted in Q1. In year-on-year terms, GDP increased 6.1%, the same rate as in the previous quarter. Domestic demand continued to act as a support and private consumption remained robust (5.6% year-on-year in Q2 and 5% in Q1) as did gross capital formation (16.1% in Q2 and 15.4% in Q1). By contrast, external demand made a negative contribution to GDP in Q2 of 1.6 pp (+0.1 pp in Q1), due to the extraordinary moderation of

PERU, COLOMBIA AND VENEZUELA

CHART 13


PERU: REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR

COLOMBIA: CONFIDENCE INDICES

VENEZUELA: INFLATION RATES AND SCARCITY INDEX
Year-on-year change

SOURCES: National sources and Fedesarrollo in Colombia.

exports, especially mining exports, which is in response to both slowing demand and temporary supply problems. According to high frequency indicators there will only be a gradual slowdown that will foreseeably be mitigated by public spending and investment, owing to the implementation of the second economic stimulus package agreed in June which is equivalent to 0.4% of GDP (in order to boost investment and public spending, to extend welfare programmes, improve infrastructures and support exports). The current account deficit increased in Q2 to 2% of GDP, due to the strong decline in the trade surplus (see Chart 13). The surplus on the financial account widened to 7.5% of GDP, as a result of higher long-term capital flows to the private sector. Inflation has shown a decreasing trend over the year, resulting from the moderation in food and energy prices, although in September it stood at 3.7%, still above the upper limit of the central bank's target interval, affected by the rise in international food prices. The central bank held the official rate at 4.25%, unchanged since May 2011. Despite the complicated external environment, the new sol has appreciated by around 4% in the year, which would have been higher without the build-up of international reserves of more than $10 billion, an increase in the stock of more than 20%. Likewise, the central bank raised average reserves in national and foreign currency by 100 bp in order to moderate the inflow of short-term foreign capital and credit growth, which over the year held on a decreasing trend, albeit at high rates (see Chart 13). Turning to fiscal matters, the non-financial public sector achieved a surplus in Q2 equivalent to 3.4% of GDP arising from the increase in current revenue which reflects buoyant domestic demand. The government envisages that the structural fiscal deficit will have been eliminated from 2013 onwards.

Venezuela's economy showed a strong upswing in growth in 2012 Q1. GDP expanded by 4.3% quarter-on-quarter and by 5.8% year-on-year and subsequently slowed to 5.4% year-on-year. Domestic demand grew 16.4% year-on-year in Q1 and 13.1% in Q2, due to the quickening of public and private consumption and, especially, investment. The contribution of external demand to growth was highly negative (-14 pp in Q1 and -11.3 pp in Q2), owing to more buoyant imports — on account of the greater availability of foreign currency in the economy — and weak exports, which even fell in year-on-year terms in Q2. Inflation has gradually moderated over the year from 29% at end-2011 to 19% in September, although the increase in the scarcity index compiled by the Central Bank of Venezuela seems to indicate the presence of some suppressed inflation (see Chart 13). Furthermore, in July government legislation came into force which aims to raise the amount of dollars in circulation in Venezuela; specifically in the parallel foreign exchange market (SITME), since it authorises certain agents to open accounts denominated in a foreign currency — accounts which, in any event, would be settled in local currency at the official exchange rate — to which dollar reserves would be applied, and authorises export firms to trade 5% of their foreign-currency revenue in SITME. As for public finances, on central bank figures, 2011 ended with a central government deficit of 3.4% of GDP, 0.1 pp down on 2010, on account of an increase in non-oil revenue of 3.2 pp of GDP, which financed a rise in current expenditure of 2.6 pp (essentially, higher debt service payments). Using other sources, such as ECLAC, the public sector deficit is estimated to have stood at around 6.5% of GDP in 2011, which, coupled with growing public debt (which has risen from 13.6% of GDP in 2008 to 35.5% in March 2012), raises doubts about the sustainability of public finances. The election year has also generated a sharp increase in expenditure (above 36% year-on-year in real terms in 2012 Q1). The current account surplus stood at 6% of GDP in Q2 in annualised terms and foreign direct investment amounted to 1.3% of GDP. After the presidential elections of 7 October which were won by the incumbent, the sovereign spread stabilised at around 900 bp.

15.10.2012.