Introduction

Between May and August 2013, the Latin American financial markets went through a bout of notable instability similar to that experienced by the other emerging economies. That bout was triggered by the Federal Reserve's announcement of a possible gradual withdrawal of monetary stimuli, against a background of moderating growth in the region and of uncertainty as to the extent of the deceleration in China. The impact took the form of a significant depreciation of the exchange rates of Latin American currencies – sharper in the currencies of countries with large current-account deficits such as Brazil or Chile (see Chart 1) – and large outflows of capital from equity and bond markets in the summer months. These trends reversed partially in September, particularly after the decision by the Federal Reserve (at a meeting of its monetary policy committee in that month) to maintain the level of monetary stimuli, diminishing the risk of generating negative dynamics in the economies most vulnerable to the international financial situation. Moreover, the fall in commodity prices under way since 2011 was interrupted in August by the signs of stabilisation of growth in China, and oil prices rose, amidst growing geopolitical risks in the Middle East, which introduced an additional offsetting factor for most Latin American countries. However, the reaction of the markets was indicative of the risks which the process of normalisation of monetary conditions may entail, not only because of the higher interest rates but also because it may give rise to a rebalancing of capital flows worldwide, thus fostering the transition to less favourable financing conditions for the region.

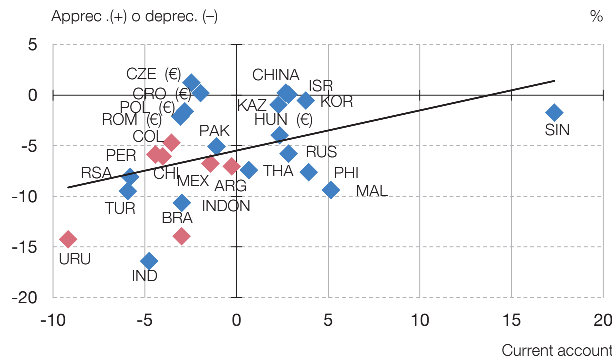
As regards the real economy, in 2013 Q2 the GDP growth of the region as a whole recovered to a rate of 3.5% year-on-year, compared with 1.9% in Q1, although that movement is skewed to the upside due to the extraordinary acceleration of GDP in Argentina (see Chart 1). Thus if Argentina's growth rate had remained similar to that in Q1, activity in the region would have grown at a rate of 2.9% year-on-year. The slowdown in H1 was not specific to Latin America, since Asia also lost dynamism at the beginning of the year due to the deceleration of China and its effects on the Asian industrial cycle, and, in the final instance, due to worsening global external demand. The most recent indicators contain, for the time being, mixed signals, with some differences across countries (more favourable in Mexico and Colombia, and less so in Argentina and Brazil). In fact, it is likely that average regional GDP growth in 2013 will not exceed that of 2012 (around 3%), one of the lowest in the past decade. Furthermore, the average inflation in the region tended to rise strongly until September, although the aggregate figure masked sharp differences across countries: 46% year-on-year in Venezuela as a result of the devaluation at the beginning of the year and the scarcity of foreign exchange, 10.5% in Argentina according to official figures and lower (5.9%) in Brazil. By contrast, inflation in the other countries was much steadier.

The economic policy response to the cyclical situation and to the financial market instability consisted of a mix of various elements, and a certain contrast between countries was noticeable. The central bank of Brazil consolidated the cyclical upturn in interest rates, with a cumulative rise of 225 basis points (bp) in the official rate since April to 9.50%; to the marked depreciation of the real it responded firstly by removing the capital controls still in force, and subsequently by announcing an energetic program of temporary intervention in the foreign-exchange market. By contrast, Mexico surprised observers with a cut of 25 bp in the official interest rate to 3.75% in September, justified

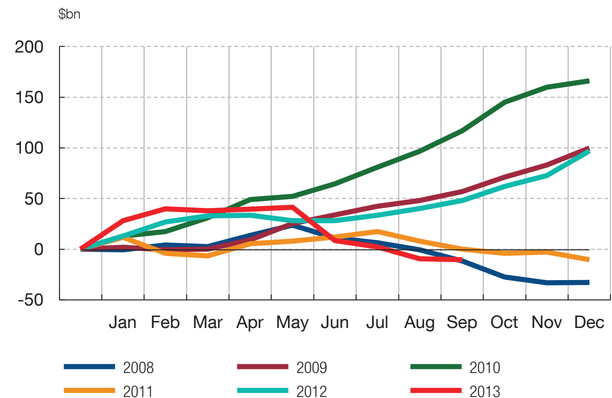
EXTERNAL POSITION, CAPITAL FLOWS, FINANCING COSTS AND ECONOMIC GROWTH IN LATIN AMERICA
Percentage, year-on-year rate and $bn

CHART 1

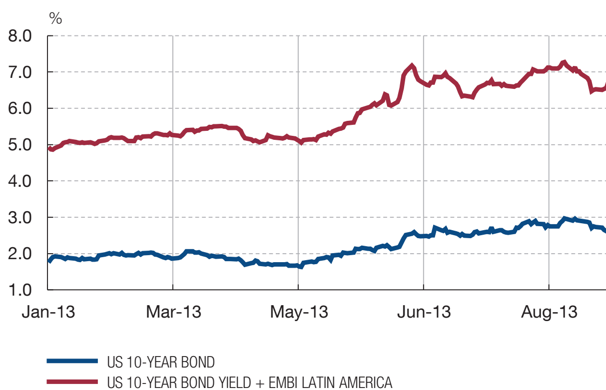
CURRENT ACCOUNT BALANCE (a) AND APPRECIATION (+) OR DEPRECIATION (-) OF THE EXCHANGE RATE (b)



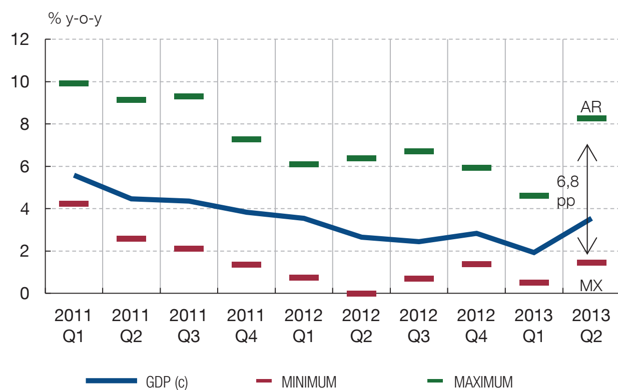
CAPITAL FLOWS TO EMERGING ECONOMIES



FINANCING COST IN DOLLARS IN LATIN AMERICA



YEAR-ON-YEAR GDP OF THE REGION AND MAXIMUM AND MINIMUM RANGES BY COUNTRY



SOURCES: National statistics and Datastream.

a 2013 Q1 figures, as a percentage of GDP.
b Against the dollar or the euro, and in the period from 22 May to 27 August 2013.
c Aggregate of the seven main economies, as a GDP-weighted average for the region.

by the widening of the output gap and the anchorage of inflation expectations. The central bank of Chile also cut its official interest rate by 25 bp in October. There were no changes in official rates in the other countries with inflation targets, although the stance of central banks tended towards a more accommodative monetary policy. This stance, at a time of widespread exchange rate depreciation, shows that there is leeway to combat the shock, at least through the use of monetary policy, and reinforces the end of “fear of floating”.

For a broader standpoint, in the medium term Latin America is facing a significant change in its external environment. Firstly, when global financial conditions become less expansionary, they will foreseeably drive growth more weakly, particularly in the economies most dependent on international financing and credit. Secondly, although recent indicators suggest that the external support from China will persist, it is likely that the shift in its growth model to give less weight to investment will impact the countries which have most benefited from the export of commodities closely linked to the industrial cycle. For these reasons, the response of markets should serve as a warning that Latin America has to under-

take structural reforms to strengthen its internal sources of growth and to maintain macroeconomic stability. If this is so, the recent period of turmoil will, to some extent, have been positive. Indeed, it is situations of financial market instability which most test the credibility generated by economic policies and the solidness of fundamentals. In this respect, the Latin American countries now present, without exception, fewer external, fiscal and financial vulnerabilities than in the 1990s, albeit somewhat more than in the expansionary period from 2003 to 2007.

External environment

The changes in the world economy in the last half have been shaped by two key factors: the doubts as to the extent of the Chinese economic slowdown and the announcements by the Federal reserve of a possible gradual reduction (tapering) in the pace of asset purchases in response to the growing perception that the economic recovery of the United States is firming. The first public mention of this possibility in late May had a rapid and significant impact on yield curves and on many asset prices, and was accompanied by a rise in volatility which escalated in summer due to the uncertainty surrounding the situation in Syria. Long-term interest rates rose in the United States, a development which was reflected in higher term premia and ended up feeding through to long-term yields in other countries, both advanced and emerging. However, since early September the perception that the Federal Reserve may postpone the initiation of tapering (an expectation which was confirmed in this month's meeting of the Monetary Policy Committee) alleviated the financial market tensions, partially reversing the trends which had been observed since late May.

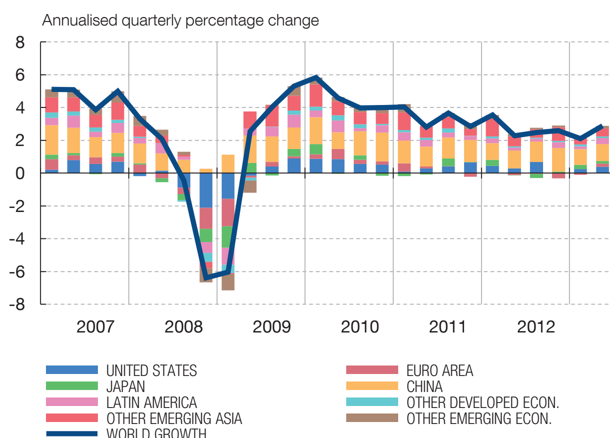
Against this background, there has been a certain recomposition of global growth (see Chart 2). Thus the emerging economies are decelerating, although they continue to grow at rates clearly higher than those of the advanced economies, while the incipient recovery of the latter seems to be firming. Indeed, in 2013 Q2 the main advanced economies, with the exception of the euro area, confirmed the improvement which they had seen in Q1, leaving behind the weakness shown in the latter stages of the previous year. Meanwhile, the euro area economy exited the recession showing quarter on quarter growth of 0.3%, following six quarters of decline. The available indicators for Q3 point to a continuation of this trend, although the recovery continues to be fragile and, on balance, the risks continue to be downside. Most notable in the short term are the risks associated with the US fiscal situation, the persistence of European market fragmentation, the tightening of financial conditions associated with the possible onset of monetary normalisation in the United States, the sharpening of the emerging economy slowdown and the worsening of the situation in the Middle East.

The main emerging regions have seen a slowdown in activity since the spring months which, with some exceptions, has stood below the expected rates. In particular, the economy of China, whose growth model is refocusing on consumption, is undergoing a gradual slowdown. Its growth rate stood at around 7.5% in 2013 H1 and the outlook is that this rate will remain unchanged, since the data published in summer have mitigated the fears of a sharper slowdown. The lower momentum of the Chinese economy has had spillover effects, particularly on the economies of emerging Asia and on commodity exporters. Against this background, the tightening of global financial conditions, associated with the possible start of monetary normalisation in the United States, led to a worsening of the growth prospects of the emerging economies, particularly of those most dependent on external financing. Although most emerging economies have sound fundamentals and significant lines of defence (flexible exchange rates and sizeable reserves), the short-term risks are not negligible, since their fiscal and external positions are more fragile than

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

CHART 2

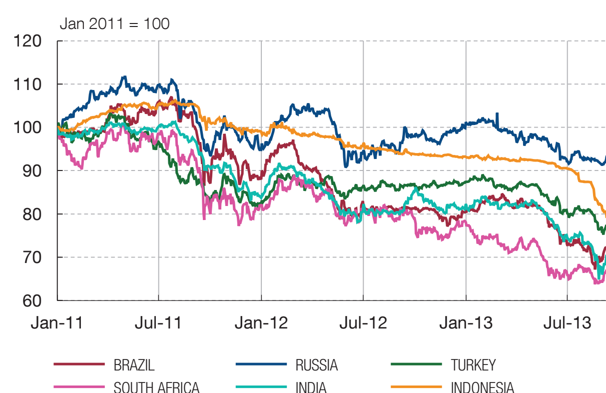
CONTRIBUTION TO WORLD GDP GROWTH



WORLD STOCK MARKETS (a)

INTEREST RATE SPREADS

EXCHANGE RATES AGAINST THE DOLLAR IN EMERGING ECONOMIES



SOURCES: Datastream, Dealogic, EPFR and JP Morgan.

a Indices in dollars.

in 2008. Therefore, it cannot be ruled out that the markets may sometimes overreact and so aggravate the financing problems of some of these economies, leading to a more pronounced slowdown.

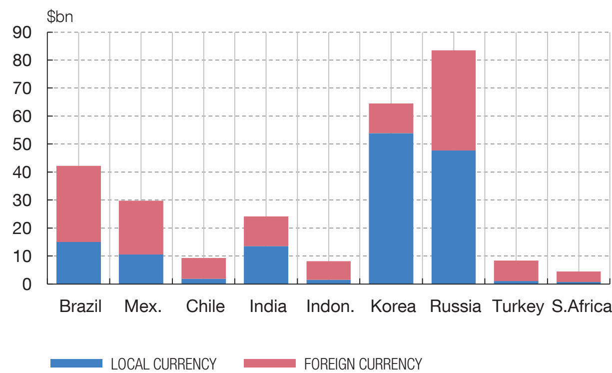
Financial markets and external financing

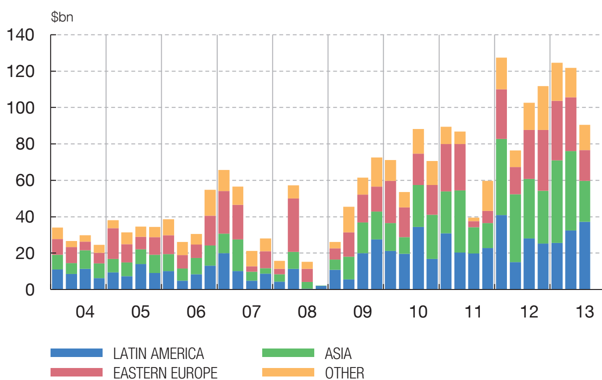
The performance of the emerging financial markets in the last six months can be divided into three distinct phases.

In the period from April to end-May, there were some stock market rises, albeit smaller than in the developed markets, and slight declines in credit risk indicators, which stood near the lows recorded at the beginning of the year (see Chart 2). The capital inflows into emerging debt funds stood at levels near their all-time highs, particularly in the tranches offering higher yields (debt issued in local currency), and the pace of fixed-income issues on the international markets held firm (see Chart 3), reaching nearly $59 billion in April, the all-time record for issuances in a single month. The conditions of access to these markets continued to be highly favourable, with average spreads of 270 bp, interest rates of 4.7% and maturities of more than 10 years, most issues being in US dollars.

BOND ISSUES AND FUND FLOWS TO EMERGING ECONOMIES
$bn

CHART 3





SOURCES: Dealogic and EPFR.

However, after the end of May two events negatively impacted market performance. First, the worse-than-expected activity figures published in some large emerging economies (China-Mexico and Brazil) pointing to a change in the world growth pattern which was detrimental, in relative terms, to the emerging economies. Second, the change in expectations about the withdrawal of monetary stimuli in the United States prompted a rise in long-term interest rates in that country and triggered a strong reaction in the emerging markets and in the higher risk segments of the developed markets. The stock markets fell by more than 8% in Latin America and Asia, and sovereign spreads rose by between 80 bp and 120 bp (to their summer 2012 levels) and exchange rates depreciated sharply (see Chart 2). In addition, the significant capital outflows from stock market and debt funds reversed the sizeable inflows recorded from September 2012 and the fixed-income issues halted, particularly in June, which saw the lowest volume of issuance since May 2010 (see Chart 3).

The emerging markets reacted unevenly to the aforementioned change in expectations. The strongest response was in the economies with high current account deficits (Indonesia, India, Turkey, Brazil and South Africa) or with the greatest needs for refinancing in US dollars (see Box 1 for an analysis of the vulnerability of Latin American economies from a historical perspective). However, this bout of capital outflows, although sharp, was comparable to other episodes of instability in the emerging financial markets, such as those in summer 2011 following the downgrading of the US sovereign debt rating and of the world

This box reviews the most common vulnerability indicators for the main Latin American economies as a whole and compares them with previous episodes of global instability, specifically in 1998 (before the Russian crisis spread to Latin America) and in 2008 (prior to the bankruptcy of Lehman Brothers). This approach is based on early warning methodology, which identifies risk situations through the unusual behaviour of a set of indicators.[1]

The indicators used reflect the assessment of financial markets and changes in economic fundamentals from the standpoint of the foreign sector and activity, fiscal positions and the banking system.[2] In certain cases, the information which they provide is unequivocal: thus, the larger a country's current account deficit or the smaller its international currency reserves, the more vulnerable it will be on the external front. In other cases, the assessment is more tentative: for example, if portfolio inflows are too high they may indicate over exposure to foreign capital and a possible risk of reversal, however, if they are too low, they may point to a lack of confidence.

The exercise identifies an increase in vulnerability based on the departure of the indicators from their long-term average, normalised by their standard deviation. This normalisation allows the indicators to be aggregated and compared directly at different points in time. The results are presented in spider charts, in which lines closer to the origin represent a less vulnerable position at a specific point in time.

The accompanying chart shows that for the region as a whole (defined as the aggregate of the nine main economies: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela and Uruguay), the levels of vulnerability in 2013 are lower than in 1998 for those indicators which in the past have been essential in anticipating crisis situations: the external sustainability, banking and fiscal indicators. By contrast, the market and real sector indicators are estimated to be in a similar situation to 1998. Specifically, the improvement in external indicators arises from a reduction in foreign debt levels and the related debt servicing, from a recovery in the net external position and a sharp increase in international reserves, one of the most robust determinants of sovereign spreads and risk premia.[3] In the case of fiscal indicators, today the region is better placed than in 1998 both in terms of public debt levels and interest payments burden.[4] The banking indicators have also picked up since the sector has more capital now, higher profitability, lower non-performing loans and deposit growth which is raising the base of financing credit in a sustainable way, thus implying a better assessment in the stock market and by rating agencies. The positive performance of the banking sector is worth noting in a region with very costly banking crises in the past and, possibly, it has also been reflected in the improved ratings of the ratings agencies.

However, a comparison between the main vulnerability indicators at present and in 2008 indicates that they have worsened slightly. With the sole exception of sovereign ratings, market indicators are in a worse position in 2013 than in 2008. The deterioration of the region's vulnerability in the last five years mainly stems from external indicators, especially exports, the current account balance and external demand. Other more sluggish indicators have also deteriorated moderately such as external debt or short-term debt. By contrast, in 2013 Q1 international reserves were considerably higher than their long-term average.

On the fiscal side, in 2013 there was a slight downturn in the region's fiscal position, the government deficit and public debt increased compared with 2008, indicating less room for manoeuvre for coping with new shocks. Conversely, the banking sector's vulnerability indicators have improved since the bankruptcy of Lehman Brothers – except for earnings per share – unlike what usually occurred in the region at times of crisis. The cause is the moderation in credit growth in tandem with a rise in the rate of increase of deposits and the sound performance of other structural indicators such as the capital ratios and the sector's assessment by rating agencies and in the stock market.

The situation of vulnerability relative to 1998 is the same or better in all of the countries. However, this is not the case with respect to 2008, where there are considerable cross-country differences (as suggested by the analysis in the section «Economic developments by country»). In short, from the analysis of these indicators the region as a whole is seemingly less vulnerable than before the crisis that was caused by Russia's default on external debt in 1998 – but it is slightly more fragile than in 2008. This is owing to the deterioration of several real external indicators with a higher cyclical component and greater dependence on global financial conditions which it is estimated would largely be explained by the performance of the higher risk countries. It should be underlined that the vulnerability indicators of the banking sector, one of the region's traditional weaknesses, not only have not deteriorated since 2008, but have improved in the vast majority of cases. On the negative side, the position of the fiscal indicators points to less leeway at present than in 2008 to cope with a revival of the external turmoil.

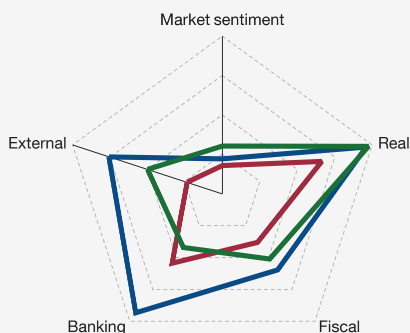
1 The basis for this type of analysis is the literature on leading indicators of crisis, the original reference of which is the article by Kaminsky and Reinhart of 1996, *The Twin Crises: The Causes of Banking and Balance-of-Payments Problems,* International Finance Discussion Paper, No. 544, March, *Board of Governors of the Federal Reserve System.* This article included a small number of indicators which was extended as further progress was made in this line of analysis.

2 For more details about the methodology, the indicators used and the reason for including them, see Sonsoles Gallego, Sándor Gardó, Reiner Martin, Luis Molina and José María Serena (2010), *The Impact of the Global Economic and Financial Crisis on Central Eastern and SouthEastern Europe (CESEE) and Latin America,* Documentos Ocasionales, n.º 1002, Banco de España.

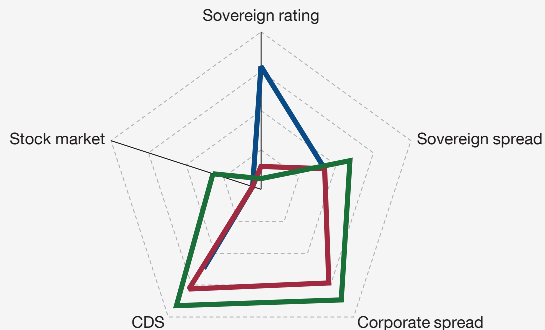
3 See Alberola, Molina and Del Rio (2012), *Boom-bust cycles, imbalances and discipline in Europe,* Banco de España DT 1220.

4 The government deficit seems to be in a worse position although its current level is clearly lower than in 1998 because the methodology compares it with its historical average and includes the fact that in 1998 the deficit fell considerably with respect to that average, even more so than in 2013.

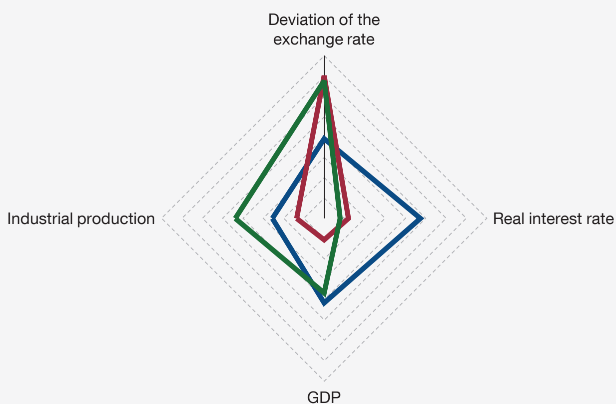
1 LATIN AMERICAN VULNERABILITY INDICATORS (a): AGGREGATE



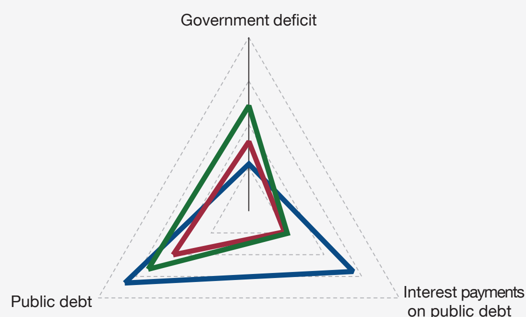
2 LATIN AMERICAN VULNERABILITY INDICATORS (a): MARKET SENTIMENT



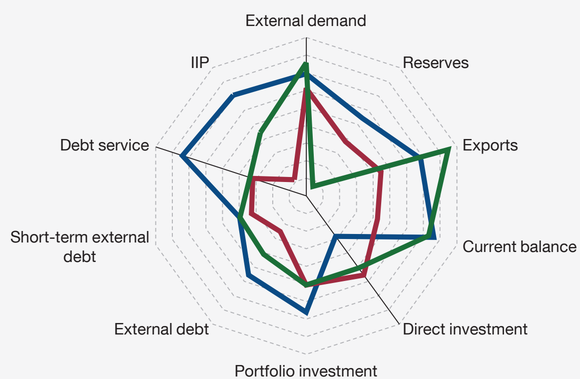
3 LATIN AMERICAN VULNERABILITY INDICATORS (a): REAL



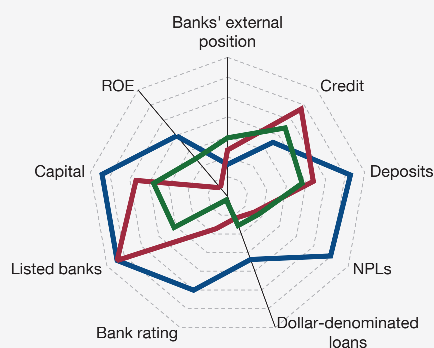
4 LATIN AMERICAN VULNERABILITY INDICATORS (a): FISCAL



5 LATIN AMERICAN VULNERABILITY INDICATORS (a): EXTERNAL



6 LATIN AMERICAN VULNERABILITY INDICATORS (a): BANKING



1998 2008 2013

SOURCE: Datastream.

a Weighted average of the nine main countries in the region.

growth outlook, and in summer 2012 when the euro area banking crisis worsened. For its part, the paralysis of securities issuance took place in a situation of the high early coverage of financing by many sovereign issuers, an absence of sizeable maturities scheduled in 2013 H2 and the possibility of replacing these sources by domestic bank credit.

Finally, in early September investors begin to discount a lower likelihood of immediate withdrawal of stimuli, which was reflected in sharp stock market rises, narrower sovereign spreads, foreign exchange appreciations and resumption of fixed-income issuance and of stock market capital inflows, particularly in the markets which had fallen most in the previous phase. These trends intensified following the Federal Reserve's decision in September to hold unchanged its monetary stimuli.

Against this backdrop, the Latin American financial markets followed the general path described above. The local-currency stock exchange indices rose by nearly 3% between mid-April and the last week of May (see Chart 4). Subsequently, until end-August, the Latin American stock markets fell by more than 8%, with the worst relative performances in Brazil (-11%) and Chile (-15.4%), which are the most liquid markets and have the economies most exposed to a change in global financial conditions and a drop in commodity prices. By contrast, the Mexican stock market fell by only 2.2%, since it benefited from the improvement in the US growth outlook. Finally, in September the stock markets recovered, with a rise of more than 7.5% in the regional local-currency index, driven by the two markets which had previously fallen most, i.e. Brazil (+11%) and Chile (+6.5%).

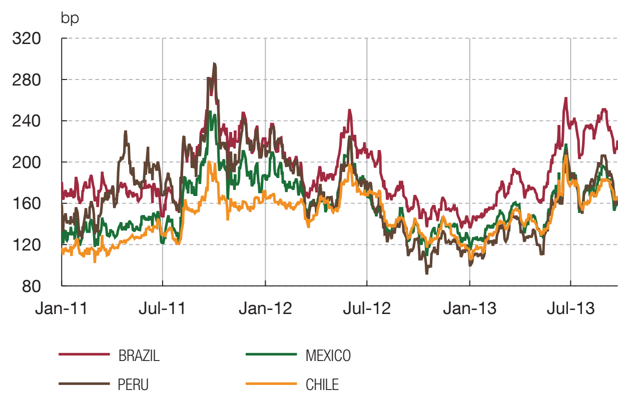
Meanwhile, sovereign spreads held relatively steady to end-May and then rose across the board (by between 50 bp and 70 bp), with the correlation between the various countries initially increasing. However, a certain discrimination was subsequently seen, with a higher increase in the spreads of Brazil and a somewhat smaller increase in those of Mexico, Chile, Peru and Colombia. From September, however, the spreads were again corrected, falling by between 20 bp and 45 bp. Local-currency medium-term interest rates rose much more, between 2 percentage points (pp) and 4 pp in Mexico and Brazil from May, to levels similar to those at end-2011, simultaneously with the depreciation of foreign currencies.

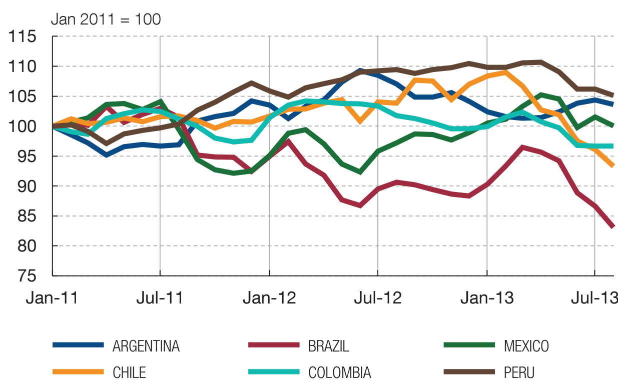
There was a certain tendency for exchange rates in the region to depreciate until end-May. This trend subsequently intensified sharply, especially in Brazil (nearly 14%; see Chart 4), which led the authorities to reverse the capital controls, to increase the amount of their interventions in the exchange market and, finally, to announce in August a regular currency purchase programme for $3 billion per week until the end of the year. However, in some cases the depreciation allowed a certain correction of the previous real appreciation, with the result that most Latin American currencies stood at real effective exchange rate levels similar to those of 2009 and 2010 (see Chart 4). Subsequently, the recovery from September, most noticeable in Brazil (8.5%) and Mexico (4.5%), only partly offset the real depreciation recorded from May.

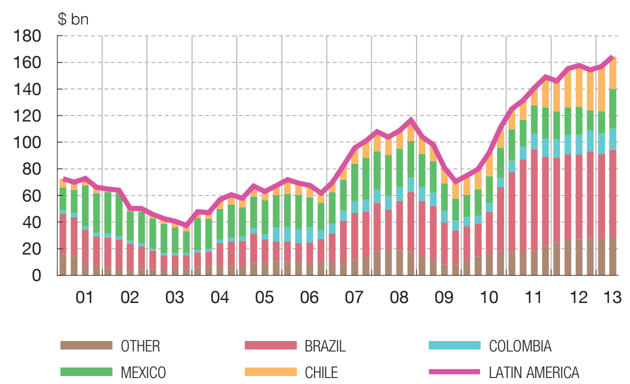
Finally, it should be noted that until Q2 the Latin American economies recorded sharp inflows of foreign direct investment, which stood at a new historical high in the region as a whole ($163 billion in 12-month cumulated terms), thanks to the recent recovery in direct investment inflows into Mexico (derived from a large transaction of $14 billion), but also owing to the increased inflows into Brazil (some $3 billion more in Q2 than in Q1). Meanwhile, portfolio investment inflows decreased with respect to 2012 Q4, but held at levels which were still high in historical terms. Mexico saw portfolio investment outflows due to the withdrawal of funds from the stock market for the first time since the end of 2008. In the period from April to September 2013, fixed-income issues in the region reached $66 million

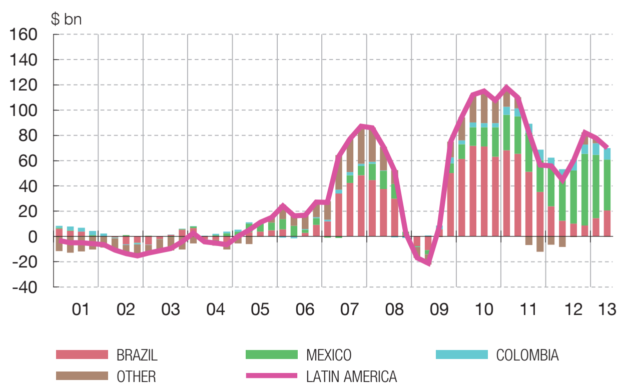
EXTERNAL CAPITAL FLOWS AND FINANCING
Indices, basis points and $ bn

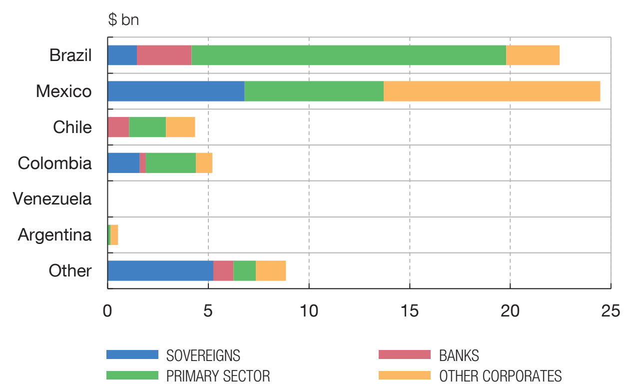
CHART 4











SOURCES: Datastream, Dealogic, JPMorgan, IMF and national statistics.

a MSCI Latin America index in local currency.

(see Chart 4), in a market dominated by primary sector firms (40% of the total), including particularly the two Mexican and Brazilian state-owned oil companies, and by sovereign issues, particularly those of Mexico. Lastly, mention should be made of the access of countries without previous experience in these markets, such as Bolivia, or with recent sovereign defaults, such as the Dominican Republic.

LATIN AMERICA: MAIN ECONOMIC INDICATORS — **TABLE 1**

	2010	2011	2012	2011		2012				2013		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	September
GDP (year-on-year rate)												
Latin America (a)	6.3	4.5	2.9	4.4	3.8	3.6	2.7	2.5	2.8	1.9	3.5	
Argentina (b)	9.2	8.9	1.9	9.3	7.3	5.2	0.0	0.7	2.1	3.0	8.3	
Brazil	7.5	2.7	0.9	2.1	1.4	0.8	0.5	0.9	1.4	1.9	3.3	
Mexico	5.1	4.0	3.8	4.4	3.9	4.6	4.2	3.1	3.3	0.6	1.5	
Chile	5.8	5.9	5.6	3.7	4.5	5.1	5.7	5.8	5.7	4.5	4.1	
Colombia (c)	4.0	6.6	4.2	7.9	6.6	5.4	4.8	2.9	3.3	2.7	4.2	
Venezuela	-1.5	4.2	5.6	4.4	4.9	5.9	5.6	5.5	5.5	0.5	2.6	
Peru	8.8	6.9	6.3	6.7	5.5	6.1	6.4	6.7	5.9	4.5	5.6	
CPI (year-on-year rate)												
Latin America (a)	6.3	6.8	6.2	6.9	7.0	6.6	6.1	6.1	6.1	6.4	7.3	7.6
Argentina (b)	10.5	9.8	10.0	9.8	9.6	9.7	9.9	10.0	10.6	10.8	10.4	10.5
Brazil	5.0	6.6	5.4	7.1	6.7	5.8	5.0	5.2	5.6	6.4	6.6	5.9
Mexico	4.2	3.4	4.1	3.4	3.5	3.9	3.9	4.6	4.1	3.7	4.5	3.4
Chile	1.4	3.3	3.0	3.1	4.0	4.1	3.1	2.6	2.2	1.5	1.3	2.0
Colombia	2.3	3.4	3.2	3.5	3.9	3.5	3.4	3.1	2.8	1.9	2.1	2.3
Venezuela	29.0	27.2	21.1	26.5	28.5	25.1	22.3	19.0	18.8	22.6	33.0	46.2
Peru	1.5	3.4	3.7	3.5	4.5	4.2	4.1	3.5	2.8	2.6	2.5	2.8
Budget balance (% of GDP) (d)												
Latin America (a) (e)	-2.2	-2.1	-2.3	-1.7	-2.1	-2.0	-1.9	-2.0	-2.1	-2.1	-2.2	
Argentina	0.2	-1.7	-2.6	-0.4	-1.6	-1.9	-1.7	-1.9	-2.4	-2.5	-2.0	
Brazil	-2.5	-2.6	-2.5	-2.5	-2.6	-2.4	-2.6	-2.8	-2.5	-2.9	-2.8	
Mexico	-2.9	-2.5	-2.6	-2.6	-2.4	-2.7	-2.4	-2.2	-2.5	-2.0	-2.2	
Chile	-0.3	1.5	0.6	2.0	1.5	1.6	1.1	0.4	0.6	0.2	-0.7	
Colombia	-3.6	-2.0	-1.9	-1.4	-2.1	-2.5	-1.0	-1.2	-1.9	-1.4	-2.5	
Venezuela	-3.6	-4.0	-4.8	—	—	—	—	—	—	—	—	
Peru	0.1	0.9	1.3	0.9	0.9	1.3	2.4	1.6	1.3	1.2	0.7	
Public debt (% of GDP)												
Latin America (a)	38.7	39.1	40.9	39.2	38.6	40.1	40.8	41.0	41.2	—	—	
Argentina	44.6	40.1	41.5	40.8	40.2	39.7	39.5	39.9	41.5	—	—	
Brazil	53.4	54.2	58.7	54.6	54.2	56.2	57.3	58.8	58.7	59.5	59.3	
Mexico	27.2	28.1	28.7	27.6	26.5	28.1	28.0	28.7	27.7	29.5	29.9	
Chile	8.6	11.1	11.9	10.6	11.2	11.2	11.5	11.3	11.9	11.4	12.0	
Colombia	34.9	33.4	32.2	34.1	33.8	32.9	32.4	32.4	32.2	32.4	—	
Venezuela	28.0	36.5	—	34.7	36.6	35.1	—	—	—	—	—	
Peru	23.4	21.7	20.2	20.9	21.7	20.7	19.8	19.5	20.1	18.9	18.0	
Current account balance (% of GDP) (d)												
Latin America (a)	-0.9	-1.0	-1.6	-0.8	-1.0	-0.9	-1.2	-1.3	-1.6	-2.1	-2.3	
Argentina	0.4	-0.5	0.0	-0.2	-0.3	-0.5	-0.4	-0.1	0.0	-0.3	-0.3	
Brazil	-2.2	-2.1	-2.4	-2.0	-2.1	-2.0	-2.2	-2.2	-2.4	-3.0	-3.2	
Mexico	-0.3	-1.0	-1.2	-0.9	-0.8	-1.0	-1.0	-0.7	-1.1	-1.4	-1.7	
Chile	1.5	-1.3	-3.5	-0.4	-1.3	-1.7	-2.4	-3.0	-3.5	-4.1	-4.0	
Colombia	-3.1	-2.9	-3.2	-2.8	-2.9	-2.7	-3.1	-3.3	-3.2	-3.5	-2.9	
Venezuela	3.7	7.7	2.9	8.3	8.3	6.9	5.7	4.2	2.9	1.8	1.5	
Peru	-2.5	-1.9	-3.6	-2.0	-1.9	-1.5	-1.8	-3.1	-3.6	-4.5	-5.0	
External debt (% of GDP)												
Latin America (a)	21.0	20.3	21.2	19.9	19.9	20.5	20.2	21.1	21.1	21.6	—	
Argentina	35.1	31.5	29.7	31.1	30.6	33.2	28.1	29.9	29.2	30.6	—	
Brazil	12.0	12.1	13.9	12.0	12.0	12.1	12.7	13.5	13.9	14.6	14.0	
Mexico	18.9	18.2	19.4	18.0	18.2	18.4	19.1	19.3	19.3	19.2	—	
Chile	38.6	39.2	43.9	38.6	39.5	39.4	40.0	42.0	43.9	43.3	42.7	
Colombia	22.4	22.9	21.6	21.7	22.9	21.1	21.0	22.0	21.7	21.0	—	
Venezuela	38.6	35.0	31.1	35.2	35.1	33.3	31.9	31.8	31.1	32.3	—	
Peru	28.4	26.9	29.3	27.6	26.9	28.8	28.9	29.9	29.5	30.6	29.6	

SOURCE: National statistics.

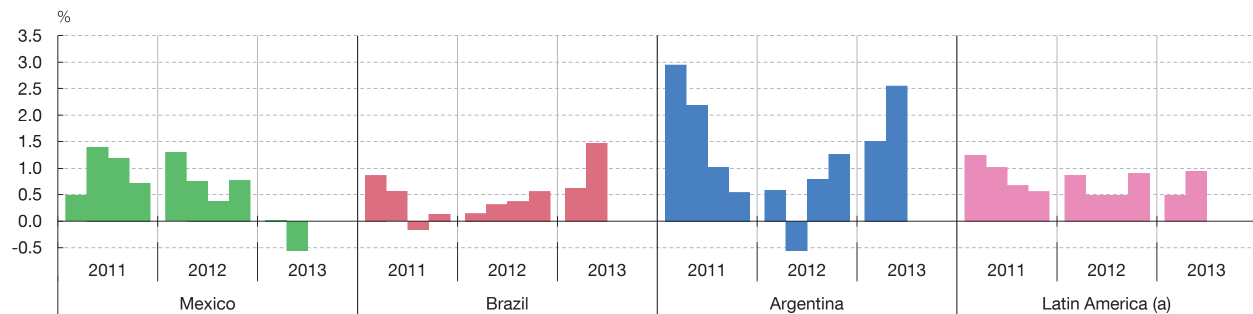
a Aggregate of the seven countries represented.
b Official figures.
c Seasonally adjusted.
d Four-quarter moving average.
e The quarterly figures for the Latin American aggregate do not include Venezuela.

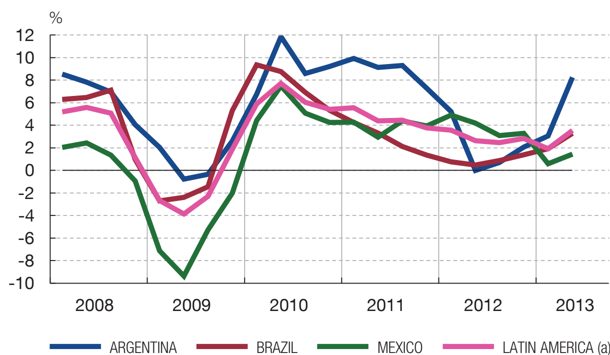
Activity and demand

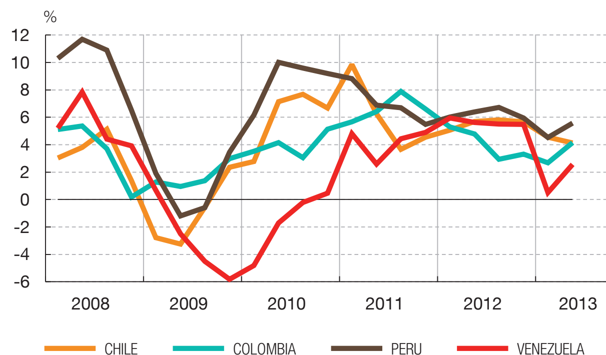
In 2013 Q2 the GDP of Latin America grew by 3.5% year-on-year (1% quarter-on-quarter), showing a recovery with respect to the 1.9% (0.5% quarter-on-quarter) growth in Q1 (see Chart 5). The weak growth in Q1 was due both to the slowdown of the economies which had previously shown more dynamism and, in particular, to the unexpectedly low growth of Brazil,

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

CHART 5







SOURCE: National statistics.

a Aggregate of the seven main economies, as a GDP-weighted average for the region.

Mexico and Venezuela (1.5%, 0.6% and 0.6%, respectively, in year-on-year terms). This behaviour was partly a result of very weak external demand. Brazil, among other countries, saw a very significant fall in exports in Q1, accompanied by an unexpected moderation of private consumption, while in Mexico the weak external demand was accompanied by a fall in public-sector investment and a deceleration of private-sector investment. In Venezuela, activity slowed as a result of the slump in government investment, which until the elections at the end of the previous year had been the main engine of growth. By contrast, the recovery in Q2 was mainly due to higher-than-expected growth in Colombia and Argentina, with rates of 4.2% and 8.3% year-on-year, respectively, although Brazil also posted somewhat more dynamic growth, mainly as a result of the take-off in investment. Argentina in particular contributed 1 pp to regional year-on-year growth, almost as much as Brazil (1.2 pp), an economy which is three times larger. The exceptional growth of the Argentine economy reflects the rebound of investment, the increase in private consumption (aided by government policies in the months leading up to the elections), a better harvest and the growth of exports to Brazil. By contrast, the quarter-on-quarter fall in Mexico's GDP left the year-on-year rate at 1.5%, as a result of the continuing weakness of public and private investment, which is considered temporary, and of a methodological change in the National Accounts time series, which trimmed growth by an additional few tenths of a percentage point.

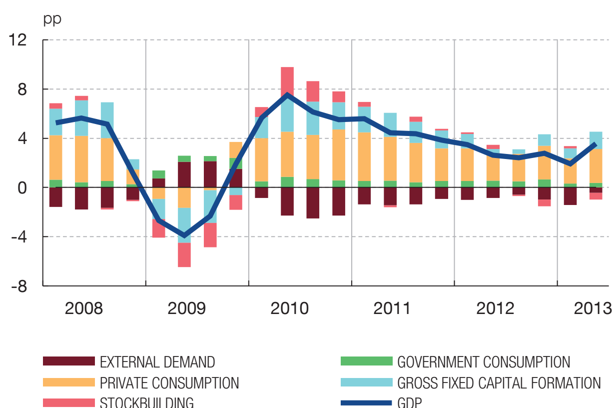
Looking at components, domestic demand and, in particular, private consumption were again the main drivers of growth in the region, partly counteracting the negative

COMPOSITION OF GDP ON THE DEMAND SIDE

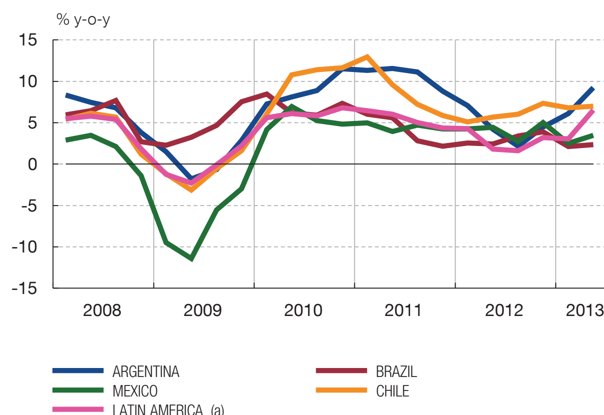
CHART 6

Year-on-year rate and pp

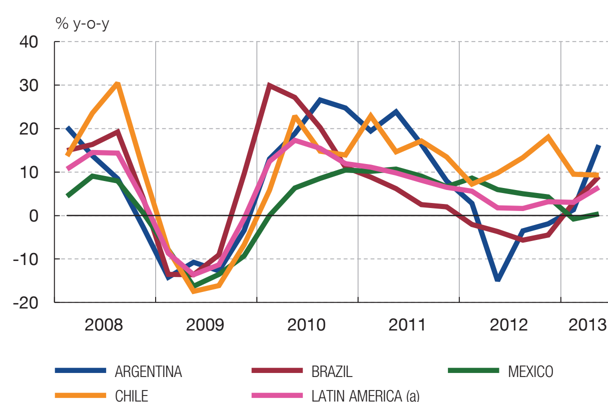
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



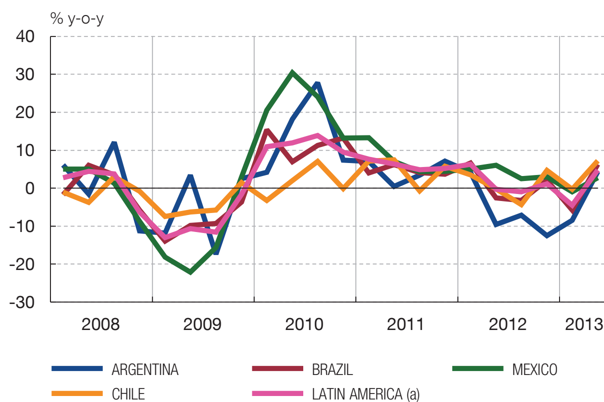
PRIVATE CONSUMPTION



GROSS FIXED CAPITAL FORMATION



EXPORTS



SOURCES: National statistics and IMF.

a Seven biggest economies, as GDP-weighted average for the region.

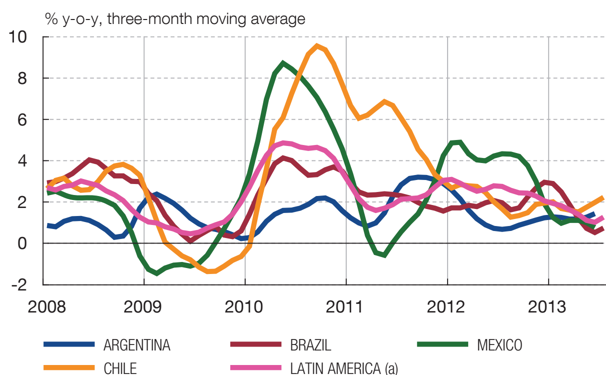
performance of external demand, especially in the first quarter of the year. Domestic demand contributed 3.4 pp to growth in Q1 and 4.2 pp in Q2 (see Chart 6), and was particularly robust in Peru and Chile (with contributions of more than 7 pp) and in Argentina in Q2 (more than 10 pp). Meanwhile, average private consumption for the region grew by 3.3% year-on-year in Q1 and by 4.2% in Q2, underpinned by the strength of the labour market (with an unemployment rate of 6.3% of the labour force, close to the region's historical low), an increase in real wages, albeit more moderate than in previous years, and ongoing credit growth. Investment, which had shown significant weakness in the past year, especially in Brazil and Argentina, accelerated to rates of 6.5% year-on-year in the region on average, buoyed by the recovery in both countries (see Chart 6). In other cases, such as Chile or Peru, investment continued to increase at high rates of 8%-9% year-on-year, although they were more moderate than in previous years due to the maturity of the mining investment cycle against a background of downtrending metal prices.

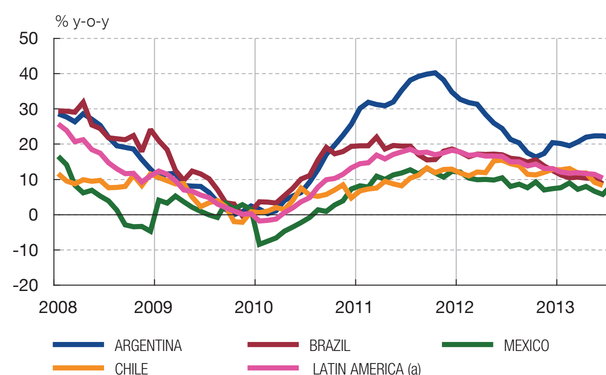
External demand showed highly negative behaviour particularly in Q1, clipping 1.4 pp from regional growth as a result of the weakness of exports, which fell by 4.5% year-on-year and only tended to recover (by 4.8%) in Q2, in consonance with world trade. By contrast,

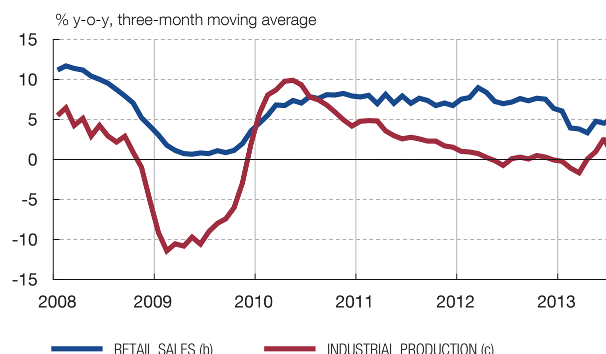
EMPLOYMENT, DEMAND AND CREDIT INDICATORS

CHART 7

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







SOURCES: National statistics and Datastream.

a Aggregate of the seven biggest economies, as a GDP-weighted average for the region.
b Aggregate of Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.

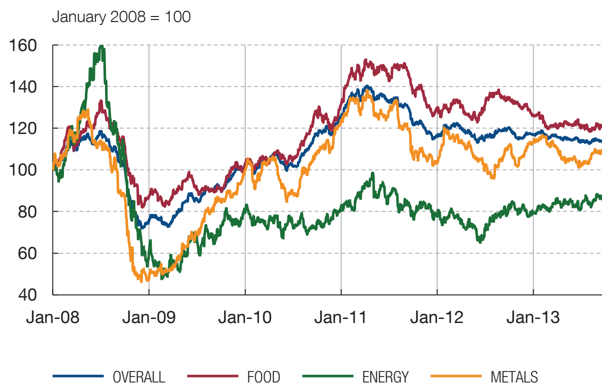
imports held at a growth rate which was more solid (4% and 7.1% year-on-year in Q1 and Q2, respectively), although far from the double-digit rates of the previous three years.

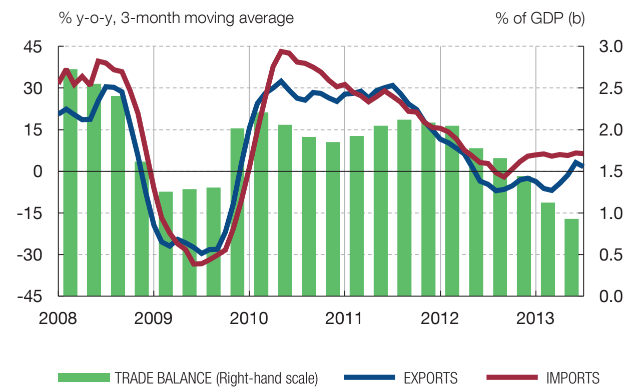
The high-frequency indicators point to a slower rate of expansion in Q3 in various countries, including Brazil, possibly with the exception of Mexico and Colombia. On the supply side, industrial production, which had shown a recovery (relatively widespread across countries) to rates approaching 2.5% year-on-year in Q2 (see Chart 7), returned in July and August to rates nearing 0% year-on-year, similar to those recorded in 2012. On the demand side, the growth of retail sales has moderated in recent years, although in the reporting period it held at 5% year-on-year. Finally, the leading indicators of business confidence and consumer confidence worsened somewhat until August in the region on average.

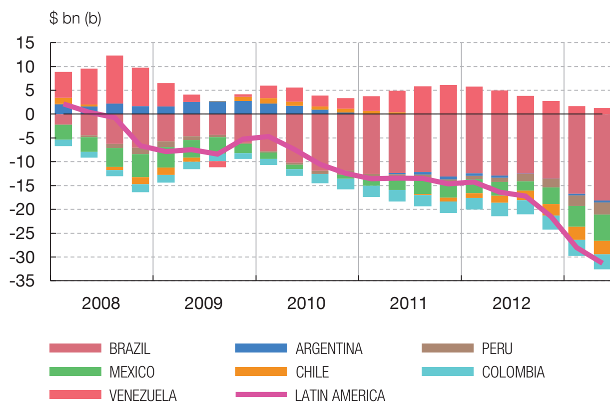
All things considered, some significant elements of domestic strength remain. In the labour market, job creation tended to moderate after the robustness of the last few years (see Chart 7) and in some countries has begun to gravitate towards jobs considered less stable, but unemployment rates have remained around their historical lows. Mexico is an exception in this respect because its unemployment rate continues to be some 2 pp above pre-crisis levels and real wages have shown more stable behaviour. One factor which may have contributed to the firmness of labour markets is the rise in households' purchasing

EXTERNAL ACCOUNTS AND DETERMINANTS
Indices, year-on-year rate of change, percentage of GDP and $bn

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.
c Aggregate of the seven main economies, as a GDP-weighted average for the region.

power due to higher real wages, which has fuelled demand for services and employment in the tertiary sector, contrasting with the relatively weak investment. Credit to the private sector continued to moderate gently, although holding the growth rates of 10% year-on-year in the region on average.

Notable in the external sector was the sharp decrease in the trade surplus, which stood at 1% of regional GDP in Q2, half that in 2012 (see Chart 8). The downtrend in the trade surplus (which only halted temporarily in the two years following the crisis, when it steadied at around 2% of GDP) reflects the weakness of exports (in quantity and price), which showed negative year-on-year rates throughout nearly all the semester, recovering minimally in July (see Chart 8). By country, the trade surplus decreased most sharply in South America and in the commodity exporting countries. In Mexico, the trade balance returned to a deficit similar to the historical average in Q1, after surpluses in 2011 and 2012. By destination, most notable were the falls in goods exports to the European Union (-8%) and within Latin America (-6%), followed by those to the United States (-3.5%). Exports to Asia held at positive growth rates (5%), although those from Chile and Peru (mainly metals) fell in the half-year period (-5% and -12%, respectively). Box 2 analyses the commodity supercycle and the implications for Latin America.

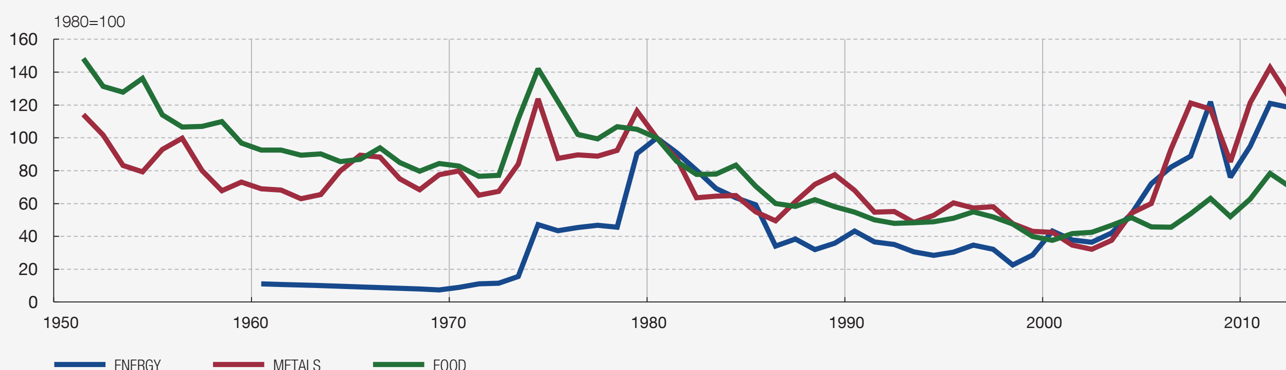
The policy decision in China and other emerging economies to shift to a less commodity-intensive growth model, along with the expansion of viable reserves of unconventional hydrocarbons, may signal the end of the high commodity prices during the past decade.

Between 2001 and 2012 real oil and metal prices tripled, while those of food rose by 69% (see Chart 1). This is behaviour consistent with the upturn of a commodity supercycle. "Commodity supercycle" is defined as a persisting deviation of real prices from the long-term trend for a broad range of commodities, the duration of which fluctuates between 20 and 70 years. These supercycles arise from an increase in commodity demand linked to historical episodes of industrialisation and urban development (as recently seen in China and India) which cannot be met immediately by the available supply, pushing real prices above trend for decades. Supercycles mainly affect commodities which are factors of production of those economies in the process of industrialisation and urban development. The deviations from trend reverse when the price signals are sufficiently strong to induce a sizeable response in supply. The recent phenomenon of unconventional hydrocarbons might be an example of a supply-side response against a background of high oil prices which, together with progress in extraction techniques, has made it economically feasible to tap large volumes of gas and oil trapped in existing oilfields.[1]

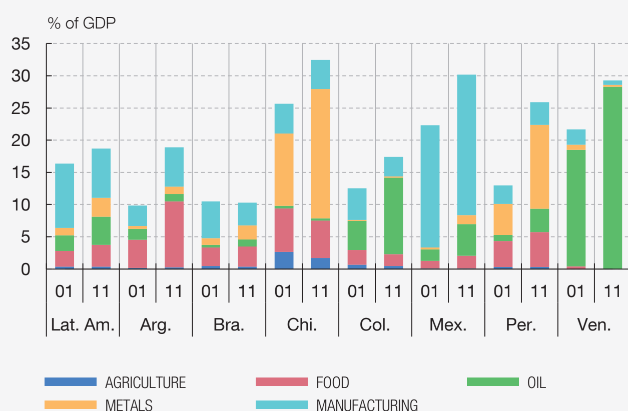
Some analyses conclude that the current supercycle is now at its point of largest deviation, although the behaviour of commodities is uneven. However, there are also reasons to conclude that the end of the supercycle is still far away or that the price correction would in any case be limited: first, the industrialisation and urban development of China and other emerging economies still has some way to run in view of the demographic outlook and the urban development plans; second, the argument that the supercycle is coming to an end is based on technologies involving high sunk costs and low marginal costs, but the marginal cost of production of unconventional hydrocarbons is relatively high; third, supply will foreseeably be progressively less able to accommodate demand as new reserves become increasingly complicated and costly to

1 For the whole world, the International Energy Agency and the US Department of Energy estimate that unconventional oil reserves amount to around 10% of total reserves.

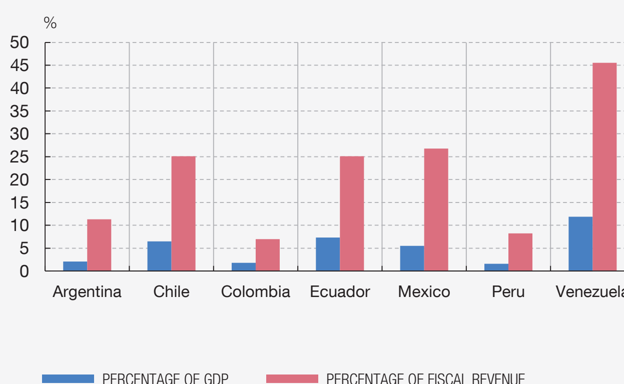
1 REAL PRICES OF COMMODITY AGGREGATES



2 TRADE OPENNESS AND EXPORT OF GOODS



3 FISCAL REVENUE FROM NATURAL RESOURCES



SOURCES: World Bank, Inter-american Development Bank, Datastream and national sources.

a Aggregate of the seven countries represented.

tap; and, lastly, using long time series and focusing on the real prices of some commodities in the past decade, the situation looks more like a recovery from the secular fall in the last two decades of the previous century.

The upturn in commodities has strengthened the productive and export specialisation of Latin America, in line with its comparative advantage. At aggregate level, the weight of commodity exports in GDP has nearly doubled in the past decade, rising from 6% in 2001 to 11% in 2011 (see Chart 2). This increase took place in all countries, including most notably Mexico, Peru, Argentina and Colombia. Commodities have become the largest component of total goods exports of all countries except Mexico, where manufactured goods continue to be the mainstay of exports. Analysis of products reveals a specialisation in food exports by Argentina and, to a lesser extent, by Brazil; in oil by Venezuela and Colombia; and in metals by Chile and Peru. In Brazil the increase in commodity exports has been accompanied by a greater variety of products, in line with the country's diversity of natural resources.

In addition to their importance for the activity and earnings of these countries, commodities also play a significant role in fiscal policy. The increase in the demand for and price of these goods has brought considerably higher fiscal revenues. On data of the Inter-American Development Bank,[2] fiscal revenue from non-renewable commodities was, on average for the period 2005-2010, equal to 7.5% of GDP and to 28% of Latin American fiscal revenue (see Chart 3), representing, for example, 12% of GDP and 46% of fiscal revenue in Venezuela and 6% of GDP and 27% of fiscal revenue in Mexico. Given the high general exposure of the public finances to commodity prices, a fall in them would have a significant impact and limit the fiscal space of countries to apply counter-cyclical policies at the end of the supercycle. Those countries which have well-defined fiscal rules or have conducted their fiscal policy prudently would enjoy more freedom of action.

The main channels through which a commodity shock is propagated to the economy as a whole are twofold: the trade channel and the impact on the fiscal accounts (as well as possible confidence effects and effects on financial flows). For a country which is a net exporter, a fall in commodity prices worsens its real terms of trade, reduces exports, worsens its external balance and depreciates its currency. The adjustment needed to reach a new equilibrium entails a depreciation of the real exchange rate so as to correct the deterioration in the external balance and the insufficiency of domestic demand. The fall in commodity prices also has a significant effect through the reduction of fiscal revenue, so monetary policy becomes particularly important because of its potential use as the main tool of counter-cyclical action. In any event, increasing world demand due to the favourable cost shock would moderate the negative impact.

A simple simulation exercise using a global model[3] allows us to assess the economic implications of a widespread correction of commodity prices in Latin America. Specifically, the scenario simulated was a permanent exogenous price fall of 20% in nominal terms with respect to current levels, which is a significant fall but not an extreme scenario. The exercise allowed us to separate the direct effect of this shock without policy responses or global effects, the monetary policy response and the effect of the supply shock on the world economy. The sum of these three effects gives the total impact of the shock. It should be noted that the effect of the fall in fiscal revenue, which could be significant if access to external financing were restricted, and the deterioration in the confidence of private-sector agents are not taken into account. The results of the exercise show that the effect of the fall in commodity prices is not large for Latin America in terms of GDP growth and is somewhat more significant in terms of its external balance. The direct impact is estimated to be a reduction of between 0.2 and 0.3 percentage points (pp) in GDP growth from 2013 to 2015 in the regional as a whole, although monetary policies would be able to limit that impact by up to 0.1 pp. Additionally, the effect of the worldwide reduction in costs (which lowers prices and raises world income) may substantially mitigate the negative impact on Latin American economic activity. The direct impact on trade balances is estimated to range from 0.25 pp to 1 pp of GDP in the three years simulated, although, considering the induced effects, the increase in world demand would mean that the trade balance would fall by slightly less.

As a result of the composition of commodity exports, the impact on each economy would differ. Here we assume a proportional fall in the price of all commodities, without distinguishing between products. However, some commodities, such as agricultural products, may be affected less by the possible end of the supercycle, and, as a result, the impact on the various Latin American economies would be a more asymmetrical.

2 Inter-American Development Bank (2013), *Recaudar no basta. Los impuestos como instrumento de desarrollo.*

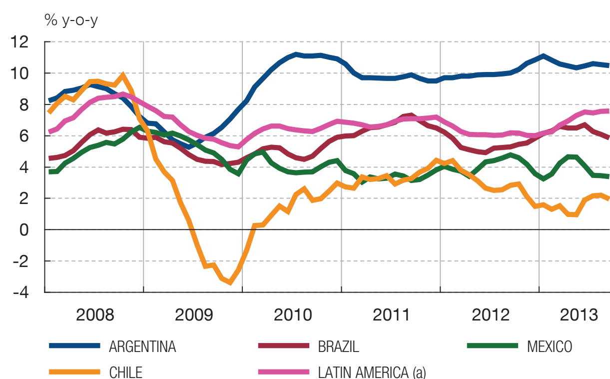
3 In this case, the NIGEM model.

Against this background, the current account deficit continued to widen in the region on average to 2% of GDP in Q2, the highest figure in the past decade. Although this deficit may be considered relatively moderate and it is mainly financed by foreign direct investment, the rapidness and extent of its growth are notable. In Peru the current account deficit reached 5% of GDP in Q2, in Chile it stood at 4.5% and in Brazil at 3.2% as the

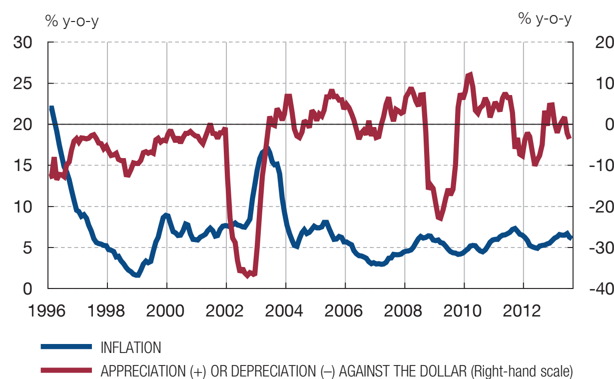
INFLATION, EXCHANGE RATE AND OFFICIAL INTEREST RATES
Year-on-year rates of change and percentage

CHART 9

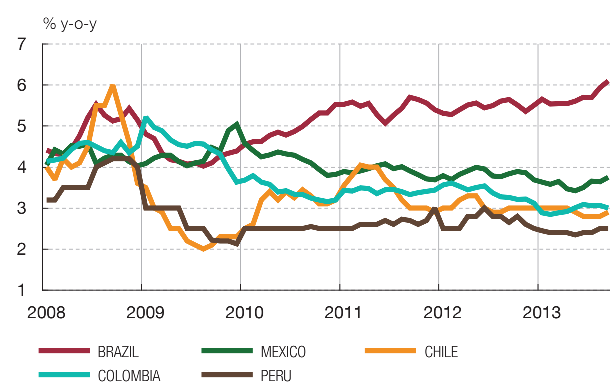
INFLATION RATE



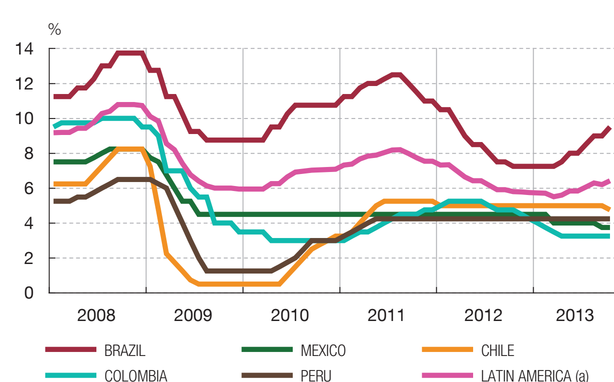
INFLATION AND EXCHANGE RATE AGAINST THE DOLLAR (a)



12-MONTH INFLATION EXPECTATIONS



OFFICIAL INTEREST RATES



SOURCES: National statistics and Banco de España.

a Aggregate of the seven main economies, as a GDP-weighted average for the region.

trade surplus disappeared and the services and income deficits widened. Meanwhile, in Venezuela the current account surplus continued to decrease (to 2% of GDP) despite the containment of imports made possible by exchange control, and in Argentina it dropped to the point of nearly coming into balance despite the import restrictions.

Prices and economic policies

Average inflation in Latin America rose in the last six months to 7.6% year-on-year in September, its peak for the last four years (see Chart 9). This average is highly conditioned by the behaviour of inflation in Venezuela (which exceeded 46% year-on-year) and, to a lesser degree, in Argentina (above 10%, according to official figures). Of the five countries with inflation targets, pressures were only seen in Brazil, since inflation peaked at 6.7% year-on-year in June, above the central bank's band (6.5%), and subsequently began to correct slightly to 5.9% in September. Conversely, in the other countries with inflation targets, except for Peru, consumer prices moved on a very moderate upward trend within the bands and in certain countries, such as Chile and Colombia, they held at the lower end of the target rate (around 2% year-on-year).

The outlook for inflation is uncertain. On one hand, the slowdown in activity should ease the demand pressures observed in Brazil, Chile and even Peru. On the other, the exchange rate depreciation in certain countries (mainly Brazil) could be large enough to pose an upward risk to the prices of tradable goods, including food, although the pass-through has

INFLATION
Year-on-year rates of change

TABLE 2

	2012			2013		2014
Country	Target	December	Fulfillment	September	Expectations (a)	Expectations (a)
Brazil	4.5 ± 2	5.8	Yes	5.9	5.8	5.7
Mexico	3 ± 1	3.6	Yes	3.4	3.6	3.9
Chile	3 ± 1	1.5	Yes	2.0	2.4	2.9
Colombia	3 ± 1	2.4	Yes	2.3	2.7	3.1
Peru	2 ± 1	2.6	Yes	2.8	3.0	2.5

SOURCE: National statistics and Consensus Forecasts.

a September 2013 Consensus Forecasts for the end of the year.

moderated noticeably over recent decades (see Chart 9) and, at present, these effects can only be seen in producer prices. In this context, inflation expectations have remained broadly unchanged in the past six months. It is worth noting that in Brazil they have not eased despite the increase in official interest rates (see Table 2 and Chart 9).

The monetary and exchange rate policy responses of the different countries in the last six months have varied, on the basis of the strength of the exchange rate deprecation and the situation of inflation, and the credibility of the inflation target. Accordingly, Brazil would be at one end of the scale, where the depreciation was very pronounced and inflation has persistently held above target during the last three years, with the result that inflation expectations showed a gradual, albeit continuous, upward drift. The central bank tightened its monetary policy significantly by increasing official interest rates five times from April to October, although economic recovery is still incipient (see Chart 9). At the opposite end of the scale, core inflation in Mexico reached new record lows of around 2.5% and the central bank unexpectedly lowered the official interest rate by 25 bp in September, despite the depreciation of the exchange rate against the dollar by more than 10% from May to September and its improved outlook of recovery due to the upturn in the US economy. Chile also cut its official interest rate by 25 bp in October. Finally, neither Colombia nor Peru, which are at different points in the cycle and whose exchange rates have depreciated to varying degrees, modified their benchmark interest rates, although they did indicate that they were more predisposed to easing their monetary policies if necessary, or (as in the case of Peru) they reduced the bank reserve requirement.

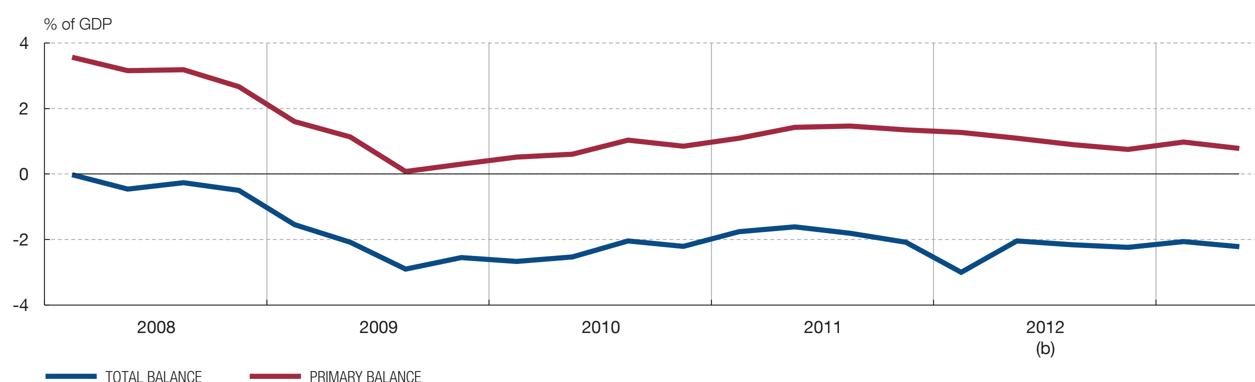
Faced with these differences, one common feature has been the reaction of exchange rate policy: a notable depreciation of exchange rates was tolerated at times of tension, although countries also used exchange rate intervention to mitigate the risk of overreaction (especially in Brazil, but also in Peru). Reserves – measured by almost any metrics – are high in the five countries with inflation targets (between 14% and 30% of GDP), although they have tended to decline in most cases in recent months, as a result of the interventions, and the short-term external debt/reserves ratio is manageable. On the positive side, in many countries the nominal depreciation that has built up has corrected sharp and protracted appreciations which had eroded competitiveness in certain cases. Consequently, it is seen in principle as a benign adjustment which, if it continues in real effective terms, should enable current account balances to improve in the medium term.

The source of inflation in Argentina and Venezuela was different, and inflation dynamics were more pronounced. The devaluation of the Venezuelan bolivar at the beginning of the

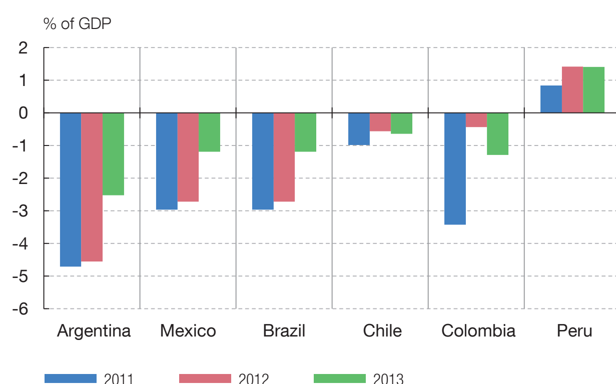
MAIN PUBLIC SECTOR FIGURES
Percentage of GDP

CHART 10

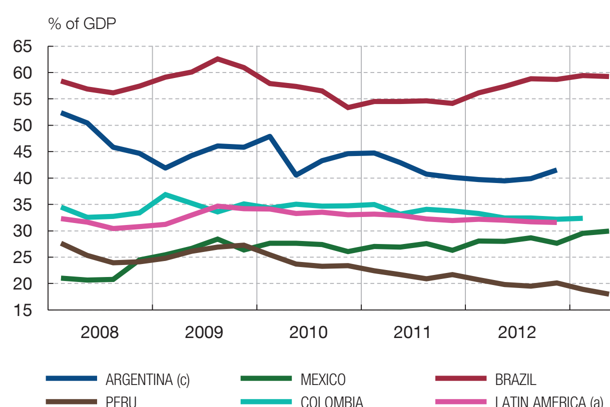
BUDGET SURPLUS (+) OR DEFICIT (–) IN LATIN AMERICA (a)



CYCLICALLY ADJUSTED BALANCE



GROSS PUBLIC DEBT



SOURCES: IMF (*Fiscal Monitor* April 2013) and national statistics.

a Aggregate of the seven main economies, as a GDP-weighted average for the region.
b In Venezuela, quarterly data estimated from annual data. In 2013, aggregate excluding Venezuela.
c Excludes untendered debt in the debt swap offers of 2005 and 2010.

year, the delays in delivering currency for imports, the increase in exchange pressure on the Argentine peso and a situation of fiscal domination in both countries contribute to explaining why inflation has remained significantly higher than in the other countries. From the standpoint of external vulnerability, the external positions of these two countries are relatively sound, since they have a current account surplus or a small current account deficit; however, this external position has deteriorated in the last year and, furthermore, reserves are low when compared internationally, they are showing a downward trend and, in the case of Venezuela, most of them are denominated in gold.

In the fiscal policy area, public finances slowed across the board on the revenue side in most countries. In some cases this was linked to the cycle, such as in Brazil and Mexico, and in others it was associated with a fall in commodities prices (such as Chile, Mexico and Peru). Expenditure, however, continued to grow more than revenue. The region's average budget deficit held at 2% and the primary surplus at 1% of regional GDP (see Chart 11). Against this backdrop, in Brazil an adjustment in spending of 0.2% of GDP was announced in summer, in an attempt to meet the primary surplus target of 2.3%, which had already been revised downwards before summer to 2.6%. The Mexican government asked Parlia-

ment to increase the deficit target to 0.4% in 2013 owing to cyclical sluggishness. Overall, the fiscal consolidation plans drawn up after the crisis have been delayed and the 2014 budgets show no changes with respect to this trend; in certain cases government deficits are expected to increase. Thus, fiscal margins are being restructured at a slow pace.

Trade and reforms

In the area of regional trade integration, the main progress was in relation to the so-called "Pacific Alliance" comprising Mexico, Chile, Peru and Colombia. At the end of August this Alliance reached an agreement on the deadlines for eliminating 100% of the tariffs between its members, most of them before the end of 2013. Furthermore, Costa Rica joined this trade bloc after signing a free trade agreement with Colombia and already having free trade agreements with the other three members – a necessary condition for membership. Accordingly, Panama signed a treaty with Colombia and began talks on entering into a treaty with Mexico. Colombia signed another agreement to liberalise foreign trade with Israel, as part of a strategy to look for new markets outside the region, while Costa Rica and Panama also signed agreements with the EFTA countries (Norway, Switzerland, Iceland and Liechtenstein). Chile extended the preferential trade agreement with India. No progress was made on trade in MERCOSUR, an issue which was not on the agenda for the last summit in July, against the backdrop of the suspension of bilateral investments and discrepancies between the two main partners in the bloc. Brazil asked its partners for greater flexibility to speed up negotiations with other players in international trade, mainly the European Union, and at the end of September it announced the withdrawal of tariffs on 100 imports which were applied last year. Finally, Ecuador applied for membership of MERCOSUR, and Paraguay was readmitted, after its membership had been suspended in 2011.

As for structural reforms, in Mexico reforms of the telecommunications industry and the banking sector were approved. Two of the most keenly anticipated proposals, the energy sector and fiscal reforms – currently before Parliament – face more opposition than the aforementioned ones. In Colombia the Plan to Promote Productivity and Employment (PIPE by its Spanish abbreviation) was approved. Among other measures, it extends the aid to the housing sector and reduces certain taxes and tariffs. By contrast, in Peru a package of measures was announced to cut the bureaucracy surrounding project start-ups and to improve the financing of small and medium-sized enterprises in order to encourage investment. Lastly, in Argentina certain rules on foreign investors' ownership of the oil industry were softened.

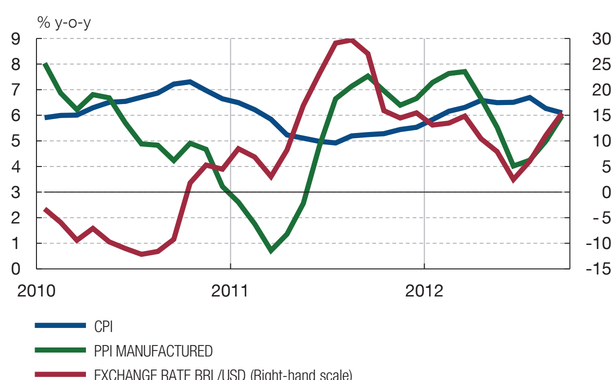
Economic developments by country

In Brazil, the recovery continued at a slow pace, although GDP for Q2 was a favourable surprise since it grew by 1.5% quarter-on-quarter (3.3% year-on-year), unlike in Q1 when it recorded lower-than-expected growth of 0.6% quarter-on-quarter (1.9% year-on-year). In terms of demand components, private consumption slowed to a year-on-year rate of 2.3% in Q2. It did so against a backdrop of high inflation, moderating consumer credit growth and a slightly less favourable labour market since, although the unemployment rate remained low (5.3% in August), both job creation and the increase in real wages eased in the first half of the year. Conversely investment, which had been contracting for several quarters, rose notably (to a year-on-year rate of 9% in Q2). Nevertheless, there are some doubts about the extent to which this recovery is the result of the effectiveness of stimulus measures (reduction of taxes, aid for exports and the promotion of directed credit) and about its continuity in a setting of a slight tightening of financing conditions and weak business confidence indicators. External demand maintained its considerable negative contribution in the first half of the year as a whole, mainly arising from the robust performance of imports associated with the recovery of investment, whereas exports contracted sharply in Q1 (down by 5.7%

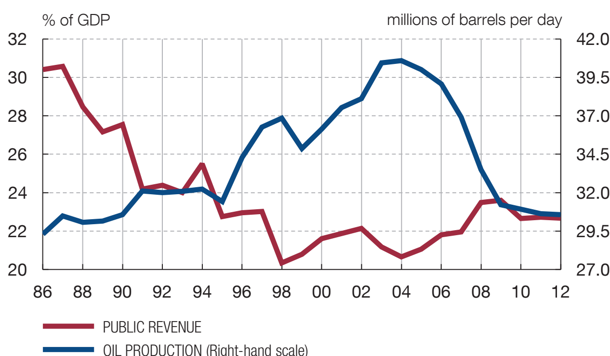
BRAZIL AND MEXICO

CHART 11

BRAZIL. PRICES AND EXCHANGE RATE



MEXICO: PUBLIC REVENUE AND OIL PRODUCTION



SOURCE: National sources.

year-on-year), but increased surprisingly in Q2 (up 6.3%). According to the higher frequency indicators it is estimated that activity will slow down in the second half of the year.

Inflation increased in the first half of the year to 6.7% year-on-year in June, above the upper limit of the target band, driven by supply shocks in food prices, the relatively narrow labour market – services inflation held at above 8% year-on-year – and the prior depreciation of the currency. However, this inflation could have been higher without certain tax cuts and reductions in the prices of regulated products introduced in this period. Since June inflation has begun to adjust slightly (see Chart 11), despite the depreciation of the exchange rate by almost a further 20% against the dollar between May and August, partly owing to the moderation of food prices and the positive base effects, and it stood at 5.9% year-on-year in September. Credit continued to show high growth rates of 16% year-on-year in nominal terms, as a result of the increase in the "directed" credit segment, particularly that extended to firms, which offset the notable easing of market credit. Against this backdrop, between April and October the central bank raised the official interest rate by a total of 225 bp, to 9.50%. The strong depreciation of the currency in response to the trend of capital outflows since May led to the withdrawal of most of the macroprudential and capital control measures adopted previously (the tax on foreign investment in fixed income [IOF by its Portuguese acronym], the 1% tax on increases in short positions in USD and the reserve requirements with respect to short currency positions held by local banks). Furthermore, the central bank announced a wide-ranging programme of dollar auctions from August until the end of the year. Following this and the stabilisation of emerging financial markets, the exchange rate has recovered significantly.

The current account deficit widened over the year to 3.6% of GDP in August due to the sharp fall in the goods surplus and rising services deficits. Net flows of direct investment have financed the bulk of the external deficit but, unlike previous years, not in full. In the fiscal realm, the limit on deductible expenses of the primary surplus target was raised, and the latter fell to 2.3% of GDP. Nevertheless, due to the fall in revenue a small tax cut was announced in order to meet the target for the year. In the draft 2014 budget the primary surplus target remains at 3.1%, but with deductible investment expenses amounting to 1%; consequently, the primary surplus target could decline to 2.1% of GDP.

In Mexico the economy performed worse than expected in the first half of the year by slowing notably (1.5% year-on-year in Q2, compared with an average of 3.2% for the pre-

vious six months). The lower momentum was particularly noticeable in Q2 when GDP fell 0.7% quarter-on-quarter, although this data was affected by a methodological revision in the compilation of GDP which includes changing the base year from 2003 to 2008 and assigns a larger weight to the construction and real estate services activities, which performed poorly due to lagging public investment. Accordingly, the demand component was more sluggish than investment, which declined by 0.2% during the first half of the year as a result of the fall in public investment, although it was also due to lower growth in private investment. Private consumption rose 3% in the first half of the year, which had less support from consumer credit and was dragged down by the poor behaviour of remittances (which stood at 2004 levels in real terms) and by a slight slowing of job creation (partly due to the labour reform – in the long term it may have beneficial effects but at present it has meant a lower rate of increase in informal employment). Similarly, external demand made a zero contribution, despite the deceleration of imports, since exports continued to perform badly faced with the fall of oil sales and the practically flat growth of manufacturing exports. The high-frequency data indicate a slight recovery of the economy. Thus, manufacturing exports improved as a result of more buoyant external demand, especially from the US, and retail sales even rose, pointing to a slight pick-up in private consumption.

Inflation, after climbing to a year-on-year rate of 4.6% in April as a result of the increase in the component of food and certain regulated goods (the gradual elimination of the petrol subsidy), eased rapidly as these temporary shocks petered out; in September it stood at 3.4%, within the central bank target range (3% ± 1%). Moreover, the core rate has held at historical lows (around 2.5%). Against this background, the central bank unexpectedly cut its official interest rate by 25 bp in September to 3.75%. On the fiscal front, the deficit held at 0.5% of GDP in Q2, without considering the investment by PEMEX, but the decline in revenue owing to the weakness of activity led the Executive to request that Parliament raise the deficit to 0.4% of GDP compared with the envisaged figure of 0%. An even bigger deficit of 1.5% is envisaged for 2014, as a result of the increase in investment and social protection spending. The current account balance posted a deficit of 1.7% of GDP in Q2, up on previous quarters as a result of the deterioration in both the trade and income balances.

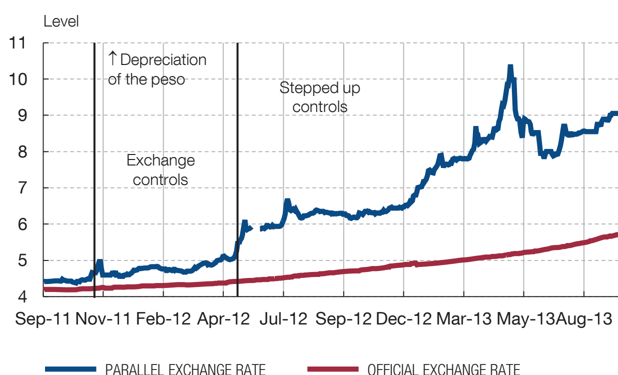
Finally, the momentum given to reform by the current Administration led two rating agencies to upgrade the country's sovereign rating; one raised it a notch and the other gave the country a better outlook. In this respect, the aim of the telecommunications reform is to increase competition and reduce costs in the industry, while the financial reform seeks to improve guarantee-enforcement and bank-resolution processes and to strengthen development banking.

Banco de México estimates place the increase in potential GDP as a result of this latest reform at 1.5 pp for the horizon of the next three years. The energy reform, which seeks to raise crude oil production in a setting which has seen it decline to 1998 levels (see Chart 11), would give the private sector access to specific oil exploration and extraction activities, while reserving ownership of this natural resource for the State. The tax reform would harmonise VAT rates across different sectors of activity, without broadening the tax bases, in addition to eliminating tax deductions and raising the top income tax rates. It is estimated that all these measures could raise revenue by 1.4 pp of GDP from 2014 in a setting of declining public revenue (see Chart 11). The tax reform also includes the application, as from next year, of a structural tax rule that allows slippage from equilibrium at times in which GDP is growing below trend, as would be the case in 2014, and which would cap current spending in situations of above-trend growth. This is in contrast to the current zero deficit rule for each year.

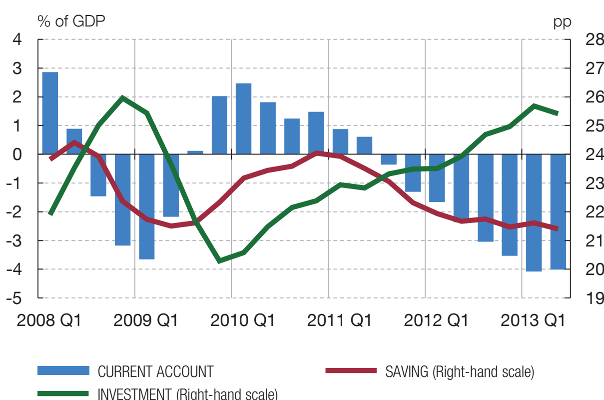
ARGENTINA AND CHILE

CHART 12

ARGENTINA. EXCHANGE RATE AGAINST THE DOLLAR



CHILE: CURRENT ACCOUNT



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

Following the strong slowdown last year, activity in Argentina rose appreciably according to official figures in the first half of 2013, posting year-on-year growth of 8.3% in Q2 after growth of 3% in Q1. The recovery may be biased upwards owing to seasonal factors (sizeable agricultural output) and to the better performance of the automobile industry. In terms of demand components, consumption was again the main driver of growth thanks to public policies (the strong increase in subsidies to low-income households) and to the increase in lending to the private sector (around 30% year-on-year in nominal terms), while the labour market remained considerably sound (the unemployment rate fell to 7.2%). Further, there has been a notable improvement in investment, especially in the capital goods component, thanks to the de facto easing of certain import restrictions and to administrative measures which routed saving towards investment. Conversely, with imports picking up (21.3%), the contribution of external demand turned very negative (-1.9 pp in Q1 and -2.2 pp in Q2).

In parallel with this recovery, official inflation rose to 10.5% in September, despite a temporary freeze on food prices; the primary deficit stood at 0.2% of GDP (though this figure rises to 2% if adjusted for central bank transfers and pension funds), and the current-account deficit at 0.3% of GDP. International reserves have fallen in the year to date by over $8 billion, standing at around $35 billion as a result of a decline in dollar-denominated deposits, the growing energy deficit and an apparent loss of effectiveness of capital controls (which were tightened for tourism). A tax amnesty was duly announced aimed at raising dollar inflows into the economy. The premium between the official and the parallel exchange rates widened to 100% at end-April (see Chart 12), but recent months have seen it narrow somewhat (to 60%) as a result of an increase in peso interest rates (the Badlar rate has risen from 14% per annum in March to 19.5% at present) and a swifter rate of depreciation of the official exchange rate (at an annualised rate of 30% in the past month, standing at 5.8 pesos per dollar). The latest conjunctural indicators show an easing in the pace of expansion of the economy, although the looser fiscal policy implemented before the legislative elections in October retains some momentum. The stock market index rose more than 40% in the March-September period, acting as a safe haven in a setting of high inflation and exchange rate uncertainty.

The level of the EMBI and of CDSs remain very high and volatile, but declined somewhat during the half-year period, influenced by the fact that, although the New York Court of

Appeals ratified the ruling obliging the country to pay the plaintiff funds that did not accept the debt swap, the ruling is currently suspended pending possible appeals. Argentina has maintained a position contrary to paying the holdouts. Hence, if the ruling becomes effective, there would be the risk of technical default, as payments to the bondholders who accepted the swap would be withheld to compensate the plaintiff funds. The Argentine government reacted to the ruling by announcing for the third time the reopening of the debt swap for holdouts under the same conditions as in 2010, seeking to deflate the arguments for a negative ruling and opening up the option for creditors with securities under foreign laws to voluntarily change to domestic jurisdiction. In principle, the appeals made by Argentina allow the problem to be deferred, but if the ruling holds firm the change of jurisdiction may be difficult. Accordingly, S&P once again downgraded Argentine bonds to CCC+.

Economic growth in Chile eased more than expected in the first half of 2013, although the growth rate remains very sound. Thus, in quarterly terms, the GDP rate expanded 0.8% in Q1 and 0.5% in Q2, and at an annual rate of 4.5% and 4.1%, respectively. Domestic demand, after performing most robustly in previous quarters, underwent a notable correction (5.8% year-on-year in Q2 compared with 8% at end-2012) owing to developments in investment (which eased as a result of the maturity of the mining investment cycle against the background of the lower price of copper), although the behaviour of inventories was also a contributing factor in Q2. Nonetheless, private consumption remained buoyant (7% year-on-year in Q2), underpinned by the favourable labour market conditions (an unemployment rate of 5.7% in August and real wages growing at 4%, although the creation of wage-earning employment has recently eased). With imports also continuing to expand strongly, the contribution of external demand was negative, although less so in Q2 than in Q1 (-0.8 pp compared with -2.8 pp), partly too as a result of a rise in mining exports following previous supply-side problems. The trade surplus fell by almost 65% in the nine months to end-September, the outcome of a 1.1% increase in exports year-on-year and of 4.2% in imports, which has widened the current-account deficit to 4% of GDP (see Chart 12), despite lower mining income outflows.

The high-frequency indicators suggest that consumption might undergo some adjustment, assisted by tighter credit conditions and the recent depreciation of the peso (5% relative to the dollar since May), although the economy as a whole appears to be stabilising. Inflation has tended as expected, rising to a degree as some of the temporary factors that pushed it down (energy prices and the behaviour of tradeable goods prices) were diluted. Even so, it stood at 2% year-on-year in September, within its target range, while core inflation remains below 1.5%. Against this background, the central bank has cut its official interest rate of 4.75% in October in light of the good inflation performance and the expected moderation of private consumption. On the fiscal front, lower revenue augurs a deficit of close to 1% of GDP for 2013.

In Colombia, following the strong moderation in 2012, activity remained sluggish in Q1 (2.7% year-on-year) but picked up appreciably in Q2 (4.2% year-on-year). The contribution of domestic demand exceeded 3 pp in the first half of the year as a whole, with the improvement in external demand, contributing 0.9 pp, proving the chief determinant of the pick-up in Q2. Private consumption also rose strongly (4.4% year-on-year), underpinned by the progressive reduction in the unemployment rate (9.9% in July), although the pace of job creation has eased. While investment grew less in Q2 (4.2% against 6.1%), this was due to an unfavourable base effect and to the run-down in inventories. While investment in civil engineering works remained very buoyant, non-residential investment recovered

somewhat. The high-frequency indicators point to the prolongation of this favourable course. Inflation, which was surprisingly lower in Q1 owing to the temporary shocks in food and regulated prices, subsequently moved on to a rising path, albeit at lower levels (2.3% year-on-year in September). Further, the recent depreciation (6% against the dollar in annual terms) appears to be having a limited pass-through to inflation, with inflation expectations remaining anchored. Against this backdrop, the central bank held its official interest rate at 3.25%. And despite the depreciation of the peso, the dollar-purchases programme was maintained, although the related amount has been reduced for the October-December period this year and a reform proposal seeking to increase the minimum level of domestic pension funds' assets abroad was brought to a halt. The central government deficit is widening slightly relative to 2012 (1.9%) as a result of the lesser momentum of tax revenue. Moreover, an economic stimulus plan was unveiled in April, which includes lower taxation of both the industrial and agricultural sectors and the extension by two more years of the exemption from tariffs on certain imports. In the external sector, the current-account deficit increased to 3.2% of GDP in the first half of the year, reflecting the lower trade surplus. Lastly, S&P upgraded Colombia's long-term foreign-currency sovereign rating to BBB.

In Peru, although the economy remains very dynamic, there has been something of a slowdown during the year. In Q2, GDP increased at a quarterly rate of 1.1% (down on 1.5% in Q1) and at an annual rate of 5.6%. Growth was underpinned by investment and government consumption (12.1% and 8.5% year-on-year, respectively, in Q2). Some adjustment has continued in private consumption (5.3% against 5.8% in 2012 as a whole) in a setting in which the labour market remains strong (the unemployment rate is at a historical low of 6% and real wage rises at 3%), but consumer credit has eased notably. A slowdown to some extent in imports has not offset the moderation in exports, especially in Q1, meaning that the contribution of external demand was negative (-3.8 pp in Q1 and -1.1 pp in Q2). The high-frequency indicators point to a gradual slowdown continuing. The current-account deficit increased in Q2 to 5% of GDP owing to the strong reduction in the trade surplus.

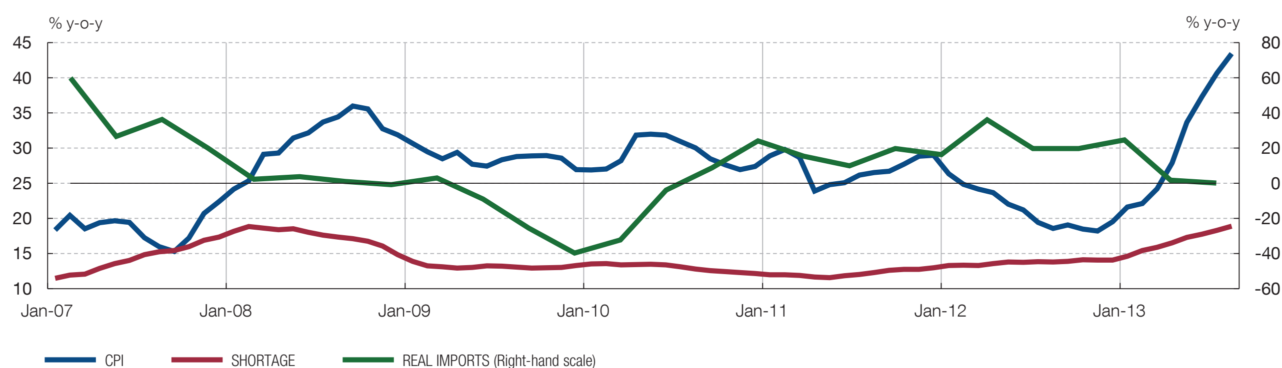
Inflation stood at 2.8% in September, close to the upper limit of the central bank's target interval (2% +/– 1 pp), due in part to temporary supply-side shocks. Inflation excluding energy and food prices has held within the target range, and long-term expectations remain anchored. Against this backdrop, the central bank kept its official rate at 4.25%, unchanged since May 2011; in contrast, however, it actively managed macroprudential policies in light of the currency depreciation (7.6% in annual terms) and the external turbulence, partly reversing from May the high levels of the bank reserve requirements. Furthermore, it stepped up its interventions on the foreign exchange market from July 1 once it considered that the initial overvaluation of the currency had been corrected and that the depreciation might be excessive. In the fiscal arena, the non-financial public sector ran a primary surplus equivalent to 1.8% of GDP in Q2, down on the previous quarters owing to some easing in the increase in current revenue and to a high level of expenditure, due especially to public-sector wage rises. Finally, S&P upgraded Peru's long-term foreign currency sovereign rating to BBB+.

In Venezuela, the economy slowed notably in the first half the year, more markedly so in Q1 (after growing at a year-on-year rate of 5.6% in 2012, it posted growth of 0.5% in Q1 and 2.6% in Q2). The main factor behind this weaker activity was the behaviour of investment (–2.9% in Q2 compared with 23.3% in 2012), associated with the halt in public investment as from Q1 and with firms' difficulties in gaining access to dollar-denominated financing.

VENEZUELA

CHART 13

INFLATION, SHORTAGE AND IMPORTS



SOURCE: Banco Central de Venezuela.

Moreover, volume exports once again posted negative year-on-year rates, making for a cumulative 35% fall compared with the level 10 years ago. Private consumption continued to be the most dynamic component (growing by 5.5% in Q2), albeit tending to slow in the context of the strong increase in inflation during the year (46.2% year-on-year in September), especially in the food component, while the depletion indicator rose to a high. The rise in inflation is caused by the devaluation last February, the shortage of currency for imports (significantly, imports, having increased by more than 25% in real terms in 2012, rose by only 0.1% in Q2, weighed down by the strong 12% decline in private imports, especially of intermediate goods) and the increase in the parallel exchange rate. In July the new dollar tender system (SICAD) commenced operating, but does not appear sufficient to cover the demand for imports. Accordingly, the government has announced that it will create an official third market for currency.

As regards public finances, the year 2012 ended with a strong increase in the central government deficit, which stood at 4.8% of GDP, and in the budget deficit (which would be notably higher owing to the deficit of other quasi-State agencies). Although the February devaluation lessened pressure to some extent owing to the increase in local-currency-denominated revenue, the deficit remains very high. Further, the current-account surplus in Q2 stood at 1.5% of GDP in annualised terms, down on 2.9% for 2012. This was due to the lower trade surplus, the result both of the decline in the volume of exports and of the fall in oil prices, given that more than 96% of foreign sales are of this commodity, some of which at prices far below the market rate in light of the preferential agreements signed by the executive branch with countries in the region or with China. Reserves fell in the six-month period by close to $3.2 billion, and most of these are in the form of gold.

14.10.2013.