Introduction

The Federal Reserve's announcement in May 2013 that it would at some point commence tapering prompted a bout of instability on Latin American financial markets and on emerging markets in general, which was followed from September by a period of some stability and recovery. Indeed, the actual start of tapering in December was digested with relative calm by the markets. However, early 2014 saw some intermittent episodes of tension, one with its epicentre in Argentina, which have affected the emerging economies with differing degrees of intensity, depending on their vulnerabilities and idiosyncrasies (less so in the case of those countries whose economic policies had already reacted during the mid-2013 episode). Significantly, in any event, the change in outlook for the monetary cycle in the United States comes in step with the firming of the recovery in this country and, with a greater lag, in other advanced economies, a recovery which is a favourable factor for the region. Nonetheless, the main concern over Latin America appears to be shifting more recently from the tightening of global monetary conditions to the risk that China may slow down more than expected.

Against this background of weaker commodities prices, and with the output gap having closed in some of the region's main economies, the second half of 2013 saw a slowdown in activity in Latin America. Average GDP across the five countries with inflation targets (excluding Argentina and Venezuela[1]) dipped from year-on-year growth of 3% in Q2 to 2% in Q4. As a result, GDP in these five economies as a whole grew by 2.3% in 2013, down on the previous year's figure of 2.9% and on the expectations of recovery that prevailed at the start of the year. Moreover, this weakness has been spreading to more countries: in 2012, only Argentina and Brazil showed lower growth rates, influenced by domestic factors; in 2013, the slowdown has progressively passed through to other countries, such as Venezuela, Mexico and also Chile. In any event, Chile, along with Colombia and Peru, has maintained growth far above the average.

While there are a wide range of different circumstances across the region's countries, one common feature in the recent slowdown has been the easing in domestic demand. This variable, having exceeded on average year-on-year growth of 3.5% in the first half of 2013, posted growth of only 1.2% in Q4, owing to the slowdown in Brazil, Chile and Mexico (see Chart 1). Conversely, external demand began to pick up in some economies in the final stretch of the year, although its contribution is as yet modest, in line with the slow recovery in the developed economies; indeed, in 2013 as a whole, it continued to subtract from growth. In addition, the slowdown in GDP has become more marked in Argentina and Venezuela as a result of specific factors in these countries, with significant risks building up.

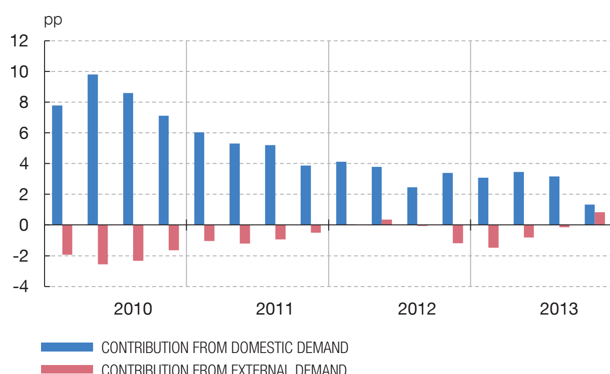
The growth outlook for Latin America for 2014 has continued to be revised downwards in recent months. On average, growth similar to and even slightly lower than that in 2013 is expected, with notable intra-regional differences. On one hand, Peru, Colombia and, to

1 At the cut-off date for this publication, Argentina and Venezuela had not released the National Accounts data for 2013 Q4; accordingly, it has not been possible to compile the LatAm-7 aggregate of the region's seven main countries, as was the habitual practice. Alternatively, a LatAm-5 aggregate comprising Mexico, Brazil, Colombia, Peru and Chile has been constructed so that recent growth in the region may be analysed and comparisons made with previous quarters.

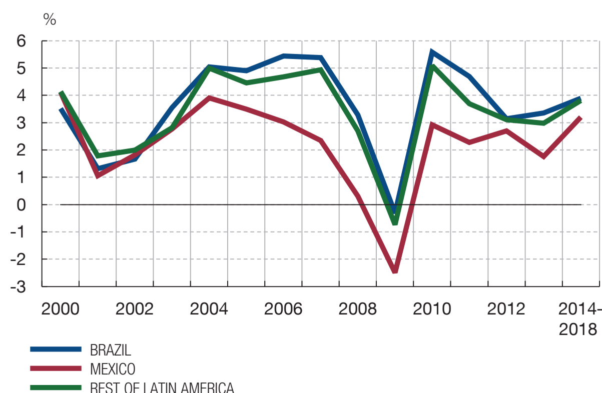
COMPOSITION OF GROWTH AND ESTIMATED GROWTH OF EXTERNAL DEMAND

CHART 1

COMPOSITION OF GROWTH IN LATIN AMERICA (a)



ESTIMATED GROWTH OF EXTERNAL DEMAND (b)



SOURCES: Bloomberg and Datastream.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru.
b GDP growth of the trading partners of the seven largest economies of the region, weighted by their share in exports.

a lesser extent, Chile are expected to remain soundly buoyant, although possibly less intensely so than in previous years. In Mexico the outlook is favourable since temporary factors, which were responsible for the slowdown in 2013, are expected to gradually fade over the course of the year; moreover, current reforms are also expected to boost confidence. The Brazilian economy, for its part, appears to have settled into a low growth rate which, viewed positively, may contribute partially to correcting its external imbalances and to shoring up its growth in the medium term, conditional upon the path of reforms being furthered. Finally, Venezuela and Argentina are expected to enter a low growth phase, with the risk of recession with high inflation.

In the countries with inflation targets, inflationary pressures appear to be manageable and expectations remain anchored. There are, however, upside risks derived from currency depreciations (in some cases substantial) and from the increase in food prices, which might offset the moderating effect of domestic demand and compound economic policy dilemmas. Some countries retain the capacity to pursue countercyclical policies, such as Peru, Colombia, Mexico and Chile which, in the absence of inflationary pressures, have been able to keep their policies accommodative and to assume the depreciation of their currencies. In Brazil, however, this leeway seems more limited at present owing to persistent inflation. In Argentina and Venezuela, inflationary pressures have worsened substantially and, although their respective economic policy responses are proving different, both economies face a series of macroeconomic constraints, singularly so in terms of forgone reserves, which obviate the application of countercyclical policies.

The year 2014 poses uncertainties for Latin America. The positive impact on the region of the recovery under way in the US economy, in the specific form of greater external demand (see Chart 1), may be offset to a greater or lesser extent by the tightening of financing conditions, and something of a slowdown in certain emerging economies. One factor of risk is the possibility that the easing in activity in China proves sharper than expected, which would have a greater impact on the countries more exposed to this economy and in which the presence of macroeconomic imbalances curtails the margin for manoeuvre of economic policy. Overall, it will seemingly be difficult for the region to recover the forceful dynamism it showed in exiting the Great Recession. Moreover, 2014 will provide a chance

to see whether the cumulative depreciation of the exchange rate is sufficient to accommodate these external shocks, and to what extent it will restrict monetary policy leeway in the future. How Venezuela and Argentina will manage a situation of low growth with major imbalances is another sizeable factor of uncertainty. All these developments highlight the importance of reinforcing economic policy frameworks and prioritising competitiveness-enhancing structural reforms.

External environment

Developments in the world economy in the past six months have continued to be influenced by two key factors: first, the slowdown in various emerging economies, in general, and doubts over the sustainability of the pace of growth in China, in particular; and further, expectations about the normalisation of the monetary cycle in the United States. Following a recovery on the financial markets at year-end, underpinned by the clarification of the US monetary strategy and by increasingly widespread signs of a pick-up in the advanced economies, there were temporary episodes of tension in the emerging financial markets in 2014 Q1 which highlight the persistence of doubts over the position of certain emerging economies that may have built up excessive imbalances.

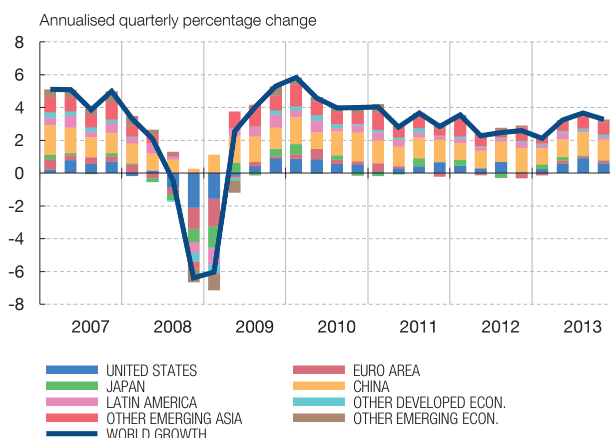
Against this backdrop, global activity quickened in the second half of 2013 to rates of around 3.5% (see Chart 2), 1 pp up on the first half of the year, as a result of the firming of the recovery in the advanced economies; accordingly, the ongoing shift in global growth towards this group of economies continued. True, the latest data point to some easing in the growth of the advanced economies in early 2014, owing to temporary factors (such as the bad weather in the United States). But they are expected to continue strengthening, in a setting of smaller fiscal adjustments than in 2013 (except in Japan), favourable monetary and financial conditions (despite the tightening), gradual recovery in real estate and labour markets, and an increase in private-sector wealth. With the exception of Japan, inflation trended downwards in this group of economies, which can in certain cases cause concern, as in the euro area (0.5% in March). The monetary authorities in these countries face a divergent outlook; while some, such as the Federal Reserve or the Bank of England, are managing the change in monetary cycle with successive alterations to their forward guidance strategies, others such as the Bank of Japan or the ECB are assessing the possibility of providing greater stimuli. The balance of risks for the advanced economies has improved, with the increase in risks associated with low inflation rates standing out.

In the second half of 2013 the growth rate of the emerging economies generally stood below expectations, with the pace of growth across the different regions remaining mixed. In 2013 on average, China grew by 7.7%, the rest of Emerging Asia by 4.4% and Eastern Europe by 1.3%, while Latin America was in an intermediate position (2.3%). The worsening outlook for the emerging economies has continued in 2014 to date. While for this year growth is expected to stabilise at similar rates to those in 2013, there are downside risks with this scenario, arising from the potential re-emergence of episodes of financial volatility and from their impact on investors' and agents confidence, and from a sharper-than-expected slowdown in China. These risks are more material for the economies with weaker fundamentals. However, significant exceptions aside, it should be clarified that the imbalances built up recently by these economies have been moderate; also, levels of vulnerability are lower than in the past, given the greater soundness of their macroeconomic policy frameworks, the solvency of their banking systems and the presence of mitigation mechanisms, such as the absorption capacity generated by exchange-rate flexibility – against a background of fewer currency mismatches – and the high level of reserves in many of these countries. In any event, greater market sensitivity has in certain cases restricted the headroom available for countercyclical policies.

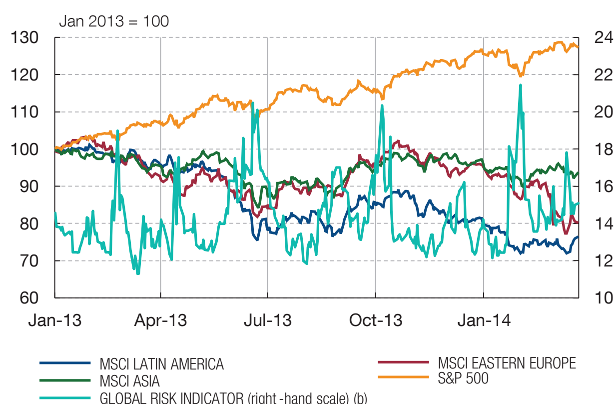
GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Annualised quarterly rate, indices and basis points

CHART 2

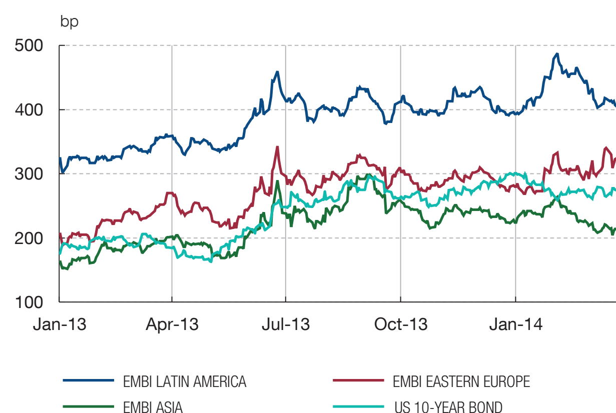
CONTRIBUTION TO WORLD GDP GROWTH



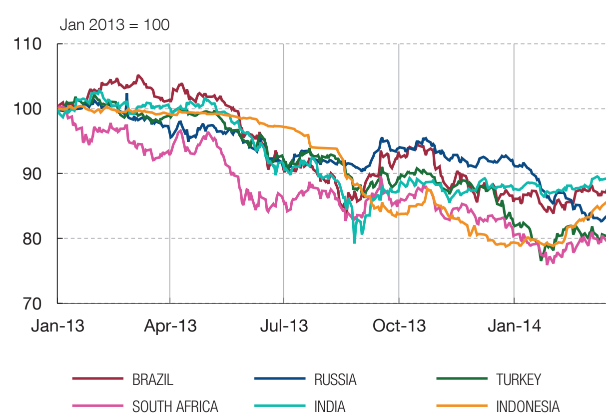
WORLD STOCK MARKET AND GLOBAL RISK INDICATOR (a)



INTEREST RATE SPREADS



EXCHANGE RATES AGAINST THE DOLLAR IN EMERGING ECONOMIES



SOURCES: Datastream and JP Morgan.

a Stock market indices in dollars.
b VIX.

Financial markets and external financing

In the final quarter of 2013, the financial indicators of the emerging economies were characterised by a stock market recovery and a downtrend in spreads and in default risk premia (see Chart 2). Stock markets regained the levels prior to the turbulence in May, while sovereign spreads, measured by the EMBI index, stabilised at some 70 bp above the levels observed in the first half of 2013. Exchange rates picked up to levels close to those seen in May, except those of the more vulnerable economies, which continued to show an 8-10% depreciation against the dollar.

In early 2014, in the new setting of gradually normalising global monetary conditions, developments in the emerging markets came to depend to a greater extent on idiosyncratic factors, economic and political alike. In light of the earlier-mentioned doubts over the outlook for China, the political tensions in Turkey and the weakness of this country's external sector, coupled with the strong and swift depreciation of the Argentine peso, gave rise to fresh turbulence in late January which was relatively widespread but more fleeting in nature than the episode in 2013 (see Chart 3). This turbulence had less of an impact on economies whose economic policies had already reacted in 2013, such as Brazil, Indonesia

and India, although a further factor of weight in this lesser reaction was the intensity of the cumulative depreciation of exchange rates. Subsequently, events in Ukraine renewed tensions, although the impact was more regional in nature, chiefly affecting the Eastern European countries and Turkey. Moreover, low financial volatility globally and low long-term yields in the United States restricted the spread of these bouts of turbulence (see Chart 2). By late March, the financial indicators of the emerging markets had recovered, in particular in those countries most affected by the turbulence in May. Nonetheless, investor sentiment towards the emerging markets is now generally less favourable than a year ago, in a setting in which doubts persist over economic activity and the financial sector in China, with possible repercussions for the external demand of the emerging economies and commodities prices.

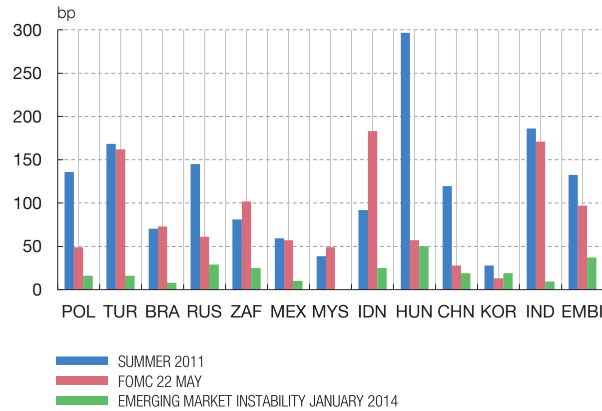
In parallel, the past six months have seen a withdrawal by minority investors from the emerging markets in the form of heavy outflows from debt funds and stock markets (see Chart 3), based on the surveys habitually used. Moreover, balance of payments figures point to a slowdown in portfolio inflows. Bond issues across the emerging economies as a whole once again reached historical highs between December and January, but a slowdown has since been perceptible. Against a background of expectations of lower global liquidity and interest rate rises, fixed-income issues are likely to be geared to a greater proportion towards asset-backed and variable-yield issues with shorter maturities and, possibly, with a higher average rating. These characteristics began to become discernible as from the third or fourth quarter of 2013, albeit incipiently (see Chart 3).

The performance of the Latin-American financial markets was similar to that of the other emerging markets, with the odd particularity suggesting a degree of intra-regional discrimination. Stock markets fell very sharply from end-September to early 2014 (especially in Brazil and Chile, although Mexico performed favourably), with indices picking up subsequently. As a result, from October 2013 to March 2014 Latin American stock markets posted an average fall of 1.3%, compared with the 3% increase on Asian bourses. This was marked by the declines in Brazil (-2.6%) and Peru (-9.6%); in Mexico, the decline was smaller (-1%) owing to the greater correlation with US markets and improved expectations on the back of Mexico's structural reforms.

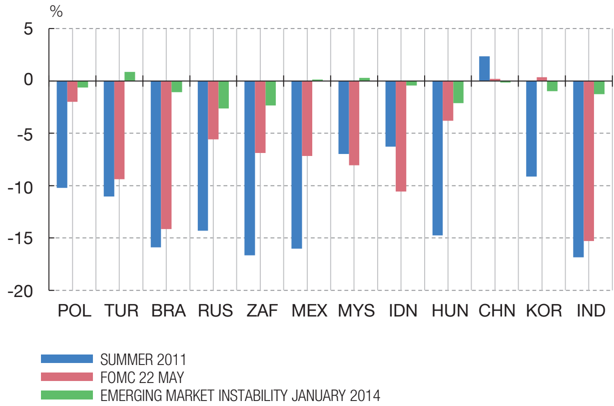
Sovereign spreads in the Latin American countries were relatively stable until the January-February episode of turbulence, when they widened somewhat, although this movement was reversed in late March (see Chart 4). Sovereign risk premia, measured by the Latin American EMBI, stood from late March at somewhat below 400 bp for the region, close to the average for the past four years. These developments were influenced by the behaviour of the Argentine sovereign spread (which narrowed by 170 bp from mid-October further to the post-election shift in the economic policy stance), and were offset in part by the increase in Venezuela (100 bp). Overall, the recent decline in the EMBI Latin America has been on a lesser scale than that in other emerging regions (15 bp since mid-October, compared with 40 bp in Asia), and with some differences from country to country. The stability of sovereign spreads has been compatible with a substantial increase in local currency-denominated long-term bond yields since late May 2013 although, once again, differences across countries have been significant (increases of almost 3 pp in Brazil, 1.7 pp in Mexico and unchanged in Chile; see Chart 4). The behaviour of spreads has been similar to that of CDS premia, which have over the past 18 months re-adjusted in step with the greater perception of risk in this region and in other emerging regions, and the reverse of what has been observed in the developed economies, as is analysed in Box 1.

SOVEREIGN SPREADS, EXCHANGE RATES, BOND ISSUES AND FUND FLOWS CHART 3
Percentages, basis points and $bn

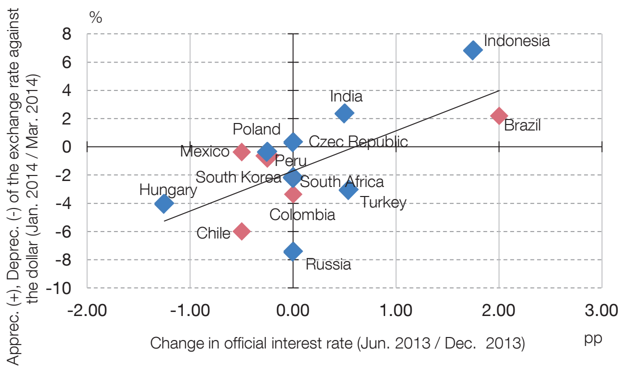
CHANGE IN SOVEREIGN SPREAD



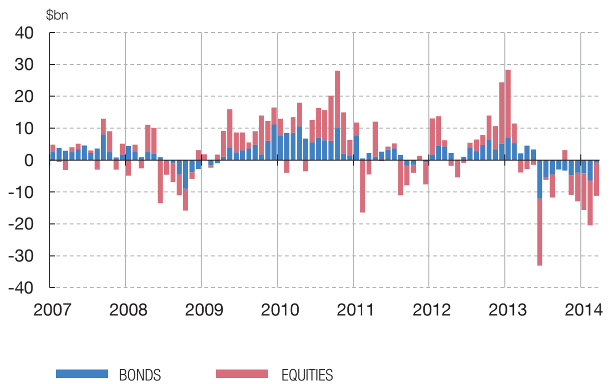
EXCHANGE RATE VARIATION



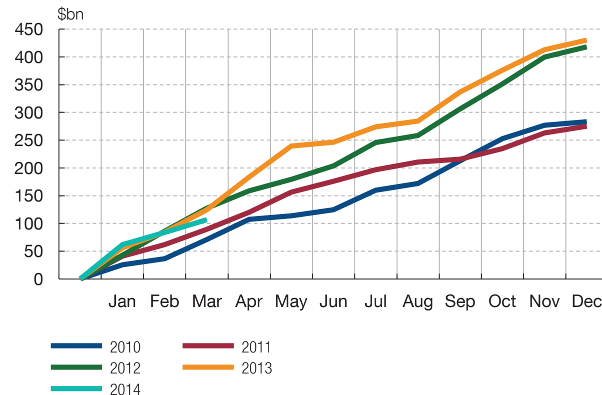
OFFICIAL INTEREST RATES AND EXCHANGE RATE AGAINST THE DOLLAR



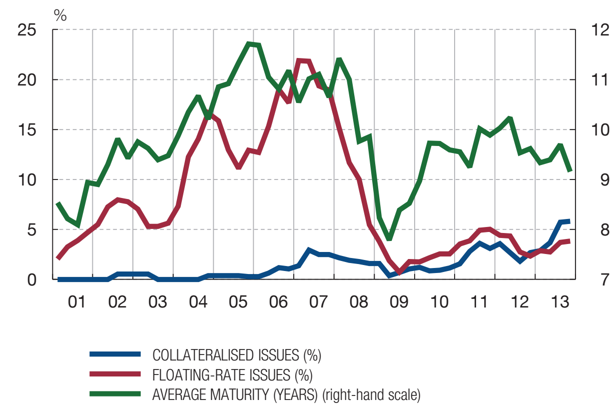
FLOWS TO STOCK MARKET FUNDS AND EMERGING DEBT



BOND ISSUANCE ON INTERNATIONAL MARKETS
(cumulative from the beginning of each year)



BOND ISSUANCE BY EMERGING ECONOMIES



SOURCES: Datastream, Dealogic, EPFR and national statistics.

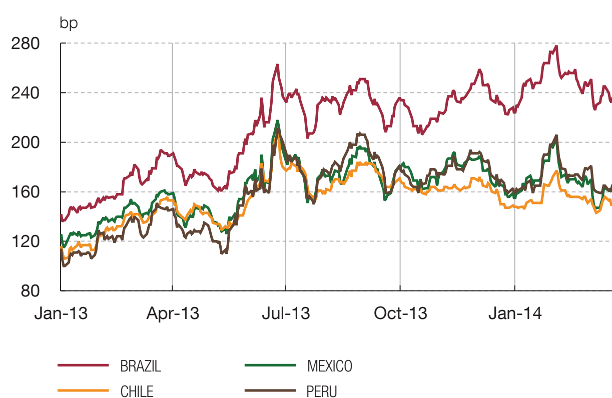
The exchange rates of the region's currencies held on a mild depreciating trend over the last six months. The exception was the Mexican peso, which appreciated by 0.8% from October. The cumulative depreciation against the dollar was more marked in the case, first, of the Brazilian real (-2%), despite intervention by the country's central bank on the currency markets and the successive rises in the official interest rate; and further, of the

FINANCIAL INDICATORS
Indices, basis points and percentage points

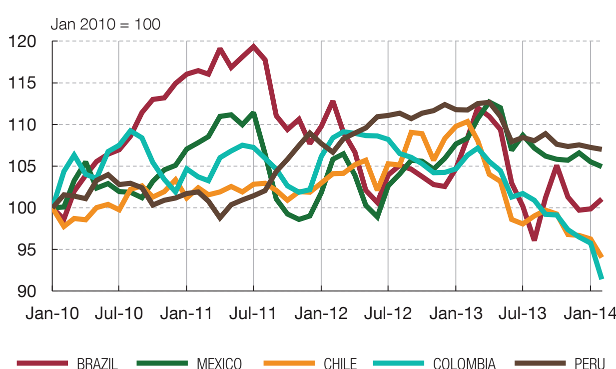
CHART 4

STOCK EXCHANGE INDICES

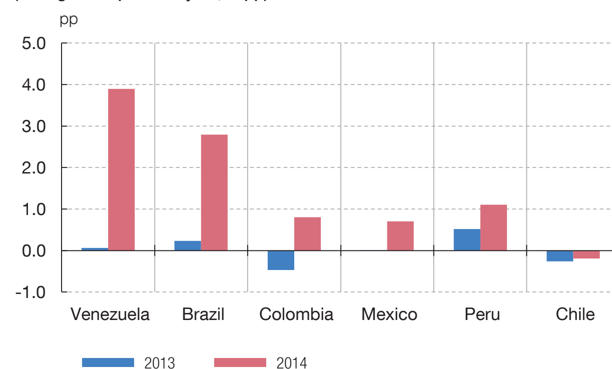
SOVEREIGN SPREADS



REAL EFFECTIVE EXCHANGE RATE



10-YEAR BOND INTEREST RATE IN LOCAL CURRENCY
(Change from previous year, in pp)



SOURCES: Datastream, JP Morgan and national statistics.

a MSCI Latin America index in local currency.

currencies of the economies more closely tied to commodities prices, such as Chile (-8.8%) and Colombia (-3.2%). In some instances, the depreciations recorded since May 2013 have enabled the prior appreciation of the real exchange rate to be corrected (see Chart 4).

Finally, despite the bleaker growth outlook, there was a firm inflow of high foreign direct investment into the Latin American economies in 2013 ($163 billion, $8.7 billion up on 2012; see Chart 5). There were notable inflows in Mexico, which broke the declining trend evident since the crisis of 2008, along with an increase in Colombia and a recovery in Venezuela, in the oil sector. Conversely, Brazil, Peru and Chile recorded lower inflows, although they were at historically high levels. Portfolio investment inflows fell by around $30 billion in 2013, to levels similar to those in 2011 (see Chart 5), with the decline centred on Mexico and Chile in the second quarter of the year. From October 2013 to March 2014, fixed-income issues in the region amounted to $60 billion, with notable issuance activity in Mexico by both the Treasury – with short-term debt refinancing operations and very long-term currency-denominated issues – and the State-owned oil corporation (23% of the total between the two), and an $8.5 billion placement by the Brazilian State-owned oil corporation (see Chart 5).

DIVERGENCE AND CONVERGENCE BETWEEN AGENCY RATINGS AND THE RATINGS IMPLIED BY SOVEREIGN CDSs

BOX 1

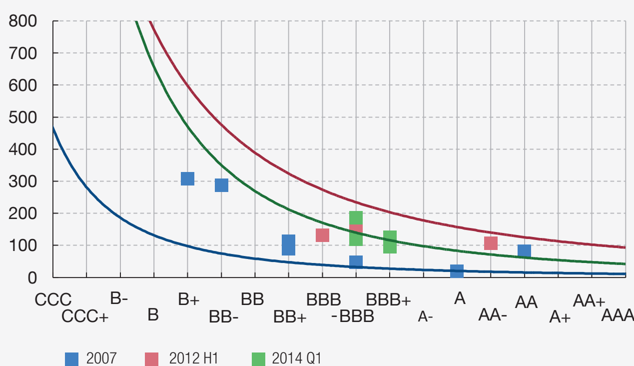
After the 2008 global financial crisis there was a notable change in the perception of risk across the main developed and emerging markets, which has reversed partially in the last year and a half. These changes in perceptions are reflected both in the sovereign ratings issued by credit rating agencies and in certain market indicators, such as credit default swaps (CDSs). However the rightward shift of the curves of CDS premia versus sovereign ratings shows that the risk measured by CDSs has increased notably for the same level of rating (see panel 1 of Chart 1). Moreover, the dispersion between the ratings assigned by agencies and those implied by CDSs has also increased.

This Box analyses the relationship between the sovereign ratings issued by Standard & Poor´s and the ratings implied by CDSs, which are derived from a regression of the agency-issued rating on the level of default premia in CDS markets. In the charts, upward movements in these two variables denote lower credit risk.

Panel 1 of Chart 1 shows the convergence of credit risk between advanced and emerging economies (the former influenced by the deterioration in the euro area), measured in terms of implied ratings and of agency-issued ratings. Also apparent is a clear divergence between the agency-issued ratings and the risk perceived by the markets at certain points in time, particularly from 2010, after the outbreak of the euro crisis. At that time, in the euro area economies under high financial stress the credit risk implied by CDSs increased notably, at a level well below the rating assigned by credit rating agencies. By contrast, in the aggregate of emerging economies the credit risk implied by CDSs was lower than that indicated by agency-issued ratings. The situation began to change at the end of the summer of 2012. First, the reduction of extreme risks in the euro area was reflected in an improvement in its implied ratings, which are now again above those assigned by agencies. The improvement again centred on the countries most affected by the crisis and, for some of them, such as Spain, the discounted rating in March 2014 stood two notches above that assigned by the rating agency. By contrast, the worsening perception of the emerging economies, particularly from May 2013 with the change in monetary policy stance in the United States, led to a revision of their credit risk, such that now the rating implied by sovereign CDS premia is BBB, two notches below that of the rating agency. The worsening of the implied sovereign rating was most marked in emerging Asia (as much as two notches below the agency-assigned level), while in eastern Europe the implied ratings

1 RATINGS IMPLIED BY CDSs, BY AREA

1 AGENCY-ISSUED RATINGS AND CDS PREMIA



2 IMPLIED AND AGENCY-ISSUED RATINGS, BY AREA

3 IMPLIED AND AGENCY-ISSUED RATINGS, BY AREA

4 IMPLIED AND AGENCY-ISSUED RATINGS, BY AREA

SOURCES: Standard & Poor’s and Banco de España.

2 RATINGS IMPLIED BY CDSs: LATIN AMERICA

1 IMPLIED AND AGENCY-ISSUED RATINGS: MEXICO

2 IMPLIED AND AGENCY-ISSUED RATINGS: BRAZIL

3 IMPLIED AND AGENCY-ISSUED RATINGS: CHILE

4 IMPLIED AND AGENCY-ISSUED RATINGS: COLOMBIA

5 IMPLIED AND AGENCY-ISSUED RATINGS: PERU

6 IMPLIED AND AGENCY-ISSUED RATINGS: URUGUAY

7 IMPLIED AND AGENCY-ISSUED RATINGS: ARGENTINA

8 IMPLIED AND AGENCY-ISSUED RATINGS: VENEZUELA

AGENCY-ISSUED (S&P) IMPLIED

SOURCES: Standard & Poor's and Banco de España.

remained in line with agency-issued ratings until February 2014, when the Ukraine crisis triggered a sharp rise in CDSs and a fall in the ratings discounted.

In Latin America (see panel 3 of Chart 1) there was a sharp discrepancy between the rating implied by CDSs and that assigned by agencies, amounting to more than three notches, which the gradual improvement in the latter has not sufficed to offset. However, the rise in CDS premia from mid-2012 caused the two measures to converge towards a BBB– rating. Examination by country shows that the implied rating of Brazil decreased sharply from the beginning of 2012 in an earlier and larger fall than the effective downgrade finally made at the end of March (see panel 2 of Chart 2). Recently there have also been declines in the implied sovereign ratings of Colombia, Peru and Chile, which had enjoyed recent upgrades in the sovereign rating assigned by Standard and Poor's. By contrast, in Mexico the CDS-implied ratings continue to be higher than agency-assigned ratings, even after the recent upgrade of the assigned rating (see panel 1 of Chart 2),[1] which reflects a perception of lower vulnerability than in the rest of the region. Finally, for Argentina and Venezuela (countries with a worse agency-assigned rating), the implied rating is even lower, reflecting a higher level of default risk than that perceived by the rating agency. The implied rating of Uruguay slipped by less than those of other economies in the region (see panel 6 of Chart 2) and is currently in line with that of the rating agency, just on the threshold of investment grade (BBB–).

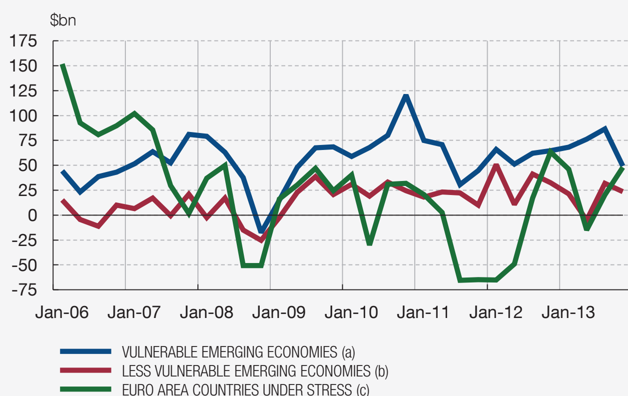
The perception of credit risk is strongly correlated with the behaviour of capital flows and issuance volume in the primary corporate bond markets. Chart 3 sets out the portfolio inflows and corporate issues in primary markets for various groups of countries: emerging economies with higher vulnerability (Turkey, Brazil, India, Indonesia, South Africa and Russia); the more stable emerging economies (Mexico, Korea and Poland); and the euro area countries under financial stress (Italy, Portugal, Ireland and Spain). As can be seen, at the same time as portfolio inflows slowed and issues slackened in the first group, those of the second remained relatively stable, while those of the European economies recovered strongly, albeit without recouping their pre-crisis levels.

In short, analysis of the ratings implied by the sovereign CDS markets and their comparison with those issued by agencies reveals information of interest on the behaviour of investors and their perceptions of the countries in question. Since agency-issued ratings change much more slowly, the implied ratings may in some cases anticipate agencies' revisions and lend firmness to the perception of greater or lesser risk. Nevertheless, the volatility of implied ratings also shows the variable, oscillatory nature of market sentiment. Specifically, the positive divergence of implied ratings in emerging economies following the crisis may reflect an over-reaction in favour of these markets, which has been corrected recently. Another interesting conclusion is that a certain substitutability can be appreciated between emerging economies and the euro area countries under stress: the dissipation of tail risks in the latter, simultaneously with the perception of greater vulnerability in the emerging economies as changes were made to US monetary policy has prompted opposing developments which are mirrored in capital flows: these now target the emerging economies to a lesser extent and are returning to the euro economies, in a trend which is reversing that of previous years.

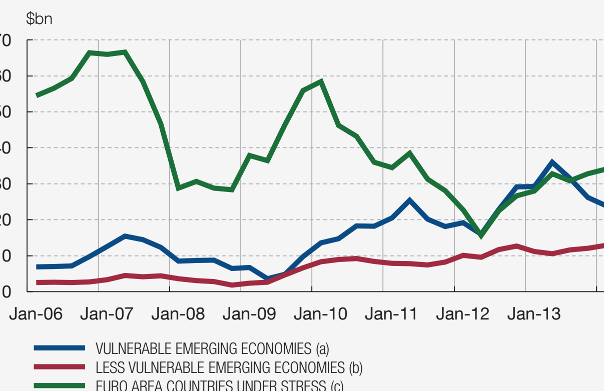
1 Somewhat similar to the situation for South Korea, Poland and Hungary.

3 CAPITAL FLOWS BY AREA

1 PORTFOLIO INFLOWS



2 ISSUANCE ON INTERNATIONAL MARKETS

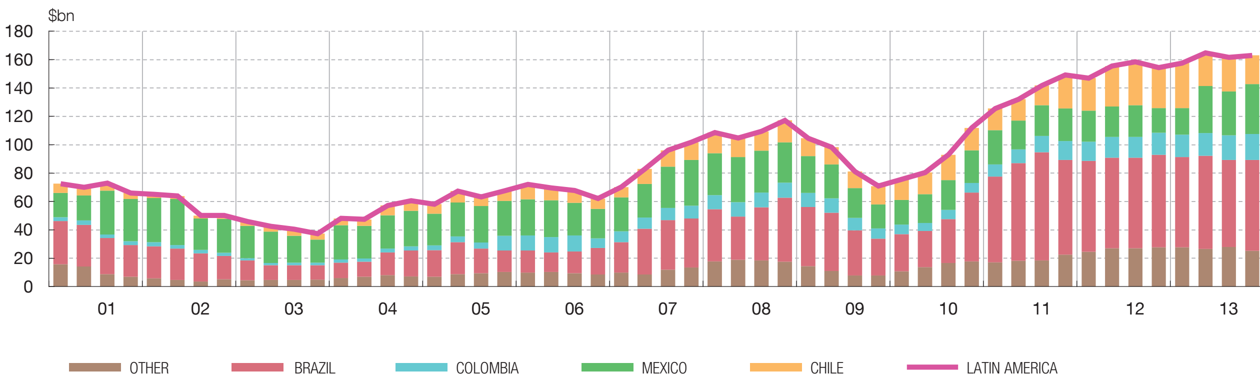


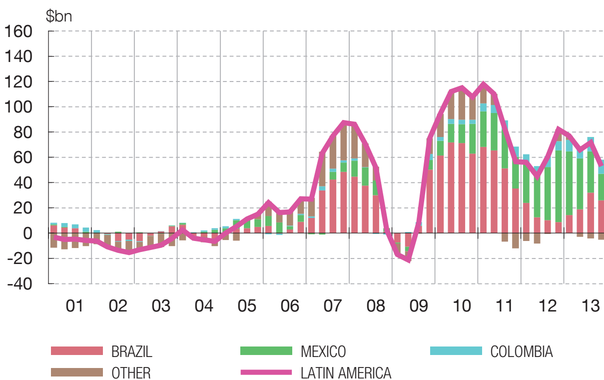
SOURCES: Datastream and Dealogic.

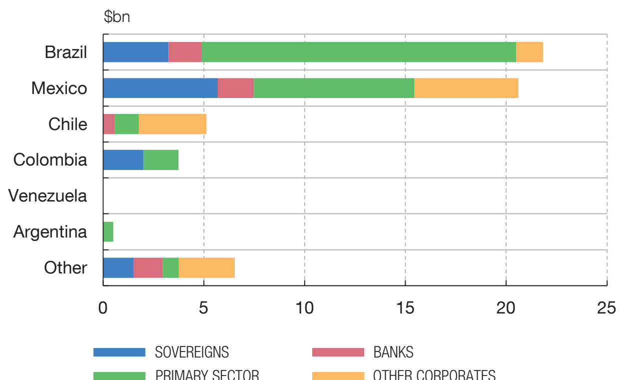
a Turkey, Brazil, India, Indonesia, South Africa and Russia.
b Mexico, South Korea and Poland.
c Spain, Italy, Ireland and Portugal.

EXTERNAL CAPITAL FLOWS
$bn

CHART 5







SOURCES: Datastream, Dealogic and national statistics.

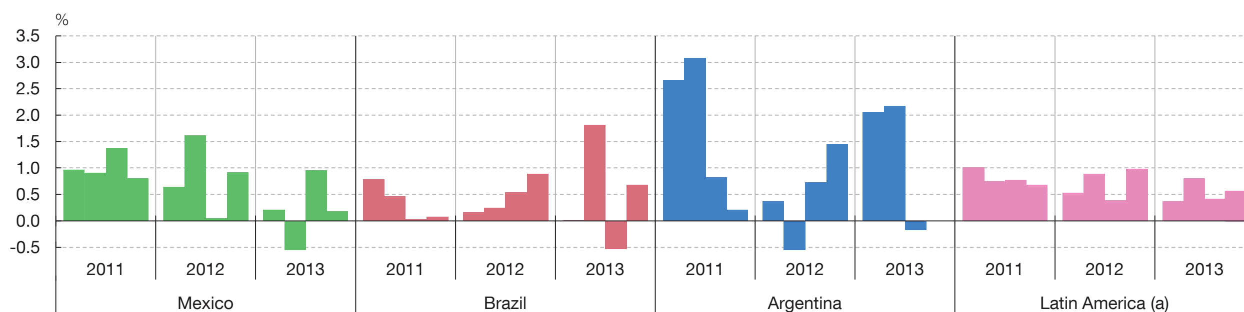
Activity and demand

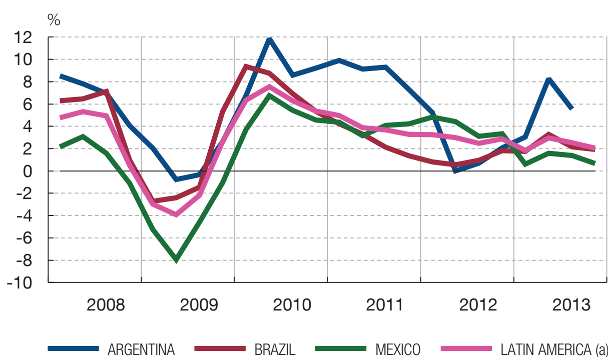
The Latin American economies[2] were unable to entrench in the second half of 2013 the incipient recovery discernible at mid-year (see Chart 6 and Table 1). Following relatively weak quarter-on-quarter growth in the third and fourth quarters, average GDP in the region slowed from 3.5% year-on-year in Q2 to 2% in Q4. Notwithstanding this widespread easing in activity, results continued to be notably mixed across the region. Activity in Colombia and Peru, with annual growth of 4.3% and 5%, respectively, was much sounder than the average, especially in the second half of the year when Colombia posted growth rates higher than those observed in 2012. Chile, whose economy had been mildly slowing, dipped surprisingly in Q4 with a decline in terms of the quarterly rate that took its year-on-year growth to 2.7% at the end of the year. Both Mexico (with meagre growth of 1.1% for the year and 0.7% year-on-year in Q4) and Brazil (which posted annual growth of 2.3% in 2013 and of 1.9% in Q4) showed a clearer easing in their growth rates, although Brazil held up better than expected in the final stretch of the year. Argentina and Venezuela, meanwhile, saw activity grind to a halt in a setting in which, despite the differences in economic policy responses, the underlying situation (worsening public finances, overvaluation of the real exchange rate, exchange rate pressures and the tailing off of international currency reserves) appear to make adjustment inevitable.

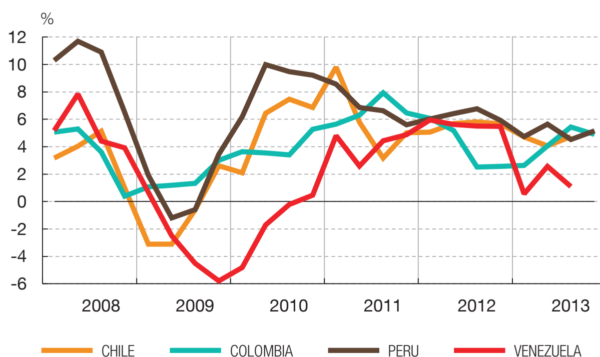
2 All the data are for the LatAm-5 aggregate (see footnote 1).

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

CHART 6







SOURCE: National statistics.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

In terms of components, the main determinant of the easing in growth in the second half of 2013 was the sluggishness of domestic demand, which marks a significant difference from the composition of growth in recent years (see Chart 7). Although the path of year-on-year growth see-sawed during 2013, the buoyancy of domestic demand tended to soften towards a year-on-year rate close to 1% in 2013 Q4, 2 pp below that at the start of the year. In contrast, external demand ceased to contribute negatively to growth, posting a positive contribution (+0.8 pp) as from Q4, against a backdrop of gradually improving exports and the diminishing momentum of imports. This may be an incipient sign of re-balancing in the region's sources of growth, with a less expansionary contribution of domestic demand relative to recent years and a more positive contribution by the external sector.

The slowdown in domestic demand originated in the weakening in gross capital formation (see Chart 7) which, after rising in the region on average to a year-on-year rate of 5.5% in Q2, failed to firm and ended the year growing at a year-on-year rate of 1.5%, albeit with significant dispersion from country to country. In Mexico and Chile, investment fell to year-on-year rates of -3% and -12.7%, respectively (with a significant temporary component in Mexico, and unexpectedly in Chile), and in Peru it slowed abruptly to 1.2% year-on-year, down from 9.5% in Q2. However, in Brazil, where investment had languished in 2012, there was a recovery which was sharper mid-year (9.1% year-on-year in Q2) and somewhat

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2011	2012	2013	2012				2013				2014
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate)												
Latin America 7 (a)	4.5	2.9	-	3.6	2.8	2.5	3.0	1.9	3.6	2.8	-	
Latin America 5 (a)	3.9	2.9	2.3	3.2	3.0	2.5	2.9	1.8	3.0	2.5	2.0	
Argentina (b)	8.9	1.9	3.0	5.2	0.0	0.7	2.1	3.0	8.3	5.5	-	
Brazil	2.7	1.0	2.3	0.8	0.6	0.9	1.8	1.8	3.3	2.2	1.9	
Mexico	4.0	3.9	1.1	4.8	4.4	3.1	3.3	0.6	1.6	1.4	0.7	
Chile	5.8	5.4	4.1	5.1	5.8	5.5	5.2	4.9	3.8	5.0	2.7	
Colombia (c)	6.6	4.0	4.3	6.1	5.2	2.5	2.6	2.6	4.0	5.4	4.9	
Venezuela	4.2	5.6	-	5.9	5.6	5.5	5.5	0.6	2.6	1.1	-	
Peru	6.9	6.3	5.0	6.0	6.4	6.8	5.9	4.7	5.6	4.5	5.2	
CPI (year-on-year rate)												
Latin America 7 (a)	6.8	6.2	7.3	6.6	6.1	6.1	6.1	6.4	7.2	7.5	8.0	-
Latin America 5 (a)	4.9	4.5	4.5	4.7	4.3	4.6	4.5	4.5	4.9	4.4	4.3	4.6
Argentina (b)	9.8	10.0	10.6	9.7	9.9	10.0	10.6	10.8	10.4	10.5	10.7	-
Brazil	6.6	5.4	6.2	5.8	5.0	5.2	5.6	6.4	6.6	6.1	5.8	6.2
Mexico	3.4	4.1	3.8	3.9	3.9	4.6	4.1	3.7	4.5	3.4	3.7	3.8
Chile	3.3	3.0	2.1	4.1	3.1	2.6	2.2	1.7	1.9	2.3	2.5	3.5
Colombia	3.4	3.2	2.0	3.5	3.4	3.1	2.8	1.9	2.1	2.3	1.8	2.5
Venezuela	27.2	21.1	38.3	25.1	22.3	19.0	18.8	22.6	33.0	43.4	52.9	-
Peru	3.4	3.7	2.8	4.2	4.1	3.5	2.8	2.6	2.5	3.1	3.0	3.4
Budget balance (% of GDP) (d)												
Latin America 7 (a) (e)	-2.1	-2.3	-	-2.0	-1.9	-2.0	-2.1	-2.1	-2.2	-2.6	-	
Argentina (b)	-1.7	-2.6	-	-1.9	-1.7	-1.9	-2.4	-2.5	-2.0	-2.3	-	
Brazil	-2.6	-2.5	-3.3	-2.4	-2.6	-2.8	-2.5	-2.8	-2.8	-3.3	-3.3	
Mexico	-2.5	-2.6	-2.4	-2.7	-2.4	-2.2	-2.5	-2.0	-2.2	-2.7	-2.3	
Chile	1.5	0.6	-0.7	1.6	1.1	0.4	0.6	0.2	-0.7	-0.5	-0.7	
Colombia	-2.0	-1.9	-1.9	-2.5	-1.0	-1.2	-1.9	-1.4	-2.5	-2.7	-2.3	
Venezuela	-4.0	-4.8	-	-	-	-	-	-	-	-	-	
Peru	0.9	1.3	1.3	1.3	2.4	1.6	1.3	1.2	0.7	0.5	0.4	
Public debt (% of GDP)												
Latin America 7 (a) (e)	39.1	40.9	-	40.1	40.8	41.0	41.2	41.4	41.3	36.4	-	
Argentina (b)	40.1	41.5	-	39.7	39.5	39.9	41.5	40.6	39.9	-	-	
Brazil	54.2	58.7	57.2	56.2	57.3	58.8	58.7	59.4	59.1	58.3	57.2	
Mexico	28.1	27.7	30.0	28.1	28.0	28.7	27.7	29.3	29.8	30.4	30.0	
Chile	11.1	11.9	12.8	11.2	11.5	11.3	11.9	11.5	12.1	12.6	12.8	
Colombia	33.4	32.2	-	32.9	32.4	32.4	32.2	33.0	33.3	35.0	-	
Venezuela	36.5	-	-	35.1	-	-	-	-	-	-	-	
Peru	21.7	20.1	18.6	20.7	19.8	19.5	20.1	18.9	17.9	17.2	18.6	
Current account balance (% of GDP) (d)												
Latin America 7 (a)	-1.0	-1.6	-	-0.9	-1.2	-1.3	-1.6	-2.1	-2.3	-2.5	-	
Argentina (b)	-0.5	0.0	-	-0.5	-0.4	-0.1	0.0	-0.3	-0.3	-0.7	-	
Brazil	-2.1	-2.4	-3.6	-2.0	-2.2	-2.2	-2.4	-3.0	-3.2	-3.6	-3.6	
Mexico	-1.1	-1.2	-1.8	-1.0	-1.0	-0.7	-1.2	-1.5	-1.7	-2.0	-1.7	
Chile	-1.2	-3.4	-3.4	-1.7	-2.4	-3.0	-3.5	-4.0	-4.1	-3.5	-3.4	
Colombia	-2.9	-3.2	-3.4	-2.7	-3.1	-3.3	-3.3	-3.6	-3.3	-3.3	-3.4	
Venezuela	7.7	2.9	-	6.9	5.7	4.2	2.9	1.7	1.3	1.9	-	
Peru	-1.9	-3.3	-4.9	-1.5	-1.7	-3.0	-3.3	-4.2	-4.5	-4.6	-4.9	
External debt (% of GDP)												
Latin America 7 (a)	20.3	21.2	-	20.5	20.2	21.1	21.1	21.6	20.6	21.2	-	
Argentina (b)	31.5	29.7	-	33.2	28.1	29.9	29.3	30.7	24.5	27.5	-	
Brazil	12.1	13.9	13.9	12.1	12.7	13.5	13.9	14.6	14.1	13.7	13.8	
Mexico	18.1	19.3	20.5	18.4	19.1	19.3	19.3	19.1	18.7	19.3	20.5	
Chile	39.2	44.1	47.2	39.4	40.0	42.0	44.1	43.5	42.9	44.4	47.2	
Colombia	22.5	21.3	24.4	20.7	20.6	21.5	21.3	21.7	22.2	23.9	24.4	
Venezuela	35.0	31.1	-	33.3	31.9	31.8	31.1	31.2	32.0	32.7	-	
Peru	26.9	29.5	29.2	28.8	28.9	29.9	29.5	30.5	29.6	29.3	29.2	

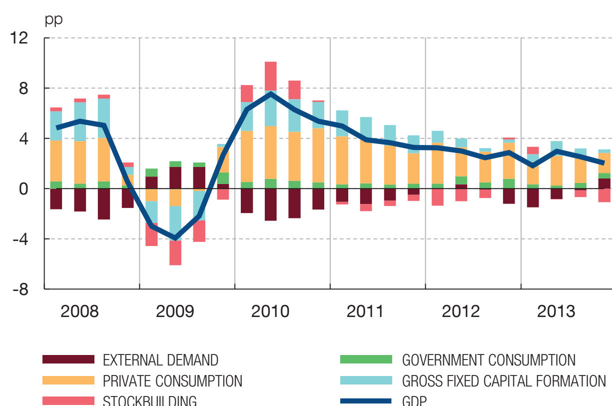
SOURCE: National statistics.

a Latin America 7: the seven countries represented. Latin America 5: except Argentina and Venezuela.
b Official data. At end-2013 the GDP methodology was changed and so far only real annual data have been published. In December 2013 publication of the new official CPI time series began. It is not planned to publish year-on-year rates until December 2014.
c Seasonally adjusted.
d Four-quarter moving average.
e The quarterly figures for the Latin American aggregate do not include Venezuela.

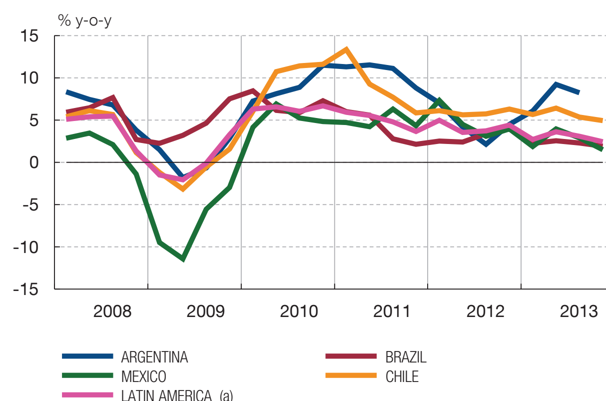
COMPOSITION OF GDP ON THE DEMAND SIDE
Year-on-year rate and pp

CHART 7

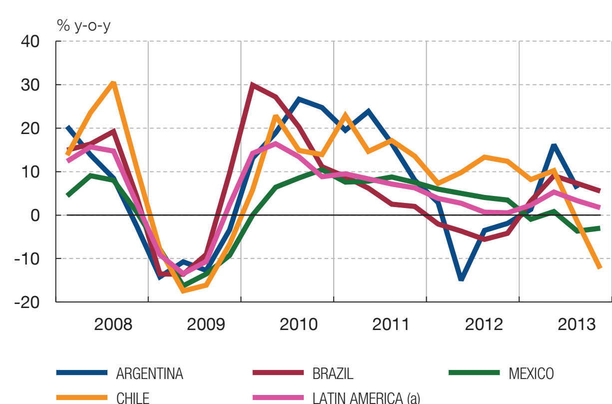
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



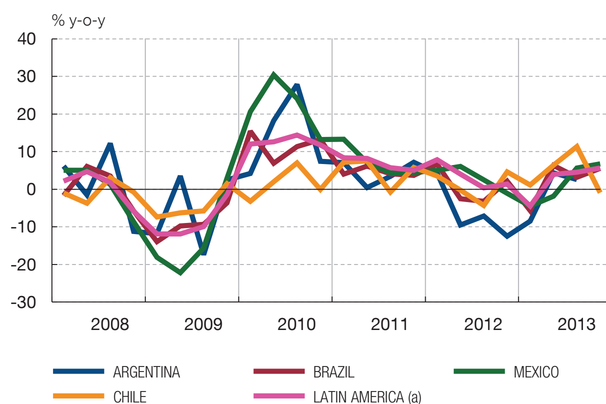
PRIVATE CONSUMPTION



GROSS FIXED CAPITAL FORMATION



EXPORTS



SOURCES: National statistics and IMF.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

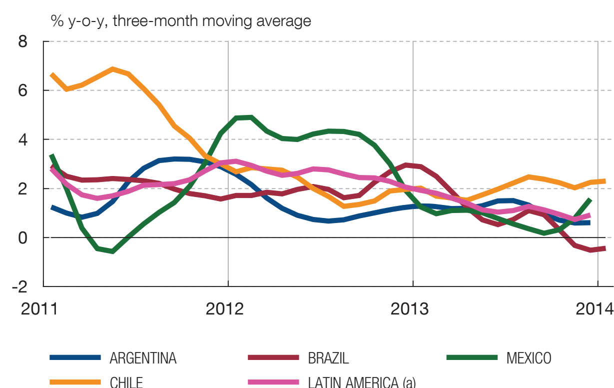
more moderate thereafter (5.5% year-on-year in Q4). In Colombia, investment, after commencing mildly in 2013, rose forcefully to 8% at the end of the year.

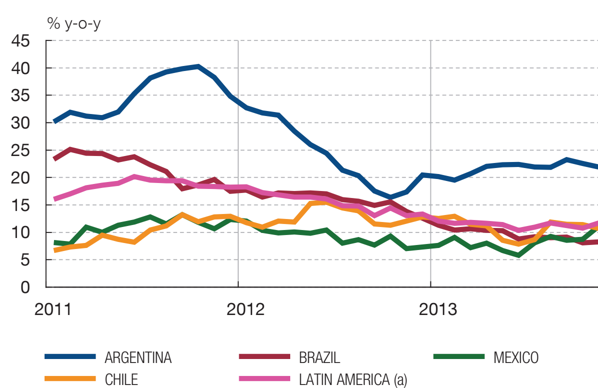
Over the region as a whole, the driving force of domestic demand continued to be private consumption (see Chart 7). This variable maintained a robust growth rate, thanks to the continuing soundness of labour markets, since the unemployment rate ended 2013 at 6.1% of the labour force, around its historical low. Despite this, job creation tended to ease (see Chart 8), in line with events in 2012, and other determinants of consumption, such as wages and credit, posted lower growth than that previously observed. This may explain why, in countries such as Brazil and Mexico, an appreciable slowdown in private consumption has been witnessed, to year-on-year rates of 1.9% and 1.5%, respectively, in Q4. Finally, government consumption held at a high rate of increase in most countries in the region, especially in the most dynamic economies, such as Colombia, Peru and Chile, where it exceeded the growth of the two previous years.

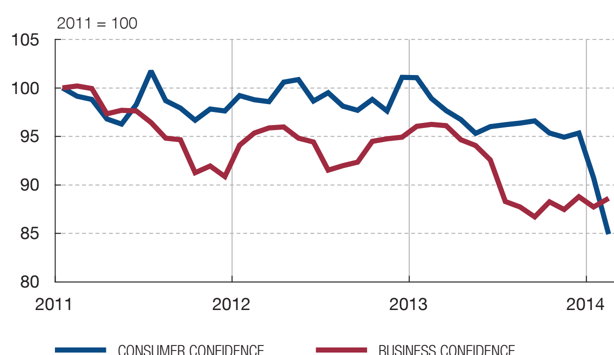
As to external demand, exports were notably and increasingly buoyant in the second half of 2013, posting growth of 5.6% year-on-year in Q4. In Mexico and Peru, exports

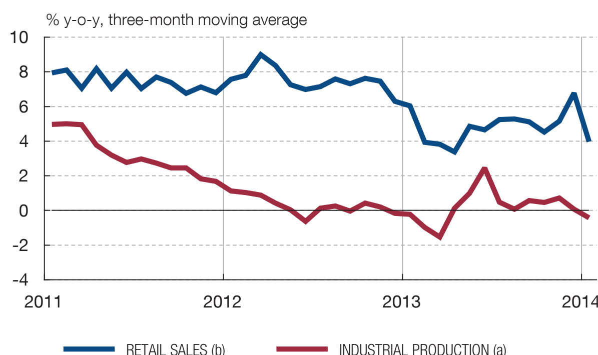
EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Year-on-year rate, indices and three-month moving average of the year-on-year rate

CHART 8









SOURCES: National statistics and Datastream.

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

grew by 6.7% and 3.1%, respectively, in Q4 following the collapse in Q1, and in Brazil there was a slight recovery over 2013 as a whole (2.5%), after the slackness shown in 2012. Conversely, exports in Chile ground to an abrupt halt in Q4 after growing by 11% in Q3. Imports lost notable momentum in the final stretch of 2013, declining from a year-on-year rate of 7.3% in Q3 to 2.3% in Q4, dragged down by the slowdown in gross capital formation and, possibly, by the widespread depreciation of exchange rates in the region too.

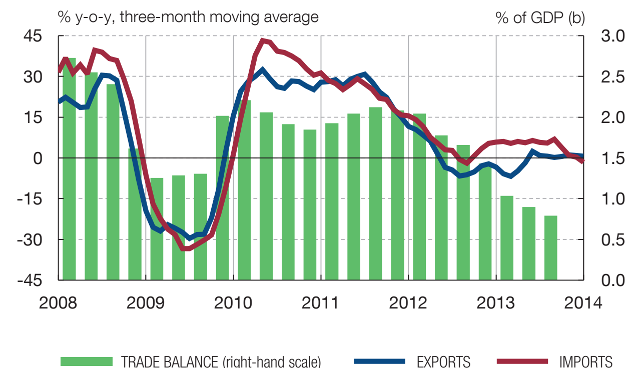
The high-frequency indicators point to continuing weakness in early 2014, but with divergences from country to country. Thus, while certain coincident indicators of activity and industrial output were growing at a sound pace in Brazil, they were easing to some degree in Peru and Chile, with signs of slackness of external demand bearing negatively on the productive activity of the export sector. On the demand side, retail sales proved notably dynamic in January, although the signs in February are mixed, with declines in both the business and consumer confidence indices, in Brazil, and a more positive trend in Mexico and Peru. Argentina and Venezuela are witnessing a collapse in confidence indicators, which might augur a decline in activity.

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

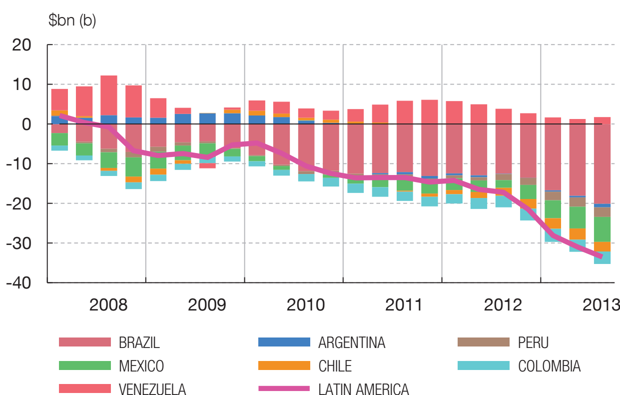
CHART 9

COMMODITIES PRICES

EXPORTS AND IMPORTS (a)



CURRENT ACCOUNT BALANCE



TERMS OF TRADE (c)

SOURCES: Datastream, national statistics and central banks.

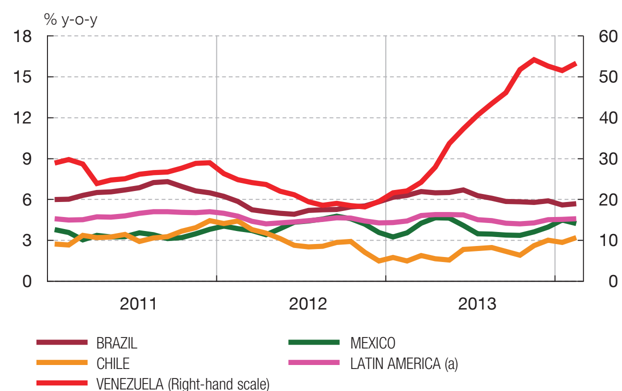
a Customs data in dollars, aggregate of the seven main economies.
b Four-quarter moving average.
c Aggregate of the seven main economies, as a GDP-weighted average for the region.

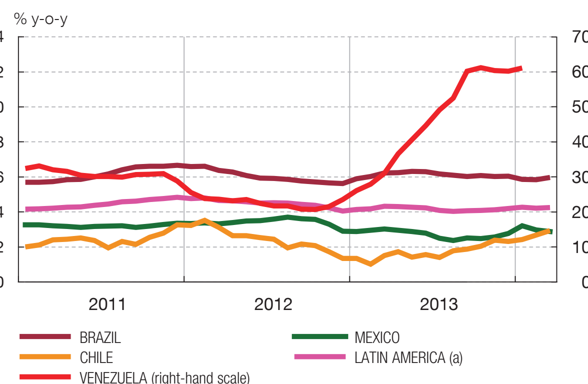
On the external front, the trade surplus continued to narrow to 0.8% of regional GDP, less than half the figure in 2012, stabilising in Q4. This stabilisation is due to a resurgence in exports by the biggest economies in the region, Brazil and Mexico, a development that contrasts with the year-on-year decline experienced by other major exporters of commodities, such as Chile, Colombia and Peru. Imports, meanwhile, quickened to 2013 Q3, easing in Q4 and thus providing for the stabilisation of the trade surplus. Country by country, the reduction in the surplus was most marked in South America and in the commodities-exporting countries, except in Chile, where it improved owing to the decline in imports, linked to the sluggishness of investment.

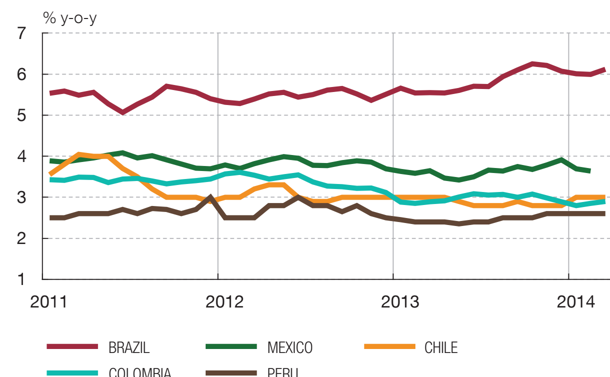
Despite this stabilisation in the trade surplus in the closing months of the year, the current account deficit continued to widen in the region on the whole (see Chart 9). It stood at 2.5% of GDP in Q4, the highest figure of the past decade. The protracted worsening in the Brazilian current account deficit was of note (-3.6% of GDP), as was that of Peru (-4.9%) and Mexico (-1.7%), prompted by the forgone revenue from remittances and the increase in investment income payments. In the remaining countries, the deficit held stable, and even fell slightly in

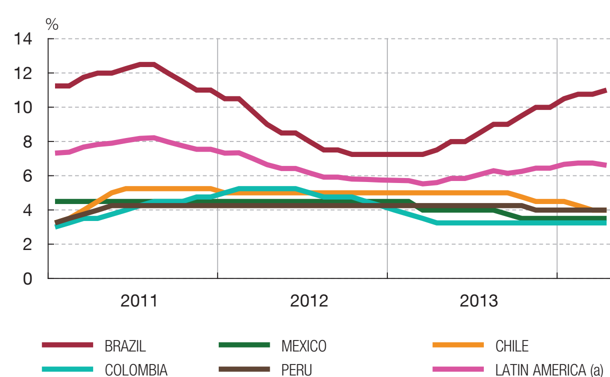
INFLATION AND OFFICIAL INTEREST RATES
Year-on-year rates of change and percentage

CHART 10









SOURCES: Datastream and national statistics.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

Chile to -3.4% of GDP. Generally, the financing of current account deficits have been mostly covered with foreign direct investment (FDI) flows, which have sustained a good pace over the year; however, in some cases such as Brazil and Peru the coverage ratio has worsened in the face of the strong expansion of the deficit and some easing in FDI. Finally, in Venezuela and Argentina the strong appreciation of the exchange rate and the contraction in activity are also expected to have checked real imports, but to have made their value soar, while exports have also declined, with the subsequent worsening of these countries' respective current accounts.

Prices and economic policies

In the five countries with inflation targets (which involves excluding Argentina and Venezuela again), year-on-year inflation rose slightly from 4.4% to 4.6% from September to March (see Chart 10). There was a relatively widespread uptrend in consumer prices, especially in early 2014, partly as a result of rising food prices and the depreciation of exchange rates. In Brazil, despite the fact that inflation was easing, the rate remains the highest of the five countries in question and has recently risen further (6.2% year-on-year in March). In any event, the main tensions and risks are centred on Venezuela and Argentina, where inflation stood in February at rates of 53% year-on-year and 3.4% month-on-month, respectively.[3]

3 In accordance with the new CPI methodology, which only publishes monthly data.

INFLATION
Year-on-year rates of change

TABLE 2

	2013			2014		2015
Country	Target	December	Fulfillment	March	Expectations (a)	Expectations (a)
Brazil	4,5 ± 2	5.9	Yes	6.2	6.0	5.6
Mexico	3 ± 1	4.0	Yes	3.8	4.1	3.5
Chile	3 ± 1	3.0	Yes	3.5	3.1	3.0
Colombia	3 ± 1	1.9	Yes	2.5	3.1	3.1
Peru	2 ± 1	2.9	Yes	3.4	2.7	2.6

SOURCES: National statistics and Consensus Forecasts.

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

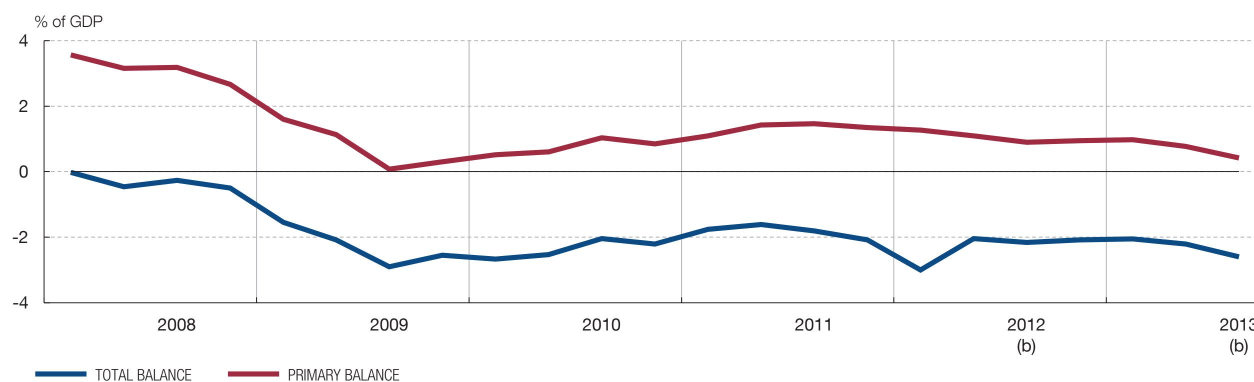
The inflation outlook differs from country to country. In Brazil, prices continue to show downward stickiness and expectations have held in the upper part of the target range, despite the weakness of growth and the tightening of monetary policy in the past year (see Table 2). The depreciation of the exchange rate, the rise in food prices and the risk of a hike in energy prices, given the prevailing drought, might continue hampering price moderation. In Chile, too, the depreciation of the exchange rate might impose greater pressure on prices in the short run. In Colombia, inflation is expected to continue increasing mildly until stabilising around the central bank's target level, after having stood temporarily in the lower part of the band in late 2013. In Peru and Mexico, the recent rise appears to be due to a greater extent to temporary supply-side factors, whereby a change in direction may be expected in the coming quarters. In all cases, the cumulative exchange rate depreciation introduces the main upside risk, although pass-through is limited and second-round effects are not observed.

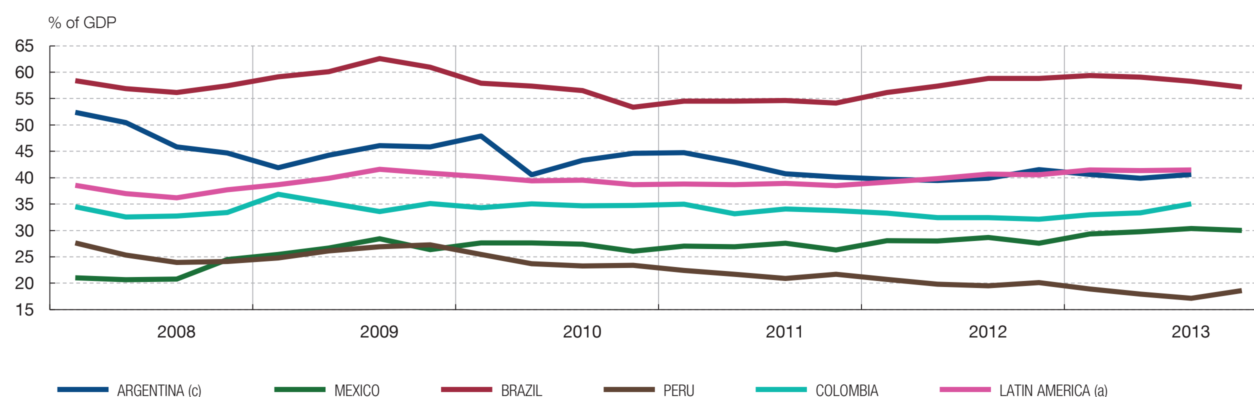
Monetary policy responses have also differed. In Brazil, the monetary authority extended the contraction in the phase of its policy, initiated on April 2013, with further rises in the official interest rate from October to April, up to 11%. At the other extreme, the Chilean central bank initiated an expansionary cycle last October, in response to the slowdown in activity, making four cuts to lower the rate to 4%. Peru has also shown an expansionary bias: after the unexpected 25 bp cut in November, the official interest rate held at 4%, but the central bank has continued reducing local-currency-denominated bank reserves, seeking to counter the absorption of liquidity in local currency arising from the intervention on foreign exchange markets to contain the depreciation. In the remaining countries, the stance was accommodative: Mexico has kept its official rate at 3.5% following the 25 bp cut in October, while the official rate in Colombia has now stood at 3.25% for a year.

In the foreign exchange realm, the authorities have continued allowing currencies to depreciate in 2013 Q4 and in 2014 to date, although the depreciation has generally been less sharp than during the episode last summer. Mexico and Chile did not intervene on the foreign exchange markets; however, in other countries the monetary authorities have intervened to temper the depreciation and prevent excessive volatility, with possible unwanted effects on inflation or on economic agents' financial positions in dollarised economies. Thus, in Brazil the dollar swap programme launched in the summer of 2013 was extended to end-2014, and in Peru the habitual policy of intervention on the spot market was maintained. Colombia, by contrast, retained its reserves-purchase programme, for a limited amount. In any event, these economies' indicators of external vulnerability

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP

CHART 11





SOURCE: National statistics.

a Aggregate of the seven main economies, as a GDP-weighted average of the region.
b In Venezuela, 2012 quarterly data estimated from annual data. In 2013, aggregate excluding Venezuela.
c Excludes untendered debt in the debt swap offers of 2005 and 2010.

remain robust, their level of foreign reserves is appropriate and the ratio of reserves to short-term external debt is manageable (see Box 2).

Venezuela and Argentina are worthy of mention, since their respective levels of inflation, the highest in the region, have risen to highs in recent years, pushed by heavy currency depreciations. In the case of Venezuela, escalating prices reflect the widespread shortage of products – since the decline in currency reserves constrains imports – and the monetisation of the growing fiscal deficit. Faced with this situation, the policy response has been to create a system of multiple exchange rates which entails a strong devaluation of the currency and which in any event brings about only temporary relief to public finances, but progress in other areas has not been announced. In Argentina's case, steps towards correcting the exchange rate overvaluation take the form of a broader re-gearing of economic policy. The measures adopted by the economic authorities in Argentina and Venezuela are detailed in the section on economic developments by country.

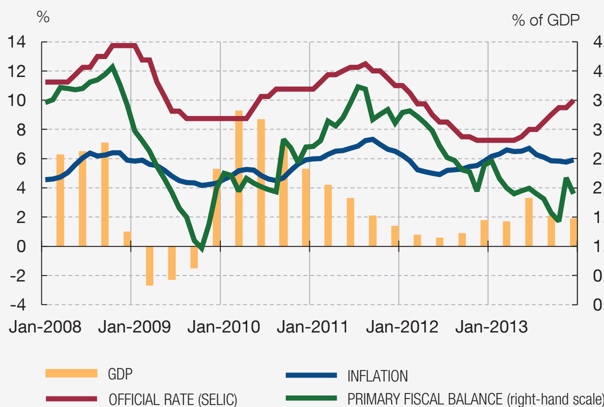
Turning to fiscal policy, there was a widespread fall in revenue in 2013, derived from the cyclical slowdown in the region and from lower commodities-related receipts, whereas

During the latest bouts of turmoil, the emerging economies perceived as more vulnerable due to their larger macroeconomic imbalances were the hardest hit (see Chart 1). Contributing to this were, depending on the cases, the greater depth of their financial markets, the sharp appreciation of their currencies and the capital inflows received in the past expansionary phase.[1] Brazil has been one of the countries showing highest volatility. Moreover, its rating

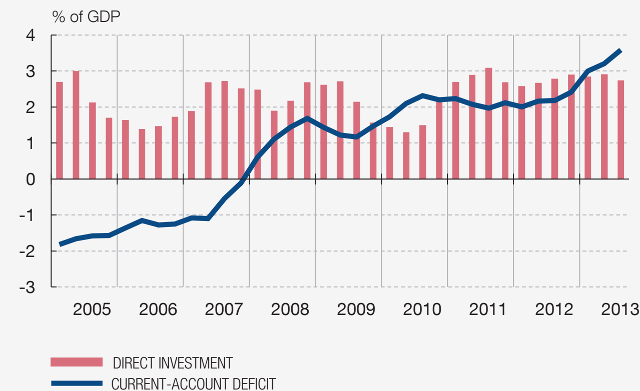
1 See B. Eichengreen and P. Gupta (2014), *Tapering Talk: the Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets*, Policy Research Working Paper Series 6754, World Bank.

1 EFFECT OF TAPERING ON BRAZIL

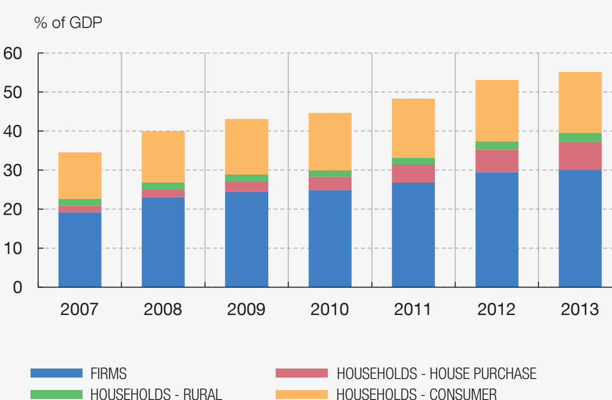
2 GDP AND MACROECONOMIC POLICIES



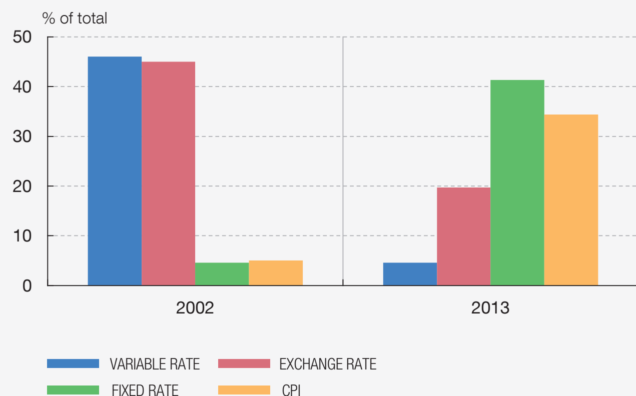
3 CURRENT ACCOUNT AND DIRECT INVESTMENT



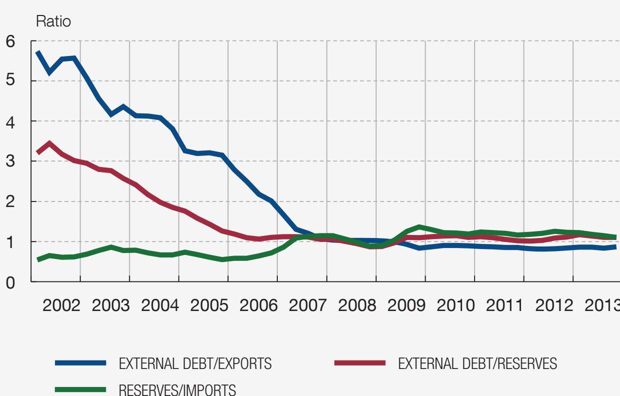
4 CREDIT TO THE NON-FINANCIAL PRIVATE SECTOR



5 STRUCTURE OF GOVERNMENT DEBT



6 INDICATORS OF EXTERNAL VULNERABILITY



SOURCES: IBGE, Ministério da Fazenda, Banco Central do Brasil, Datastream, IPEA and Banco de España.

has recently been revised downward by the credit rating agency S&P. Although the Brazilian economy has significant economic imbalances, it also has the means to mitigate the effects of a less favourable economic and financial environment. This Box assesses the strengths and weaknesses of the Brazilian economy in the current economic scenario.

From 2003 Brazil saw a stage of sustained economic growth underpinned by the commodity boom. Simultaneously, institutional reforms were adopted and economic policy frameworks were strengthened to underpin macroeconomic stability. This enabled Brazil to confront the recent global crisis with sufficient latitude to adopt decidedly counter-cyclical policies (in some cases based on a more active role of the public sector) and navigate it with notable buoyancy (see Chart 2). However, this also contributed to create excessive growth expectations. During the years of expansion, Brazil has barely progressed in introducing the structural reforms needed to raise productivity, such as developing infrastructure or simplifying its tax system and bureaucracy,[2] a failing which has not helped to reduce its traditional supply rigidities and has constrained its investment ratio, which has remained among the lowest in the region (18% of GDP). When in 2011 activity cooled unexpectedly and certain imbalances (inflation and the external and fiscal deficits) widened, structural rigidities surfaced, prompting a revision of growth expectations. Thus, for example, the IMF, in its latest regular analysis of Brazil (Article IV) lowered potential growth to 3.5%.

The external deficit is perceived by investors as another source of vulnerability, against a background trend of tightening global financial conditions. The current account balance of Brazil has deteriorated since 2008 to a deficit of -3.6% of GDP in 2013 (see Chart 3), leaving behind the times of surplus. This development is explained in part by the world economic slowdown and the worsening terms of trade, but it also reflects Brazil's loss of competitiveness related to its strong exchange rate,[3] growing labour costs[4] and low productivity increases.[5] In the short term, the depreciation of the real will be the main source of gains in the economy's competitiveness which will act as a cushion against the moderating domestic demand, although they are unable to replace the supply policies needed to boost competitiveness and growth potential.

The scant progress in the area of structural reforms has eroded investor sentiment towards Brazil. In general, there has been a certain tendency to expand the role of the State in the economy, timidity in implementing deregulatory policies and a certain relaxation in compliance with macroeconomic objectives. Inflation remains at around 6%, 1.5 pp above the central target, despite the fact that the economy has been growing at below potential for three years and the primary fiscal surplus fell from 3.1% to 1.9% of GDP between 2011 and 2013, thus failing to meet the government's target. Monetary policy had to be tightened (the Selic rate rose by 375 bp to 11% between April 2013 and April 2014), given the highly entrenched inflation with upside risk. By contrast, fiscal policy and directed credit have been expansionary (see Chart 4). Although the government plans a neutral fiscal policy for 2014 (primary surplus target of 1.9% of GDP) and a moderation of public credit, the fact that it coincides with an electoral year poses doubts as to whether these objectives will be met (thus the credit rating agencies signal the fiscal situation as one of the main factors of risk).

Bank credit to the private sector grew at an annual average rate of 21% between 2004 and 2013, underpinned by the macroeconomic stability, the lower cost of borrowing, steady employment growth and a policy of promoting directed credit through government-owned banks. This growth favoured the financial deepening of the economy, although in some segments the pace has been overly rapid. Private agents' ability to pay, eroded by the high interest rates (near 30% for open-market credit) and short average maturities may be further weakened by the tightening of financial conditions. There are, however, factors which moderate this source of risk: the stock of credit is low (54% of GDP), especially in the case of mortgage credit (6% of GDP); the banking system is well capitalised (solvency ratio of 15%) with sizeable provisions (coverage ratio of 1.5) and moderate non-performing loans (3.6%); and macro-prudential policy is active and strict.

In any event, the Brazilian economy has significant strengths which mitigate many of the risks mentioned above. The economic policy framework is a strength despite its recent deterioration, with a central bank whose objective is inflation control, a flexible exchange rate and adherence to a law of fiscal responsibility. Also, government debt now has a more sustainable structure (see Chart 5), with only a small proportion denominated in foreign currency (4.7% of the total in 2013) and an average maturity of 4.4 years. This improvement has mitigated exchange and interest rate risk, easing the constraints on monetary policy conduct, previously limited by the high weight of short-term debt denominated in foreign currency. The stock of foreign reserves means that net government debt is low (35% of GDP); indeed, the public sector has a net creditor position in foreign currency, so depreciation reduces the stock of net debt.

Additionally, Brazil's lower external vulnerability than in the past (see Chart 6) reduces the probability of a balance of payments crisis like those seen in previous periods (1998-2002). Firstly, the current-account deficit is financed basically through foreign direct investment, which is a stable source of finance, although the recent increase in the external deficit has weakened that ratio somewhat. As a result of that form of financing, the Brazilian

2 See FMI (2013), *Article IV and Selected Issues, Brazil*, July.
3 See World Bank (2013), *Latin America`s Deceleration and the Exchange Rate Buffer*, Semiannual Report, October.
4 See OECD (2013), *Economic Review, Brazil*, August.
5 See S. Sosa, E. Tsounta and H.S. Kim (2013), *Is the Growth Momentum in Latin America Sustainable?* IMF Working Paper/13/109.

economy maintains its net debtor position vis-à-vis the rest of the world at manageable levels (14% of GDP). Most of the external liabilities are from direct investment (46%), a percentage which has increased significantly since 2002 at the expense of other investment; moreover, they are mostly (70%) denominated in local currency. Secondly, external reserves represent 17% of GDP, equivalent to more than a year of imports. Finally, the gross external debt has fallen by half in the past decade to 15% of GDP, with a scant weight of short-term debt (10% of the total). For all these reasons, the sustainability of Brazil's external debt, as measured by the ratios to external reserves or exports, has improved, facilitating the access of the sovereign to the international financial markets.

In short, although the Brazilian economy has certain fragilities which make it vulnerable to fresh bouts of turmoil in the markets (structural deficiencies, high external deficit, high credit growth), it also has significant buffers with which to hold them in check and prevent a disproportionate impact on economic activity and financial stability. Nevertheless, the constraints on growth are palpable and will make it difficult for the economy to grow sustainedly and robustly in the coming years unless new structural reforms are introduced.

expenditure is holding at robust growth rates (see Chart 11). This has seen several economies, Peru and Colombia among them, joining others who were already experiencing a downturn in their fiscal balances. In Brazil, fiscal policy has maintained the expansionary stance of recent years, amplified by a directed credit-boosting policy, while budgetary targets have failed to be met, despite undergoing interim revisions. This is one of the reasons behind the recent credit downgrade, which highlights the tightness of fiscal margins. In 2014, the government foresees a neutral stance, with a stable primary surplus at 1.9% of GDP. Mexico met its fiscal target, with a deficit of 2.3% of GDP. Fiscal policy will be more expansionary in 2014, albeit remaining within the parameters of the new fiscal rule.

Trade and reform

As in the preceding months, regional integration processes advanced at different paces depending on whether analysis is made of the group of countries more oriented to the Pacific, with greater progress, or the Southern Cone. Globally, the trend towards greater trade liberalisation is becoming entrenched, as reflected in the first multilateral agreement reached since 1995 – at the WTO Summit in Bali – and on the progress, albeit with difficulties, in the negotiations for multinational agreements such as the Transpacific Partnership or the agreement between the United States and the European Union. Against this background, the protocol for the liberalisation of trade among the Pacific Alliance countries (Colombia, Peru, Chile and Mexico), which neutralises tariffs for 92% of trade, was finally signed in February 2014. At the same time, negotiations began or free trade agreements were approved with other markets, such as Turkey (Peru), Thailand (Peru and Colombia) and Panama (Mexico and Colombia). The MERCOSUR countries appear to continue to be standing on the sidelines of these tendencies. The political dispute over Venezuelan membership and Paraguay's suspension were the focus of attention in the half-year period, and the submission of offers to resume negotiations of the treaty with the European Union was postponed, owing essentially to the low coverage of products susceptible to liberalisation offered by Argentina. That gave rise to tensions within the group, since Brazil and Uruguay once again called for the obligation to negotiate agreements en bloc to be made null and void. Finally, mention should be made of the progress in negotiations between the EU and Ecuador to sign a co-operation treaty.

As regards structural reforms, Mexico approved a fiscal reform (of somewhat less breadth than expected, but which includes a structural fiscal rule) in late 2013, and an energy

sector reform, which proved more ambitious than initially planned, as well as being in line with the main recommendations by multilateral agencies. In the case of Peru, a reform of fiscal accountability legislation was approved, in order to make it more structural. In Chile, the change in government entailed the creation of new welfare benefits, and a tax reform was announced with a view to it funding educational reform. In Argentina, the dispute between the government and Repsol over the expropriation of YPF was resolved, and a price indicator more in step with IMF recommendations began to be published.

Economic developments by country

In *Brazil*, GDP in Q4 surprised on the upside, growing at a quarterly rate of 0.7% after falling by 0.5%. But the recovery continues at a slow pace, with year-on-year growth of 1.9% in Q4, down from 2.2% the previous quarter. Indeed, in 2013 as a whole, the economy grew by 2.3% (1% in 2012), below expectations at the start of the year. In terms of demand components, the higher growth in 2013 is attributable to the rise in investment, which grew by 6.3%. Both private and government consumption slowed on the previous year, affected by high inflation, lower confidence, high financing costs and lower growth in consumer credit. External demand made a negative contribution in 2013 as a whole (-0.9 pp), given the greater buoyancy of imports (driven by the improvement in investment) relative to exports which, in any event, picked up in the second half, assisted by the depreciation of the real. Despite easing somewhat since June, inflation held at a high level (6.2% year-on-year in March), with upside risks. This derived from the strong cumulative depreciation over the past year, which was by more than 11% against the dollar and might prove persistent, and the possible reduction in subsidies to certain regulated products. Free-market lending slowed appreciably, especially consumer credit, although total credit retained its dynamism owing to the boom in directed credit. Against this backdrop, the central bank, having changed the bias in its policy in April 2013, implemented rises in official rates totalling 375 bp, up to 11% in April, although at the past two meetings the pace of increases has eased to 25 bp. The current account deficit widened considerably to 3.7% of GDP in 2013 as a result of the trade surplus being practically wiped out. The primary surplus for the public sector dipped to 1.9% of GDP, the worst figure since 2001 (see Chart 11). In 2014, the primary surplus target, which was initially set at 2.1% of GDP, fell to 1.9%, which implies a more neutral fiscal policy stance compared with the expansionary one of previous years. However, in April Standard & Poor´s downgraded Brazil's sovereign debt rating (the country's first downgrade since 2002), owing to low growth, to the cumulative deterioration in the external accounts and public finances, and to doubts over the consistency of fiscal policy and its limited margin for manoeuvre in the face of external shocks. The high-frequency indicators were more positive in early 2014, although they have not yet become entrenched. What is anticipated in some change in the composition of growth, with a greater contribution by external demand, assisted by the depreciation of the exchange rate and an easing in domestic demand.

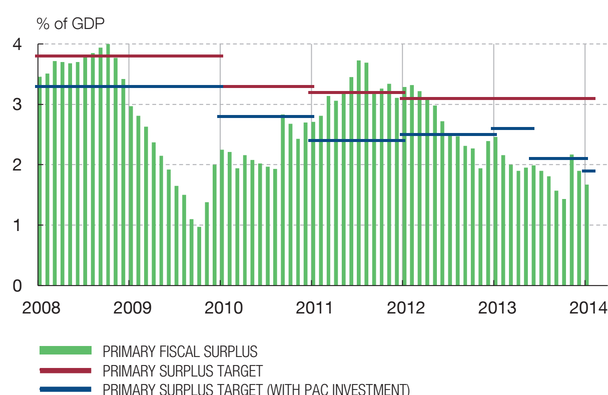
In *Mexico,* GDP expanded by 1.1% in 2013, compared with 3.9% in 2012. The figure was far lower than expected at the start of the year, apparently as a consequence of several temporary factors: the relative weakness of the US recovery (especially in the first half of the year), the decline in the construction industry and the delay in implementing public spending derived from the new incoming administration. The contribution of external demand turned positive in the second half of the year (1.5 pp on average) in light of the strong moderation in imports and the marked pick-up in exports in Q4 (6.7% year-on-year). A pick-up in the economy is expected in 2014, given the momentum of economic policy and the improvement in external conditions, although the indicators at the beginning of the year have been mixed, and the rise is estimated to take place from Q2. Inflation increased from October, owing to supply-side factors. Adding to these in January was the

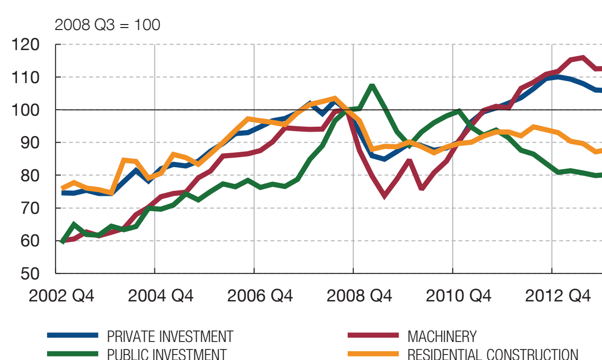
effect of the fiscal reform, which took inflation in March to a year-on-year rate of 3.8%, slightly below the upper limits of the target range. However, the underlying rate has held at historical lows (2.9 % in March) and inflation expectations remain anchored. The peso has depreciated by 7.7% over the past year, less than other currencies in the region despite the lack of intervention on the foreign exchange market. Against this background, the central bank cut official interest rates by 25 bp in September and October, holding them since at 3.5%. On the fiscal front, the deficit target of 2.3% of GDP in 2013 was met (considering PEMEX investment). For 2014, a bigger stimulus is envisaged, with a deficit close to 3.5% owing to increases in spending on infrastructure and social security. The current account balance for 2013 as a whole posted a deficit equivalent to 1.8% of GDP, a notable deterioration on the previous year (-0.7%), due in part to the trade balance, which went from surplus into deficit. In any event, the external imbalance remains covered in its entirety by FDI, which has broken the declining trend of recent years. Finally, the government approved two major new reforms, in the fiscal area and in the energy sector. The first was somewhat less ambitious than foreseen, given that it did not alter the VAT tax bases and left certain sectors outside this tax. It did, however, harmonise tax rates across export-geared sectors and others, and it increased the State tax-raising capacity by around 1 pp of GDP. Furthermore, a new fiscal rule was approved to correct the procyclical bias of the current balanced-budget rule, setting a ceiling on spending and allowing slippage from the equilibrium level if GDP grows below potential. In the case of the energy reform, which was more ambitious than expected, private-sector participation is permitted at all stages of hydrocarbons production, which augurs a strong increase in foreign direct investment over the coming years; a sovereign wealth fund has been created (with the oil revenue remaining after attending to the maintenance of certain public spending ratios); and the electricity sector is opened up to private-sector participation. Thanks largely to these advances, an upgrading of sovereign debt was announced by Standard and Poor's (to BBB+) and, subsequently, by Moody's (to A3).

Although activity in *Argentina* regained greater momentum in 2013, it weakened noticeably in the second half. Growth was 3% in 2013, a figure incorporating a methodological change that prevents its comparison with previous data. In terms of components, private consumption was the driving force, assisted by public policies, the increase in lending to the private sector (by around 30% year-on-year) and a relatively sound labour market (the unemployment rate fell to 6.4%, albeit with less job creation and lower growth in real wages). Investment eased in the second half, despite construction picking up. But the key characteristic of 2013 was the heightening of the pressures on the balance of payments. Thus, despite capital controls, there was a growing outflow of currency through the current account, which posted a deficit of 0.9% of GDP, with a high tourism deficits adding to the rising energy deficit. These dynamics, in the context of exchange-rate intervention, resulted in a heavy absorption of external reserves. In these circumstances, there has been something of a shift in economic policy since last November, initially with the aim of checking the decline in currency reserves. The pace of depreciation of the peso increased strongly, up to 6.2% in December, compared with a monthly rate of 1.5% during the first half of the year. Further, quotas on certain imports were increased and an attempt was made to reduce the premium on the parallel exchange rate, through the sale of dollar-denominated bonds by State agencies. Nonetheless, during the first two weeks of January, the downturn in reserves accelerated, resulting in further economic measures. Thus, on 22 January the authorities ceased to intervene on the foreign exchange market for two days, prompting a depreciation of 16% (to 8.01 pesos per dollar, see Chart 12), while uncertainty took the premium on the parallel exchange rate to 70%. Subsequently, in an attempt to restore confidence, capital controls were eased for individuals, who were allowed to

BRAZIL AND MEXICO

CHART 12





SOURCE: National statistics.

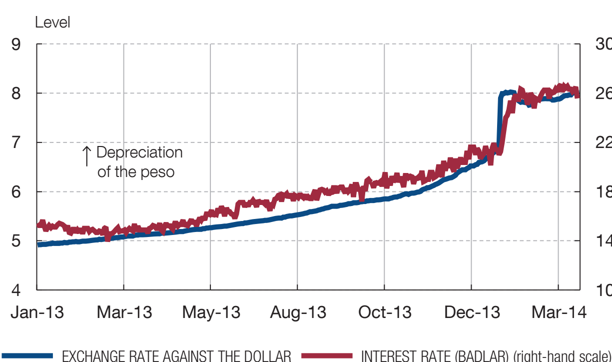
purchase dollars for saving purposes, with certain restrictions. At the same time, the interest rates on pesos were raised (by 900 bp) and sterilisation increased, with a rise in reserve requirements. More recently, a reduction in energy subsidies has been announced in an attempt to contain fiscal worsening. As a result of these measures, the exchange rate has stabilised at around 8 pesos per dollar, the premium on the parallel rate has fallen and the decline in reserves has been checked, although a regulatory change that obliged the banking system to reduce its position in dollars also contributed here. Despite the fact that the measures implemented are steps in the right direction, the short-term outlook is uncertain. According to the new indicator, cumulative inflation in the first two months of 2014 is estimated to have increased by 7.2%. Over the course of 2013, the primary deficit amounted to 3% of GDP. Finally, Argentina has made progress in recent months in normalising its external relations, reaching agreements with litigating private corporations, commencing negotiations with the Paris Club and improving relations with the IMF. This change may be conducive to the opening up of certain foreign funding facilities and attract foreign investment to the oil sector. In any event, a difficult fiscal adjustment lies ahead, without which recent reforms may prove insufficient, and without it being possible to rule out second-round effects on wages in these circumstances.

In *Chile*, the pace of growth eased in 2013. This was especially so in Q4, when it posted a quarterly decline of 0.1%, resulting in a marked year-on-year slowdown to 2.7%. Over the course of 2013 growth was 4.1%, compared with 5.4% in 2012, with a slowdown in domestic demand to 3.4%. Contributing particularly to this was investment, with a rise of only 0.4% (in Q4 this variable even fell by 12.3%). Hence, compounding the strong correction in investment in machinery and equipment, against the background of the levelling off of mining investment, was the unexpected stagnation of construction. Meantime, though moving on a mildly slowing trend, consumption continued to be a mainstay, growing by 5.4% (4.6% in Q4), thanks to the favourable labour market conditions. Specifically, the unemployment rate remains at a low (6%) and real wages increased by 3%. Government consumption also exerted a positive influence, albeit to a lesser extent, after increasing by 4.2% over the year, although it eased in the final quarter. The contribution of external demand turned positive (0.6 pp), given the adjustment on imports and some pick-up in exports, which increased by 4.3%. The balance of payments posted a slight downturn in the trade surplus, despite which the current account deficit stabilised at 3.4%

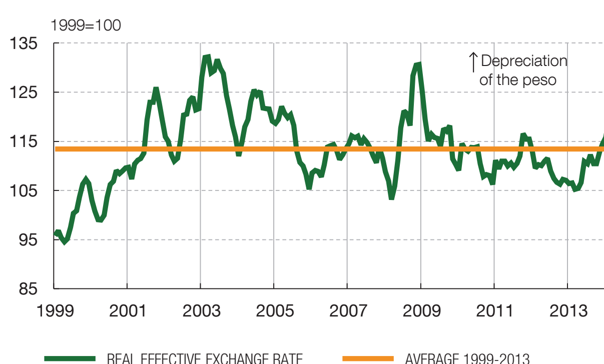
ARGENTINA AND CHILE

CHART 13

ARGENTINA. EXCHANGE RATE AGAINST THE DOLLAR AND INTEREST RATE (BADLAR)



CHILE: REAL EFFECTIVE EXCHANGE RATE



SOURCES: National central banks and Datastream.

of GDP, comfortably financed by FDI flows. Inflation, which had remained contained, has risen in recent months in the face of supply-side shocks in food and energy. In March it stood at 3.5%, somewhat above its central target. Underlying inflation has also risen, to 2.9%, evidencing some pass-through due to the depreciation of the peso (see Chart 12). The central bank began last October to pursue an expansionary monetary policy, having made four 25 bp cuts to the official rate to date, to 4%. At the fiscal level, strong moderation in spending at the end of the year enabled, despite lower revenue, an effective fiscal deficit of 0.6% of GDP and a structural deficit of 0.7% of GDP, above-target, to be recorded in 2013. As a result, the 2014 target of a structural deficit of 1% of GDP along with higher structural revenue attributable to the depreciation should provide for an expansion in public spending, thereby exerting some momentum. Despite this factor, growth in 2014 will ease. The main risk is associated with the possibility that a slowdown and change in the pattern of growth in China may entail a further decline in the price of copper, which would have adverse effects on growth and on the external and fiscal accounts. The draft tax reform includes a progressive rise in taxes on corporations, a reduction in the maximum personal income tax rate and some rises in indirect taxes. The reform is expected gradually to raise revenue by 3 pp of GDP, with an increase of 0.3% of GDP in 2014, with the aim of financing educational reform.

In *Colombia*, GDP grew by 4.3% in 2013 as a whole, marginally up on 4% in 2012. The pace of expansion quickened throughout the year. This greater dynamism was underpinned by investment in civil engineering works. However, investment in capital goods remained sluggish, with the industrial sector recovering at a slower pace than expected. Final consumption quickened to 4.9% in Q4 (4.7% for the year) thanks to an equivalent increase in private consumption, driven by greater job creation and by the cuts to the official rate in 2013. The contribution of external demand to growth turned positive in 2013 (0.3 pp), as the increase in exports (5.3%) outpaced that in imports (2.1%), owing to the weakness of investment in capital goods and the exchange rate depreciation (9.2% over the past year). The high-frequency indicators point to growth remaining buoyant and potentially more balanced, against the backdrop of the expected recovery in exports and in non-residential private investment. Despite the depreciation, inflation continued to surprise on the downside (2.5% year-on-year in March), which might denote that the output gap, following the increase in investment in recent years, could remain negative. In this setting, the central

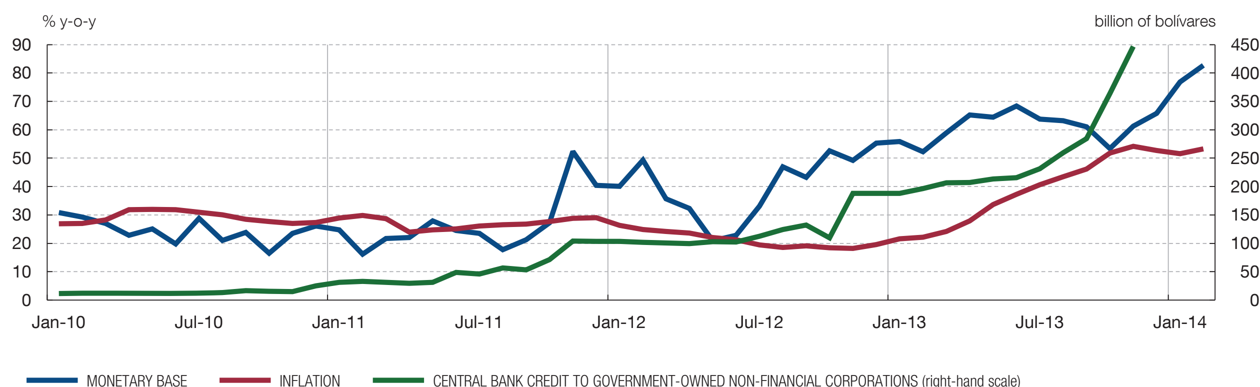
bank has kept the official rate at 3.25% since last April and extended its dollar purchase programme at least until next June. On the fiscal front, the target of holding the structural deficit on a declining path was met, with a figure of 2.4% of GDP being recorded. The current account deficit widened to around 3% of GDP, reflecting an increase in the rate of investment. Colombia is not among the countries most affected by the current bout of tension on the emerging markets, maintaining net portfolio investment inflows. Further, the Government is considering reducing the withholding tax on foreign bondholders, seeking to increase their participation in the local market. Lastly, Fitch raised Colombia's long-term sovereign foreign currency rating to BBB.

In *Peru,* activity regained greater momentum in the second half of the year, especially in Q4, when GDP posted quarter-on-quarter and year-on-year rates of growth of 1.4% and 5.1%, respectively. Even so, growth for the year as a whole (5%) was down on the previous year (6.3%). In terms of components, private consumption remained very dynamic, growing by 5.2% in 2013 in a setting in which the labour market remains robust. By contrast, investment increased more slowly than expected, growing by 5.9% in 2013 (1.8% in Q4), much less than in 2012 (14.8%). The contribution of external demand turned slightly positive in the second half of the year (although over the year as a whole it subtracted 1 pp), as a result of the more marked easing in imports than in exports. The current account deficit widened notably in 2013, to 4.9% of GDP, owing to the deterioration in the trade balance. This high current account deficit, though it could be a factor of vulnerability, reflects the increase in the investment ratio, financed by long-term capital and chiefly aimed at the tradeables (mining) sector. Inflation, after having stood within its target range in the second half of 2013, quickened more recently to 3.4% in March. Core inflation also stood above its target. The central bank has kept its official rate unchanged, excepting a surprise 25 bp cut in November to 4%. Conversely, it has sought to ease monetary conditions by means of reductions in the local currency reserve requirements, to offset intervention on the foreign exchange market in defence of the sol. On the fiscal front, the public sector posted a primary surplus in 2013 equivalent to 2.3% of GDP, markedly worse owing to a much bigger increase in expenditure than in revenue. Fitch raised its credit rating of Peru's foreign-currency-denominated debt to BBB+ and that in local currency to A–. With a view to 2014, the indicators of activity and confidence show greater momentum, partly due to the better performance of the primary sectors, which should be conducive to somewhat higher growth than in 2013.

In *Venezuela,* the economy retained the sluggishness shown during the first half of the year. After growing by 5.6% in 2012, and although it has not officially released the figures for Q4, it was announced that GDP grew by 1.6% in 2013. In terms of components, this slowdown is attributable to the strong correction in investment, against a backdrop of collapsing imports, as a result of the shortage of foreign currency and of the fall-off in public investment. Private and government consumption remain the most dynamic components, albeit tending to slow, owing to the moderation of credit and to a labour market where, despite unemployment holding at 7.5%, wages underwent a notable loss in purchasing power for the second year running. Inflation surged above 50% towards the end of the year, driven by a lower official distribution of currency for imports, a very strong increase in the money supply due to the funding of public entities (see Chart 14) and a depreciation of the black market exchange rate, with the depletion indicator standing at a high. The government's response was to increase price controls, passing legislation on fair prices, which sets ceilings for increases in prices and profits. To alleviate the currency constraint, the government set in train a new dollar tender system (SICAD I) last July, under which currency is delivered to importers at lower exchange rates than the official parity (42%); finally, in

VENEZUELA **CHART 14**

MONETARY BASE AND INFLATION



SOURCE: Banco Central de Venezuela.

March 2014 a new parallel market – SICAD II – was created. In principle, this makes the exchange controls in force in the country since 2003 more flexible, allowing for trading in currency, both in cash and in government bonds issued to the private sector, which may retain a greater portion of its export revenues to route them to this market. The exchange rate on this new market stood close to that of the parallel market (52 bolivars per dollar, 87.9% below the parity for preferential imports). This heavy devaluation will impact the inflation rate but, conversely, it will ease the State’s budgetary constraint and reduce pressure on the central bank’s currency reserves, which fell once more during the six-month period and stood below the maturities of external debt scheduled for 2014. At the same time, the opening up of this new market might reduce the level of shortages insofar as it provides swifter access to the foreign currency needed for imports. The rating agencies downgraded the country’s sovereign rating in December and once again in March.

14.4.2014.