REPORT ON THE LATIN AMERICAN ECONOMY: SECOND HALF OF 2015

Introduction

The slowdown in activity in Latin America since mid-2011, against a background characterised by the lower momentum of the Chinese economy and falling commodity prices, sharpened in 2015 Q2 due to the unexpected worsening of the recession in Brazil. The national accounts data available for the six main economies[1] indicate that in Q2 the region grew by 0.3% year-on-year (compared with 0.7% in Q1), the lowest figure since the crisis (see Chart 1). However, the aggregate figure is highly skewed by the fall in Brazilian GDP (–2.6% year-on-year in the quarter). Among the other countries, Peru and Colombia posted relatively solid growth of 3% year-on-year, while Mexico, Chile and Argentina grew by around 2%.

From summer, the turmoil caused by the fall in the Chinese stock market and the subsequent depreciation of the yuan, the further decline in commodity prices to lows approaching those of 2008 and, as an exceptional feature, the loss of the investment grade rating by Brazil, contributed to further weaken the region's growth outlook, as reflected in the unfavourable performance of the financial markets (see Chart 1). The 2015 and 2016 GDP growth forecasts for Latin America have been revised downwards in recent months to stand at around 0% for 2015 and 1% for 2016, the lowest for the last seven years.

Inflation rose to 6.3% in August, as measured by the average of the five countries with inflation targets, nearly 1 percentage point (pp) more than at the beginning of the year. Except for Mexico, where the impact of the structural reforms is making itself felt in the lower prices of some goods and services, the upward trend was relatively widespread across all countries, albeit much more marked in Brazil (where it reached 9.5% year-on-year), mainly as a result of the rise in administered prices. In Chile, Colombia and Peru, consumer prices grew by more than 4% year-on-year (more than 5% in Chile) to stand at or above the upper bound of the central banks' target range. Despite the cyclical weakness, the significant exchange rate depreciation is having a substantial effect on observed inflation and, in some countries, is beginning to pass through to inflation expectations.

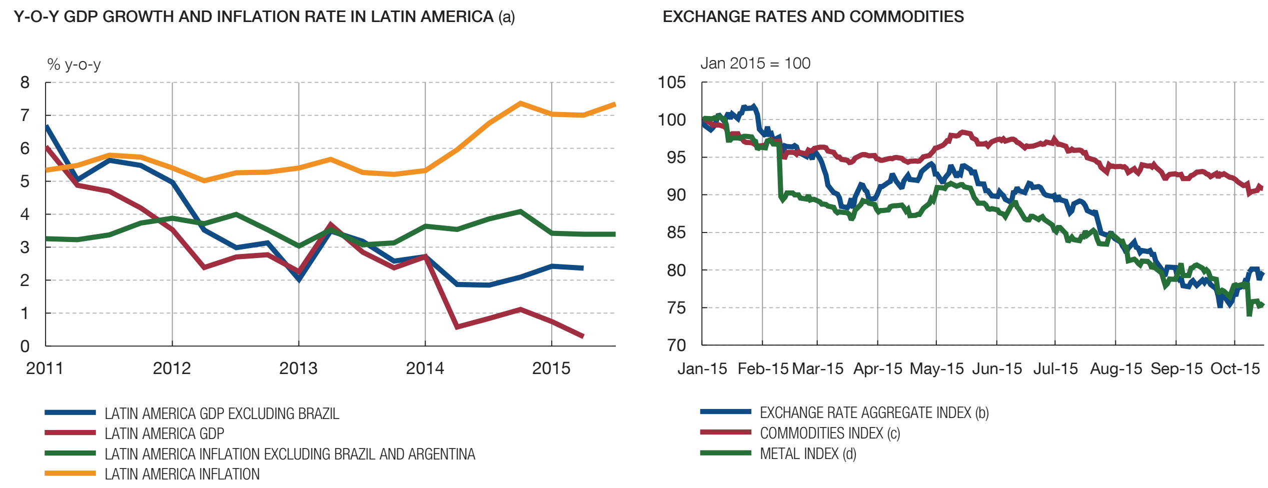
In general terms, economic policy stances are not responsive to the economic slowdown. First, the short-term monetary policy leeway seems to have been exhausted by the rise in consumer prices. In particular, Brazil raised interest rates to 14.25%, a hike of more than 7 percentage points (pp) in the overall upward cycle comprising the last two years. Of the other central banks operating with inflation targets, three raised official interest rates (Peru, Colombia and Chile) and Mexico held them unchanged. Second, fiscal policies continue to be consistent with a scenario of lower commodity prices in most countries. Brazil is unable to complete the envisaged fiscal adjustment for 2015 and the mid-year government deficit was near 9% of GDP. In other countries there have also been slippages in the government deficit with respect to the initial target, largely due to lower revenue.

Thus, against a background in which the correction of imbalances takes on particular importance as an economic policy objective, the outlook is for a low-growth scenario in the region as a whole, although with significant differences between countries. The risks to growth remain on the downside, not only due to the possibility of a greater-than-expected

1 Argentina, Brazil, Colombia, Chile, Mexico and Peru. No official data available on Venezuela since 2014 Q3; the indirect evidence points to a deep recession.

GDP, INFLATION, COMMODITIES AND EXCHANGE RATE

CHART 1



SOURCES: National sources and Datastream.

a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru as a GDP-weighted average for the region.
b Weighted average of indices of exchange rates against the dollar for Latin America excluding Argentina.
c CRB BLS commodities index.
d CRB metal Index.

downturn in China and the uncertainty that continues to surround the Federal Reserve's future normalisation of interest rates, but also due to the stance to be adopted by domestic economic policies. By contrast, the adjustment of domestic demand and the depreciation of exchange rates are working in favour of the correction of current account imbalances, which were a source of significant vulnerability. Furthermore, Latin-American countries have built up defences (e.g. international reserves) during the expansionary phase which can now be used, and their fundamentals for coping with a low-growth phase are better than in the past.

External environment

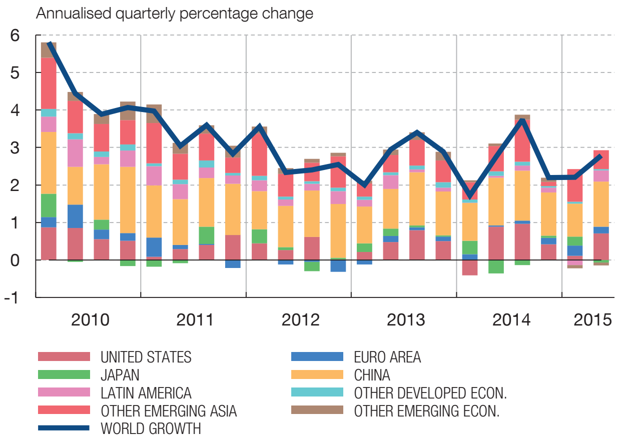
World economic growth has slowed so far in 2015, basically due to a further weakening of activity in the emerging economies (see Chart 2). Moreover, except in the euro area, the recovery of the advanced economies has been weaker than anticipated at the beginning of the year, influenced by the so far limited impact of the lower oil prices on household expenditure, the weakness of external demand and some temporary factors (such as those affecting the United States in Q1). Inflation in these economies has further decreased to very low levels and the core rates have shown greater stability, but it stands below the central bank target rates. Against this background, the monetary policy stances of the main advanced economies continue to differ: the ECB and the Bank of Japan are proceeding with their quantitative easing programmes, while expectations continue that the Federal Reserve and the Bank of England will tighten interest rates, although the global weakening is delaying and adding complexity to the decision of these central banks.

The emerging economies have continued to decelerate, as they have been doing since 2011. This trend seems to be due to weak demand from the advanced economies as they exited the crisis and because of a number of structural factors, ranging from lower gains in productivity to less favourable demographics. To these factors should be added three significant developments having unequal impacts over the last two years: first, the slowdown of the Chinese economy as a result of the rebalancing of its growth model; second, the commodity price decline (largely linked to the weaker demand from China), which has been reactivated from end-June and has severely affected commodity exporters'

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

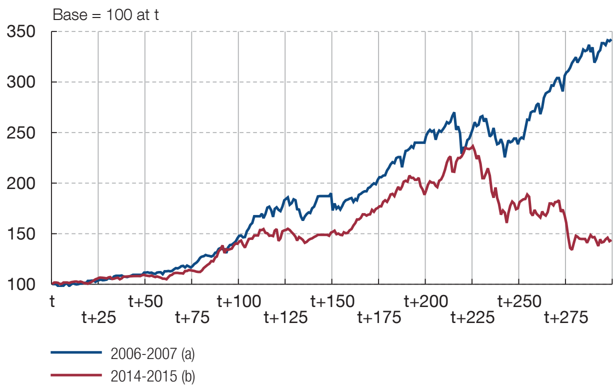
CHART 2

CONTRIBUTION TO WORLD GDP GROWTH

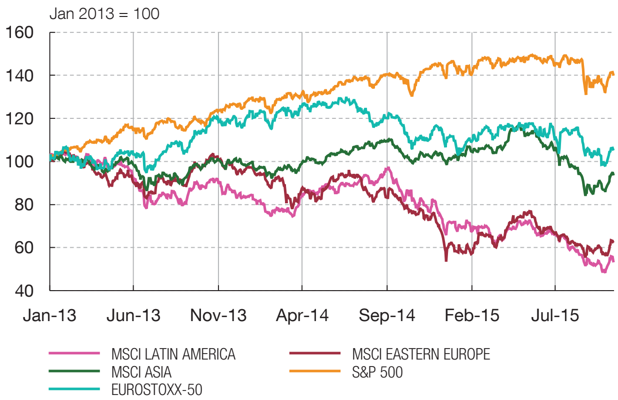


INTEREST RATE

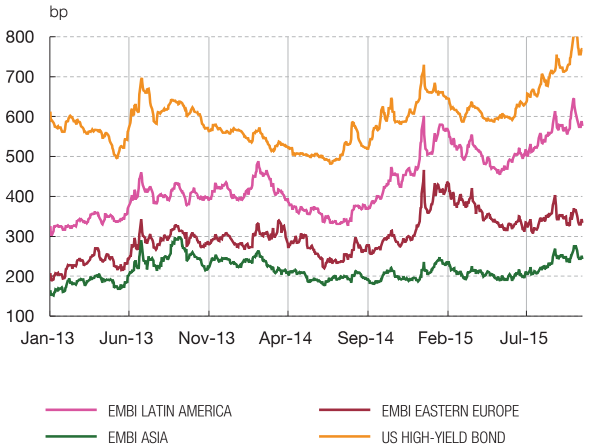
CHINA STOCK MARKET: COMPARISON OF TWO CYCLES



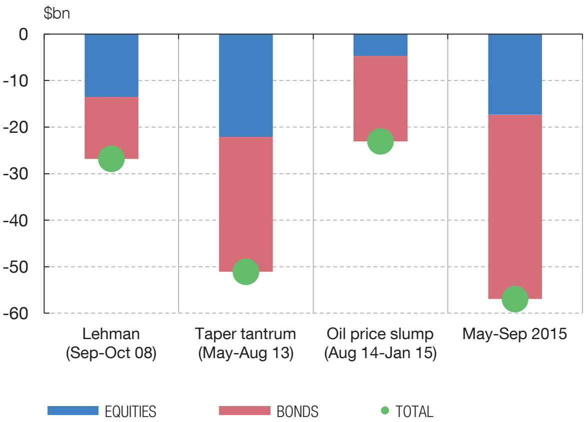
WORLD STOCK MARKETS (a)



INTEREST RATE SPREADS



CAPITAL FLOWS TO EMERGING ECONOMIES



SOURCES: Datastream and JP Morgan.

a 100 = 1 August 2006.
b 100 = 1 August 2014.
c Stock market indices in dollars.

income and investments; and finally, the tightness of global financial conditions in anticipation of the upturn in interest rates in the United States. Inflation has remained low in some emerging economies, although in Latin America and elsewhere, such as Russia and Turkey, it has shown high downward stickiness, partly due to depreciation of their currencies.

The behaviour of the international financial markets has been marked by stock market tensions in China. Specifically, the Shanghai stock market underwent two sharp corrections (see Chart 2). The first, in mid-June, was controlled through strong measures by the authorities, including official interest rate cuts and injections of liquidity into the firms financing share purchases. The second, which occurred following the change in the yuan exchange rate regime, was less abrupt but more far-reaching for the financial markets of emerging and developed economies because it coincided with unfavourable indicators on the Chinese economy which prompted growing doubts as to its resilience. This second correction fed through to advanced-country stock markets in the form of increased volatility and sharp setbacks. The other markets experienced higher volatility than in the past but without fluctuations of the virulence seen in equities (see Chart 2). Also, the misgivings as to the outcome of the negotiations between Greece and its creditors at the start of summer and the uncertainty as to the possible interest rate hike in the United States in September (which finally did not eventuate) contributed to heighten risk aversion in the financial markets.

The emerging financial markets went through a period of certain stability in May and June, favoured by the temporary steadiness of commodity prices (see Chart 2). However, the negative trend returned from the second half of June, following the first Shanghai stock market slump, and it became more marked in the second correction. The deterioration of emerging-market financial indicators was, in aggregate terms, sharper than in other previous bouts of financial turbulence, including that of May 2013, as shown by the capital outflows of equity and bonds (see Chart 2).

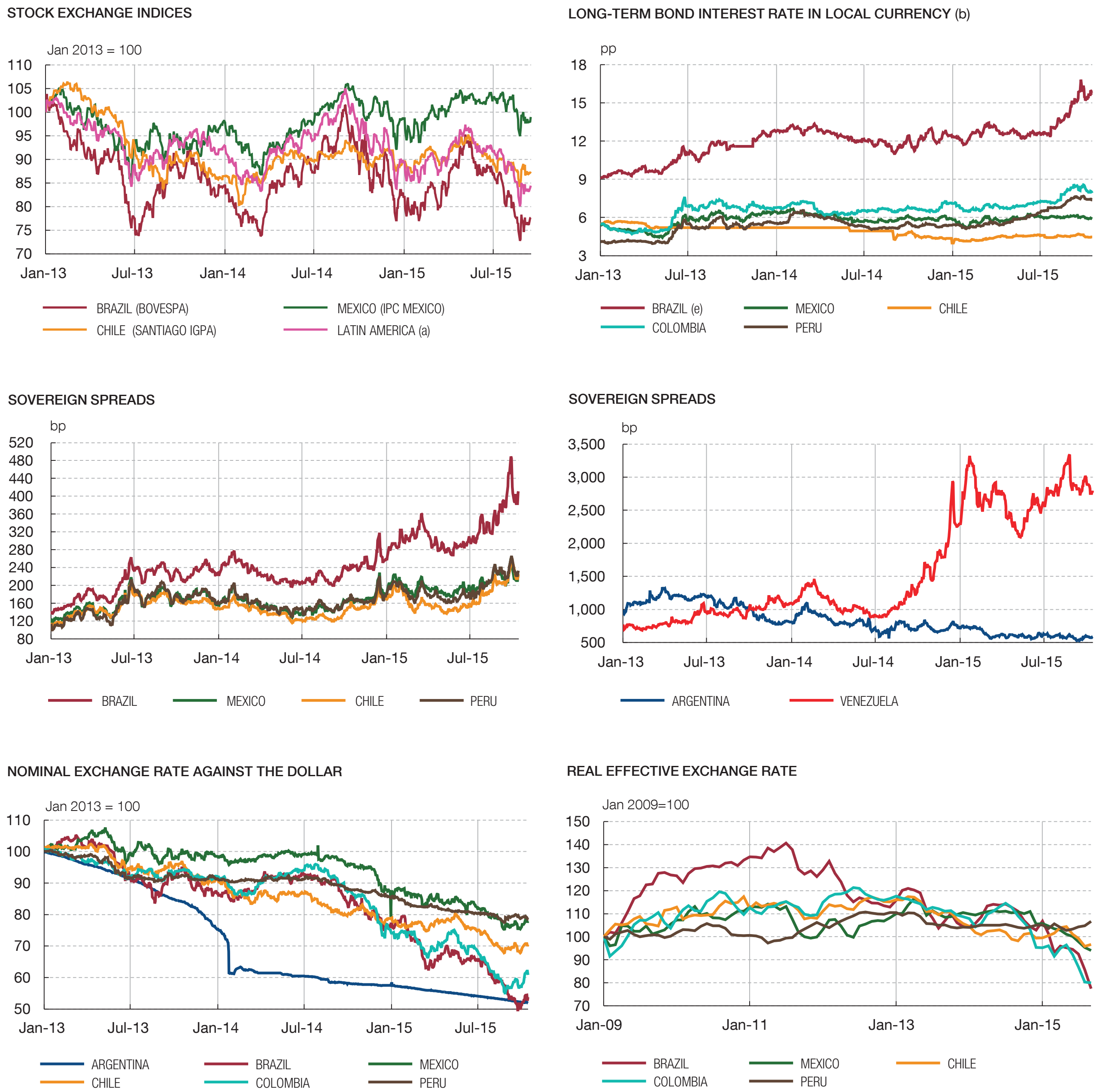
Latin American financial markets

The financial markets of Latin America performed more poorly than those of the other emerging regions (see Chart 2), since Latin America is a commodity producing region and commodity prices are a key determinant of its terms of trade. Also playing a part were specific factors such as the adverse performance of Brazil's financial markets, which worsened after a rating agency downgraded Brazil to below investment grade. By contrast, the Mexican stock market posted a much smaller fall (–2.9%), associated with the improved prospects of the US economy and its smaller exposure to China (see Chart 3). All told, the dollar-denominated MSCI Latin American stock market index fell by 25% between May and September 2015, more than eastern Europe (–18%) or emerging Asia (–20%), the oil and gas sector posting the largest fall (–48%).

Long-term bond interest rates in the local markets rose, with significant increases in Colombia and Peru [170-180 basis points (pb)], associated in part with the depreciation of the exchange rate and with the worsening of inflation expectations (see Chart 3). In any event, the special circumstances and monetary policy decisions of Brazil meant that its interest rates rose more sharply (by more than 300 bp). The sovereign spread, measured by the Latin America EMBI, tended to widen, increasing by more than 100 bp from April to 600 bp, marking a high since 2009 Q1. This behaviour was also more unfavourable than that of the other emerging areas. There was a general worsening of sovereign risk premia, with a particularly large increase in Brazil (up 190 bp to 490 bp), followed by Colombia, Chile and Peru (up between 95 bp and 100 bp); in Mexico the increase was smaller (75 bp).

FINANCIAL INDICATORS
Indices, basis points and percentage points

CHART 3



SOURCES: Datastream, JP Morgan, Bloomberg, Banco Central do Brasil and national statistics.

a MSCI Latin America index in local currency.
b 10-year government bonds in local currency.

Also, the sovereign spread of Venezuela rose by more than 820 bp to 3500 bp, against a background of high vulnerability due to its scant reserves and fragile fiscal situation. By contrast, the spread of Argentina held steady at around 600 bp.

Exchange rates tended generally to depreciate against the US dollar between May and September, depreciating more sharply in Brazil (–25.6%), Colombia (–22%) and Chile (–12%). Thus the real has depreciated by 59.4% since mid-2011, reaching a historical low against the dollar of more than 4 reales/dollar, despite the sharp rise in official interest rates. This led the central bank of Brazil to announce in mid-September further exchange market interventions, after having interrupted the currency swap programme in March this year. The countries with fewer vulnerabilities, such as Mexico and Peru, recorded smaller depreciations, although the Banco de Mexico stepped up its daily intervention in the foreign exchange markets to reduce exchange rate volatility. In Venezuela, the exchange rate quoted in the new unregulated exchange market (SIMADI) was 97% more depreciated than the official rate, with a transaction volume amounting to scarcely 5.5% of the total; the exchange rate of the parallel market depreciated sharply.

This behaviour of nominal exchange rates offset the area's inflation differential and gave rise to a significant depreciation of real exchange rates. These stood in some cases at their levels before 2005, nearly at the start of the commodity price boom (see Chart 3). Hence, gains in international competitiveness should be considered as one of the key ingredients of a possible recovery of activity in the area.

In keeping with the behaviour of exchange rates, the capital flow statistics indicate that 2015 H1 saw a smaller portfolio investment inflow (see Chart 4). In the region as a whole, gross portfolio investment inflows fell by $21 billion with respect to the previous half, to stand at $73 billion in annualised terms. Most of this decrease was concentrated in Mexico, followed by Brazil, in both cases being due to lower purchases of short-term securities. Also, there was a similar moderation in gross direct investment flows, particularly in the energy and financial sectors, attributable to smaller inflows into Brazil ($82 billion, 3.8% of GDP), Mexico and Colombia.

The fixed-income issues of the region between April and September amounted to $35.7 billion, down 45% from the same period of 2014. The main actors in this market were the public sector (37% of the total) and commodities-related firms (35% of the total), while the firms with most local exposure had greater difficulty in issuing securities (see Box 1). The decline in issuance was basically due to the fall in placements in Brazil (80% less than in the first nine months of 2014), as the Brazilian Treasury did not have recourse to the markets and Petrobras substantially reduced its issuance, although it did place a 100-year bond in June. The issuance conditions of the region worsened in terms of price (interest rates increased by 65 bp from 2014 Q3), but not in terms of maturity (see Chart 4). Regarding the currency of issuance, euro-denominated issues have increased recently to account for 20%-25% of the total in 2015 Q2, possibly in response to divergences in the expected monetary policy stances in the United States and the euro area, although international issuance came to a halt in the past quarter.

Activity and demand

Following a first quarter of very weak GDP growth (0.1% quarter-on-quarter), in regional average terms (see Chart 5 and Table 1), GDP[2] fell by 0.4% in Q2, the sharpest quarterly decline since the global financial crisis. The year-on-year rate dropped to 0.3% from 0.7% in Q1, although there were significant differences between countries. In fact, the contraction of GDP in quarter-on-quarter terms was a reflection of the sharp fall experienced by Brazil (which shaved 1.1 pp off the year-on-year growth of the region), compared with the positive contributions of Mexico (0.6 pp) and the other countries. Peru posted growth of 1.2% in Q2 (3% year-on-year), Colombia grew by 0.6% (3% year-on-year) and in Argentina there were signs of a certain recovery in economic activity, with growth of 0.5% (2% year-on-year), underpinned by public spending. In contrast, activity in Chile stagnated in quarter-on-quarter terms, after showing signs of picking up between end-2014 to 2015.

2 Aggregate of the six main countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru)

One of the main defining features of financial markets since the global financial crisis has been the growth in financing obtained by firms on international bond markets. This process may be due, on one hand, to the banking sector's diminished intermediation role and, on the other, to investor yield search in the face of low interest rates resulting from lax monetary policies. Emerging markets have also been subject to this phenomenon, prompting a substantial increase in the volume of corporate debt issued by them on the international markets. This process has attracted considerable attention and has featured an increase in the volume of debt issued by non-financial firms in emerging economies, a lengthening of maturities and the dominance of the dollar as the denomination currency since 2009.[1] Although regional studies point to similar trends in Latin America,[2] the evidence available is somewhat limited from a statistical viewpoint and may add bias. Specifically, information on financing obtained by firms is either not compiled at consolidated level or does not take into account whether subsidiaries are explicitly dependent financially on parent companies, despite the fact that many firms often use their subsidiaries to raise funds on the capital markets. Moreover, such studies do not generally analyse the financial position of the issuing firms.

1 See R. McCauley, C. Upper and A.Villar (2013), "Emerging market debt securities issuance in offshore centres", Box 2, *BIS Quarterly Review,* September; P. Turner (2014), "The global long-term interest rate, financial risks and policy choices in EMEs", *BIS Working Paper* 441; H. Shin (2014), "The changing face of financial intermediation", Lecture at the BIS 84th Annual General Meeting.

2 See IADB (2014), "Global recovery and monetary policy normalization. Escaping a chronicle foretold?", *2014 Latin America and Caribbean Macroeconomic Report.*

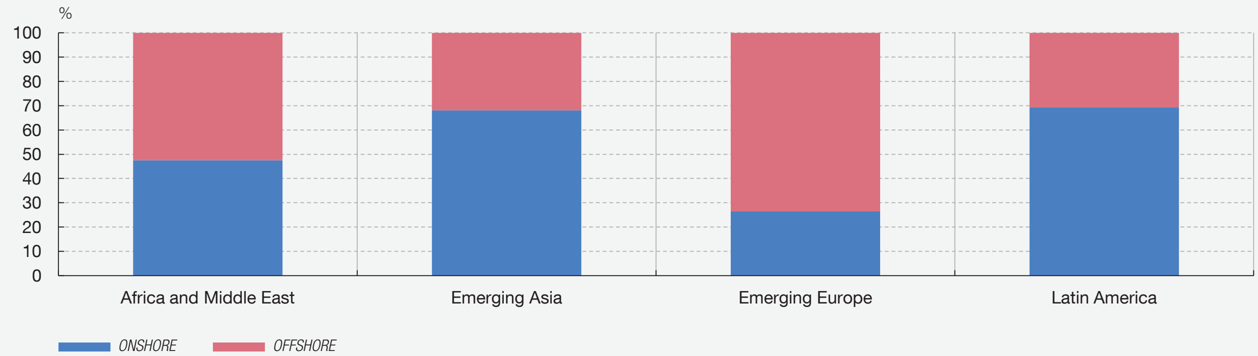
This box examines the risks stemming from the financing of Latin American firms on international bond markets[3] since 2000. A compilation of individual bond data and the financial accounts of the firms guaranteeing them is used to overcome the two statistical limitations mentioned above.[4] Combining these two sources of information at firm level allows the financing patterns of firms at consolidated level to be analysed, by identifying the bonds guaranteed by firms in emerging markets, following the methodology established by Fuertes and Serena (2014). Also, access to the financial accounts enables us to analyse the solvency of the firms guaranteeing these assets.

The first finding of interest regarding the post-crisis financing model of Latin American firms is the considerable volume of bonds issued through offshore subsidiaries. Chart 1 provides a breakdown of the total volume of bonds issued by country of domicile of the issuing firm. In the case of onshore issuance, the country of domicile of the firm guaranteeing the bonds issued is the same as that of the issuer (it is, in fact, the same firm, usually the parent). In other cases, bonds are issued through subsidiaries whose country of residence is not that of the parent company guaranteeing them. Such bonds are mainly issued through

3 The database was provided by Bloomberg and includes all bond issues of non-financial firms in a group of Latin American countries. It includes issuance on local and international markets (in local or foreign currencies), and also provides balance-sheet information on the issuing firms. The countries examined are Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru and Venezuela.

4 A. Fuertes and J. M. Serena (2014), "Firms' financial soundness and access to capital markets"», *Financial Stability Journal*, Banco de España, no. 27; "How firms borrow in international bond markets: Securities Regulation and Distribution of Credit Risks" (2015), mimeo.

BOND ISSUES IN INTERNATIONAL MARKETS GUARANTEED BY NON-FINANCIAL CORPORATIONS OF EMERGING ECONOMIES. BREAKDOWN BY COUNTRY OF ISSUER'S REGISTERED OFFICE. CHART1

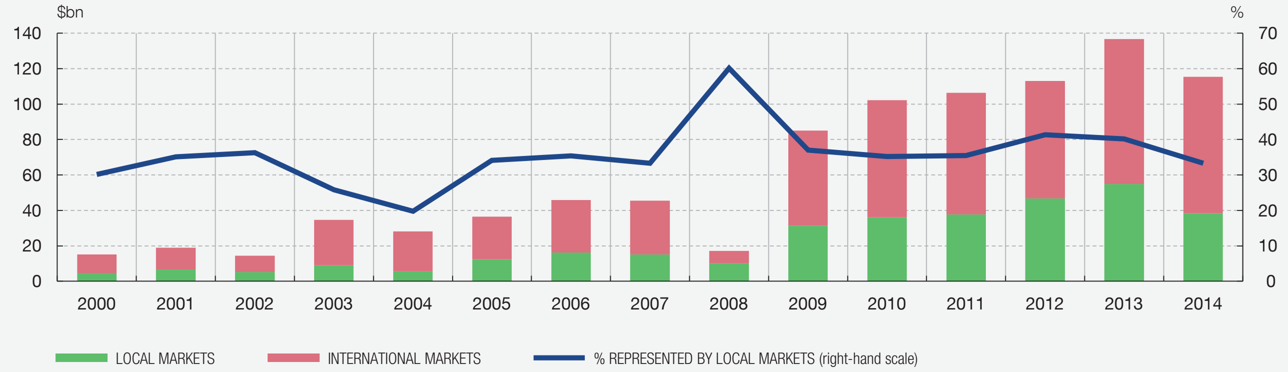


SOURCES: Bloomberg and Banco de España.

a Offshore centres are countries where financial vehicles of firms whose parent belongs to another economy have their registered offices: Cayman Islands, the Netherlands, Luxembourg, Virgin Islands, Singapore, Isle of Man, Ireland, Republic of the Marshall Islands, Republic of Mauritius, Hong Kong and Bermuda. Non-offshore centres are the countries of domicile of non-financial subsidiaries whose debt is guaranteed by a parent from an emerging country.

subsidiaries in offshore centres. Since the volume of such debt issues accounts for more than 30% of total issuance by Latin American firms, not taking these issues into account would lead to an underestimation of the volume of debt issued (this finding is replicated, with different percentages, in other emerging regions). The second finding indicates that the substantial increase in the volume of issuance on international markets over this period has not led to a decline in issuance on local debt markets. In fact, the proportion between the two has remained stable (see Chart 2).

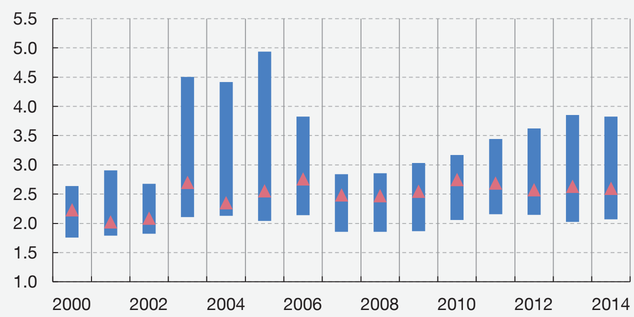
BOND ISSUES GUARANTEED BY LATIN AMERICAN NFCs: LOCAL AND INTERNATIONAL MARKETS — CHART 2



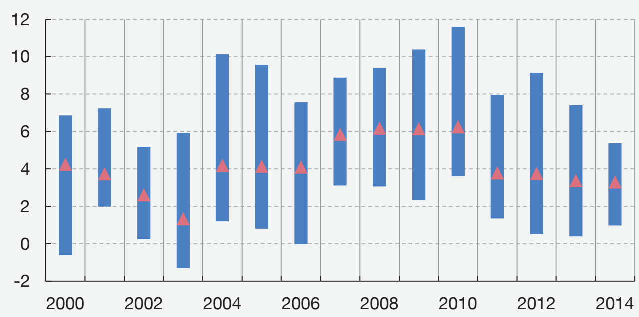
SOURCE: Bloomberg.

FINANCIAL RATIOS: HISTORICAL BEHAVIOUR AND DISPERSION — CHART 3

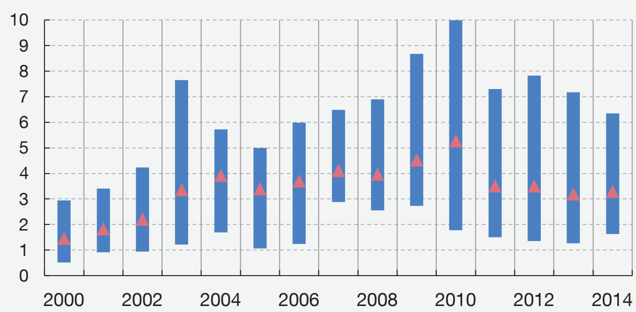
3.1 LEVERAGING



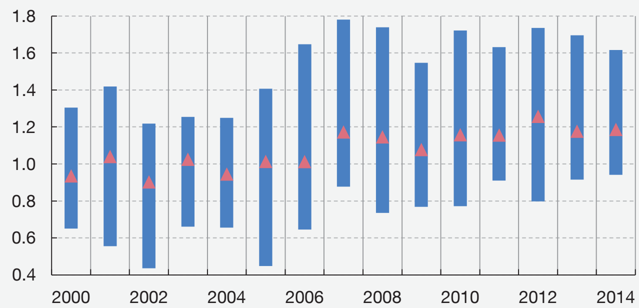
3.2 RETURN ON ASSETS



3.3 INTEREST COVERAGE RATIO



3.4 CURRENT RATIO



INTERQUARTILE RANGE — MEDIAN

SOURCE: Bloomberg.

Chart 3 shows how the financial position of Latin American firms guaranteeing debt issues has evolved over the 2000-2014 period. Their position is represented using a series of ratios which analyse aspects such as leverage (total assets to common equity), profitability (return on assets), solvency (interest coverage ratio) and liquidity (current ratio)[5]. The decline observed in firms' profitability and solvency in recent years is notable, although the level of leverage has not increased and the liquidity of issuing firms seems to have improved.

However, this aggregate performance may mask localised risks associated with the group of firms with a less favourable financial position. In fact, given that the volume of debt has risen significantly in absolute terms, the volume issued by these firms may also have increased. Figure 4 explores this by showing the amount of corporate debt issued in capital markets by firms with poor financial ratios[6], both in absolute terms and as a proportion of total issuance. Although there has been an increase in the volume issued by firms with high leverage and, in particular, by those with negative return on assets, the amount issued by the latter accounted for less than 20% of the total in 2014.

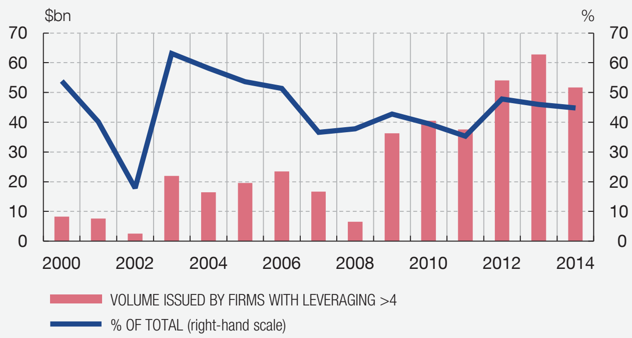
In short, in recent years, there has been a substantial increase in the financing obtained by non-financial firms in Latin America on bond markets, partly through the issuance of bonds by offshore subsidiaries. Also, although financial metrics have not deteriorated overall, the volume of debt guaranteed by firms with weak fundamentals has increased. And, lastly, it is worth mentioning two aspects which go beyond the matters discussed in this box. First, the risks associated with foreign currency indebtedness in the event of a sharp depreciation of local currency exchange rates and any available hedging, whether natural or ad hoc. Secondly, the need to identify the purpose of the financing obtained, whether it be productive investment or, alternately, carry trade transactions, equity buybacks or dividend distribution.

5 The interest coverage ratio is defined as earnings before interest, taxes, depreciation and amortisation (EBITDA) with respect to debt interest expense. The current ratio is defined as assets which may be turned into cash within a maximum of one year, divided by liabilities with a one-year maximum maturity.

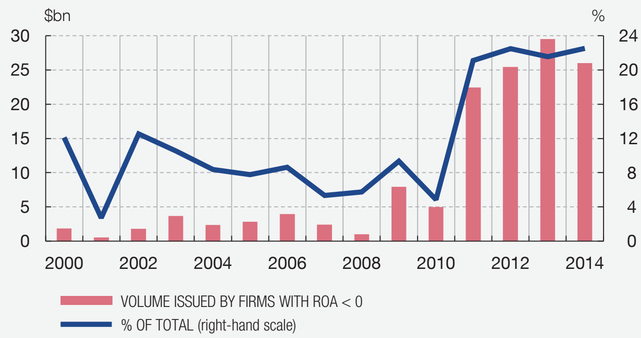
6 The financial ratio values considered low for the firm are the same as those used by the IMF (2014) in *Regional Economic Outlook: Asia and Pacific. Sustaining the Momentum: Vigilance and Reforms. April 2014*.

ISSUANCE BY NFCs WITH POOR FINANCIAL RATIOS CHART 4

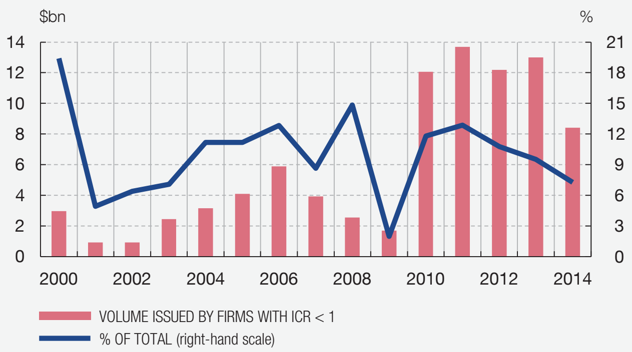
4.1 VOLUME ISSUED BY HIGHLY LEVERAGED FIRMS



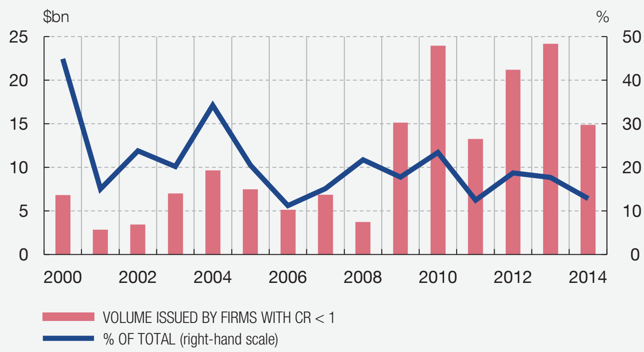
4.2 VOLUME ISSUED BY FIRMS WITH LOW ROA



4.3 VOLUME ISSUED BY FIRMS WITH LOW ICR



4.4 VOLUME ISSUED BY FIRMS WITH LOW CURRENT RATIO

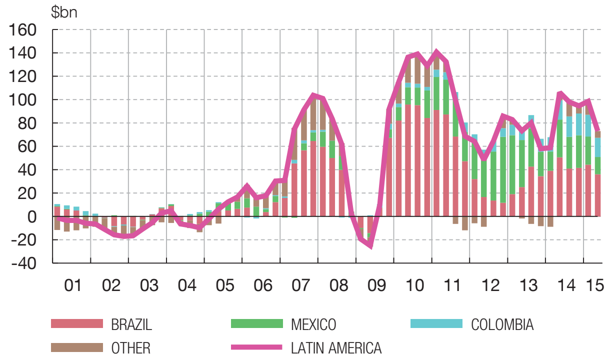


SOURCE: Bloomberg.

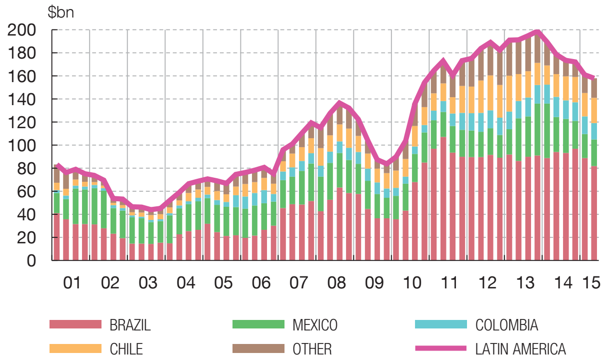
EXTERNAL CAPITAL FLOWS AND FINANCING
$bn, % and years

CHART 4

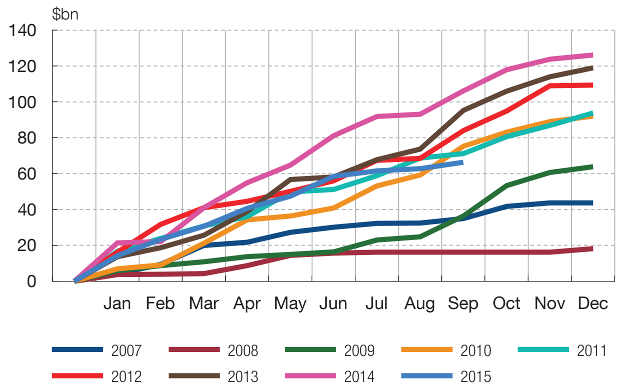
LATIN AMERICA: 12-MONTH CUMULATED PORTFOLIO INVESTMENT FLOWS



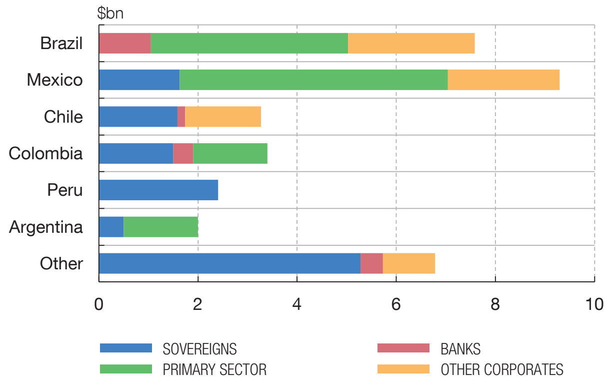
LATIN AMERICA: 12-MONTH CUMULATED FDI FLOWS



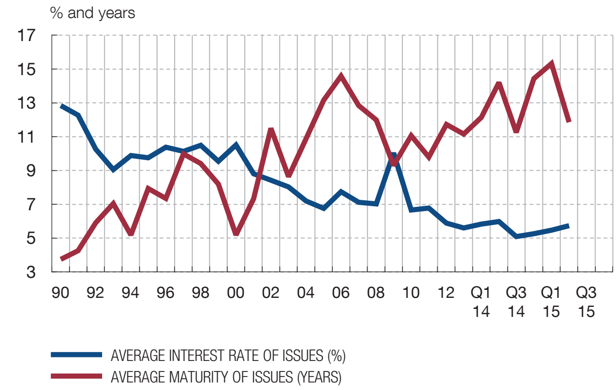
LATIN AMERICA: FIXED INCOME ISSUES IN INTERNATIONAL MARKETS



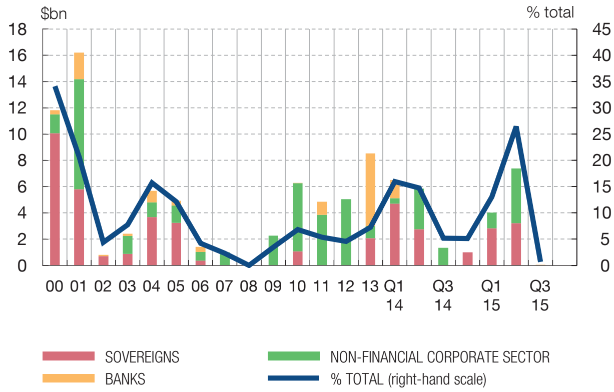
INTERNATIONAL ISSUES IN LATIN AMERICA: FROM APRIL TO SEPTEMBER 2015



LATIN AMERICA: FIXED-INCOME ISSUES OF NON-FINANCIAL CORPORATE SECTOR



LATIN AMERICA: FIXED-INCOME ISSUES IN EUROS

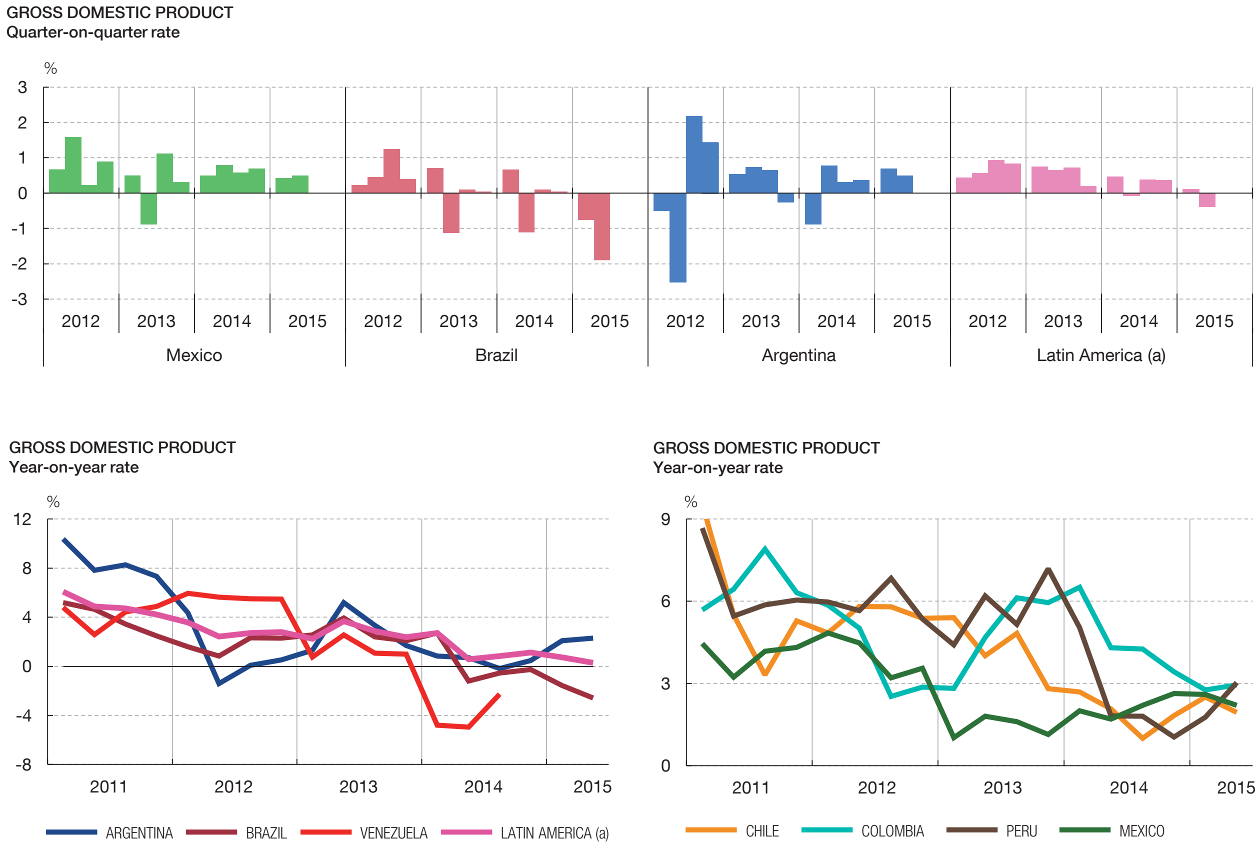


SOURCES: Datastream, Dealogic, JP Morgan, IMF and national statistics.

Analysis of the GDP components shows a continuation of the domestic demand and external demand rebalancing process which started in 2014, in parallel with the moderation of growth (see Chart 6). Practically all growth in Q2 was driven by the positive contribution of external demand (1.4 pp), which was widespread across all countries, with the exception of Argentina. A positive aspect of this, unlike in 2014, was the fact that the favourable contribution of the foreign sector did not only reflect a decline in imports, but also a rise

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

CHART 5



SOURCE: National statistics.

a Latin America 6 as a GDP-weighted average for the region.

in exports, which grew by 4.7% year-on-year in Q1 and 5.1% year-on-year in Q2, suggesting that exchange rate depreciation is beginning to have stabilising effects. The rise in exports was observed in the two largest economies, Mexico and Brazil, but was not widespread across all countries.

By contrast, domestic demand trimmed year-on-year growth in the region by 1.1 pp in Q2. Again, this was basically due to the adjustment in Brazil (where it shaved off more than 5 pp), while the other countries made a positive contribution to domestic demand. Also regarding domestic demand, the contraction of gross fixed capital formation (see Chart 6) intensified (–3.4 % year-on-year, compared with –1.6 % in the first quarter). This decline in investment was centred on three countries: Brazil (–11.9% year-on-year), Peru (–9.7%) and Chile (-3%). Among the key causes of this decline were the worsening terms of trade, the contraction of foreign direct investment, falling business confidence indicators and, in some cases, the delay in the execution of investment projects and tighter financing conditions. In Mexico, however, investment grew by more than 5% year-on-year for the fourth consecutive quarter. In the financial arena, lending to the private sector was not immune to this scenario, posting growth of around 5% year-on-year in real terms, as compared with 10% in early 2014 (see Chart 7). Again, it is necessary to distinguish between countries; in Brazil, lending stopped growing in real terms, especially that extended by public-sector financial institutions, while in Mexico it rose by more than 5%.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2013	2014	2013		2014				2015		2015
			Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	September
GDP (year-on-year rate)											
Latin America 6 (a)	2.8	1.3	2.9	2.4	2.7	0.6	0.8	1.1	0.7	0.3	
Argentina	2.9	0.5	3.3	1.7	0.8	0.7	-0.2	0.5	2.1	2.3	
Brazil	2.7	0.1	2.4	2.1	2.7	-1.2	-0.6	-0.2	-1.6	-2.6	
Mexico	1.4	2.1	1.6	1.1	2.0	1.7	2.2	2.6	2.6	2.2	
Chile	4.2	1.9	4.8	2.8	2.7	2.1	1.0	1.8	2.5	1.9	
Colombia (b)	4.9	4.6	6.0	5.9	6.5	4.3	4.3	3.4	2.8	3.0	
Venezuela	1.3	—	1.1	1.0	-4.8	-5.0	-2.3	—	—	—	
Peru	5.8	2.4	5.2	7.2	5.0	1.8	1.8	1.0	1.8	3.0	
CPI (year-on-year rate)											
Latin America 5 (a)	4.6	5.0	4.4	4.4	4.7	4.9	5.2	5.2	5.4	5.8	6.3
Argentina (c)	10.6	22.6	10.5	10.7	6.9	13.5	18.2	22.6	18.4	15.4	14.4
Brazil	6.2	6.3	6.1	5.8	5.8	6.4	6.6	6.5	7.7	8.5	9.5
Mexico	3.8	4.0	3.4	3.7	4.2	3.6	4.1	4.2	3.1	2.9	2.5
Chile	2.1	4.4	2.3	2.5	3.2	4.5	4.7	5.3	4.4	4.2	4.6
Colombia	2.0	2.9	2.3	1.8	2.3	2.8	2.9	3.5	4.2	4.5	5.4
Venezuela	38.5	57.3	43.4	52.9	53.3	55.6	57.5	61.3	—	—	
Peru	2.8	3.2	3.1	3.0	3.4	3.5	2.9	3.2	3.0	3.3	3.9
Budget balance (% of GDP) (d)											
Latin America 6 (a)	-2.4	-4.1	-2.5	-2.4	-2.6	-2.9	-3.5	-4.0	-5.0	-5.2	
Argentina	-1.9	-2.5	-1.8	-1.8	-2.0	-2.0	-2.1	-2.2	-3.2	-3.3	
Brazil	-3.1	-6.2	-3.3	-3.3	-3.0	-3.4	-4.6	-6.2	-7.8	-8.1	
Mexico	-2.3	-3.2	-2.8	-2.3	-2.8	-3.2	-3.4	-3.0	-3.4	-3.6	
Chile	-0.7	-1.5	-0.5	-0.7	-1.0	-0.8	-1.1	-1.2	-1.4	-1.3	
Colombia	-2.2	-2.6	-2.7	-2.2	-2.7	-3.6	-3.4	-2.6	-3.0	-2.7	
Venezuela	—	—	—	—	—	—	—	—	—	—	
Peru	0.5	-0.4	0.5	0.5	0.4	0.0	0.0	-0.5	-1.0	-1.5	
Public debt (% of GDP)											
Latin America 6 (a)	39.4	43.7	40.2	38.6	41.3	40.7	42.2	43.0	—	—	
Argentina	32.6	40.8	32.5	33.2	37.9	36.1	36.7	38.2	—	—	
Brazil	53.3	58.9	58.2	56.7	53.7	55.0	57.6	58.9	62.1	63.0	
Mexico	31.1	33.2	30.3	29.9	31.6	31.8	32.6	31.8	33.8	33.5	
Chile	12.8	15.1	12.6	12.8	12.8	13.5	13.7	15.1	14.3	16.2	
Colombia	34.5	37.7	34.9	34.6	35.9	35.1	35.6	37.7	39.6		
Venezuela	—	—	—	—	—	—	—	—	—	—	
Peru	19.1	19.5	17.7	19.0	17.8	18.3	18.4	19.4	18.9	20.0	
Current account balance (% of GDP) (d)											
Latin America 6 (a)	-2.8	-3.2	-2.8	-2.8	-2.9	-2.9	-2.8	-3.2	-3.3	-3.2	
Argentina	-0.8	-1.4	-0.6	-0.7	-1.1	-1.1	-1.0	-1.0	-1.2	-1.4	
Brazil	-3.4	-4.5	-3.4	-3.4	-3.5	-3.5	-3.5	-4.4	-4.5	-4.3	
Mexico	-2.4	-2.1	-2.3	-2.3	-2.6	-2.4	-2.2	-1.9	-2.2	-2.2	
Chile	-3.7	-1.2	-3.8	-3.7	-3.2	-2.7	-1.8	-1.2	-0.5	-0.1	
Colombia	-3.3	-5.2	-3.2	-3.2	-3.5	-3.9	-4.2	-5.2	-5.7	-6.0	
Venezuela	2.4	—	1.2	1.5	2.8	2.9	2.2	—	—	—	
Peru	-4.2	-4.0	-4.3	-4.4	-4.1	-4.3	-3.7	-4.0	-4.2	-3.6	
External debt (% of GDP)											
Latin America 7	20.7		19.8	20.4	23.5	21.9	21.8				
Argentina	22.7	26.5	22.9	21.8	28.6	26.5	25.9	24.8	27.0		
Brazil	12.9	15.0	13.7	13.8	13.6	14.5	14.4	15.0	15.3	16.2	
Mexico	20.4	21.9	19.3	20.6	20.8	20.9	20.9	21.9	24.3	24.9	
Chile	47.3	56.8	44.4	47.2	48.7	50.4	52.3	56.8	58.5		
Colombia	24.2	26.8	23.7	24.2	25.0	25.6	26.1	26.8	32.9		
Venezuela	36.3	—	34.6	32.8	31.0	28.5	26.9	—	—	—	
Peru	29.2	31.7	29.3	29.3	30.1	30.5	31.1	31.8	32.4		

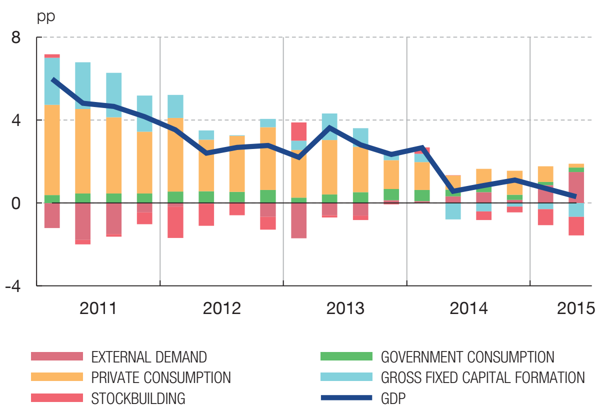
SOURCE: National statistics.

a Latin America 6: all the countries represented, except Venezuela; Latin America 5: all the countries represented, except Argentina and Venezuela.
b Seasonally adjusted.
c 2014 inflation is calculated as the cumulative figure since December 2013.
d Four-quarter moving average.

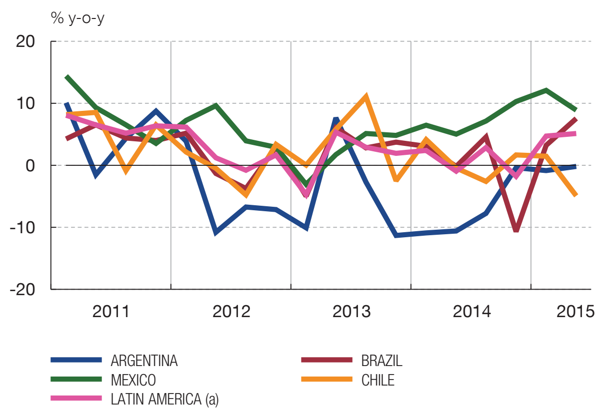
COMPOSITION OF GDP ON THE DEMAND SIDE
Year-on-year rate and pp

CHART 6

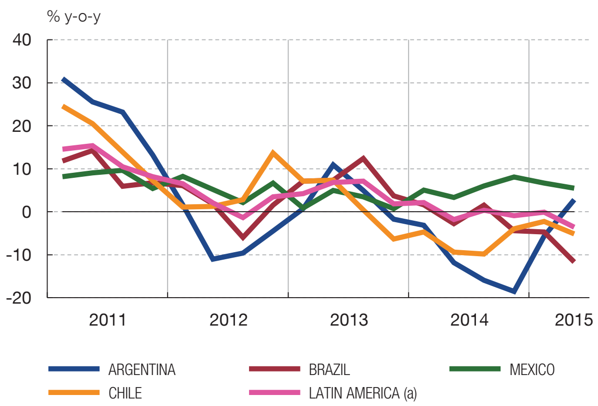
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



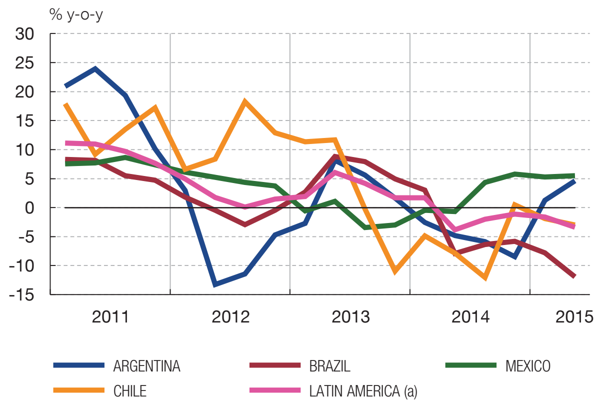
EXPORTS



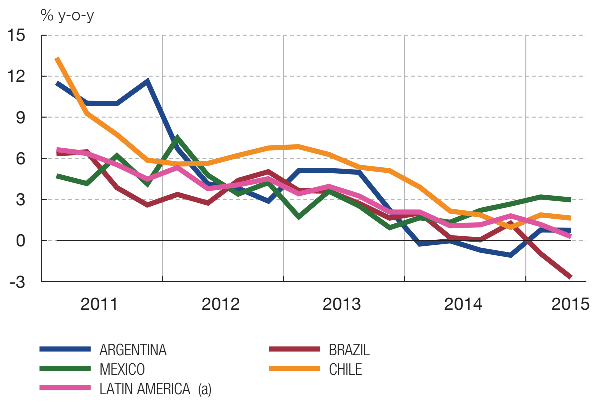
IMPORTS



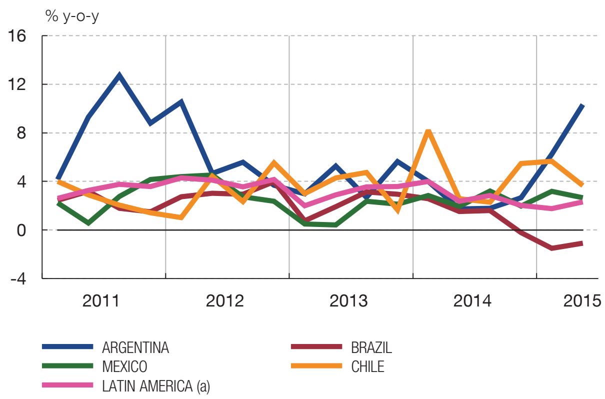
GROSS FIXED CAPITAL FORMATION



PRIVATE CONSUMPTION



GOVERNMENT CONSUMPTION



SOURCES: National statistics and IMF.

a Latin America 6 as a GDP-weighted average for the region.

Private consumption has taken longer to adjust, but has already started to feel the impact of the worsening terms of trade on household income, of the change of trend in the labour market and, in some cases, of tighter financing conditions. In 2015 Q2, the growth in consumption was the lowest for the last seven years (0.3% year-on-year as compared with 1.2% the previous quarter). The trend towards moderation was widespread across countries, but again, there were major differences: consumption fell in Brazil (-2.7% year-on-year) but recovered somewhat in Argentina (0.7%) and Chile (1.6%), while the other countries posted growth rates of above 3%.

The region's labour market, which had proved very resilient to the slowdown in activity in recent years, began to show signs of greater weakness in 2015 (see Box 2). The unemployment rate rose to 6.3% of the labour force, from a historical low of 5.3% at end-2014 (see Chart 7). Job creation moderated to 0.8% in July, with opposing trends in Brazil (-1%) and Mexico (2%). In Brazil, jobs were destroyed mainly in the formal segment of the industrial and construction sectors, leading to a sharp rise (7.7%) in the unemployment rate, which began to have an effect on real wages. Meanwhile, in Mexico, where the labour market benefited from the plan to encourage formal employment in the construction sector, the unemployment rate fell to minimum levels (4.4%) and real wages rose slightly. There were also disparities in the other countries: the unemployment rate dropped to 6.6% and 9.4% in Argentina and Colombia, respectively, rose moderately in Chile, and held stable in Peru.

As regards trade balances, although exports increased in real terms, the fall in commodity prices (–20% since the beginning of the year in the case of metals, –10% for energy —the lowest since 2009— and –2% for food, see Chart 8) continued to result in falling nominal exports in the region as a whole (–15%). Thus, the contraction in imports (of varying intensity depending on the country), which is fostered by the depreciation of exchange rates and the drop in final demand, is not permitting a reversal of the trade deficit, which has continued to expand in the region as a whole (see Chart 8). The situation varies from country to country: in Chile, the trade surplus accounted for more than 3% of GDP, and in Brazil the trade balance remained virtually in balance, after posting a slight deficit in 2014. In Mexico, the deficit increased (–0.5% of GDP), as was the case in Peru and Colombia, while in Argentina, the trade surplus decreased.

The current account deficit for the region as a whole fell by only 0.2 pp (from 3.3% to 3.1% of GDP) between Q1 and Q2. However, this stability masks the improvements in the current account balances of Chile (now practically in balance after two years of adjustment and a previous deficit of -4%), Peru (owing to an improved income balance), and, incipiently, Brazil, although its figures give rise to some doubt as they coincide with the implementation of a methodological change in the last two quarters, making comparison with 2014 difficult. By contrast, the current account balances deteriorated somewhat in Argentina (–1.4%), Mexico (–2.2%) and, in particular, Colombia (–6%).

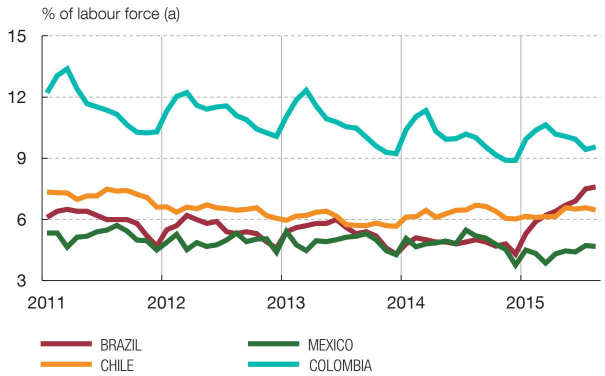
Economic activity trends do not seem to have been substantially affected in Q3. Industrial production continued to post negative year-on-year rates in regional average terms, which were widespread across all countries except for Mexico (see Chart 7). Retail sales, which had been relatively resilient in previous years, showed a marked moderation, mainly as a result of Brazil's negative figures and a slowdown of growth in Colombia, partly offset by more favourable behaviour in Argentina, Mexico and Chile. Confidence indicators also fell, particularly with respect to firms, to the lowest levels since 2011 (see Chart 7), and the decline was widespread across all countries except Peru. Consumer confidence indicators,

EMPLOYMENT, DEMAND AND CREDIT INDICATORS

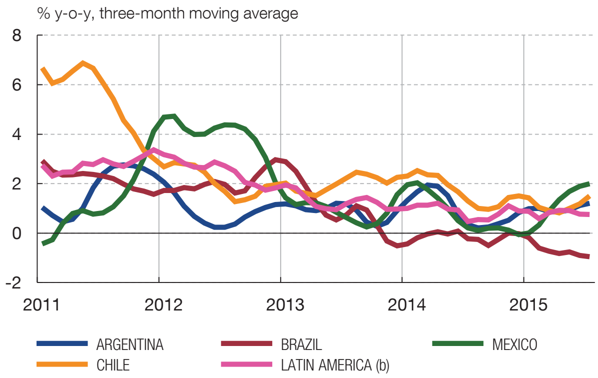
CHART 7

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

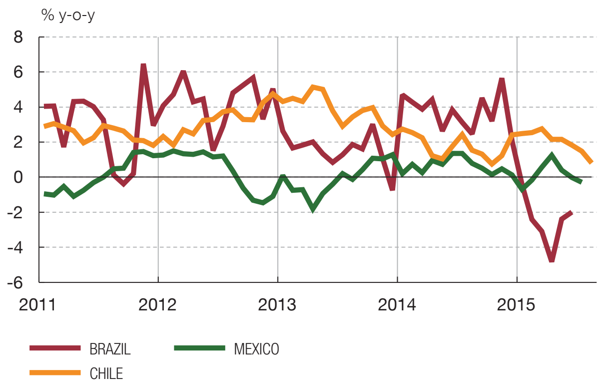
UNEMPLOYMENT



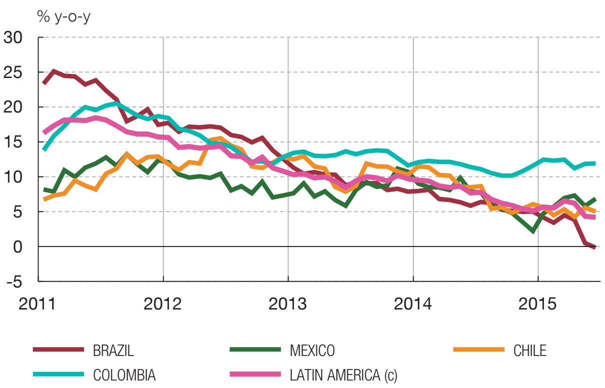
JOB CREATION



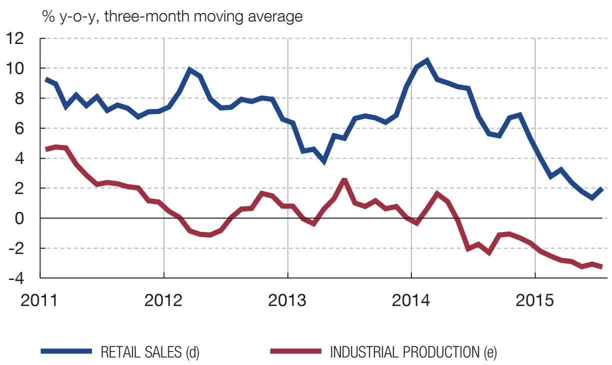
REAL WAGES



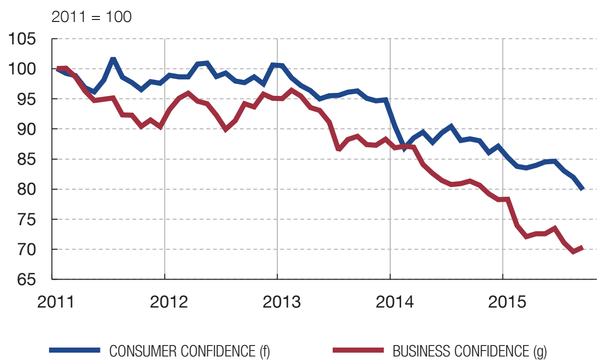
REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR



DEMAND AND ACTIVITY INDICATORS



CONSUMER AND BUSINESS CONFIDENCE INDICES



SOURCES: National statistics and Datastream.

- **a** Except Brazil and Mexico (% of working-age population).
- **b** Aggregate of Argentina, Brazil, Chile and Mexico.
- **c** Aggregate of Brazil, Chile, Colombia and Mexico.
- **d** Aggregate of Brazil, Chile, Colombia and Mexico.
- **e** Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
- **f** Aggregate of Argentina, Brazil, Chile, Mexico and Peru.
- **g** Aggregate of Brazil, Chile, Mexico and Peru.

From a historical perspective, Latin America has seen the highest levels of inequality worldwide (see Chart 1); in fact, 25% higher than would be expected given its level of economic development.[1] In this setting, reducing inequality has become pivotal to the economic policy debate in recent decades, since it is considered to be a key prerequisite for achieving economic stability and real convergence with advanced economies. This concern materialised in the adoption of a series of policies initially aimed at eliminating extreme poverty and known as "conditional cash transfers".[2] These policies, together with certain structural factors (such as the decline in the education premium[3]) and other short-term economic factors (particularly the economic recovery following the crisis of the previous decade and the rise of employment), resulted in the emergence, in the first decade of this century, of a new middle class[4] made up of more than 50 million individuals. Although poverty levels fell by almost 30%, there was an increase in the population segments in income bands still at risk of poverty in the event of economic instability or a change in public policies. The

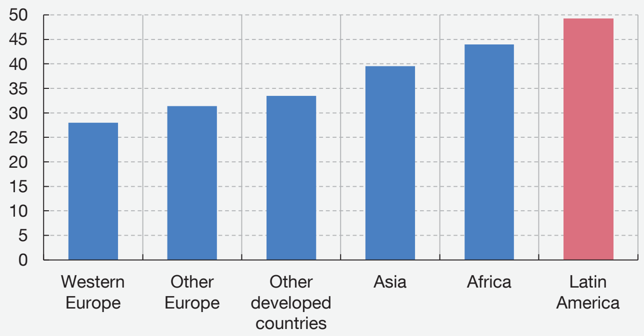
1 F. Alvaredo and L. Gasparini (2013), «Recent Trends in Inequality and Poverty in Developing Countries», CEDLAS, *Working Papers* n.º 0151, CEDLAS, Universidad Nacional de La Plata.

2 The conditional transfer programmes, which were introduced in Mexico in the late 1990s through the "Progresa" programme and later spread to other countries in the region, are based on two principles: first, financial aid is targeted to families in the low income/wealth percentiles, with dependent children. second, the aid is conditional on the fulfilment of commitments regarding nutrition, health or education.

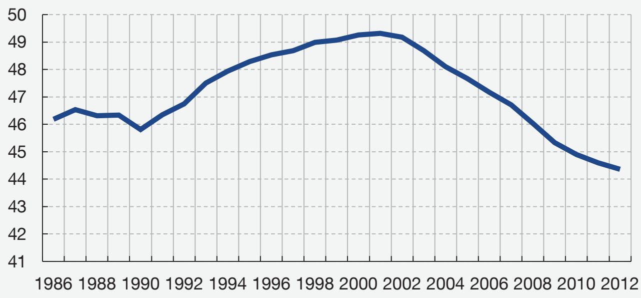
3 In this context, "education premium" refers to the average return of an additional year of tertiary education. For more details, see Montenegro, Claudio E. y Harry A. Patrinos (2014), «Comparable estimates of returns to schooling around the world», *World Bank Policy Research Working Paper* 7020.

4 According to a World Bank study (2014), the poverty line in Latin America is income of less than 4 dollars/day, the "at-risk" threshold is income of between 4 and 10 dollars/day, and middle income is between 10 and 50 dollars a day.

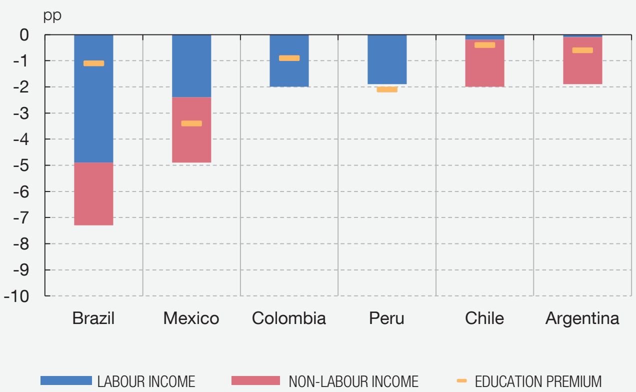
1 INTERNATIONAL COMPARISON OF GINI INDEX, 2002



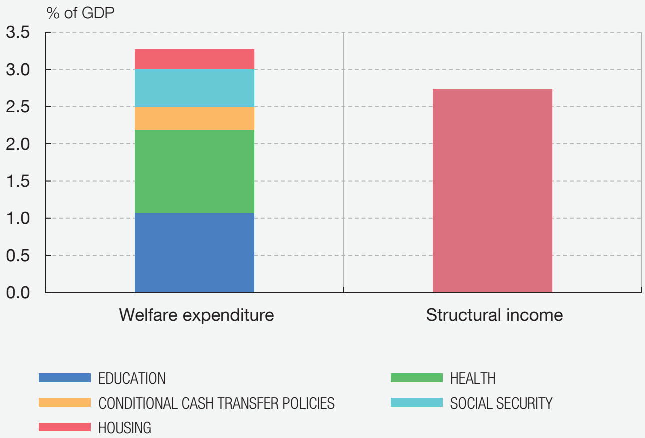
2 GINI INDEX IN LATIN AMERICA



3 REDUCTION OF INEQUALITY IN HOUSEHOLD INCOME AND IN EDUCATION PREMIUM (a)



4 WELFARE EXPENDITURE AND STRUCTURAL REVENUE IN LATIN AMERICA (b)



SOURCES: SWIID and CEPAL.

a Source: L. O., Cord, Barriga, L. Lucchetti, C. Rodríguez-Castellón, L. Sousa and D. Valderrama (2014), Inequality stagnation in *Latin American in the aftermath of the global financial crisis* and Montenegro et al. (2014) (see footnote 3 above). Period between 2003 and 2013. The fall in inequality is measured in Gini points.

b Source: E. Alberola, I. Kataryniuk, A. Melguizo and R. Orozco (2015), *Fiscal policy and the cycle in Latin America: the role of financial conditions and fiscal rules, forthcoming Working Paper,* Banco de España. Between 2004 and 2010.

combination of these factors has led to the widespread reduction of income inequality in recent years, marking a turning point in the history of Latin America (see Chart 2). This box examines the determinants of the process of reducing income inequality in Latin America, placing special emphasis on education.

Wage compression was the key underlying common factor for the reduction in income inequality in Latin America,[5] especially as a result of the decline in the education premium in Latin America, which fell around 20% between 2003 and 2012 (see Chart 3). This could either be explained by an increase in the supply of skilled labour or by a decrease in the quality of such labour. Although the level of spending on education in Latin America has approached that of advanced economies, increasing from 4.2% to more than 5% of GDP in the last 13 years, as a result of practically achieving universal primary education, there is little evidence to show that such spending has been effective, as reflected in the educational results measured by the PISA survey, in which Latin American countries scored lower than other countries with the same level of economic development. According to the OECD, the poor quality of education in Latin America represents an educational attainment gap equivalent to two years of schooling, with respect to the OECD average. On the other hand, the number of skilled individuals has continued to grow in recent years at a similar rate to that of past decades, and there is still a shortage of workers with the skills needed on the job market (CDE-CAF-CEPAL, 2014).

There are other factors which help to explain the decline in the "education premium". One of these is the fall in the wages of older workers with tertiary education, which may be an indication that skills become obsolete at an ever-faster pace, thus reducing the relative wages of workers with a higher level of education. In addition, the growing trade with China, reflected in a greater demand for tradable products with lower added value, such as commodity-related products, may have led to a greater relative demand for unskilled workers, and consequently, to an increase in their wages.

Some authors stress the importance of the increase in non-labour income as a factor contributing to lower inequality (see Chart 3), especially in countries where redistributive public policies were pushed in the form of more ambitious and progressive fiscal transfer programmes, such as Brazil or Mexico. The effects of fiscal policy measures were reflected in broader coverage, for 22% of the Latin American population according to CEPAL data, an unprecedented increase in social spending, the reduction of extreme poverty and higher school enrolment and attendance. However, the transfer programmes had uneven effects on the final health and education indicators (CEPAL, 2011), and may even have entailed perverse incentives which reduce the participation rate and increase informality. Such programmes must be correctly parameterised in order to ensure that they are not an obstacle to people joining the formal labour market.

Although inequality has indeed been reduced in Latin America, it remains high, and the outlook for the coming years is uncertain. On the one hand, external factors, including the fall in the price of the region's exports, have led to the disappearance of some of the short-term economic factors which were helping to reduce inequality. On the other, the margin for rapid improvements in inequality by providing access to education has also narrowed. Thus, two major challenges lie ahead: first, the fact that the increase in unskilled workers' real wages is due to higher demand in sectors linked to the commodities cycle and to a strengthening of labour market institutions (minimum wages, trade unions), may have led to a loss of competitiveness of the manufacturing sectors. This means that in an adverse international setting, future wage increases should be linked to improvements in productivity. Secondly, the rate of expansion of social spending policies has exceeded that of economic growth and structural tax revenue (see Chart 4), and brings with it increasing social demands for the redistribution of wealth. From now on, redistribution proposals should be accompanied by tax reforms and improvements in the effectiveness of existing programmes.

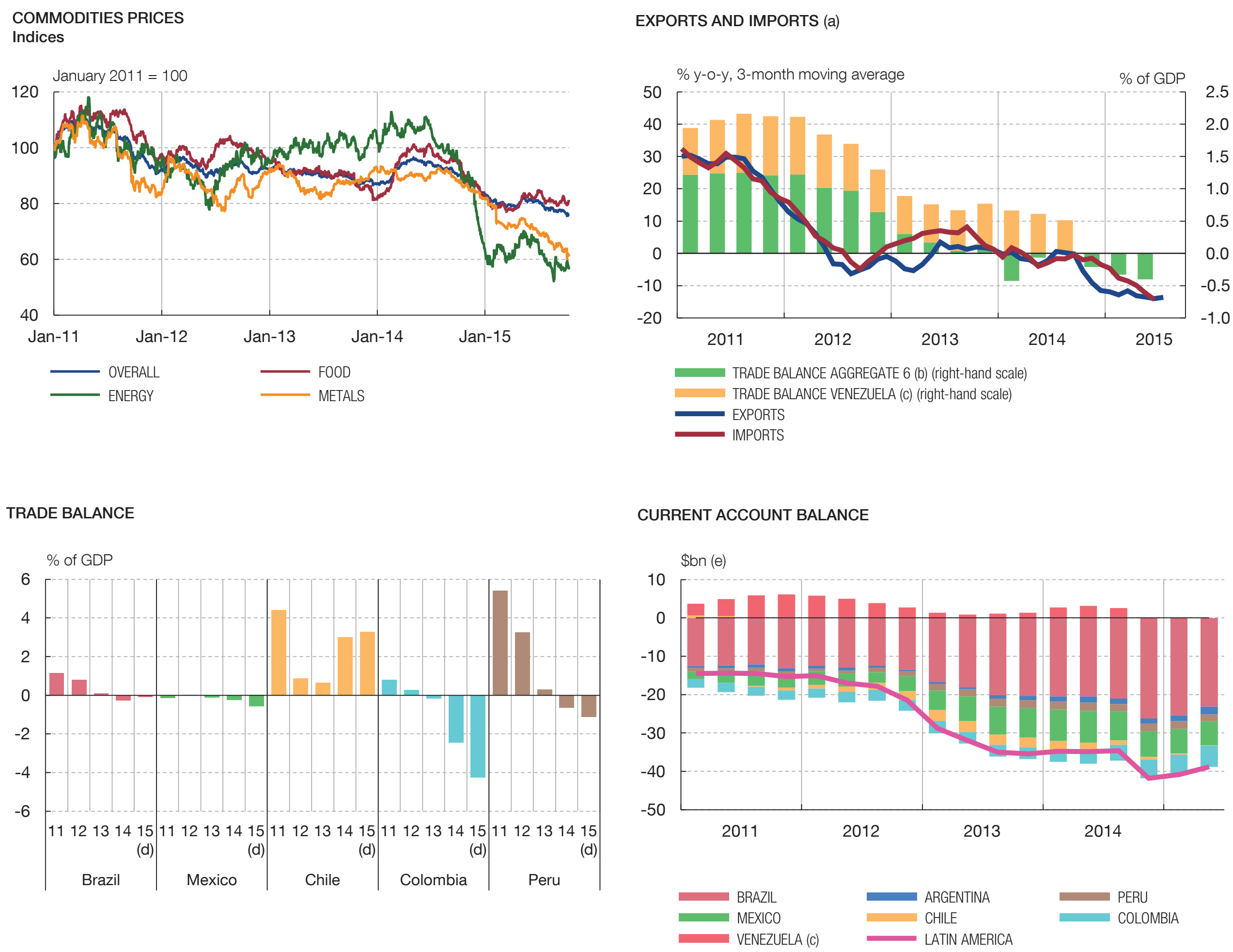
5 For more details, see World Bank (2015), «Jobs, wages and the Latin American slowdown».

on the other hand, showed greater disparities, with steep declines in Brazil, Chile and Colombia, but a upward movements in Mexico, Peru and Argentina.

Prices and economic policy

With the exception of Mexico, inflation rose in the last six months in the Latin American countries with central bank inflation targets. The average year-on-year rates of the CPI in the five countries stood at 6.3% in September, nearly 1 pp more than at the beginning of the year (see Chart 9). This increase is largely explained by the pick-up in consumer prices in Brazil (9.5% year-on-year), although an upward trend was observed in almost all

EXTERNAL ACCOUNTS AND DETERMINANTS CHART 8
Indices, year-on-year rates of change, percentage of GDP and $bn



SOURCES: Datastream, national statistics and central banks.

a Customs data in dollars.
b Latin America 6: Argentina, Brazil, Chile, Colombia, Mexico and Peru.
c Since 2014 Q4 no data is published for Venezuela.
d Four-quarter cumulative data, until 2015 Q2.
e Four-quarter moving average.

countries, despite the slowdown in activity. The depreciation of exchange rates is no doubt beginning to have an effect on household spending. Thus, inflation rose in Chile to 4.6% in September, to 5.4% in Colombia and to 3.9% in Peru, around 1 pp above the upper bound of the target range in all three countries. In contrast, Mexico benefited from the progressive fading of the upward effects of the fiscal changes of 2014 and the reforms in the telecommunications and energy sectors, and from lower US gas import prices. Inflation in Mexico, at 2.5% year-on-year, stood at the bottom of the central bank's target range. In Argentina, official inflation moderated to 14.4% year-on-year, and monthly growth to 1%, at a similar pace to the depreciation of the peso. However, private sources continue to place inflation within the 25%-28% range. Venezuela has not published inflation figures since the end of 2014 (when inflation exceeded 60%).

Core inflation also tended to rise in all countries except Mexico, standing at 8% year-on-year in Brazil and close to 6% in Chile. The breakdown of tradeable and non-tradeable goods (see Chart 9) shows that the former have experienced a continued upward trend in the last two years, reaching year-on-year rates exceeding 4%, which are very similar to those of non-tradeables, in a setting of ongoing exchange rate depreciation. Although the available country evidence does not show a significant increase in pass-through relative to the historical average, the scale of exchange rate depreciation and the perceived lasting nature of the shock seem to explain the recent rise in domestic prices. In fact, since the publication of the previous six-monthly report (see Table 2), the projected inflation rate for the end of the current year has increased by around 2 pp in Brazil, and by between 1 pp-1.5 pp in Chile, Colombia and Peru, and the 12-month inflation outlook has worsened in Chile, Colombia and Peru (see Chart 9). In Brazil, inflation is expected to fall substantially in 2016, as a result of the purely mechanical discounting of the rise in administered prices in 2015, which account for almost 25% of the CPI, and inflation expectations have decreased since the beginning of 2015, to 5.8% in August, which may suggest that monetary policy credibility has been restored, as a result of tightening.

In the area of monetary policy, Brazil's central bank raised the official interest rate by 150 bp in the last six months, to 14.25% (a cumulative increase of 650 bp over the last two and a half years (see Chart 9). Furthermore, in order to strengthen its credibility, it lowered the inflation target ranges for 2017 to 3%-6%. Peru's central reserve bank raised its official interest rate by 25 pp to 3.5% in September, for the first time in four years after inflation expectations reached the upper bound of the target range. Colombia followed, with a rise of 25 pp, and Chile also increased the official interest rate, both countries doing so in the month of October. In Mexico, the central bank continued to link its decisions in this area to the monetary policy of the Federal Reserve, although there have been recent indications that it may no longer continue to do so.

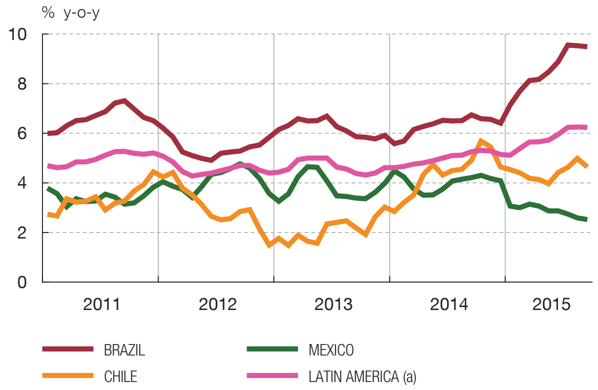
As regards fiscal policy, most noteworthy is the deviation from the deficit targets set at the beginning of the year in many of the countries, mostly as a result of lower revenue, against a background characterised by slowing activity. On average for the region, the government deficit was higher in mid-2015 than during the crisis (see Chart 10), and the primary balance turned negative for the first time since the early 2000s, mainly as a result of developments in Brazil. The fiscal adjustment in this country has proved more politically complex than expected, and the government deficit stood at more than 9% of GDP in the first half of 2015, as a result of a sharp fall in revenue and an increase in debt interest expenses. This led to one of the rating agencies withdrawing Brazil's investment-grade rating. Chile and Peru, with greater fiscal leeway (low levels of government debt and extensive external resources), envisaged some countercyclical fiscal stimulus measures in 2015. In Argentina, the primary deficit rose to -1.5% of GDP and the government deficit to more than -3%, as a result of a strong expansion of spending. The overall result, with varying degrees of intensity depending on the country, is that fiscal policy is becoming either more expansionary or less restrictive than envisaged, since expenditure is generally growing more than expected, while revenue is growing less than expected.

Trade and reforms

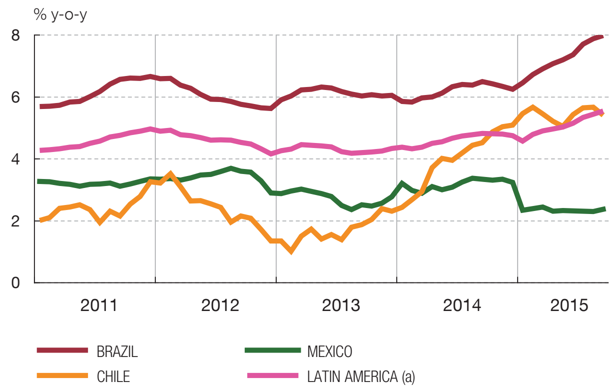
Following the change of government in Brazil and Uruguay as a result of the elections at the end of 2014, MERCOSUR announced that some of the non-tariff barriers between trade bloc members would be reviewed in less than six months with a view to removing them. Also, it ratified its commitment to submit to the European Union in November an offer to reduce tariffs by nearly 87% of total goods and services traded, to be liberalised in 15 years, which will probably include indexation clauses for Argentina in some products. Argentina and Brazil have also flexibilised the agreement restricting automobile trade between them since 2008.

INFLATION AND OFFICIAL INTEREST RATES CHART 9
Year-on-year rates of change and percentage

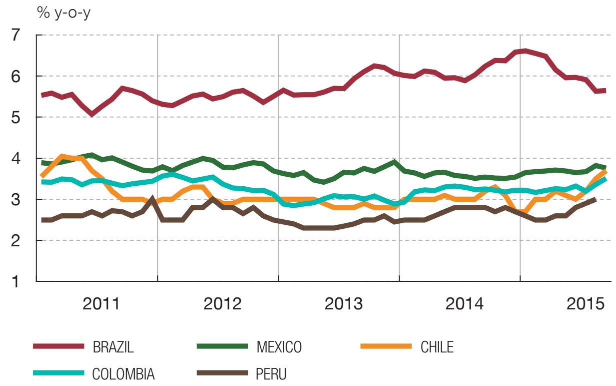
INFLATION RATE



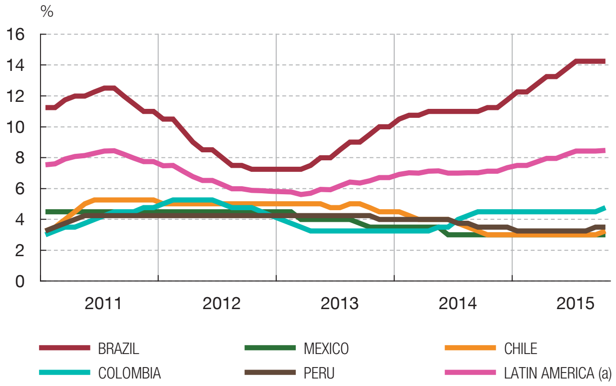
CORE INFLATION RATE



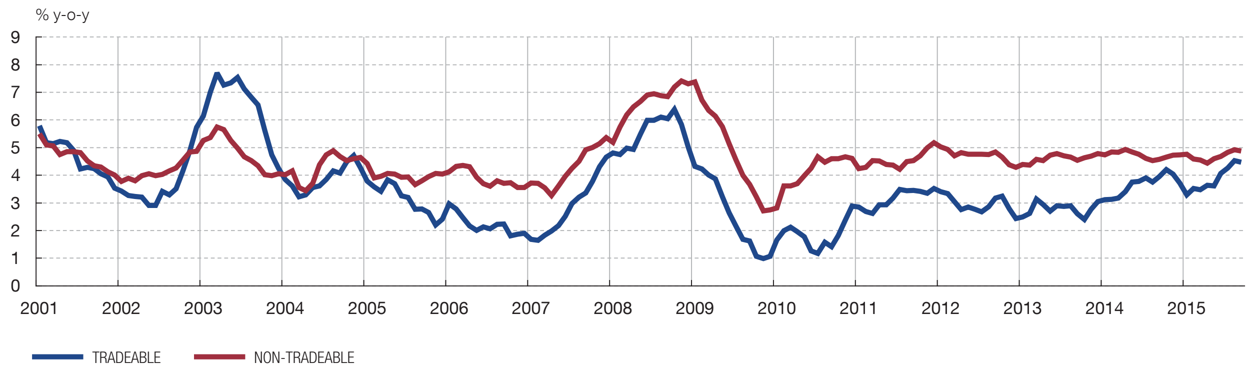
12-MONTH INFLATION EXPECTATIONS



OFFICIAL INTEREST RATES



TRADEABLE AND NON-TRADEABLE GOODS PRICES (b)



SOURCES: Datastream, national statistics and Banco de España.

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

The members of the Pacific Alliance have expressed their intention to step up intra-regional trade (which scarcely represents 5% of the total), make further headway in freedom of worker movement and forge bonds with the Association of Southeast Asian Nations (ASEAN). Also, various trade agreements are in the process of being arranged or have been signed or have come into force between Central America and South Korea, Colombia and Costa Rica, Honduras and Peru, Panama and Mexico, and Colombia and China. If the

INFLATION
Year-on-year rates of change

TABLE 2

Country	2014 Target	2014 December	2014 Fulfillment	2015 September	2015 Expectations (a)	2016 Expectations (a)
Brazil	4.5 ± 2	6.4	Yes	9.5	9.3	5.8
Mexico	3 ± 1	4.1	No	2.5	2.8	3.4
Chile	3 ± 1	4.6	No	4.6	4.5	3.3
Colombia	3 ± 1	3.7	Yes	5.4	4.4	3.4
Peru	2 ± 1	3.2	No	3.9	3.7	3.2

SOURCES: National statistics and Consensus Forecasts.

a September 2015 Consensus Forecast for the end of the year.

latter agreement comes to fruition, Colombia will become the fourth country of the region, behind Chile (2006), Peru (2010) and Costa Rica (2011) to have a free trade agreement with China. Agreements of this type normally bring the immediate liberalisation of between 60% and 90% of the signatory countries' exports to China, with indexation clauses and longer time periods for the reduction of tariffs on imports of low value-added manufactured goods. The end of September saw the signature of the Trans-Pacific Partnership (TPP) agreement, which seeks to liberalise in two years the trade between 12 Pacific rim countries (among them the United States, Japan, Canada and Australia, but not Korea or China), some of which, namely Mexico, Chile and Peru, have already signed bilateral agreements with most TPP members.

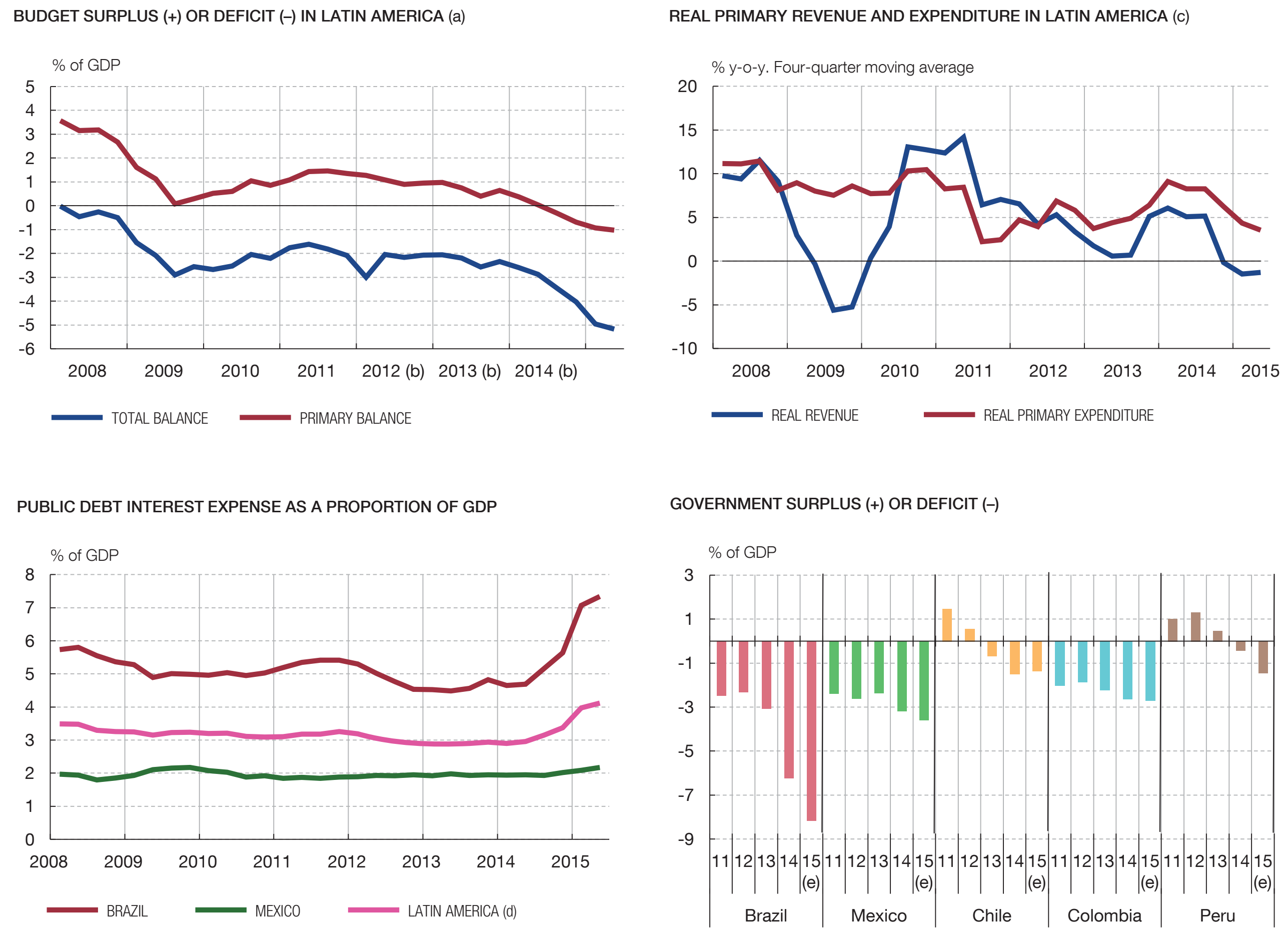
In the area of structural reforms , Mexico has conducted the first and second tenders of shared production contracts under the new legislation passed in 2013, with mixed results overall. The initial results of the non-oil energy reform were reflected in lower inflation derived from smaller petrol price rises, from the favourable effect of lower natural gas prices and from decreases in electricity rates. The telecommunications reform (approved in July 2014) also led to cuts in telephone rates through the elimination of long-distance charges and the greater competition in the sector. In Colombia the government announced the start-up of a plan to foster productivity and employment, similar to that implemented in 2013, which envisages increased government investment in educational infrastructure, public works and rural and urban housing, more investment in the regions, and sectoral measures in industry, commerce, tourism, mining and energy. The government intends to announce a new tax reform which will probably include a VAT increase, a broadening of tax bases, cuts in fuel subsidies, the elimination of certain exemptions and new taxes.

Economic developments by country

The recession deepened in *Brazil* in 2015 Q1 and Q2 (with quarterly decreases of –0.7% and –1.9%), after a year of stagnation. In year-on-year terms, GDP fell by –2.6% in Q2 after contracting by –1.6% in Q1, as a result of a sharp adjustment in domestic demand, which was hit by the slump in private consumption (–2.7% year-on-year in Q2) and by the fall in investment (–11.9%) against a background of sharp deterioration in business confidence. The depreciation of Brazil's currency helped the positive contribution of external demand to growth, although the continuing fall in imports also reflected the adjustment of domestic demand (11.7% year-on-year in Q2). The indicators of 2015 Q3 continue to point to a deepening of the recession, with signs of deterioration in the labour market. Inflation was 9.5% year-on-year in September, after having stood all year above 6.5%, the upper limit of the central bank's target band. Despite this, the inflation expectations for 2016 have decreased since the beginning of the year, possibly as a result of the monetary policy

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and year-on-year change

CHART 10



SOURCES: Datastream and national statistics.

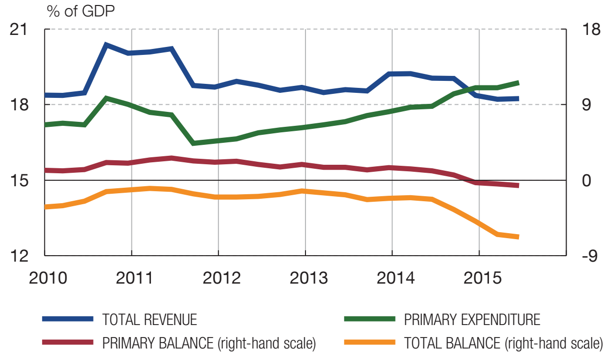
a Aggregate of the seven main economies, as a GDP-weighted average of the region.
b In Venezuela, 2012 quarterly data estimated from annual data. From 2013, aggregate excluding Venezuela.
c Latin America 5. Weighted average.
d Latin America 6. Weighted average.
e Four-quarter cumulative data, until 2015 Q2.

tightening, which raised the official interest rate to 14.25%. Also, the funding of public-sector banks was restricted. As a sign of its commitment to low inflation, the central bank reduced its inflation target range to 3%-6% for 2017. In the tax sphere, the cumulative primary balance for the twelve months to July decreased to –1% of GDP (see Chart 11), and the deficit rose sharply to –9.1% of GDP, contributing to an increase in public debt, which reached 63% of GDP. Against this backdrop, and in view of the difficulty in approving the envisaged fiscal adjustment measures, the government announced a reduction in the primary surplus to 0.15% of GDP (1.1% previously) for the current year. Further, the 2016 draft budget, which targets a primary surplus of 0.7% of GDP, and a fiscal adjustment package were submitted to parliament, it being uncertain whether they would be approved. Following the revision of the sovereign debt credit rating, the Brazilian real depreciated by roughly an additional 10%, prompting another intervention by the central bank in the foreign exchange market by means of currency swaps under a programme discontinued at the start of the year. Regarding the external sector, the current account deficit improved to –4.3% of GDP and financial inflows decreased considerably, including most notably direct investment, which fell by –24%.

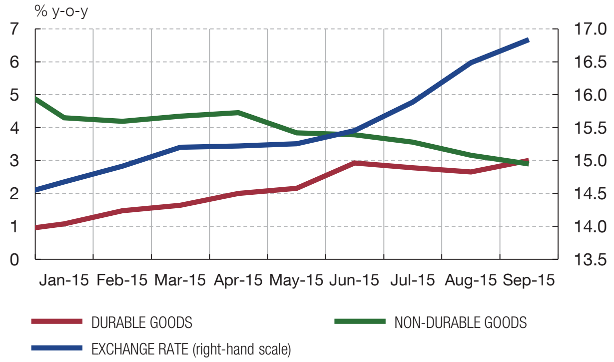
BRAZIL AND MEXICO

CHART 11

BRAZIL. CENTRAL GOVERNMENT OUTTURN



MEXICO. FEED-THROUGH OF DEPRECIATION TO PRICES



SOURCE: National statistics.

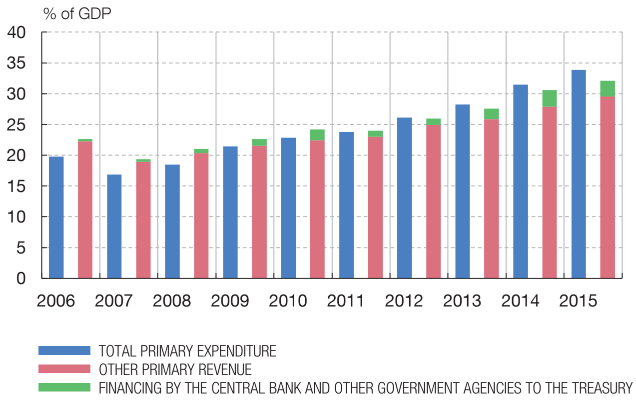
In 2015 H1 the economic recovery lost some steam in *Mexico*, with year-on-year growth rates at 2.6% in Q1 and 2.2% in Q2. Notable developments in recent economic activity are the positive contribution to growth of net external demand, based on the strong performance of exports buoyed by higher US demand for manufactured products and by a weaker peso, factors which served to offset the lower revenue from oil exports. On the domestic demand side, the most dynamic component was private investment, particularly in capital goods (up by nearly 10% in the half), although public investment also recovered somewhat. Private consumption advanced by 3% in the half, underpinned by the buoyancy of the labour market, which continues to benefit from the employment programme, and by the quickening growth of credit to the private sector. The data published for 2015 Q3 point to the persistence of a moderate pace of activity. Against this background, inflation continued its downward trend, reaching 2.5% year-on-year in September, i.e. in the bottom half of the central bank's target band, and the underlying rate remained around 2.3%. The slack in productive capacity, and the lower electricity, telecommunications and petrol prices, helped to maintain this favourable scenario, despite the depreciation of the currency (see Chart 11). The central bank held its official rates at 3% and its announcements continued to point towards synchronisation with the Federal Reserve's process of normalization. In the fiscal sphere, the public finances worsened slightly, since the deficit of –3.6% of GDP in Q2 was 0.4 pp more than in 2014 as a result of expenses accelerating with respect to revenue. The current account balance showed a deficit of –2.2% of GDP in H1 (–1.9% in 2014) owing to the higher trade deficit, which, with a fall of –43% in oil exports, amounted to –0.6% of GDP. The volatility of the peso and the anticipated commencement of the normalisation cycle in the United States led the central bank to step up its intervention in the foreign exchange markets, raising the daily amount for sale to $200 million (previously $52 million) and to reduce from 1.5% to 1% the depreciation necessary to activate the tender mechanism. As a result, the international reserves fell by $3,459 million.

The GDP of *Argentina* in 2015 Q2 grew by 0.5% quarter-on-quarter (2.3% year-on-year), after rising by 0.7% in Q1. The most notable feature was the strength of government consumption, which again acted as the main engine of growth, increasing by 10.3% year-on-year, although investment also showed considerable dynamism, with year-on-year growth of 4.6% in 2015 Q2, driven by the buoyancy of construction. Private consumption showed timid growth in H1 of 0.8% year-on-year. The contribution of the external sector turned negative at -0.4 pp, as a result of the reactivation of imports, mainly in the capital

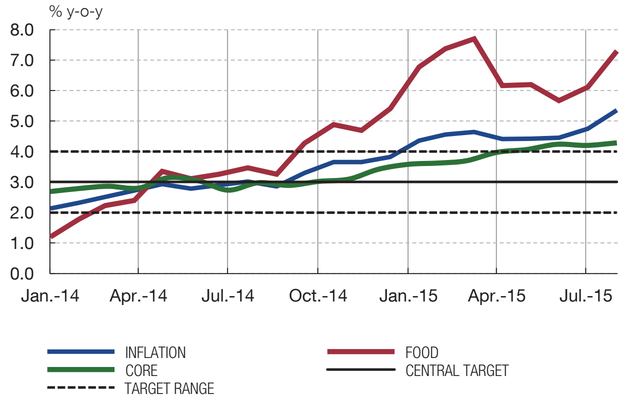
ARGENTINA AND COLOMBIA

CHART 12

ARGENTINA: PRIMARY REVENUE AND EXPENDITURE



COLOMBIA: INFLATION



SOURCE: National sources.

goods component, which benefitted in part from the slow depreciation of the nominal exchange rate and the fall in exports. As a result, the current account deficit increased in in 2015 H1 owing to the sharp drop in the trade surplus. The situation of Brazil, the loss of competitiveness with respect to other emerging countries and the low price of agricultural exports, particularly soya, point to significant external pressure in the future. The official inflation rate decreased gradually during the year to stand at 14.7% in August, as a result of the low rate of depreciation of the peso. International reserves have risen by nearly $2 billion, owing to the placement of debt issues by the government in the year and the activation of most of the Chinese yuan swap. The latest economic indicators show that the rate of expansion of the economy has held firm, buoyed by an increase in real wages and a very loose fiscal policy. Accordingly, the sharp fiscal imbalance and its financing through currency issuance continue to be the main risk of the Argentine economy (see Chart 12). The primary deficit has expanded significantly in the year to date, standing at –1.6% of GDP, with expenditure growing by more than 40% in nominal terms, particularly social security expense and private-sector subsidies, while revenue grew by around 30%. The government deficit is estimated at around –3.3% of GDP in Q2 (–2.5% in 2014), while monetary financing has held at somewhat more than 2% of GDP.

In *Chile,* GDP stagnated in 2015 Q2 after the recovery of activity since end-2014. This lower growth can be attributed above all to a smaller contribution from external demand. Domestic demand also showed signs of weakness, since private consumption grew little under the effects of the worsening labour market, and investment shrank again in a setting of lower business confidence and political and economic uncertainty; in addition, the change in stockbuilding increased significantly. The downtrend in inflation since the beginning of the year ceased in May and the inflation rate returned to the central bank's target range (4%-2%). Subsequently, exchange rate depreciation spurred inflation once again, and in August it posted growth of 5% year-on-year, which has raised longer-term inflation expectations to 3.5%. Against this background the central bank held the interest rate at 3% until October, when it raised it by 25 bp. In the fiscal sphere the deficit was –1.8% of GDP (–1.5% in 2014) as a result of lower revenue from copper. In the external sector, the more favourable performance of the terms of trade enabled the trade surplus to remain somewhat above that recorded in 2014. Meanwhile, the current account deficit fell to 0.1% of GDP owing to the smaller payments of mining income to the rest of the world.

In *Colombia,* after the sharp moderation in growth in 2014, activity steadied at rates around 3% in 2015 H1. Notably, the contribution from domestic demand dropped to 2.8 pp in Q2 from 7.4 pp in 2014, mainly as a result of the adjustment in investment (which slowed to very moderate growth of 1.9% year-on-year), reflecting the worse outlook of the oil sector. The high-frequency indicators suggest that the deceleration will continue in H2. For its part, inflation held on an upward path throughout 2015 to reach 5.4% year-on-year in September, partly due to the sharp rise in food prices (see Chart 12). Also, the depreciation of the currency (nearly 30% with respect to the dollar) fed through partly to inflation and the medium-term inflation expectations started to edge upwards to stand at 3.5% in September, at the top of the central bank's target range. Against this background, in September the central bank raised the official interest rate by 25 bp to 4.75%. According to the government's latest projections, this year the government deficit will reach –3% of GDP (–3.8% in 2016), 0.8 pp more than expected, as a result of the lower oil prices and lower economic growth. In the external arena, the current account deficit rose to –6% of GDP in H1, again due to the low oil prices, which took the trade deficit to a record high of –4.2% of GDP. Foreign direct investment in H1 (4.5% of GDP) fell by –22.5%, dragged down by the mining and energy sectors (–40%).

In 2015 Q2, the GDP of *Peru* rose by 1.2% quarter-on-quarter (3% year-on-year), following an increase of 0.5% in Q1. However, some further quarters are needed to be able to say that a sustained recovery of activity is in sight. Growth was underpinned by private consumption (3.3% year-on-year in Q2) and by government consumption (9.1% year-on-year), while investment continued to decline (–9.7% year-on-year), as a result of sub-national government budget outturn problems and of lower mining investment. The contribution of the external sector to growth turned positive in Q2 at 0.2 pp, since imports contracted more than exports, which fell somewhat more slowly. The high-frequency indicators suggest that in H2 economic activity will gradually improve, underpinned by the improved performance of the mining sector, although a more severe manifestation of the *El Niño* phenomenon constitutes a risk to growth. In 2015 H1 the current account deficit stood at –3.9% of GDP due to the higher trade deficit caused by the sharp fall in mining exports. Inflation increased continuously to reach 4% in August, against a background of currency depreciation which ended up raising the medium-term inflation expectations to nearly 3%. In this setting, the central bank raised the interest rate in September by 25 bp to 3.25% and stepped up its foreign exchange interventions.

In *Venezuela,* the latest available GDP figures relate to 2014 Q3, but the scant economic indicators available suggest that in 2015 the economy remains in deep recession. Inflation figures since the end of last year are also lacking. The available estimates for the private sector indicate that it may be growing at 3-digit rates, due to disruptions in the supply of products as a result of the scarcity of foreign currencies for import purposes, to the increase in the money supply for financing the government deficit (which, on partial Treasury budget outturn data, is estimated to be as high as 25% of GDP) and to effective exchange rate depreciation. International reserves stood at $16.3 billion, the lowest level since the beginning of 2003 (3% of GDP), of which $6.5 billion may be liquid and the rest is in gold. In order to preserve the level of reserves, the government has taken various measures, including the withdrawal of a part of the country's position in SDRs in the IMF, more stringent exchange controls, the reduction of shipments abroad of subsidised oil, the granting of discounts in debt collections from countries belonging to Petrocaribe and, fundamentally, the signature of various financing agreements with China, for nearly $15 billion.

23.10.2015.