REPORT ON THE LATIN AMERICAN ECONOMY: FIRST HALF OF 2015

Introduction

In 2014 the economic activity of Latin America grew at a rate of 1.3%, the lowest of the past decade except for 2009 when the region felt the brunt of the global financial crisis. This performance prolonged a four-year low-growth phase that was triggered mainly by external factors (such as the end of the commodity price boom or the decline in the momentum provided by China) but in which domestic factors have loomed increasingly large, particularly in the main South American economies. Thus in 2014 the continued decline in the terms of trade (which accelerated in the second half of the year for the oil exporting countries due to the oil price slump), the weak foreign demand (particularly from China) and the tighter external financial conditions were among the key determinants of the sluggish activity in the region. However there were also domestic factors contributing to the low growth, such as the fall in investment against a background of worsening confidence or, in some cases, the application of restrictive macroeconomic policies. Against this backdrop, in 2014 two countries (Brazil and Venezuela) were hit by “technical” recessions of varying intensity; another two (Chile and Peru) underwent significant dips in growth to annual rates of 1%-2%, well below their potential rate, while Colombia and Mexico showed greater resilience in the year as a whole.

Inflation remained relatively high on average in the five countries with stated inflation targets, in a setting of exchange rate depreciation and in contrast to the consumer price containment at global level. There were, however, significant differences between countries. In Brazil inflation rose significantly in early 2015 (to 8.1% year-on-year in March, due partly to the rise in administered prices), while in Colombia, Chile, Mexico and Peru year-on-year inflation was more moderate. A case apart are Argentina and Venezuela, with inflation rates of around 20% and 65% (the highest in the world), respectively, as a result particularly of monetary financing of the budget deficit.

The region is addressing the new economic scenario (change of monetary cycle in the United States, trend towards deceleration in China, low commodity prices) with some strengths, albeit also with vulnerabilities. Notable among the latter is the worsening of current account balances in many countries as a result of the decline in the terms of trade, not counteracted by exchange rate depreciation for the time being, except in Chile. The ability of monetary and fiscal policies to deal with a less favourable external environment and slowing domestic demand varies from country to country, but is generally considered to be less than in 2008 and 2009. Further, while the shocks currently affecting the region are of a more permanent nature or the output gap is closed, expansionary demand policies are not appropriate and the counter-cyclical policy response must be more limited. In any event, save in Brazil, monetary policies are now highly accommodative. The fiscal policy response is proving to be more heterogeneous, since in some countries it is moderately counter-cyclical, while in others it is clearly contractionary. The main strengths lie in the high levels of international reserves, the limited public-sector indebtedness and the (controlled) exchange rate flexibility. Despite this, the short-term outlook is for low growth on average across the region, due to the absence of external stimulus and the ongoing recessionary climate in certain large economies representing nearly 50% of the region’s GDP. Exchange rates are acting as the first shock absorbers (see Chart 1) and should help to adjust relative prices and the composition of demand. In any event, there is a need for structural reforms to restimulate growth based on factors less dependent on the foreign sector.

TERMS OF TRADE AND REAL EFFECTIVE EXCHANGE RATE

CHART 1

SOURCES: National sources and JP Morgan.

External environment

The performance of the world economy in 2014 H2 and so far this year has been shaped by three main inter-related developments: the deceleration of the Chinese economy and the change in its growth pattern, the sustained appreciation of the US dollar (driven by the divergence in the monetary policy cycles of the main advanced economies, with the euro area and Japan pressing ahead with their monetary expansion, while the United States may see interest rate rises this year) and the sharp fall in oil prices. Indeed, after some years of relative steadiness (around $110 per barrel of Brent), in summer 2014 oil prices started a dive which in mid-January 2015 culminated in lows of around $45 per barrel of Brent. They subsequently recovered to $60 per barrel and have held at somewhat below that level since mid-February. Food and metal prices showed a slightly downward trend in this same period.

The main advanced economies have performed relatively favourably and in recent months the cyclical divergences between them have narrowed somewhat as a result of Japan's exit from its technical recession, the recovery in the euro area and slightly worse-than-expected macroeconomic figures in the United States (although this economy's buoyant prospects remain in place for the coming quarters). In these economies the strengthening has generally been underpinned by the recovery of private consumption, fostered by favourable monetary and financial conditions and by the increased purchasing power of households associated with improved labour markets and lower inflation. In contrast, business investment continued to show a certain weakness. Meanwhile, the behaviour of economic activity differed notably across the various emerging regions, partly reflecting the impact of the fall in oil prices, according to each economy's reliance on this commodity. In particular, emerging Asia's economies performed positively, although China continued its gentle slowdown, which proceeded in parallel with the rebalancing of the economy towards a more sustainable model which gives greater weight to domestic consumption.

With the exception of some emerging areas, inflation held at very low rates (negative in some cases), which allowed numerous central banks both of advanced and emerging economies to intensify the expansionary stance of their monetary policies, in contrast to the expected tightening of interest rates in the United States.

The monetary policy divergences of the main central banks and the fall in oil prices shaped the behaviour of the international financial markets. Until mid-January there were increases in volatility, driven by diverse factors: political uncertainty in Greece, risks associated with the drop in oil prices (doubts as to the resilience of some oil exporting economies and the risk of deflation in some developed economies) and geopolitical tensions, most notably in Russia. Subsequently, from end-January, the announcement of the ECB's asset purchase programme and the expansionary measures adopted by other central banks, along with the partial rebound in and subsequent stabilisation of oil prices, mitigated investors' risk aversion. In any event, throughout the period analysed, the divergence of the monetary policy cycles of the main advanced economies has been reflected in a higher increase in the volatility of foreign exchange markets than in that of other segments. In this respect, the dollar continued appreciating against the major currencies. By contrast, ten-year government debt yields did not reflect the differences between economies to the same extent, but rather declined across the board in the first part of the period, in a flight to quality, and subsequently rose slightly.

In turn, the emerging financial markets deteriorated sharply from the beginning of October 2014, basically because of the oil price slump which particularly affected oil exporting countries. Thus some countries considered vulnerable, such as Russia, saw their most severe stock market falls and widening of sovereign spreads since the collapse of Lehman Brothers, although other markets previously notable for the strength of their fundamentals, such as Mexico, Colombia or Malaysia, were also profoundly affected. In addition, the appreciation of the dollar lessened the appeal of carry trade transactions in the emerging markets and led to positions being unwound in the most liquid markets, initiating a period of capital outflows.

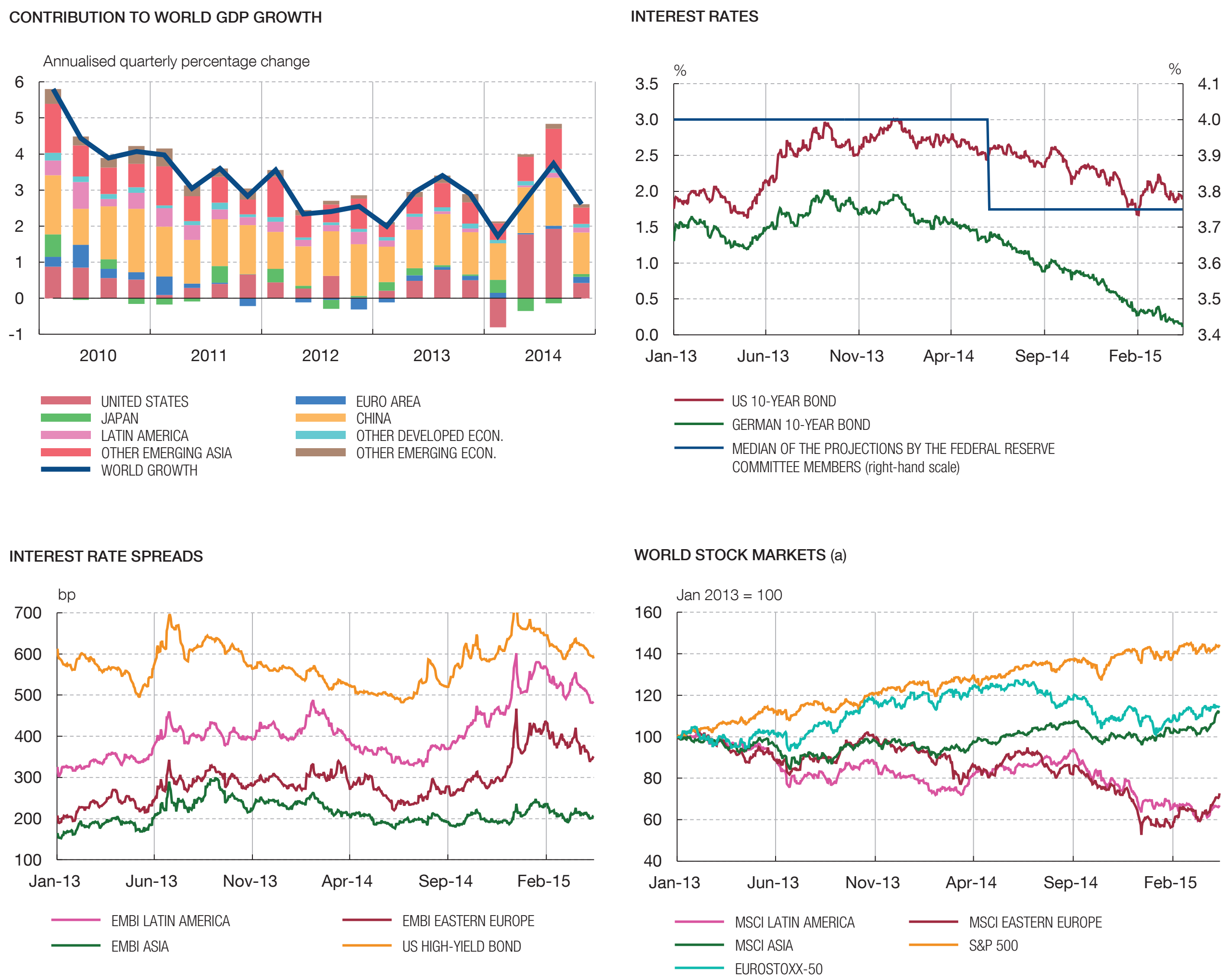
Latin American financial markets and external financing

Against this background, the Latin American stock markets performed less favourably than those of the other emerging economies (see Chart 2), since commodity-related firms have a greater weight than in other regions. The Latin America dollar-denominated MSCI index fell by 22.6% between October 2014 and March 2015, compared with the decline of 20.9% in eastern Europe or the rise of 4.6% in Asia. Excluding mining or oil-related sectors, the fall in the Latin America index is markedly smaller (see Chart 3). Notable in local currency terms is the fall in the stock markets of the countries most affected (commercially and fiscally) by the fall in oil prices and in commodities in general (see Chart 3), such as Colombia (where the market fell by 27% between October and March), Peru (with a drop of 22%) and Mexico (with a decline of nearly 10% to year-end, although the market subsequently recovered when oil prices bottomed out and began to recover slightly).

The fall recorded by Brazil (8% in the months examined) is more associated with idiosyncratic factors, such as the completion of the electoral process at end-October, the announcement of restrictive monetary and fiscal policies against a background of markedly weak activity, the difficulty in approving these adjustment measures in Congress, and the problems besetting the state oil company Petrobras, including the downgrading of its credit rating to below investment grade.

The sovereign spreads of Latin American countries similarly trended upward from October, increasing by nearly 130 basis points (bp) to end-March, a worse performance than that of the other emerging areas (increase of 100 bp in eastern Europe and no change or a slight decrease in Asia) (see Chart 2). Again, this performance was determined by the sovereign spreads of the oil exporting countries (see Chart 3), such that the sovereign spread of the region excluding those countries widened by nearly 40 bp, compared with an increase of more than 350 bp for the oil exporting countries (80 bp excluding Venezuela). Argentina's sovereign spread held steady or tended to narrow, in the absence of any news on external debt default since summer 2014, while Venezuela's reached all-time highs as the oil price slump eroded the country's main strength (its current account surplus) and the level of

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



SOURCES: Datastream and JP Morgan.

a Stock market indices in dollars.

liquid reserves dropped below the external debt payments scheduled for 2015, raising the probability of default. The sovereign spreads of Chile and Peru widened moderately (by 17 bp and 30 bp, respectively) in view of their relatively low levels of vulnerability, while that of Brazil increased by nearly 100 bp for the idiosyncratic reasons described earlier. Long-term bond yields on local markets did not, on the contrary, show significant upward movements and generally remained at the levels reached after the May 2013 turmoil.

In keeping with the behaviour of sovereign spreads, the credit risk premia reflected in CDSs increased throughout the region. In Venezuela the CDS premium rose by nearly 5,000 bp, meaning that from early January the markets are discounting a probability of default of 100%. For Brazil and Peru, the premia would be compatible with a sovereign rating of BB-, two notches below the average rating of the region (BB+), and a downgrading of one notch with respect to October 2014. The markets are also factoring in sovereign rating downgrades in all countries, especially in Brazil (three notches, so it would lose its investment grade).

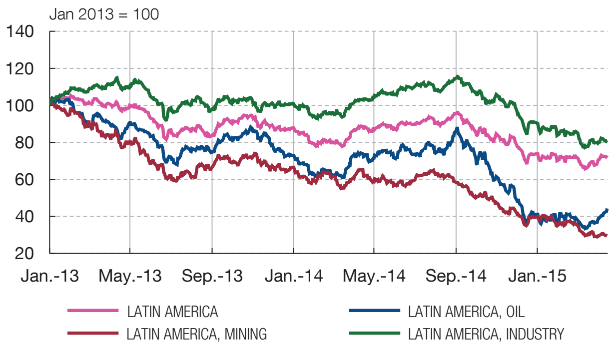
Between October 2014 and March 2015, exchange rates showed a general tendency to depreciate against the dollar, more sharply in Mexico (-12%), Colombia (-23%) and Brazil

FINANCIAL INDICATORS

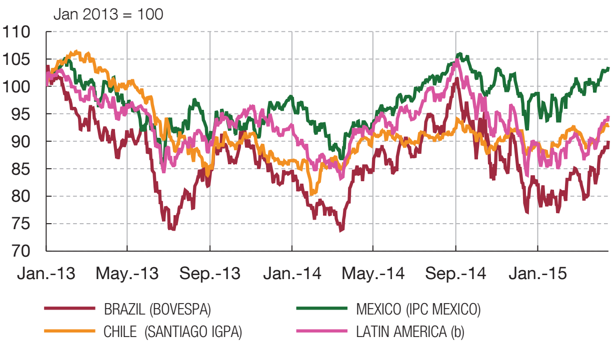
Indices, basis points and percentage points

CHART 3

STOCK EXCHANGE INDICES (a)



STOCK EXCHANGE INDICES



SOVEREIGN SPREADS

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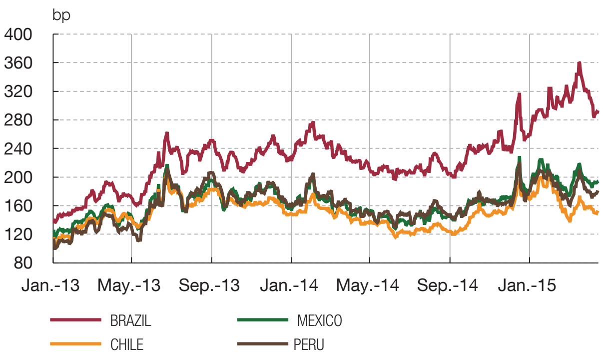
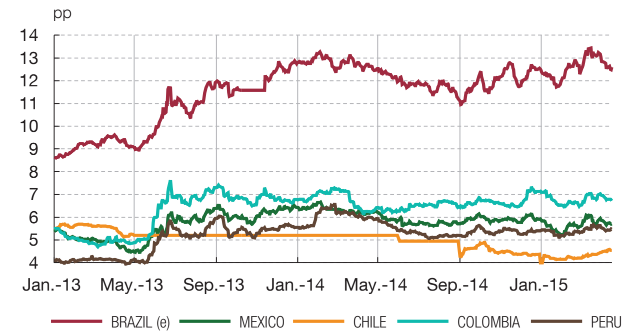
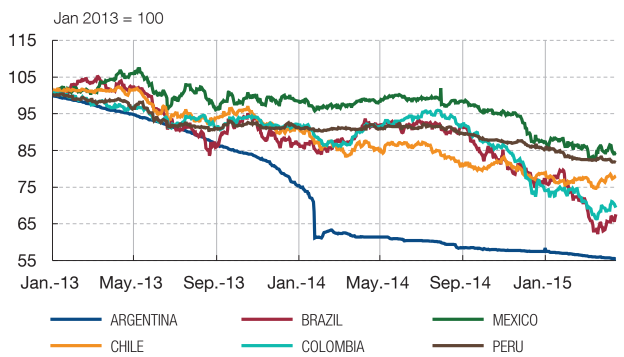


SOVEREIGN SPREADS

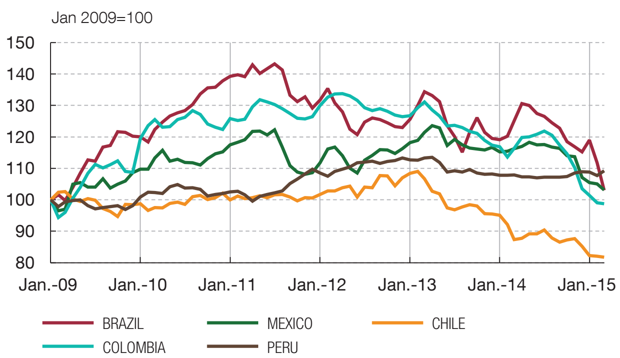
MEDIUM-TERM BOND INTEREST RATE IN LOCAL CURRENCY (d)



NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



REAL EFFECTIVE EXCHANGE RATE



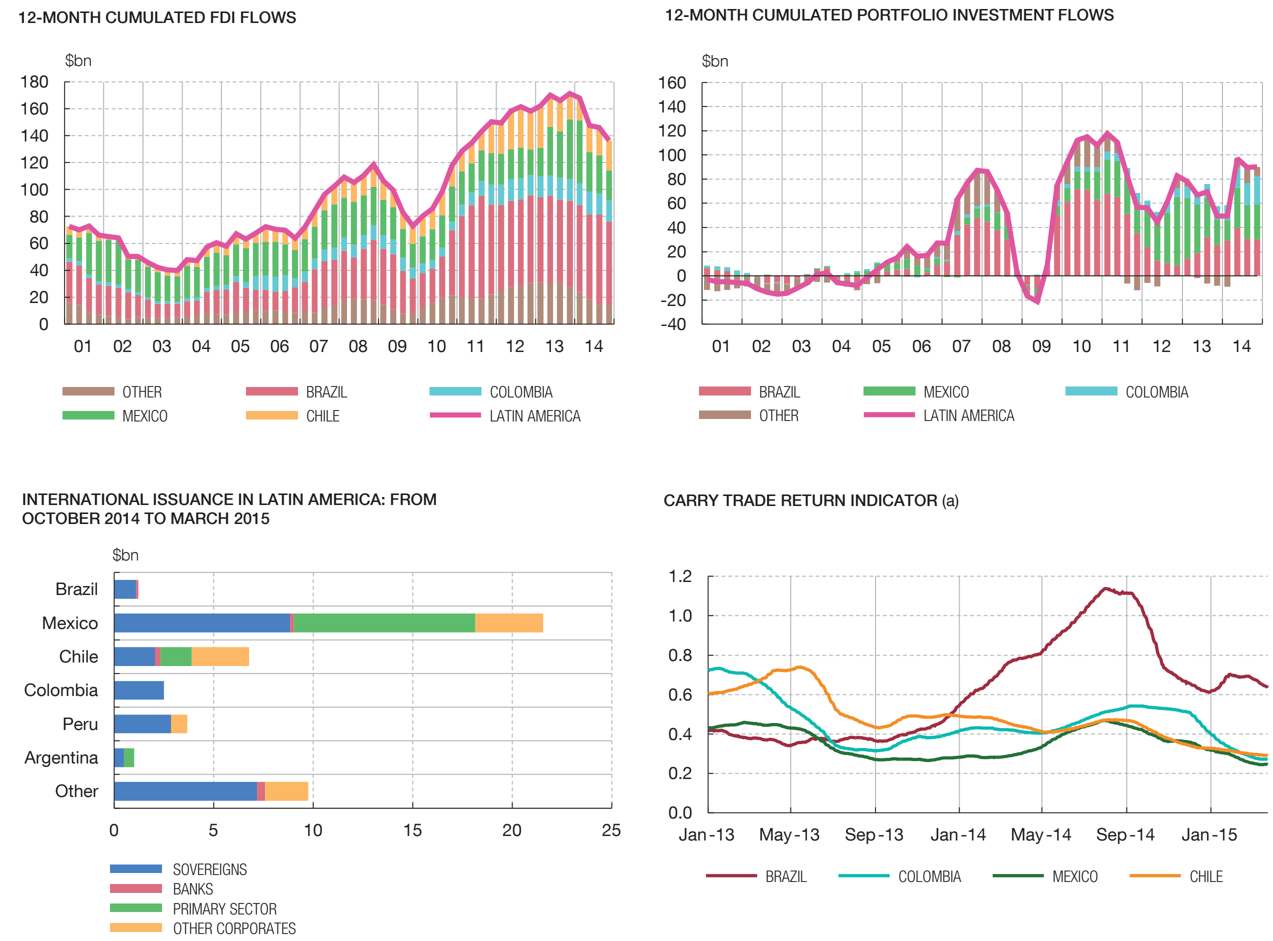
SOURCES: Datastream, JP Morgan, Bloomberg, Banco Central do Brasil and national statistics.

a Stock exchange indices in dollars.
b MSCI Latin America index in local currency.
c Bolivia, Ecuador, Colombia, Mexico, Venezuela.
d 10-year government bonds in local currency.
e 5-year interest rate swap.

EXTERNAL CAPITAL FLOWS AND FINANCING

$bn, percentage points and years

CHART 4



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

a Short-term interest rate spreads against the dollar divided by the volatility of exchange rate options.

(-25%, where the real dipped to 3.3 reais per dollar, its lowest level since 2003) than in the rest of the region (see Chart 3). In addition to the above, another factor in the depreciation of the Mexican peso and the Brazilian real was probably their more liquid and deeper financial markets, which are better equipped for currency hedge transactions than less liquid markets. The sharp depreciation of these currencies led to the reactivation of the official intervention programme in Mexico, to renewed interventions via swaps in Brazil (this programme was finally discontinued in March) and to the non-renewal of the dollar purchase programme in Colombia. In Venezuela a new foreign exchange market was started up in which foreign currencies can be freely bought and sold at exchange rates which are 96% lower than the official rate and near the parallel exchange rate, although the volume of transactions is very small. This behaviour of nominal exchange rates has passed through, at least in part, to real rates, reversing in some cases the loss of competitiveness accumulated since 2009 (see Chart 3).

The information available on capital flows indicates an appreciable moderation of capital inflows into the region in 2014. This is explained by the decline in direct investment, which is the non-callable component of financial flows. Thus direct investment inflows into Latin America as a whole amounted to $140 billion (in annualised terms) in 2014 Q4, compared with $175 billion in 2013 (see Chart 4). This fall to levels similar to those of mid-2011 arose basically from the decline in inflows into Mexico ($21.6 billion less than in 2013) and, to a lesser extent, into Brazil ($6 billion less). Thus the basic balance (percentage of the current account deficit covered by direct investment) worsened in nearly all countries, falling below 1 in Brazil, Colombia and Peru, indicating a greater reliance on debt to finance their growing external imbalances. However, portfolio inflows increased during the year in all countries, particularly in Colombia, Mexico and Brazil (in the latter two cases, in shorter-term instruments), although they moderated towards the end of the year, in keeping with the loss of the attraction of carry trade transactions in some of these markets (see Chart 4).

Finally, between October 2014 and March 2015, fixed income issuance by the region decreased substantially with respect to the previous six months (to $47 billion from $61 billion), basically as a result of the sharp fall in placements in Brazil, where the corporate sector issued only $1.1 billion, compared with more than $27 billion in 2014 H1. The absence from the market of Petrobras, which had raised $13.6 billion in the first six months of last year, largely explains this decrease; in fact, Petrobras has announced an asset sale programme to finance part of its operations. Contrastingly, placements in Mexico rose from $15.6 billion in April-September 2014 to $22.5 billion in the half-year under examination, with increased activity by the state oil company (43% of total issuance) and the government (39% of the total). So far the conditions of these issues have not changed substantially and in fact there has been a slight fall in primary market interest rates and a lengthening of maturities, with the exception of issues in Brazil, although, as noted above, their volume has been extraordinarily low.

Activity and demand

Amidst the general trend of deceleration, the most notable features of activity and demand patterns in late 2014 were the unevenness of growth rates and the diversity of cyclical positions. In some countries, such as Brazil, the deceleration has probably not touched bottom. By contrast, in others, such as Chile, there are signs of steadiness and even of recovery of demand. Meanwhile, in Mexico, a recovery based on foreign demand continues to gather strength, although growth was lower than expected in 2014. These divergences between countries derive, firstly, from the differing momentum of their main trading partners (pick-up in the United States and slowdown in China) and, secondly, from agents' expectations as to macroeconomic policy management and the boost to structural reforms (which seem to have been positive in Mexico and more uncertain elsewhere). Also, the oil price slump since October is impinging positively on the growth prospects of countries such as Chile which import most of the energy they consume, but extremely negatively on the activity and the external and fiscal position of some of the region's main oil exporters (see Box 1). In a positive light, the exchange rate depreciation, insofar as it does not pass through to inflation, will foreseeably allow external demand to make a greater contribution to growth in 2015.

Specifically, the pace of change of activity in the region slowed further in 2014, since GDP grew by 1.3% in the year as a whole, 1.3 percentage points (pp) less than in 2013. The regional average for 2014 H2 indicates that growth stabilised at very low rates under 0.5% in quarter-on-quarter terms (see Chart 5). Thus the year-on-year GDP growth rates of the six main economies (excluding Venezuela, because its Q4 figure has not yet been released) went from 0.9% year-on-year in Q3 to 1.1% in Q4 (see Table 1). These low growth rates are largely explained by the marked weakness of the Brazilian economy, whose GDP fell in year-on-year terms by 0.6% in Q3 (revised down from the initial figure) and by 0.2% in Q4. For its part, Venezuela underwent a contraction in activity of nearly 3% in the year, albeit with an upward pattern throughout. The rest of the region exhibited uneven trends: Mexico

Oil prices, which had shown a certain stability on international markets until mid-2014, began to fall in July, collapsing as from October. Specifically, the price of a barrel of West Texas Intermediate (WTI) – the benchmark for Latin American oil exporters – fell from $90 per barrel in September to $44 in mid-January 2015, although it has recently rebounded to over $55.[1] The impact on Latin America of this shock differs greatly from country to country, given that some economies import practically all the oil they consume (such as Chile and some of the Central American countries), and in others oil is an export product (in the case of Venezuela, almost the only export good) and a source of substantial tax revenues. For the former, the decline in oil prices is a positive supply-side shock that raises agents' purchasing power and generates gains in competitiveness, as it lowers output costs; moreover, by reducing expenditure abroad, the trade balance improves. For the latter, in contrast, a reduction in foreign revenues ensues and, therefore, a deterioration in the trade balance, with consequences for disposable income and also for public finances.

1 Levels of $50 per barrel of West Texas intermediate (WTI) entail a 60% decline from the 2008 peak. However, it should be borne in mind that each country has its own price for the crude it exports, which will depend on its quality, transport costs, etc. For example, the Venezuelan mix has a price close to 10% below WTI; however, its rate of change is very similar to that of WTI.

This Box analyses the effects of the decline in oil prices in three of the region's main oil exporting countries: Colombia, Mexico and Venezuela. Although in the three instances the impact is adverse, there are highly significant differences between them. Firstly, because the predominant transmission channel is different: Colombia is chiefly affected by the trade channel, Mexico by the impact of tax revenues and Venezuela by both (see Panel 1). Secondly, because during the commodity boom years the reaction of the local oil industry and of the economy as a whole was different: in Colombia, the oil sector gradually gained in importance, to the extent that it now accounts for 5% of GDP; by contrast, in Mexico, where the economy is more diversified, the weight of the oil industry has systematically diminished, now also representing 5% of GDP; lastly, in Venezuelan the oil industry is strategic (11% of GDP), but output has stagnated in the last six years. Thirdly, because the current macroeconomic situation and, therefore, economic policy leeway differ greatly.

A first sign of the scale of these effects is discernible in the downward revision of the expected GDP growth in these three countries. Indeed, an increase in activity of 3.6% is expected for Colombia in 2015, compared with 4.8% in 2014; in Venezuela a contraction of 7% is anticipated; and in Mexico's case the expectations of a boost to medium-term growth induced by the energy reform approved some months ago have eased most appreciably.

1 WEIGHT OF THE OIL SECTOR IN THE ECONOMY

Country	Production (bn bpd)	Average oil price 2014 Q4 ($)	% of exports	% of tax revenue	% of GDP
Mexico	2.2	66.3	11	30	5
Colombia	1.0	62.9 (a)	53	20	5
Venezuela	2.4	64.5	96	47	11

SOURCE: National statistics.

a Crude oil sale price of Ecopetrol.

2 MACROECONOMIC SITUATION AND POLICY ROOM FOR MANOEUVRE

Country	Fiscal balance as % of GDP	Current account balance as % of GDP	Reserves as % of GDP	Fiscal rule (year of application)	Oil stabilisation fund, as % of GDP
Mexico	-3.2	-2.1	15	2014	0.3
Colombia	-2.4	-4.2	13	2014	0.2
Venezuela (a)	-14.9	+2.9	6	—	—

SOURCES: National statistics and IMF.

a Estimated from 2011 central government data.

In a more detailed analysis, the biggest effect through the trade channel[2] is seen in Venezuela, where a 10% decline in oil prices would entail a 6% drop in exports and a cut in the current surplus of 0.5% of GDP. Hence, the decline in oil prices since October would be on a sufficient scale to wipe out the current account surplus which the country ran before the shock (3% of GDP) and was considered the country's main strength; however, the sharp contraction in imports, whose volume has fallen by almost 25% in the past two years, has acted as a counterweight. In Colombia, the trade balance worsened considerably, by more than 2 pp of GDP, taking the current deficit to a 15-year high (-4.2% of GDP). Lastly, the importance of this channel in Mexico is more limited, given that a 10% decline in the price of the Mexican mix accounts for only a 0.9% drop in exports. Nonetheless, the biggest risk associated with the decline in oil prices would stem from potentially lower foreign investment inflows under the energy reform launched last year, although certain amendments to the reform (tendering of shallow-water instead of deepwater areas) do try to increase the attractiveness for potential investors.

The impact of the fall in oil prices on the fiscal position of these countries depends not only on the change in price, but also on output, on the weight of oil revenues in total public revenues (see Panel 2) and on the exchange rate at which crude export revenues are converted into local currency.[3] Thus, the depreciation of the exporting countries' currencies against the dollar, which usually accompanies a decline in oil prices, partly mitigates the fall in oil revenues when these are recorded in the domestic currency. In this respect, Mexico and Colombia have flexible exchange rates – albeit with intervention rules – that have depreciated by 15% and 25%, respectively, since October. Venezuela's case is more complex, since there is a system of multiple exchange rates with an extremely overvalued official exchange rate, used, until some months back, to value oil-related tax revenues.

Bearing this in mind, in Colombia's case estimates suggest that the fall in prices recorded since June would have reduced oil tax revenues by at least 10%[4] in 2014, and the Government estimates an additional reduction of 60% in 2015, which would lead to a 10% fall in tax revenues in the current year. In Mexico, the same decline in oil prices since June has reduced oil-related tax revenues by 42%, and total revenues by 13% in 2014. In the case of Venezuela, the impact of lower oil prices on the fiscal position is much more complicated to estimate, given the lack of official figures.[5] In 2013, the latest year for which figures are available, oil revenues accounted for 46.6% of total central government revenues. These oil revenues, measured in nominal terms and in local currency, depend, as indicated earlier, on crude output and on the international price, and on the exchange rate at which PDVSA revenue is converted into national currency. Estimating the effect of these three variables with a very simple regression shows that the decline in oil prices since June would have given rise to a reduction in oil revenues potentially amounting to 45%, which would lead to a decline in total revenues of 21% in 2014.

The pass-through this decline in revenues to the budget deficit is not immediate, since it depends, in the first two cases, on the fiscal rules recently approved or amended, and on various mechanism set in place to insulate the public sector from the vagaries of oil prices. In fact, such mechanisms were introduced in Colombia and Mexico in 2011 and in 2013 (although both came into force in 2014), respectively. They envisage the accumulation of oil revenues in a sovereign wealth fund subject to specific rules, relating essentially to expected oil prices in the long run and potential output.[6] The little time both systems have been in force has limited their ability to smooth fluctuations in public revenues associated with the recent decline in oil prices. Hence, the sovereign funds in both countries have built up a relatively small amount (scarcely 0.2%-0.3% of GDP), although under the escape clauses, in situations of cyclical weakness, the rule shall not give rise to a contractionary fiscal policy, which would further exacerbate such weakness. In Mexico, moreover, an active policy has been pursued for several years to insulate public finances as far as possible from changes in oil prices, through taking out a hedge position in the futures markets. In Venezuela's case, the pass-through to the deficit is complicated, as only central government figures are available, to which should be added the effect on the other tiers of government whose revenues depend to a greater or lesser extent on oil, such as PDVSA and the various investment funds. In any event, the fall in prices has a bearing on what is already a very weak fiscal position, which the IMF quantifies as an overall general government deficit of 15% of GDP, and without any prior saving mechanisms.

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2 In the trade channel only price effects are considered, since in the short term oil is difficult to replace with other products.

3 In the case of Venezuela it should be borne in mind, moreover, that the country has entered into several association agreements with Central American and Caribbean countries, and with China. These agreements envisage lower-than-market prices. Finally, another factor to be taken into account would be each country's commodity exploitation market structure, and here the range is from State monopolies that transfer dividends to the Treasury (Mexico), through exploitation with strict rules to ensure most of the revenues for the State oil company (Venezuela) to more open markets with State investment that provides dividends to the State and foreign investment that pays specific royalties for operating in the country.

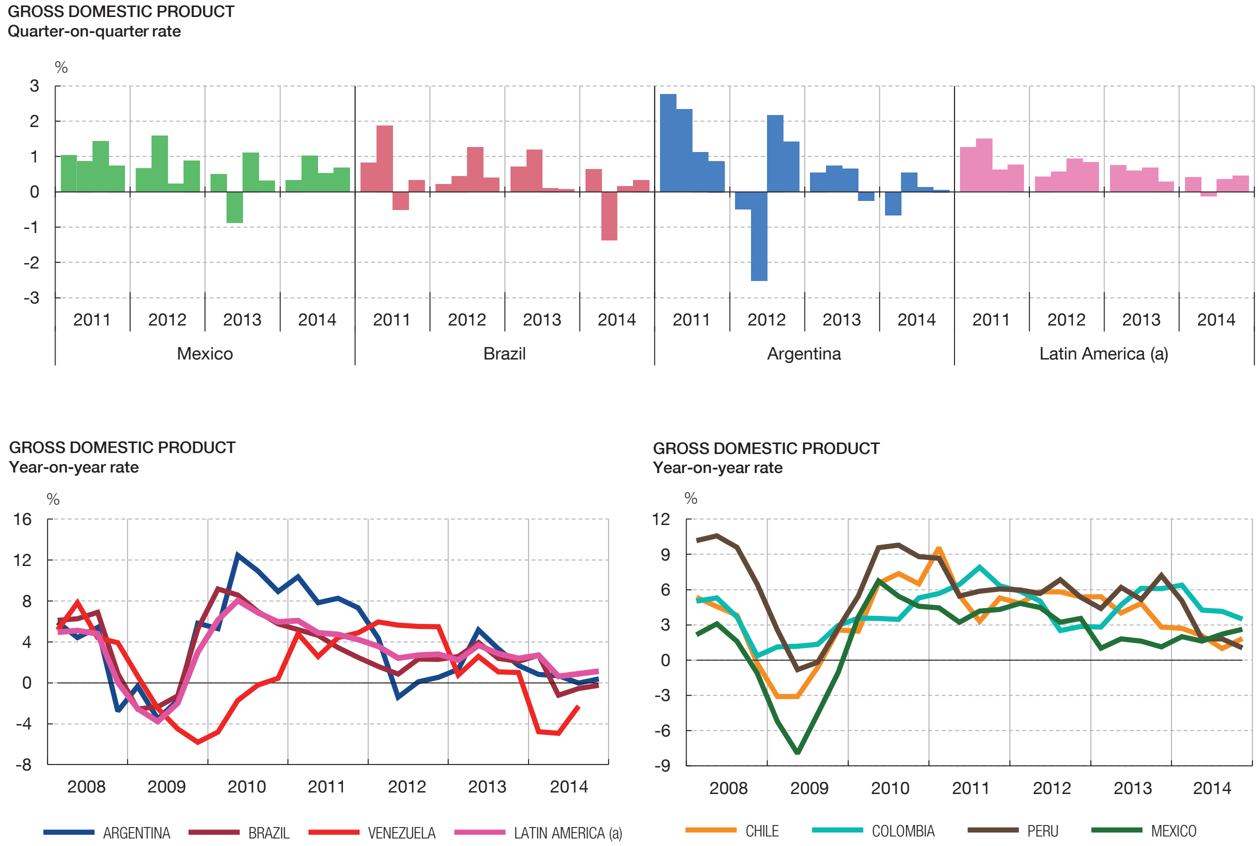
4 This amount includes only the withholding at source of the value of oil exports, in the absence of the figures on Ecopetrol dividends and other taxes on the oil sector.

5 The uncertainty over tax figures in Venezuela is very high, since the Ministry of Finance does not publish data for the whole of the public sector and for central government beyond 2011 and after 2013, respectively, when much of public spending in recent years has been by the State oil company PDVSA and the group of investment funds present in the country. Accordingly, the figures in this Box should be viewed with great caution.

6 For greater details on the Colombian rule, see J.C.Berganza (2012), *Fiscal rules in Latin America: a survey,* Documentos Ocasionales, No. 1208, Banco de España; and on the Mexican rule, the Box on structural reforms in Mexico in the *Report on the Latin American economy. Second half of 2014,* Economic Bulletin, Banco de España, October 2014.

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.

showed somewhat greater dynamism (with year-on-year growth of 2.2% in Q3 and 2.6% in Q4), Colombia and Peru saw a certain additional slowdown, and Chile an incipient recovery in the last quarter, although from very low growth rates (see Chart 5).

By component, the regional average data show that domestic demand contributed only 0.4 pp to year-on-year growth in Q3, although the contribution amounted to 0.9 pp in Q4 (see Chart 6), while foreign demand contributed around 0.2 pp in Q4 compared with 0.5 pp in Q3. This lower contribution stemmed from a fall in exports (-1.8% at regional level), which was partially offset by the fall in imports (-0.9%). The divergence between the behaviour of exports in Brazil, with a year-on-year fall of 10.7% in Q4, and Mexico, with an increase of more than 10% year-on-year in Q4, reveals, among other things, the different growth prospects in their main trading partners (upward in the United States and downward in China). On the negative side, Colombia recorded a fall of 2% in its exports in Q4, owing to the slump in the price of its main export.

Gross fixed capital formation contributed negatively to growth, although in Q3 and Q4 it showed a certain recovery. However, in this component there were growing differences across countries. In Mexico, the growth rate rose significantly thanks to its private component (9.9% year-on-year in Q4), perhaps partly associated with the structural reforms and with the vigorous foreign demand from the United States. In Chile, where the uncertainty stemming from the approval of the tax reform dissipated, the adjustment of the

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

	2013	2014	2013				2014				2015
			Q1	Q2	Q3	Q4	Q1	Q1	Q3	Q4	March
GDP (year-on-year rate)											
Latin America 6 (a)	2.7	1.3	2.2	3.7	2.9	2.4	2.7	0.6	0.9	1.1	
Argentina	2.9	0.5	1.3	5.2	3.3	1.7	0.8	0.7	0.0	0.4	
Brazil	2.7	0.1	2.6	3.9	2.4	2.1	2.7	-1.2	-0.6	-0.2	
Mexico	1.4	2.1	1.0	1.8	1.6	1.1	2.0	1.6	2.2	2.6	
Chile	4.2	1.9	5.4	4.0	4.8	2.8	2.7	2.1	1.0	1.8	
Colombia (b)	4.9	4.6	2.8	4.7	6.1	6.1	6.4	4.3	4.2	3.5	
Venezuela	1.3		0.8	2.6	1.1	1.0	-4.8	-5.0	-2.3		
Peru	5.8	2.4	4.4	6.2	5.2	7.2	5.0	1.8	1.8	1.1	
CPI (year-on-year rate)											
Latin America 5 (a)	4.6	5.0	4.5	4.9	4.4	4.4	4.7	4.9	5.1	5.2	5.7
Argentina (c)	10.6	22.6	10.8	10.4	10.5	10.7	6.9	13.5	18.2	22.6	—
Brazil	6.2	6.3	6.4	6.6	6.1	5.8	5.8	6.4	6.6	6.5	8.1
Mexico	3.8	4.0	3.7	4.5	3.4	3.7	4.2	3.6	4.1	4.2	3.1
Chile	2.1	4.4	1.7	1.9	2.3	2.5	3.2	4.5	4.7	5.3	4.2
Colombia	2.0	2.9	1.9	2.1	2.3	1.8	2.3	2.8	2.9	3.5	4.6
Venezuela	38.5	57.3	22.6	33.0	43.4	52.9	53.3	55.6	57.5	61.3	—
Peru	2.8	3.2	2.6	2.5	3.1	3.0	3.4	3.5	2.9	3.2	3.0
Budget balance (% of GDP) (d)											
Latin America 6 (a)	-2.4	-4.0	-2.1	-2.2	-2.5	-2.4	-2.6	-3.0	-3.6	-4.2	
Argentina	-1.9	-2.5	-1.9	-1.8	-1.8	-1.8	-2.0	-2.0	-2.1	-2.3	
Brazil	-3.3	-6.7	-2.8	-2.8	-3.3	-3.3	-3.2	-3.7	-4.9	-6.7	
Mexico	-2.3	-3.2	-2.0	-2.2	-2.8	-2.3	-2.8	-3.2	-3.4	-3.1	
Chile	-0.7	-1.5	0.2	-0.7	-0.5	-0.7	-1.0	-0.8	-1.1	-1.2	
Colombia	-2.2	-2.6	-1.4	-2.5	-2.7	-2.2	-2.7	-3.6	-3.4	-2.6	
Venezuela	—	—	—	—	—	—	—	—	—	—	
Peru	0.5	-0.4	1.2	0.7	0.5	0.5	0.4	0.0	0.1	-0.4	
Public debt (% of GDP)											
Latin America 6 (a)	40.1		41.4	40.1	40.2	38.6	41.3	41.8			
Argentina	32.6		32.1	31.7	32.5	33.2	37.9	36.1			
Brazil	56.7	63.5	59.4	59.0	58.2	56.7	57.5	59.0	61.9	63.5	
Mexico	31.1	33.4	29.3	29.7	30.3	29.9	31.8	32.0	32.9	32.0	
Chile	12.8	15.1	11.5	12.1	12.6	12.8	12.8	13.5	13.7	15.1	
Colombia	34.6	37.7	33.0	33.3	34.9	34.6	35.9	35.0	35.6	37.7	
Venezuela	—	—	—	—	—	—	—	—	—	—	
Peru	19.0	19.4	19.5	18.5	17.7	19.0	17.8	18.2	18.4	19.4	
Current account balance (% of GDP) (d)											
Latin America 7	-2.5		-2.1	-2.3	-2.6	-2.6	-2.7	-2.7	-2.6		
Argentina	-0.8	-1.4	-0.3	-0.3	-0.6	-0.7	-1.2	-1.1	-0.9	-0.9	
Brazil	-3.4	-3.9	-2.8	-3.0	-3.4	-3.4	-3.5	-3.5	-3.5	-3.9	
Mexico	-2.4	-2.1	-1.6	-2.0	-2.3	-2.3	-2.6	-2.5	-2.3	-2.1	
Chile	-3.7	-1.2	-4.2	-4.2	-3.8	-3.7	-3.2	-2.7	-1.8	-1.2	
Colombia	-3.2	-5.2	-3.5	-3.2	-3.2	-3.2	-3.5	-4.0	-4.3	-5.2	
Venezuela	2.3	—	1.4	0.9	1.2	1.5	2.8	2.9	2.2	—	
Peru	-4.4	-4.1	-3.6	-3.9	-4.3	-4.4	-4.2	-4.4	-3.8	-4.1	
External debt (% of GDP)											
Latin America 7	22.6		20.0	19.6	19.8	20.4	23.5	24.0	24.2		
Argentina	22.6	25.8	23.0	21.7	22.9	21.8	28.6	26.6	26.6	25.8	
Brazil	13.8	14.8	14.6	14.1	13.7	13.8	13.6	14.3	14.2	14.8	
Mexico	20.1	21.8	19.1	18.7	19.3	20.6	20.8	21.1	21.0	21.8	
Chile	47.3	56.8	43.5	42.9	44.4	47.2	48.7	50.4	52.3	56.8	
Colombia	24.2	26.8	21.5	22.0	23.7	24.2	25.0	25.6	26.1	26.8	
Venezuela	56.1		43.4	46.1	49.6	56.1	58.1	59.2	61.7		
Peru	29.2	31.7	30.5	29.6	29.3	29.3	30.1	30.5	31.1	31.7	

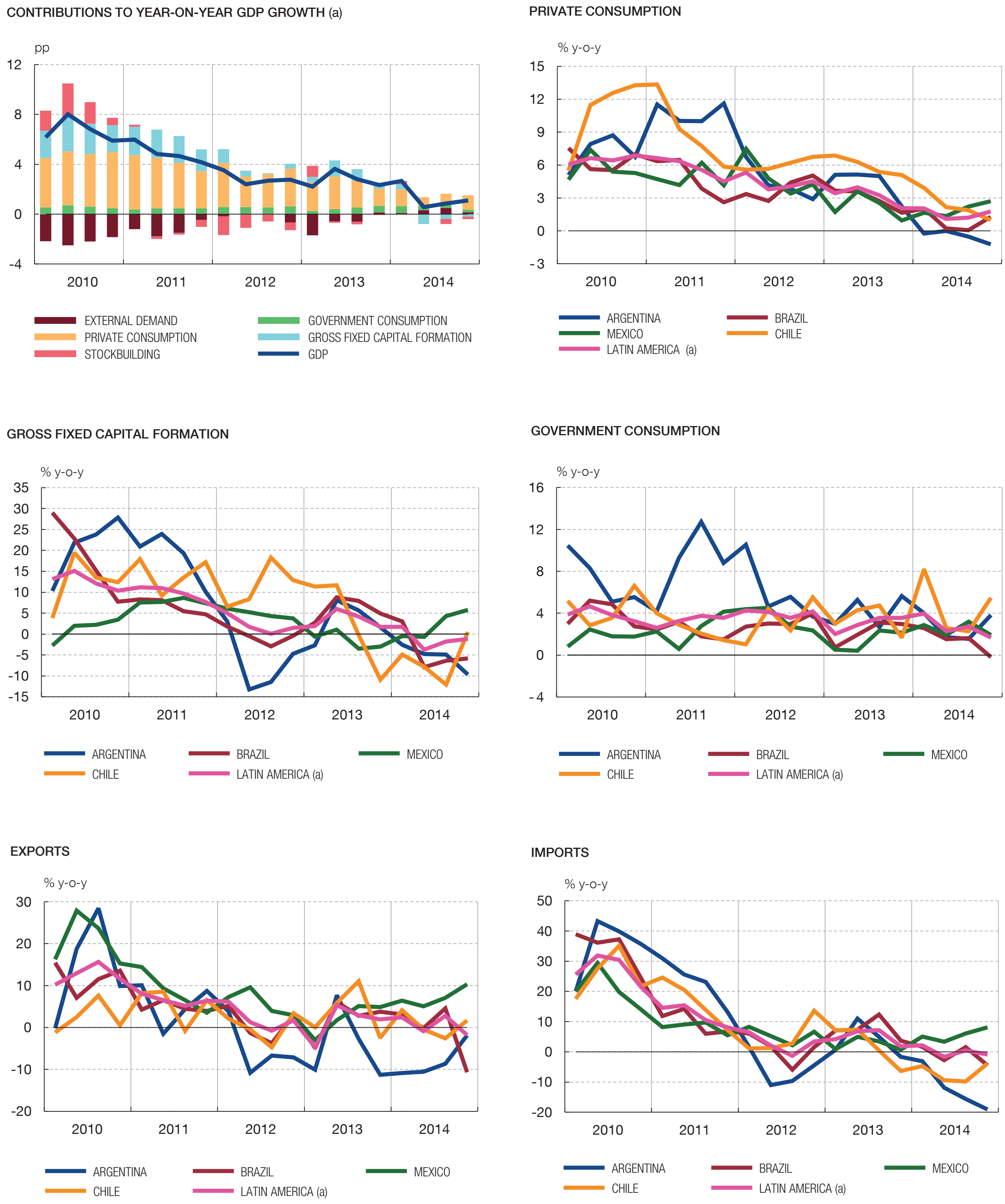
SOURCE: National statistics.

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.

investment cycle over the last two years seems to be coming to an end and investment went from falling at rates above 12% to rising at 0.5% year-on-year in Q4. In Colombia, investment slowed moderately in Q4 as a result of the adjustment in the construction and infrastructure sector, and to a lesser extent in the oil sector, but even so it continued to be

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

CHART 6



SOURCES: National statistics and IMF.

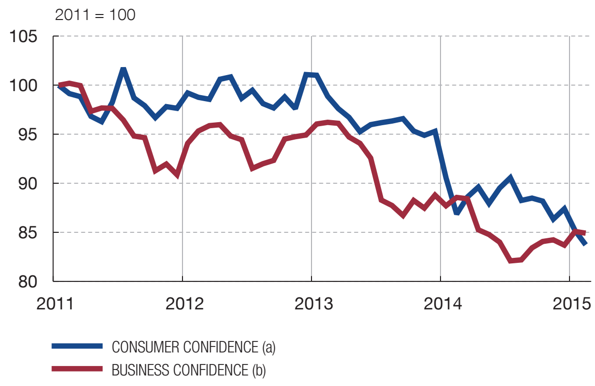
a Latin America 6 as a GDP-weighted average for the region.

the fastest-growing component of demand. By contrast, in Brazil investment dropped sharply in H2 (-6.1% on average), against a background of falling business confidence indicators which did not regain ground after the elections. Both the announcement of a procyclical economic policy adjustment and the uncertain extent of the impact of factors

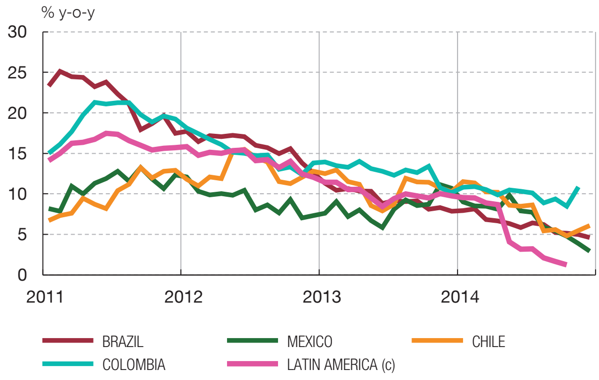
EMPLOYMENT, DEMAND AND CREDIT INDICATORS CHART 7

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

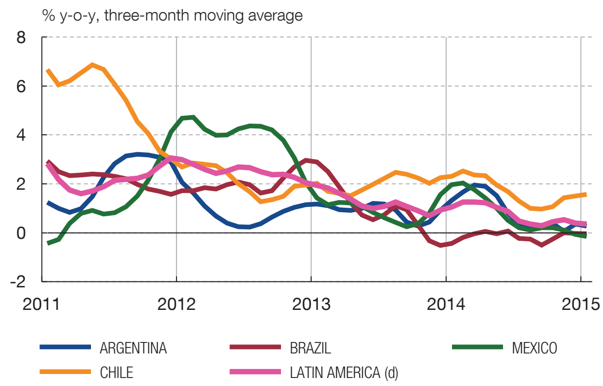
CONSUMER AND BUSINESS CONFIDENCE INDICES



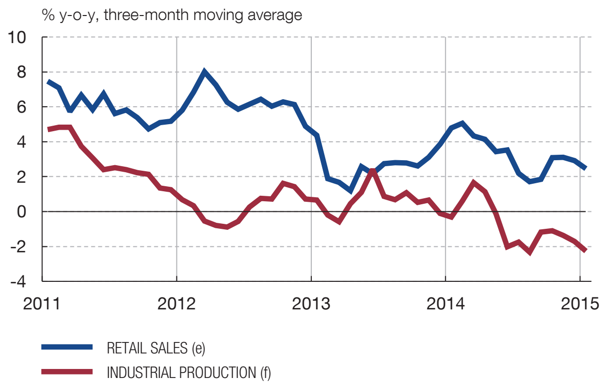
REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR



JOB CREATION



DEMAND AND ACTIVITY INDICATORS



SOURCES: National statistics and Datastream.

a Aggregate of Argentina, Brazil, Chile, Mexico and Peru.
b Aggregate of Brazil, Chile, Mexico and Peru.
c Aggregate of Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
d Aggregate of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
e Aggregate of Brazil, Chile, Colombia and Mexico.
f Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

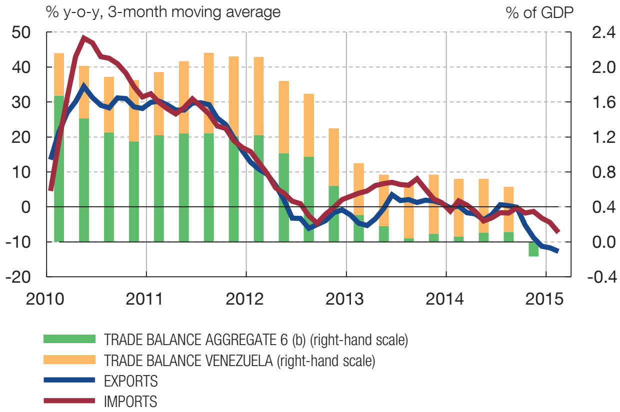
such as the corruption scandals in the state oil company Petrobras seem to be behind this performance. In Argentina and Venezuela the import restrictions gave rise to sharp falls in investment, in machinery and equipment in the former and in construction in the latter.

The behaviour of private consumption over the six-month period was, by contrast, somewhat more uniform across the region. On average in Latin America private consumption continued to slow, posting a growth rate near to 1.5% in 2014 as a whole (compared with 3% in 2013), although recovering somewhat in Q4 (1.8%, compared with 1.2% previously). Brazil, Chile, Argentina and Venezuela all recorded low or even negative growth rates in H2, while in Colombia and Peru consumption continued to show its robustness. In Mexico, consumption recovered towards the end of the year, posting a rate of 2.7% year-on-year. The general situation of most labour markets remained healthy, as evidenced by unemployment rates near their historical lows (5.4% of the labour force in the region on average at end-2014). However, job creation generally showed signs of weakness and fell, in line with previous quarters, to rates below 1% (see Chart 7). Some countries, such as Brazil, saw jobs destroyed in the six-month period. In Mexico, by

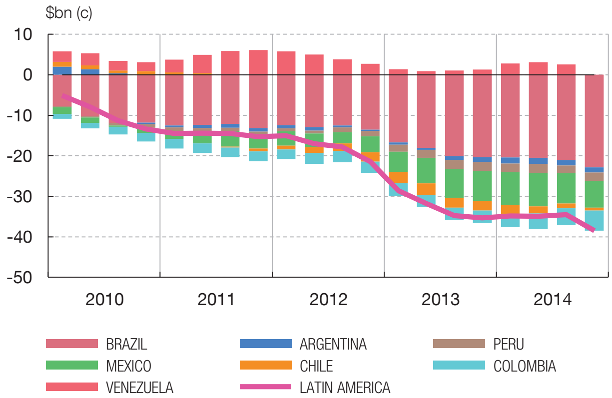
EXTERNAL ACCOUNTS AND DETERMINANTS
Indices, year-on-year rates of change, percentage of GDP and $bn

CHART 8

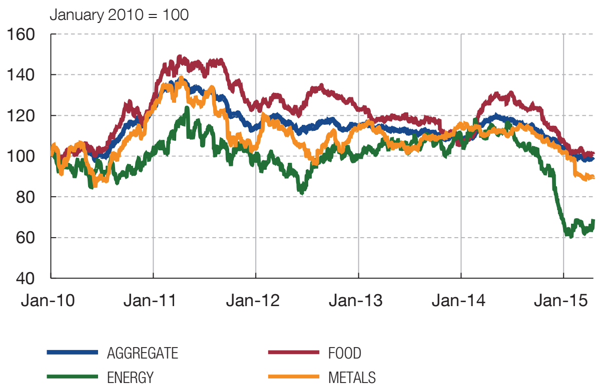
EXPORTS AND IMPORTS (a)



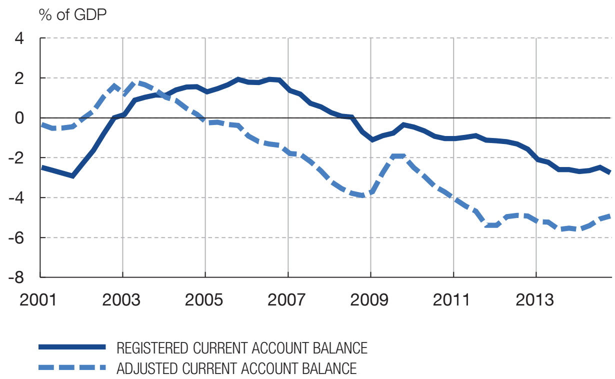
CURRENT ACCOUNT BALANCE



COMMODITY PRICES



REGISTERED AND ADJUSTED EXTERNAL BALANCES (d)



SOURCES: Datastream, national statistics and central banks.

a Customs data in dollars.
b Latin America 6.
c Four-quarter moving average.
d Estimate of adjusted balances, setting export and import prices as the average from 1990 to 2007. In the cases of Chile and Peru, a fixed level in the income balance has been estimated as a percentage of GDP.

contrast, job creation in the formal sector strengthened considerably, and simultaneously informal employment decreased. Real wages buoyed up consumption, since they grew in most countries; in some cases (such as Brazil) unemployment transfers and support for low income households also increased significantly; in turn, lending to the private sector slowed (in Brazil, in the sectors most closely linked to private consumption, such as credit cards) (see Chart 7). Finally, it should be noted that government consumption lent some momentum to growth in Brazil and Chile and in the more vulnerable countries (see Chart 6).

The trade surplus of the region decreased by 0.2 pp of GDP to 2014 Q3 (see Chart 8), owing to the smaller surplus of Venezuela. Excluding that country, the region's trade account remained virtually in balance until Q3 (+0.1% of GDP), although in 2014 Q4 and the opening months of 2015 it showed a deficit, owing to the behaviour of nominal exports, which fell in the regional aggregate by nearly 10% year-on-year (see Chart 8). This fall was attributable to the oil price slump, but also to the contraction in exports to China (particularly those of Brazil), which was barely offset by an increase in exports to the United States. The current account deficit held steady at around 3% of GDP in regional average terms, owing to a slight improvement in the income balance (associated with lower profit repatriation by foreign firms in the commodities sector) and an increase in transfers received. By country, the deficit decreased slightly in Mexico and Peru and, above all, in Chile, but worsened in the rest. The recent decline in the terms of trade narrowed the difference between the region's current account balance and the current account balance adjusted for the change in terms of trade (see Chart 8).

Finally, the most frequent indicators for 2015 Q1 suggest that the aforementioned intra-regional divergences remain. Thus, industrial output posted rates of change around -2%, as a result of developments in Brazil, Chile, Argentina and Peru, while in Colombia and Mexico the rates remained positive. Retail sales rose strongly in Mexico and Colombia, while they decelerated in Brazil. In the countries for which PMI indices are published, the trends in Q1 are upward, except for Brazil, albeit starting from levels that are still very low compared with the historical average.

Prices and economic policies

In the past six months, since the publication of the previous *Report on the Latin American Economy,* inflation in the five countries with inflation targets steadied, on average, at relatively high levels, standing at 5.7% year-on-year in March 2015 (see Chart 9). In fact, at end-2014, only in Colombia and Brazil had consumer prices remained within, albeit towards the top of, the band set by their central banks (see Table 2). The regional average masks, however, an increase in the divergences across countries with respect to the first half of 2014.

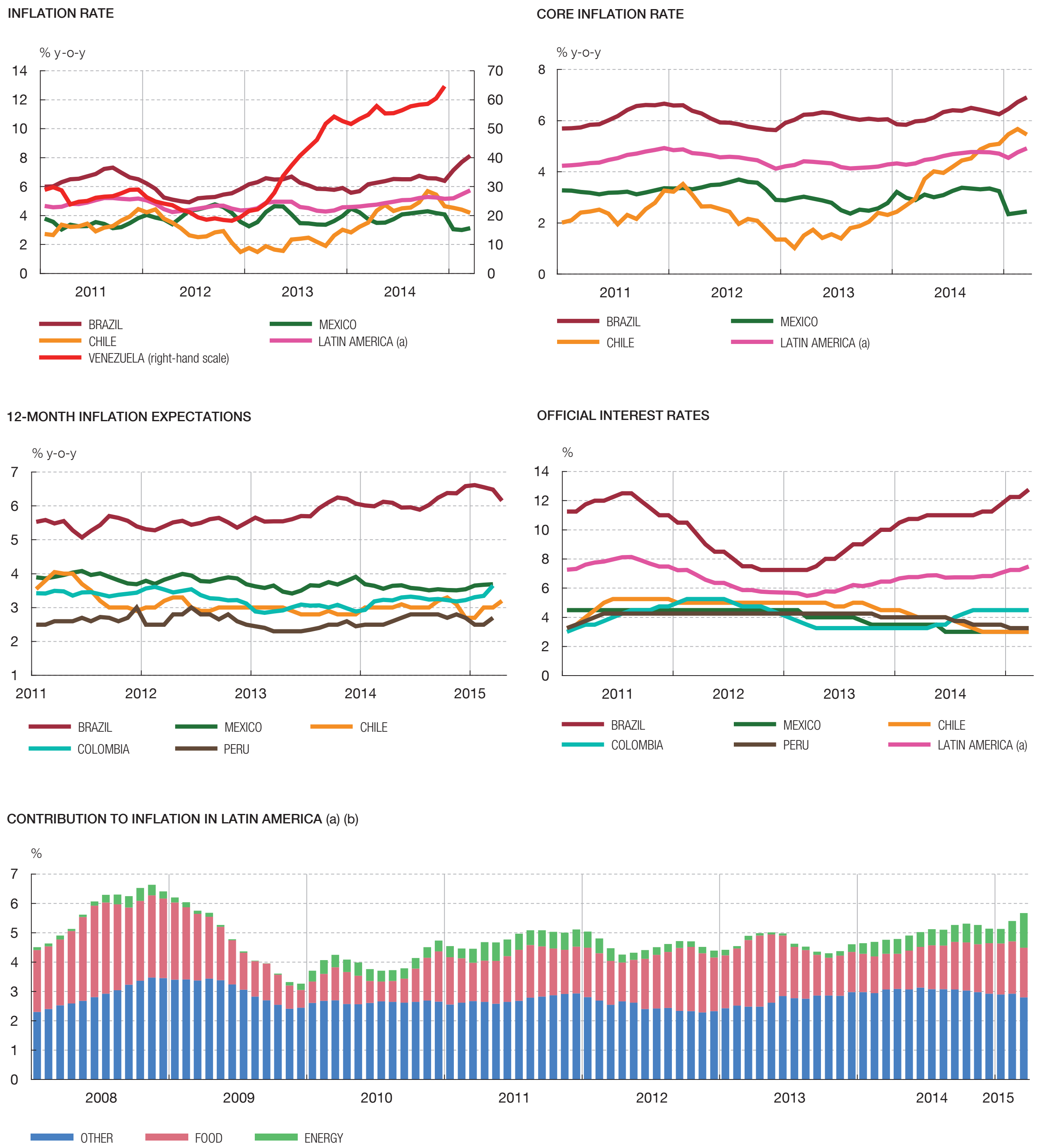
In Brazil, inflation rebounded in March to 8.1% year-on-year, the highest level in the last ten years and more than 1.5 pp above the upper bound of the range. Part of this increase is a result of rises in some administered prices (which increased by 13.3% year-on-year in March) against a background of fiscal adjustment, and the impact is, in principle, temporary. However, the various inflation components continued to evidence pressures to a greater or lesser degree, since the core rate stood at 8% year-on-year and the rate of change in non-tradable goods prices at 7.5% and in the price of services (excluding those with regulated prices) at 6.1%. Thus only tradable goods showed a certain moderation in 2014 H2, to 5.7% year-on-year in March. This is particularly noteworthy because it took place against a background of sharp exchange rate depreciation, a symptom of weak domestic demand.

In the other countries with inflation targets, the general trend was one of either deceleration or stabilisation. In the former case are Mexico (3.1% year-on-year in March) and Peru (3% year-on-year), with inflation at the central bank's target and no evidence of pass-through of exchange rate depreciation. In Chile and Colombia inflation remained at the top of the target range, at 4.2% and 4.6% year-on-year, respectively, in March, evidencing the effect of exchange rate depreciation. In both cases, part of the pressure on prices has passed through to core inflation, although medium-term inflation expectations remain anchored. The impact of the oil price slump on inflation was noticeable especially in oil importing countries such as Chile, Peru and, to a certain extent, in Argentina also. In Argentina, Colombia, Mexico and Brazil petrol prices are administered (and subsidised) and the final impact on consumer prices is smaller (see Chart 9). Argentina and Venezuela continued to post very high inflation rates, above 20% and 60% year-on-year, respectively, against a background of monetary financing of the budget deficit, although inflation moderated somewhat in Argentina in early 2015 against a backdrop of standstill in activity, exchange rate stability and falling oil prices.

In this setting, the divergences observed in monetary policies in 2014 H1 increased (see Chart 9). The central bank of Brazil (which in April had halted the upward interest rate cycle) intensified its monetary policy tightening after the October presidential election in

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

CHART 9



SOURCES: Datastream and national statistics.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru as a GDP-weighted average for the region.
b Banco de España calculations stripping out the food and energy indices from the overall index.

order to lend more credibility to the inflation target (4.5%). The rise of 125 bp to 12.75% in the official interest rate, on top of the previous rise of 375 bp, makes the monetary adjustment strongly procyclical in the short run. Despite this, the exchange rate has continued to depreciate (reaching 3.3 reais per dollar), making a cumulative depreciation of 30% in the past year and of more than 50% since the beginning of 2011, contained by the central bank's exchange rate intervention programme. Also, the government announced

INFLATION
Year-on-year rates of change

TABLE 2

	2014			2015		2016
Country	Target	December	Fulfillment	March	Expectations (a)	Expectations (a)
Brazil	4.5 ± 2	6.4	Yes	8.1	7.7	5.5
Mexico	3 ± 1	4.1	No	3.1	3.1	3.4
Chile	3 ± 1	4.6	No	4.2	3.0	3.0
Colombia	3 ± 1	3.7	Yes	4.6	3.5	3.1
Peru	2 ± 1	3.2	No	3.0	2.6	2.6

SOURCES: National statistics and Consensus Forecasts.

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

cuts in the state funding to public development banks (whose loan market share has reached 50%) and two increases in the lending rates of those banks (to 6%).

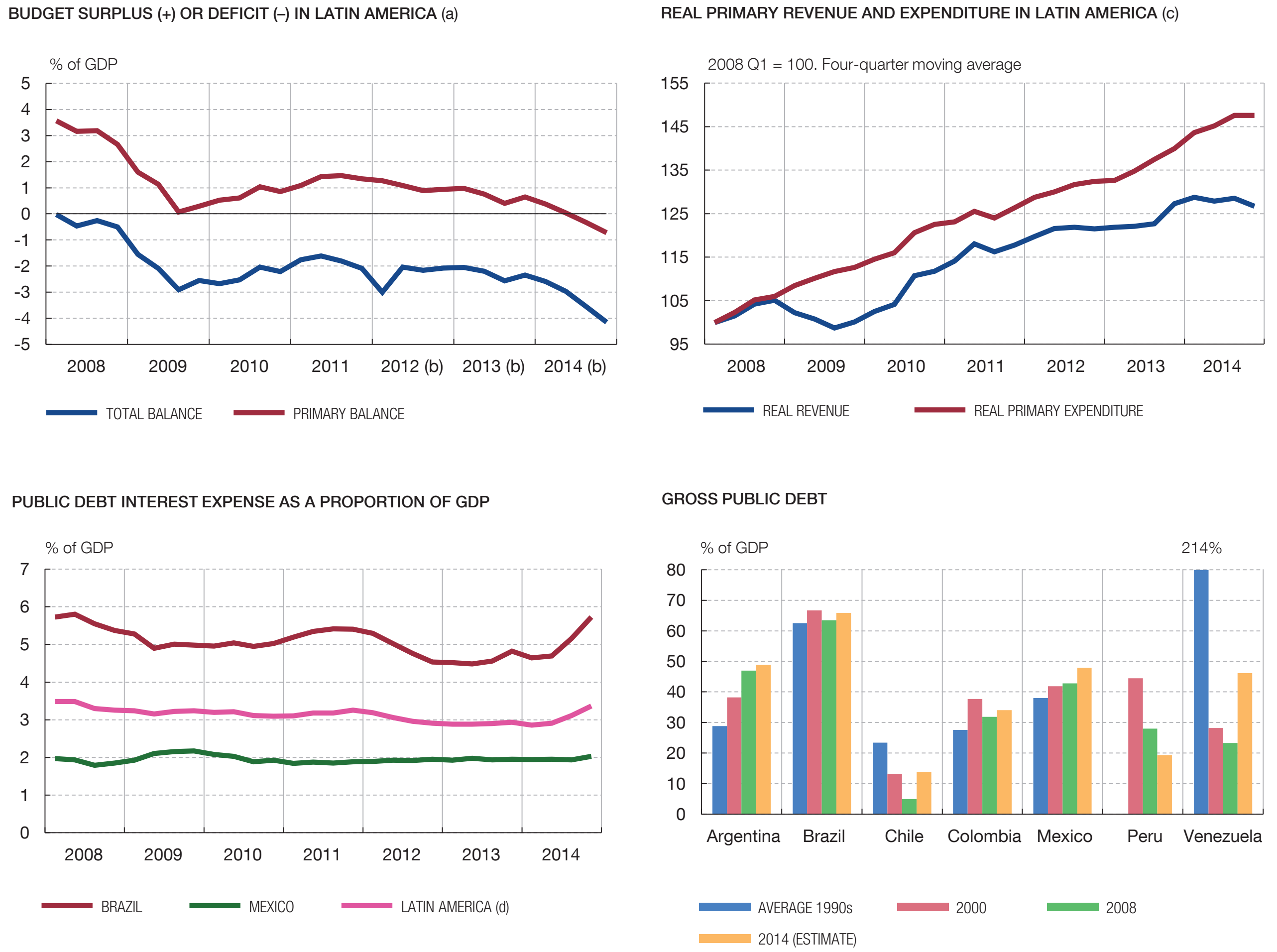
In the other countries with inflation targets, Mexico and Colombia held their official interest rates unchanged in the past six months, while the central bank of Chile trimmed its official interest rate by 25 bp to 3% in October and the central bank of Peru did so twice, by 50 bp each time, to 3.25%. Both in Mexico and, above all, in Chile and Peru, monetary policies have been expansionary over the past year and a half, and only in Colombia, which ended its upward interest rate cycle in mid-2014, has monetary policy been more neutral. Interestingly, in all four countries the projections are for inflation to decrease or at least steady in 2015, and yet while in Colombia and Peru the markets are factoring in the possibility of new interest rate cuts (more likely if stable terms of trade were to halt the exchange rate depreciation), in Mexico the market is discounting an interest rate rise in accordance with the US monetary cycle. In Chile expectations have changed in the past month and no longer discount official interest rate cuts.

Exchange rate depreciation has been an important factor for monetary policy in most countries, since although attempts have been made to help real exchange rates adjust to lower terms of trade, Peru and, recently, Mexico have intervened in the foreign exchange market, selling reserves to smooth these trends, and Colombia has completely discontinued its reserve accumulation programme. In addition, Peru has used macroprudential policy to reduce its vulnerability to depreciation of the sol (making debt denominated in foreign currency more expensive than that denominated in national currency).

Meanwhile, in the fiscal policy arena, the end of 2014 saw, practically without exception, an across-the-board widening of budget deficits (or, in the case of Peru, the evaporation of the budget surplus) (see Chart 10). This was mainly a result of the poor revenue performance owing to the cyclical position and the fall in commodities-related receipts, although in some countries it was also a result of expanded government spending, which helped to sustain household income and private consumption. In Brazil the deficit widened substantially in 2014 to 7% of GDP, and with a view to 2015, despite the political difficulties, the authorities are trying to implement a fiscal adjustment, which will have procyclical effects in the short term but which is necessary to put public finances back on a firm footing and strengthen their credibility in the medium term. In the other countries the fiscal worsening in 2014 was less pronounced. For 2015, in Mexico, Colombia, Peru and Chile the existence of fiscal rules should bestow a countercyclical or acyclical nature on fiscal policy, thereby isolating to some extent the fiscal accounts from commodity price fluctuations

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and index

CHART 10



SOURCES: National statistics and IMF.

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 and 2014 aggregate excluding Venezuela.
c Latin America 5.
d Latin America 6.

(see Box 2). Even so, the responses differ. In Colombia and Peru the fiscal rule, the stabilisation funds, and, above all, the low level of government debt have prevented a procyclical adjustment (additional to that envisaged in medium-term consolidation plans) despite the fall in oil, copper and other metal prices. In Chile fiscal policy is determined, firstly, by the tax rise under the recently approved tax reform, and secondly, by the desire to carry out an expansion to counteract the fall in growth, with a sharp increase in this year's investment budget. Also, the projected deficit has been relaxed to -1.9% of GDP, although the target is still to reach a balanced budget (in terms of the cyclically-adjusted balance) in 2018. Mexico has announced an expenditure adjustment for both 2015 and 2016, against a background of falling oil prices and falling oil production, as a signal to the markets that the risk that a part of the oil slump may be permanent will not induce it to resort to greater indebtedness in a situation of change in the global financial cycle.

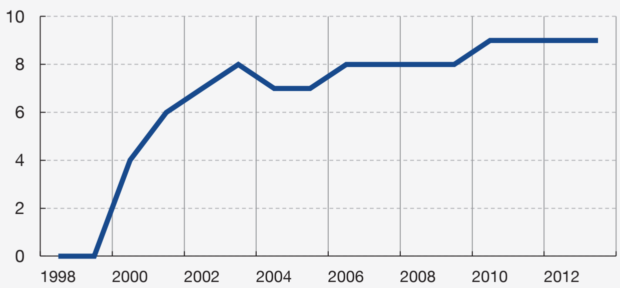
Trade and reforms

Over the period analysed, headway was made in trade liberalisation, both globally, with the signing of the Trade Facilitation Agreement that re-opens the Doha Round negotiations, and regionally, with renewed momentum in the area of influence of the Pacific Alliance. Thus, progress was made at different levels (start of conversations, completion of parliamentary

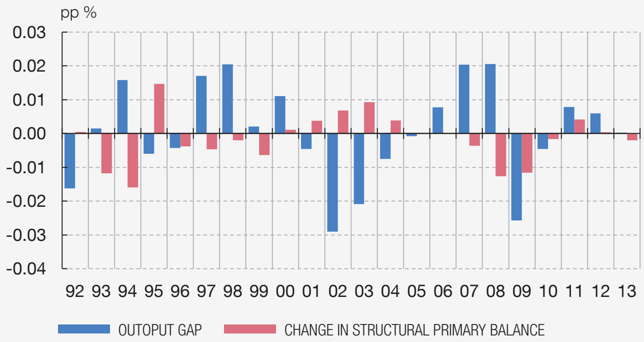
The use of fiscal policy as a business cycle smoothing tool represents a historical challenge in Latin America. In the empirical literature, fiscal policy has systematically been found to behave procyclically for Latin America (i.e. the application of an expansionary fiscal policy when the cycle is buoyant and a contractionary policy when the economy is in recession), as occurs in other emerging economies. The intensity of the procyclical bias is exacerbated in Latin America by the relative insubstantiality of the automatic stabilisers, low revenue-raising capacity and the dependence of public revenues on commodities exports, and also by external financial conditions that amplify economic fluctuations. In particular, the high dependence of the Latin American countries on external financing and episodes of sudden stops in capital inflows, against a backdrop of exchange rate rigidities, have traditionally given rise to procyclical fiscal policy responses, especially in downturns.

However, a change in behaviour can be seen in recent years. In particular, during the global financial crisis Latin American economies held up particularly well, with counter-cyclically geared macroeconomic policies to alleviate the effects of the crisis. Moreover, a significant institutional change in budgetary terms was observed from the onset of the new millennium, in the form of the implementation of a more

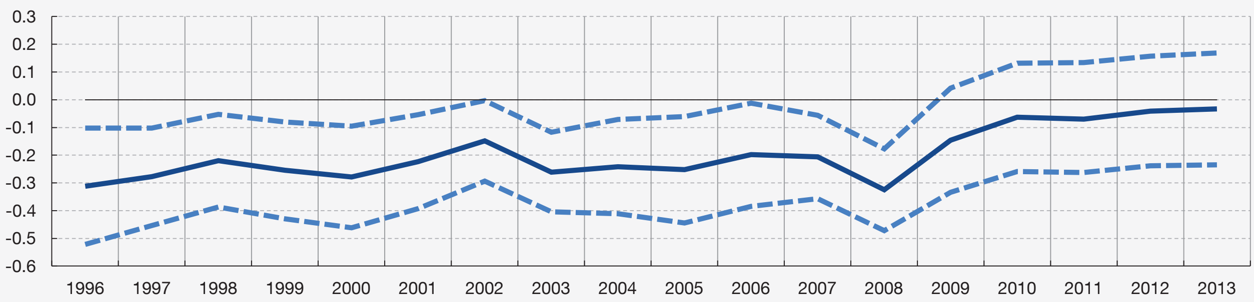
1 NUMBER OF COUNTRIES WITH FISCAL RULES IN LATIN AMERICA



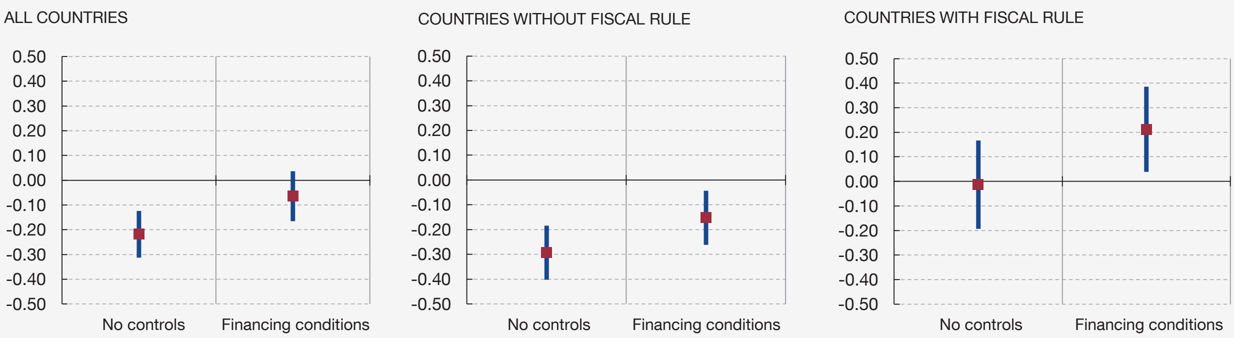
2 OUTPUT GAP AND STRUCTURAL PRIMARY BALANCE



3 COEFFICIENT OF FISCAL POLICY REACTION TO THE ECONOMIC CYCLE (a)



4 COEFFICIENT OF FISCAL POLICY REACTION TO THE ECONOMIC CYCLE, BY DETERMINANT



SOURCES: IMF Fiscal Rules Dataset, CEPAL, OECD and Banco de España.

a Output gap coefficient in a MCO regression with a 7-year rolling window and a 90% confidence interval. A negative (positive) coefficient denotes a procyclical (counter-cyclical) fiscal policy.

robust fiscal framework involving the adoption of rules in many countries in the region (see Panel 1). These fiscal rules have been developed with various aims. In some countries they seek to restrict the growth of debt or the primary deficit in order to enhance the sustainability of public finances in the medium and long term, while in others the aim is the stabilisation of the cycle and the generation of fiscal space in upturns so as to be able to undertake fiscal expansions in recessive times. The creation of sovereign funds drawing on commodities revenues in Chile, and more recently in Colombia and Mexico, and the introduction of medium-term structural balance sheet objectives are some of the economic policy developments linked to these fiscal rules.

In order to be able to assess the fiscal policy stance in Latin America, primary structural budget balances (i.e. excluding the interest burden and the impact of the business cycle from the total public balance) must be estimated and adjusted, moreover, for the impact of commodities prices, since many of the region's countries depend to a greater extent on revenues from primary goods exports to balance their public finances, and their prices also show highly persistent temporary fluctuations. For a sample of eight of the main Latin American economies[1] in the period 1990-2013, this Box shows primary structural balances adjusted for the price of commodities – using OECD and IMF methodology[2] – and assesses whether the change in external financing conditions, on one hand, and the introduction of fiscal rules, on the other, have provided for a shift towards a fiscal policy able to smooth the business cycle.[3]

Panel 2 shows the primary structural balance and the output gap in the countries analysed, as an arithmetic mean. As can be seen, counter-cyclical fiscal policy situations are seldom observed in the period in question; i.e. periods in which either a positive output gap (economic expansion) is accompanied by a positive change (restrictive fiscal policy stance) in the primary structural balance, or a negative output gap (economic recession) occurs at the same time as the change in the primary structural balance turns negative (restrictive fiscal policy stance). However, there was a break in this pattern in 2009 due to the major fiscal impulse applied in response to the global financial crisis, and in the years immediately after the crisis there were some improvements in the primary structural balance in favourable economic circumstances. The prevalence of the procyclical fiscal policy stance in the region over the past 25 years is corroborated by a simple econometric analysis, in which the primary structural balance is regressed on the output gap. In fact, Panel 3, which illustrates the changes in the coefficient measuring the cyclical response of fiscal policy in the form of a seven-year moving window together with confidence bands of 90%[4], shows that procyclicality in the region was relatively stable and significant up to the reaction to the 2009 crisis. Following the 2009 fiscal impulse, the coefficient measuring the fiscal policy response to the cycle ceases to be significant, i.e. fiscal policy ceases to be procyclical and becomes acyclical.

To analyse changes in financial conditions in respect of the relationship between the fiscal policy stance and the cycle, the foregoing regression includes an indicator, derived from the literature analysing debt sustainability,[5] which seeks to approximate the financial position of the public sector. This indicator is constructed as the primary structural balance that would stabilise the public debt/GDP ratio in each period, given the implied yield paid by the public sector on debt issued[6] and the growth of the economy. This variable takes into account financing conditions and the underlying fiscal situation, such that it measures the fiscal space of the authorities.[7] The results indicate that financing conditions significantly influence the cyclical response of fiscal policy. As can be seen in Panel 4, the procyclical nature of fiscal policy lessens once the influence of financing conditions is taken into account.

The impact of the introduction of fiscal rules on the fiscal policy response to the cycle is more difficult to evaluate. First, it is not easy to assess whether fiscal rules contribute to eliminating the counter-cyclical bias of fiscal policy or whether, on the contrary, their creation is part of a process in which improved institutions may be a step forward towards achieving fiscal discipline. Further, measurement of the quality of fiscal rules is an open issue. This study uses the IMF database[8] to construct different *de jure* indicators of fiscal rules, without going into an assessment of either their suitability or the de facto compliance with the fiscal rules.[9] The primary structural balance regression is estimated once again on the output gap, allowing the coefficient of this latter variable to differ depending on the existence or not of fiscal rules.[10] The results show that countries whose fiscal discipline is underpinned by a fiscal rule have been able to make progress towards eliminating the procyclical tendency of fiscal policy (see Panel 4). Whether this behaviour shows that fiscal rules function as a signalling mechanism of a commitment to a more stable fiscal policyremains open to discussion.

1 Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay.

2 See Daude, Melguizo and Neut (2011), "Fiscal policy in Latin America: counter-cyclical and sustainable?", *Economics: The Open-Access, Open-Assessment E-Journal,* vol. 5, 2011-14.

3 Alberola, Kataryniuk, Melguizo and Orozco (2015), "The long (and unfinished) march towards fiscal policy stabilisation in Latin America: the role of financial conditions and fiscal rules", mimeo.

4 A negative coefficient in the regression denotes procyclical behaviour of fiscal policy, and vice versa.

5 Alberola and Montero (2006), "Debt Sustainability and Procyclical Fiscal Policies in Latin America", *Economía, LACEA, Journal of the Latin American and Caribbean Association* – 7 (1), pp. 157-193, autumn.

6 Specifically, this variable is constructed as follows: $TB=[(r-g)/1+g]*D(-1)$, where r is the average yield effectively paid, g is GDP growth and D(-1) the stock of debt in the previous period.

7 The inclusion of this variable in the regression of the primary structural balance is potentially subject to a problem of endogeneity, since the financing conditions may also depend on the fiscal policy stance. To try and resolve this problem, an instrumental variables estimate is used.

8 *IMF Fiscal Rules Dataset.* See A. Schaechter, T. Kinda, N. Budhina and A. Weber (2012), *Fiscal Rules in Response to the Crisis – Towards the "Next-Generation" Rules. A New Dataset.*

9 See J.C. Berganza (2012), *Fiscal rules in Latin America: a survey*, Documentos Ocasionales, no. 1208, Banco de España.

10 So as to take into account the problem of endogeneity mentioned in footnote 7, an external instrument is used (durability of the political regime, obtained from the Polity IV database, to reflect the broader perspective of macroeconomic stability with a long-term approach by a more stable political regime).

procedures, signing of agreements or entry into force) in the establishment of free trade agreements by Mexico, Colombia, Chile, Peru and Central America with Asian and European countries such as Turkey.

In the case of MERCOSUR, some progress was made in opening up towards other areas, with agreements signed to start negotiations with Lebanon, Tunisia, Russia, Belarus and Kazakhstan, in addition to South Korea and Pakistan, and ratification of the free trade offer made to the European Union in mid-2014 covering 90% of trade. Measures were also adopted to facilitate the free movement of goods and persons within the area, such as an arrangement to allow Uruguay and Brazil to trade with each other in their local currencies, further momentum for the Mercosur passport programme and acceleration of the process of accession for Bolivia. Chile put forward the possibility of the Pacific Alliance moving closer to MERCOSUR on matters not related to lower tariffs. By contrast, Argentina and Brazil renewed the restrictions on sales of cars with Mexico for another four years.

Turning to structural reforms, in Mexico new legislative initiatives were enacted to combat corruption and violence and to boost productivity, increasing integration between the production chains of SMEs and large corporations and promoting the funding of activities and projects that entail productive potential or investment in human capital. In addition, the new regulatory bodies of the various sectors affected by the reforms began to take shape and the Mexican Oil Fund was established. In Colombia a moderately broad tax reform was introduced that aims to close the revenue gap in the 2015 budget, raising income tax and creating a new wealth tax. Lastly, in Chile, an education reform guaranteeing free schooling and an electoral reform making the voting system more proportional were passed and it was announced that a labour reform, including measures to facilitate trade union membership, guarantee the right to strike and changes in employment contracts, would be put before Parliament before the end of the year.

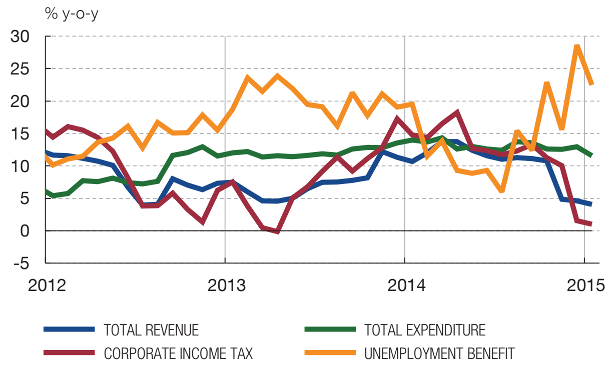
Economic developments by country

With the review of the national accounts figures published in March, *Brazil's* economy came out of "technical" recession in 2014 H2, growing by 0.2% and 0.3% in quarterly terms in Q3 and Q4, respectively, although the year-on-year rates remained negative in the last three quarters of the year (-1.2%, -0.6% and -0.2%, respectively). Thus, growth in 2014 amounted to 0.2% (compared with 2.7% in 2013), on the back of continued weakness in domestic demand, which contributed just 0.1 pp to growth in 2014. The sharp contraction in investment continued (some 6% year-on-year in Q4), while private consumption posted moderate growth. External demand contributed 0.4 pp in Q4, with exports falling sharply (-10.7% year-on-year) owing to weak manufacturing and oil sales, by product, and to weak exports to China and the EU, by country. The higher frequency indicators for 2015 Q1 point to continued weakness in domestic demand, exacerbated by the effect of the most severe drought in decades. The labour market shows some signs of weakness, as job creation rates continued to fall, especially in manufacturing, even though the unemployment rate remained at all-time lows (partly owing to the decline in the labour force) and real wages rose by 2.4%. Inflation continued to climb throughout the year, closing 2014 at 6.4% year-on-year, and in January 2015 it broke through the target range ceiling (+4.5%, with bands of +/-2%) as a consequence of the government's adjustment of administered prices, reaching 8.1% year-on-year in March. Core inflation has rebounded, especially since the start of the year (8% in March), as have inflation expectations, which anticipate that inflation will not return to within the central bank's target range until mid-2016. Against this backdrop, shortly after the elections the central bank surprised the markets by resuming official interest rate hikes, with a cumulative increase of 125 bp up to 12.75%, in an attempt to anchor inflation expectations. In addition, the volume of intervention by means of currency

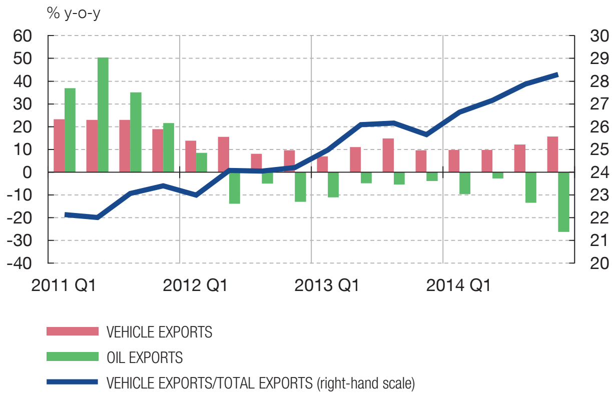
BRAZIL AND MEXICO

CHART 11

BRAZIL. GOVERNMENT REVENUE AND EXPENDITURE



MEXICO. OIL AND VEHICLE EXPORTS



SOURCE: National statistics.

swaps was first halved, and this instrument was then eliminated at the end of March. The Brazilian real depreciated by 14% against the dollar in the six-month period, reaching more than 3.3 reais per dollar in 2015 Q1, its lowest point since 2003. From the fiscal standpoint (see Chart 11), the primary balance stood at -0.6% of GDP in 2014, a sharp deterioration compared with previous years (1.8% of GDP in 2013) and short of the target for the year (+0.2% of GDP) which had already been revised down. However, the new government has announced a fiscal package consisting of expenditure cuts equivalent to 0.7% of GDP and tax increases equivalent to 0.4% of GDP. These measures aim to redress the fiscal accounts and restore credibility in the medium term, although in the short term they could have a negative impact on activity and drive up inflation in 2015. Turning to the external sector, the current account deficit widened to 4% of GDP in 2014 (compared with 3.6% of GDP in 2013) as a result of the erosion of the trade surplus and the emergence of a modest deficit (0.2% of GDP) associated with the decline in the terms of trade and lower exports to China. In the financial account, portfolio inflows rose moderately, from 1.1% of GDP in 2013 to 1.4% in 2014, taking advantage of Brazil's higher interest rates. Moody's placed the outlook on the sovereign rating to negative and Standard and Poors left it unchanged.

The *Mexican* economy grew by 2.1% in 2014, compared with 1.4% in 2013, recovering throughout H2, albeit at a slower than expected pace. On the demand side, exports continued to be the main growth driver (7.1% in Q3 and 10.3% in Q4), boosted by the growth in activity in the United States and its impact on the manufacturing industry (especially the automobile industry) (see Chart 11) which more than offset the decline in oil exports. Investment was the most dynamic component of domestic demand, growing by 2.3% in the year (compared with a fall of 1.6% in 2013), in view of the good performance of private investment (5%) which more than offset the decline in public investment (-7%). Private consumption remained weak, although the good performance of the labour market, which is benefiting from the plan to encourage employment in the formal sector, provided it with heightened momentum. Indeed the unemployment rate fell to 4.4% in Q4. The published data for 2015 Q1 point to growth rates similar to those seen in Q4, driven by external demand. At the end of the year inflation stood at 4.1% year-on-year, slightly above the upper bound of the central bank's target range (3% ± 1%), with core inflation below the headline rate (2.4% in February) and inflation expectations for the medium and long term anchored around 3%. The Mexican peso depreciated in tandem with the decline in oil prices, reaching its lowest point for six years and triggering the automatic intervention rule to curb volatility. Subsequently, supply was increased by a further $52 million per day at auctions with no minimum price, as downward pressure heightened. In this setting, the central bank has held official rates at 3% throughout the last six months, pointing to possible synchronisation of monetary policy with the Federal Reserve, and in consequence markets are factoring in the first rate increase for 2015 Q3. On the fiscal front, public finances worsened owing to the slowdown in revenue which was attributable, above all, to the 42% slide in oil revenue, despite the positive effect of the tax reform approved in October 2013 and the currency depreciation. Thus the deficit stood at 3.2% of GDP (compared with the target of 2.5%), almost 1 pp above the 2013 figure. Against this backdrop, in January the Mexican government announced public spending cuts of 0.7% of GDP for 2015, particularly affecting current spending but also investments in Pemex and the Federal Electricity Committee, and further cuts for 2016.

In *Argentina* the weak activity that had characterised 2014 H1 continued in H2. GDP grew by just 0.1% and 0% in quarter-on-quarter terms in Q3 and Q4, respectively, meaning that in 2014 overall GDP rose by 0.5%, compared with 2.9% in 2013. The key factor behind the weak activity levels in 2014 are the restrictions on manufacturing imposed due to import controls, which have had a particularly harsh impact on intermediate goods, against the current backdrop of trade and financial isolation and the scarcity of foreign currency. On the expenditure side, the rate of decline of investment accelerated year-on-year to 4.9% in Q3 and to 9.7% in Q4, resulting in a fall of 5.6% in the year overall. Household consumption decreased by 0.5% in 2014, after a decade of growth over 3%, reflecting the exhaustion of domestic sources of growth. In turn, government consumption rose by 2.8% in the year overall (the lowest figure in a decade), after the rate of growth accelerated in Q4 to 3.8% year-on-year. Conversely, the external sector's contribution went from a negative 1.4 pp to a positive 1.4 pp as a consequence of the severe contraction (more than 12%) in imports, more than offsetting the decrease in exports (see Chart 12) which felt the brunt of the decline in the terms of trade and weak external demand, especially from Brazil, the country's leading trading partner. The forecasts for 2015 point to a continued weak economic performance. In this setting, in 2014 the current account deficit widened to 0.9% (from 0.8% in 2013). In turn, international currency reserves stabilised around $30 billion, thanks to import controls and several currency swaps activated in Chinese yuan ($3.8 billion). The official inflation rate reached 23.9% year-on-year in December and although the fall in oil prices and the disappearance of the effect of the sharp devaluation in early 2014 are helping to smooth it, the continued monetisation of the budget deficit, which closed the year at over 3% of GDP, remains a significant upside risk factor. The increase in the budget deficit was a result of higher public spending (42% per annum), arising from subsidies to the private sector, which more than offset the higher revenue (41%). The official exchange rate depreciated by almost 50% in 2014, closing the year at 8.1 pesos per dollar, although the rate of depreciation slowed in H2 and the gap with respect to the unofficial exchange rate narrowed. The expiry in 2015 of the Rights Upon Future Offers (RUFO) clause relating to the restructured debt, which granted holders of restructured bonds the right to any improved terms granted to other creditors, did not prompt any change in the negotiations with the holdout creditors, meaning that the country remains in a situation of sovereign default on its restructured debt.

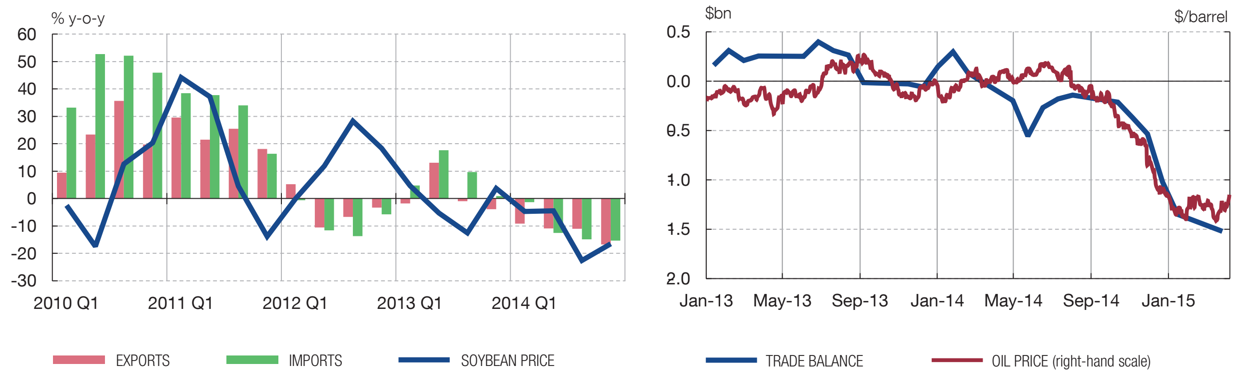
Chile saw a sharp deceleration in economic activity in 2014, although the pace of slowdown moderated in the closing months of the year and, especially, in early 2015. In 2014 overall, GDP grew by 1.9% year-on-year and the data for both 2013 and 2012 were revised up by 0.1 pp, to 4.2% and 5.5%, respectively. In quarterly terms, the economy grew at a slightly faster pace (0.9%) in 2014 Q4, and in particular the rate of contraction of domestic demand moderated, driven by public spending (5.5% year-on-year) and by gross fixed capital formation which moved into positive territory (0.5% year-on-year) after five consecutive

ARGENTINA AND COLOMBIA

CHART 12

ARGENTINA. FOREIGN TRADE

COLOMBIA. TRADE BALANCE AND OIL



SOURCES: INDEC, Secretaria de Agricultura of Argentina and DANE.

quarters of markedly negative figures. External demand made a positive contribution (3.2 pp) to growth in 2014, as imports declined. The unemployment rate remained low (6.3% of the labour force). The trade surplus widened, triggering a very substantial correction in the current account deficit (1.2% of GDP, compared with 3.4% in 2013). In the financial account, foreign direct investment and portfolio investment rose. Inflation, which rebounded to 5.7% year-on-year in October, has moderated in recent months, partly as a result of the drop in oil prices, reaching the upper bound of the target range. The central bank has made one official interest rate cut since September, taking rates down 25 bp to 3%. On the fiscal front, in 2014 the deficit amounted to 1.6% of GDP (above the 0.9% estimated in the budget law) and the structural deficit to 0.5%, owing to higher spending, against a backdrop of cyclical slowdown and as a consequence of lower copper revenues (2% of GDP and 10% of tax revenue), virtually half the 2011 figure. In the first year of the tax reform, the forecast increase in revenue (0.3% of GDP) was achieved. In 2015, tax revenue is forecast to grow by 2% of GDP thanks to the tax reform, with an effective fiscal deficit of 1.9% of GDP and a structural deficit of 1.1% of GDP. Both the stabilisation funds and the low sovereign debt continue to allow Chile to implement a counter-cyclical tax policy.

In 2014 *Colombia* posted the highest growth in the region, as GDP rose by 4.6% (compared with 4.9% in 2013). However the pace of growth slowed significantly in the course of the year, from 6.4% year-on-year in Q1 to 3.5% in Q4, as a result of the deceleration in domestic demand and, in particular, in government consumption and investment (even though, in the year as a whole, the latter was the most dynamic component, posting growth of almost 11%). The pace of growth of private consumption, however, accelerated in Q4, offsetting the slowdown in the other components. The contribution of external demand turned negative again in 2014 (-2.8 pp) as a consequence of the poor performance of exports (-1.7%), marked by the sharp slide in oil exports, which contrasted with the strong import performance (9.2%), reflecting the good investment momentum. Hence the trade deficit widened to 2.4% of GDP in the year (see Chart 12) and the current account balance deteriorated sharply (-5.2% of GDP, compared with -3.2% in 2013). In the financial account, direct investment fell as a result of lower investment in the mining and energy sector, but portfolio investment inflows rose by 68%. The Q1 indicators signal that the rate of growth will continue to slow, even though both credit and the labour market continue to perform well. Inflation, which at the end of 2014 was very close to the upper bound of the target range (+3%, with bands of +/-1 %), began to rise in the closing months of the year and continued to do so in early 2015, reaching 4.6% in March, as a consequence of higher food prices and the currency depreciation. In this setting, the central bank has left the official interest rate unchanged at 4.5% since September, following the rate increases in July and August, and has halted its dollar purchases on the currency markets. The exchange rate fell by more than 20% against the dollar in 2014, and has fallen by more than 8% in 2015 to March, against a backdrop of lower oil prices and the worsening growth outlook. In the fiscal arena, in 2014 Colombia met its structural deficit reduction target of 2.3% of GDP, recording a figure of 2.4%. For 2015, compliance with the fiscal rule initially demanded a tax increase in order to achieve higher revenues. However, in view of the expected decline in oil revenues, the government announced expenditure cuts of 3% and admitted a cyclical deviation of -0.6% in the budget update, entailing an increase in the budget deficit to 2.8% of GDP, which will be financed by issuing government debt.

In *Peru* the loss of economic momentum deepened in Q4, with growth of 0.4% in quarter-on-quarter terms and year-on-year growth of 1%. In the year overall, GDP rose by 2.4%, well short of the 2013 figure (5.8%). By component, private consumption decelerated moderately, but investment fell by 2% owing to the contraction in mining output. External demand made a marginally positive contribution due to the import correction. The current account deficit narrowed in 2014, although it still stood at 4.1% of GDP, as the trade balance deteriorated, moving from a surplus to a deficit owing to the fall in metal prices. In 2015, activity and confidence indicators point to moderate economic growth rates at the start of the year. For its part, inflation eased to within the monetary authority's target range, posting a year-on-year rate of 2.8% in February 2015. The central bank held interest rates unchanged, although certain macro-prudential measures were taken (local currency bank reserve requirements were lowered and limits were imposed on currency derivative operations), in a setting of depreciation of the new sol. Sales of dollars were also made to curb exchange rate volatility and new intervention measures were introduced using currency swaps. On the fiscal front, in 2014 the public sector primary deficit was equivalent to 0.1% of GDP.

The *Venezuelan* economy recorded a very poor performance in 2014. Ahead of the release of the GDP figures for Q4, GDP fell by 4.9% year-on-year in H1 and by 2.3% in Q3. By component, this is attributable to the collapse in investment (-27.5% in Q1, -18% in Q2 and -9.3% in Q3), against a backdrop of import restrictions as a result of the extreme scarcity of foreign currency. The poor performance of private consumption moderated in the course of the year, going from -4.2% in H1 to -1.6% in Q3, with both credit and the labour market continuing to perform reasonably favourably, despite the significant drop in real wages. Government consumption remained the most dynamic component, growing by 2.1% in Q3. The positive contribution made by external demand is explained by the decline in imports, although this contribution contracted sharply as the year progressed (from 13.1 pp in Q1 to 2 pp in Q3). The fall in oil prices is responsible for the decline of almost 10% in nominal terms in exports. Nevertheless, as imports also contracted, the current account surplus stood at 3% of GDP in Q3 2014 (slightly above the figure of 2.3% in 2013). In October 2014, international reserves amounted to 6% of GDP, but liquid reserves were less than $6 billion, as the majority of reserves are held in gold. Inflation soared to 65% in December (the latest figure released), in view of the shortage of foreign currency for imports, the increase in the money supply to finance the budget deficit and the effective exchange rate depreciation in view of the closure ordered of the SICAD I and SICAD II markets and the opening of a new parallel free-floating foreign exchange market (SIMADI) on which the currency traded 93% below the official exchange rate. The rating agencies downgraded the country's sovereign rating to CCC.

17.4.2015.