

Introduction

Economic performance in Latin America in 2015 H2 was largely determined by the growing intensity of the recession in two countries that make up 45% of the region's GDP, namely Brazil, where activity declined by 3.9% in 2015 overall, and Venezuela, where it fell by 5.7%. Accordingly, GDP in the region receded by 0.4% in the year,¹ the worst figure recorded since 2009. There were, however, major differences from one country to another. In Chile, Colombia, Peru and Mexico combined, GDP rose by 2.7% (see Table 1). Growth rates in Argentina, Mexico, Chile and Peru were higher than in 2014, while in Colombia the pace of growth slowed but it was still a robust 3.1%.

In 2015 Latin America continued to adjust to the decline in the terms of trade that began in 2011. A large part of that adjustment was made through exchange rate depreciation, in most countries as part of an orderly process. In some cases, however, the fact that it coincided with adverse internal factors made correction of imbalances difficult, exacerbating the recessionary pattern or sharply driving up inflation. In fact inflation surprised on the upside in most countries, requiring official interest rate rises, against a backdrop of moderately expansionary fiscal policies.

The outlook is complex for 2016, in view of the external environment (the year began with low growth among the region's main trading partners) and the fiscal and external vulnerability displayed by some of the region's economies. The need to redress the imbalances accumulated in recent years will continue to place a constraint on the contribution economic policies can make to recovery. Even in the countries with sounder fundamentals, lower public revenue as a result of the persistent decline in commodities prices, higher indebtedness in recent years or high inflation limit the room for manoeuvre for macroeconomic policies. On the more positive side, the significant adjustment in real exchange rates has restored some external competitiveness and should prompt a recovery in exports and a favourable shift in capital flows, especially towards the economies that display fewer vulnerabilities. In any event, in recent months there have been further downward revisions of forecasts for 2016 and GDP is expected to fall in the region for the second consecutive year (once more owing to declines in Brazil and Venezuela), for the first time in Latin America since the external debt crisis of 1982-1983 (see Chart 1). In all the other countries except Peru the pace of growth is also expected to decelerate compared with 2015.

The structure of this Latin American report has changed compared with past editions. The second section will be devoted to the usual analysis of the economic situation in the region, but in more succinct form. It will now be followed by two thematic sections, providing a more detailed analysis of specific aspects that are either common to all the economies of Latin America or specific to a particular country. The recent inflation performance is the first of the two topics chosen for this report. The rise in prices in most of the region's economies in 2015 was unexpected and was in contrast to the inflation performance in other emerging countries and regions. It is linked to a factor common to Latin America, namely exchange rate depreciation and its pass-through to prices. The third section analyses this effect in several of the countries that have an inflation-targeting

¹ Weighted average GDP of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

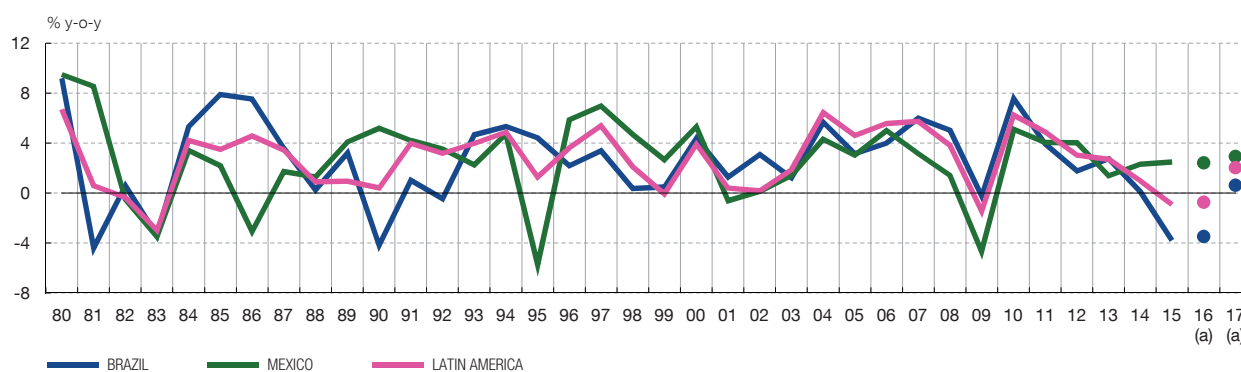
TABLE 1

| | 2014 | 2015 | 2014 | | | | 2015 | | | | 2016 |
|---|------|-------|------|------|------|------|------|------|-------|-------|-------|
| | | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | March |
| GDP (year-on-year rate) | | | | | | | | | | | |
| Latin America-7 | 1.0 | -0.4 | 2.4 | 0.4 | 0.4 | 0.7 | 0.2 | 0.1 | -0.5 | — | |
| Latin America-4 (a) | 2.6 | 2.7 | 3.3 | 2.2 | 2.4 | 2.5 | 2.5 | 2.5 | 2.8 | 2.7 | |
| Argentina | 0.5 | 2.1 | 0.8 | 0.7 | -0.2 | 0.5 | -0.3 | 3.9 | 3.5 | 0.9 | |
| Brazil | 0.1 | -3.8 | 3.2 | -0.8 | -1.1 | -0.7 | -2.0 | -3.0 | -4.5 | -5.9 | |
| Mexico | 2.3 | 2.5 | 2.3 | 1.8 | 2.3 | 2.6 | 2.5 | 2.4 | 2.8 | 2.5 | |
| Chile | 1.9 | 2.1 | 2.7 | 2.3 | 0.9 | 1.6 | 2.7 | 2.1 | 2.2 | 1.3 | |
| Colombia (b) | 4.4 | 3.1 | 6.3 | 4.0 | 4.0 | 3.3 | 2.7 | 3.1 | 3.2 | 3.3 | |
| Venezuela | -3.9 | -5.7 | -5.2 | -5.4 | -2.7 | -2.6 | -1.4 | -4.7 | -7.1 | — | |
| Peru | 2.4 | 3.3 | 5.0 | 1.9 | 1.8 | 1.2 | 1.9 | 3.1 | 3.2 | 4.7 | |
| CPI (year-on-year rate) | | | | | | | | | | | |
| Latin America-5 (a) | 5.0 | 6.0 | 4.7 | 4.9 | 5.2 | 5.2 | 5.4 | 5.8 | 6.2 | 6.6 | 6.4 |
| Argentina (c) | 22.6 | — | 6.9 | 13.5 | 18.2 | 22.6 | 18.4 | 15.4 | 14.7 | — | — |
| Brazil | 6.3 | 9.0 | 5.8 | 6.4 | 6.6 | 6.5 | 7.7 | 8.5 | 9.5 | 10.4 | 9.4 |
| Mexico | 4.0 | 2.7 | 4.2 | 3.6 | 4.1 | 4.2 | 3.1 | 2.9 | 2.6 | 2.3 | 2.6 |
| Chile | 4.4 | 4.3 | 3.2 | 4.5 | 4.7 | 5.3 | 4.4 | 4.2 | 4.8 | 4.1 | 4.5 |
| Colombia | 2.9 | 5.0 | 2.3 | 2.8 | 2.9 | 3.5 | 4.2 | 4.5 | 4.9 | 6.4 | 8.0 |
| Venezuela | 62.2 | 121.7 | 57.7 | 60.9 | 63.2 | 65.4 | 79.5 | 89.7 | 126.5 | 170.1 | — |
| Peru | 3.2 | 3.5 | 3.4 | 3.5 | 2.9 | 3.2 | 3.0 | 3.3 | 3.8 | 4.1 | 4.3 |
| Budget balance (% of GDP) (d) | | | | | | | | | | | |
| Latin America-5 (a) | -4.3 | -6.5 | -2.6 | -3.0 | -3.6 | -4.3 | -5.1 | -5.3 | -5.8 | -6.5 | |
| Argentina | -2.5 | — | -2.1 | -2.3 | -2.3 | -2.5 | -3.3 | -3.6 | — | — | |
| Brazil | -6.0 | -10.4 | -2.9 | -3.3 | -4.5 | -6.0 | -7.6 | -8.0 | -9.2 | -10.4 | |
| Mexico | -3.2 | -3.5 | -2.8 | -3.2 | -3.4 | -3.2 | -3.3 | -3.7 | -3.3 | -3.5 | |
| Chile | -1.6 | -2.2 | -1.0 | -1.1 | -1.4 | -1.6 | -1.9 | -2.0 | -2.1 | -2.2 | |
| Colombia | -2.6 | -3.1 | -2.7 | -3.6 | -3.4 | -2.6 | -3.0 | -2.5 | -2.7 | -3.1 | |
| Venezuela | | | | | | | | | | | |
| Peru | -0.5 | -2.9 | 0.4 | 0.0 | 0.0 | -0.5 | -1.0 | -1.5 | -2.1 | -2.9 | |
| Public debt (% of GDP) | | | | | | | | | | | |
| Latin America-5 (a) | 43.2 | 48.8 | 40.1 | 40.7 | 42.3 | 43.2 | 44.9 | 45.6 | 47.7 | 48.8 | |
| Argentina | 40.7 | — | 31.3 | 34.7 | 36.1 | 40.8 | 39.5 | 39.6 | 41.4 | — | |
| Brazil | 57.2 | 66.2 | 52.1 | 53.2 | 55.8 | 57.2 | 60.5 | 61.8 | 64.7 | 66.2 | |
| Mexico | 33.1 | 35.8 | 32.1 | 32.3 | 33.1 | 33.1 | 33.8 | 33.9 | 35.0 | 35.8 | |
| Chile | 15.1 | 18.2 | 13.4 | 14.0 | 14.6 | 15.1 | 15.9 | 16.5 | 17.5 | 18.2 | |
| Colombia | 37.7 | 41.3 | 35.9 | 35.1 | 35.6 | 37.7 | 39.6 | 40.2 | 43.0 | 41.3 | |
| Venezuela | — | — | — | — | — | — | — | — | — | — | |
| Peru | 20.0 | 23.3 | 18.2 | 18.3 | 18.5 | 20.0 | 20.0 | 19.9 | 21.2 | 23.3 | |
| Current account balance (% of GDP) (d) | | | | | | | | | | | |
| Latin America-7 | -2.9 | -3.3 | -2.6 | -2.8 | -2.8 | -2.9 | -3.1 | -3.2 | — | — | |
| Argentina | -1.1 | -2.7 | -1.0 | -1.2 | -1.1 | -1.1 | -1.1 | -1.5 | — | — | |
| Brazil | -4.3 | -3.3 | -3.3 | -3.6 | -3.8 | -4.3 | -4.4 | -4.2 | -4.0 | -3.3 | |
| Mexico | -1.9 | -2.8 | -2.4 | -2.4 | -2.2 | -1.9 | -2.0 | -2.1 | -2.6 | -2.8 | |
| Chile | -1.3 | -2.0 | -3.3 | -2.6 | -1.7 | -1.3 | -0.9 | -1.1 | -1.5 | -2.0 | |
| Colombia | -5.2 | -6.5 | -3.4 | -3.9 | -4.2 | -5.2 | -5.7 | -6.0 | -6.7 | -6.5 | |
| Venezuela | 0.7 | -2.0 | 2.2 | 2.2 | 1.6 | 0.7 | -1.2 | -1.7 | -2.2 | -2.0 | |
| Peru | -4.0 | -4.4 | -4.1 | -4.3 | -3.8 | -4.0 | -4.3 | -3.8 | -4.3 | -4.4 | |
| External debt (% of GDP) | | | | | | | | | | | |
| Latin America-5 (a) | 21.5 | — | 19.8 | 20.6 | 20.6 | 21.5 | 22.3 | 23.5 | 25.1 | — | |
| Argentina | 26.3 | — | 23.6 | 25.4 | 25.5 | 26.3 | 26.0 | 26.2 | — | — | |
| Brazil | 14.6 | 19.1 | 13.2 | 14.0 | 13.9 | 14.6 | 14.9 | 16.0 | 17.5 | 18.9 | |
| Mexico | 22.1 | 26.1 | 20.8 | 21.7 | 21.4 | 22.0 | 22.5 | 23.8 | 25.0 | 26.0 | |
| Chile | 56.5 | — | 48.9 | 50.9 | 52.6 | 56.5 | 57.8 | 59.4 | 60.3 | — | |
| Colombia | 26.8 | — | 25.1 | 25.4 | 25.6 | 26.8 | 29.2 | 31.2 | 34.6 | — | |
| Venezuela | 21.8 | — | 30.7 | 28.9 | 24.8 | 21.8 | 18.1 | 15.5 | 13.8 | — | |
| Peru | 31.8 | 35.5 | 30.2 | 30.5 | 31.1 | 31.8 | 32.3 | 32.2 | 34.5 | 35.5 | |

SOURCE: National statistics.

- a Latin America-5: all the countries represented, except Argentina and Venezuela.
Latin America-4: Mexico, Chile, Colombia and Peru.
- b Seasonally adjusted.
- c 2014 inflation is calculated as the cumulative figure since December 2013.
- d Four-quarter moving average.

1 GROWTH IN LATIN AMERICA



SOURCES: IMF (WEO) y Consensus Forecasts.

a Consensus Forecasts projections.

regime. Lastly, the fourth section reviews and places in context the recent economic policy changes made in Argentina and reviews the outlook and risks going forward.

Recent economic performance in Latin America

EXTERNAL ENVIRONMENT AND FINANCIAL MARKET PERFORMANCE

Since the last Latin American report was published in October the world economy has underperformed expectations somewhat, in a setting marked by higher volatility in financial markets and sluggish trade flows. Among the main advanced economies, the pronounced slowdown in activity in the United States in 2015 Q4, which seems to have continued into 2016 Q1, was particularly noteworthy, while in all other advanced economies the pace of growth generally steadied at moderate levels. The emerging economies continued to face major headwinds – the gradual economic slowdown in China, low commodities prices and the deterioration in investor sentiment in the financial markets – that have contributed to prolonging the slowdown in activity and there is no clear sign of any turning point in this respect. Against this backdrop, global economic growth forecasts have been revised down again and the balance of risks has continued to deteriorate.

In turn, in the international financial markets volatility has increased. On the one hand, the process to liberalise the capital account and increase the flexibility of the exchange rate in China continued to generate instability worldwide and prompted significant capital outflows from that country. Moreover, the continued decline in oil prices, down to 13-year lows in early 2016, triggered risk aversion in the financial markets that particularly affected the corporate sector in the major oil-producing and exporting countries. On the other hand, although the interest rate rise in the United States at the end of 2015 caused no notable turbulence in the emerging markets, as it was already largely factored in, doubts about the strength of the recovery in the United States, together with heightened instability in China and a further decline in oil prices, gave rise to another episode of high market stress at the start of 2016 that drove up the cost of borrowing for emerging economies once more. Since mid-February, as crude prices have recovered (up to over \$40 per barrel of Brent), the expectations of monetary tightening in the United States have been put back, the Chinese financial markets have steadied and the ECB and the Bank of Japan have continued with their expansionary policies, the emerging markets have undergone a strong recovery, the continuity of which is difficult to assess.

Financial markets in Latin America performed in tandem, though with more marked fluctuations, chiefly as a result of the high weight of the oil companies as a percentage

of the local stock markets and corporate credit risk indicators. Moreover, as many of those companies are State-owned, this fed through to sovereign risk. In effect, while the sovereign spread of the countries of the region that are least dependent on oil prices rose by 50 bp, the sovereign spread of those most dependent on oil prices rose by 230 bp (see Chart 2).²

By country, it is interesting to note that the latest market upswing has had the most favourable impact on the countries with high vulnerabilities. For instance Brazil, where the stock market recovery, narrowing of sovereign spreads and, especially, exchange rate appreciation (12% against the dollar) since February have all been greater than in the other countries in the region, leading the central bank to intervene in the foreign exchange markets to halt it. The reason for this marked improvement is the expected change in the political cycle, which is subject, in any event, to great uncertainty; all three leading credit rating agencies have placed Brazil's sovereign rating below investment grade.

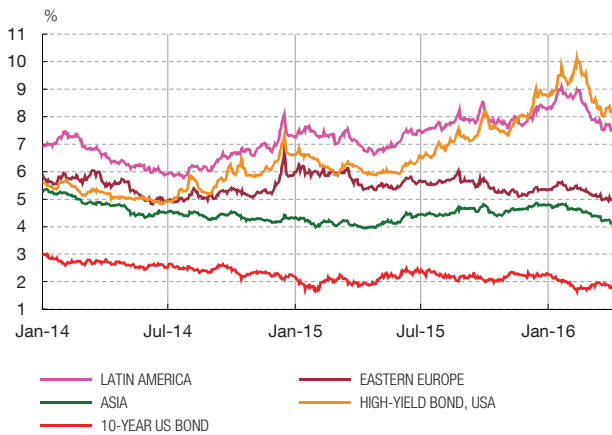
In both Colombia and Mexico the dependence of their external accounts and public finances on oil prices caused their market indicators to deteriorate severely, despite their sounder fundamentals. In Mexico the rapid response from the authorities (announcing a coordinated fiscal and monetary adjustment and subsequent financial support for PEMEX) smoothed the fall. In Argentina and Venezuela market performance was also conditioned by the political cycle. In Venezuela the sovereign spread remained above previous highs (3,000 bp), in a setting marked by a sharp increase in real, fiscal and external vulnerabilities and expectations of a default that did not materialise. The opposition win in the general election prompted the government to announce fiscal and exchange rate adjustment measures that to date have had negligible effects on the markets. By contrast, in Argentina and as analysed in detail in the last section of this article, the new economic policy stance following the election of the country's new president gave rise to a substantial improvement in market perception.

In 2015 H2 the decline in capital flows that began in early 2014 continued. In effect, both portfolio inflows and inflows of foreign direct investment fell to their lowest levels since 2011 and 2010, respectively (see Chart 3). In the region as a whole, gross portfolio inflows in 2015 amounted to \$26.8 billion, almost \$70 billion less than in 2014, as inflows to Mexico and Brazil declined. Gross direct investment inflows totalled \$157 billion, some \$17 billion less than in 2014, also owing to lower inflows to Brazil (\$23 billion less), although direct investment inflows both to Mexico and Argentina grew in 2015. The lower level of capital inflows was reflected in foreign exchange reserves, which fell in all countries in the region from June 2015, reaching all-time lows in Ecuador, Argentina and Venezuela. More recently, since March 2016, capital inflows to emerging markets, including those in Latin America, have recovered significantly.

Fixed income issuance in 2015 Q4 dropped to levels not recorded since early 2009 (see Chart 3). Brazil made no placements in international markets between June 2015 and March 2016, while issuance in Mexico was almost 75% lower than in the same period of 2014. Moreover, international issuance was not replaced by local issuance, which also declined in 2015 Q4, down to \$4.5 billion. In 2016 Q1 issuance in international markets regained momentum, driven both by sovereign and euro issues (55% and 42% of the total, respectively).

² Excluding Venezuela, the increase would be 110 bp.

1 INTEREST RATES (a)



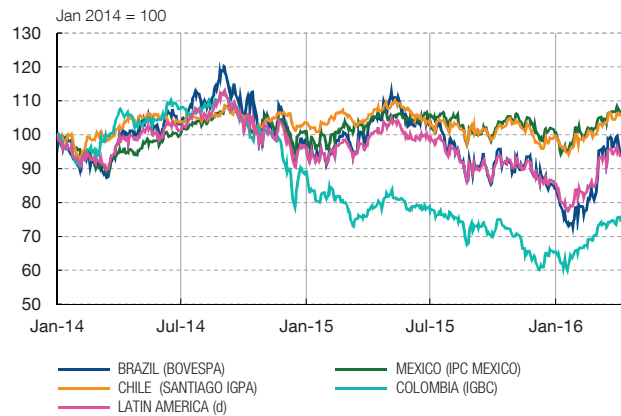
2 CHINA AND OIL



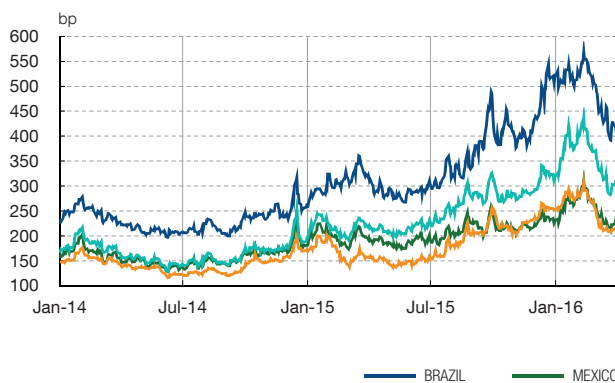
3 SOVEREIGN SPREADS



4 STOCK EXCHANGE INDICES



5 SOVEREIGN SPREADS



6 NOMINAL EXCHANGE RATE AGAINST THE DOLLAR

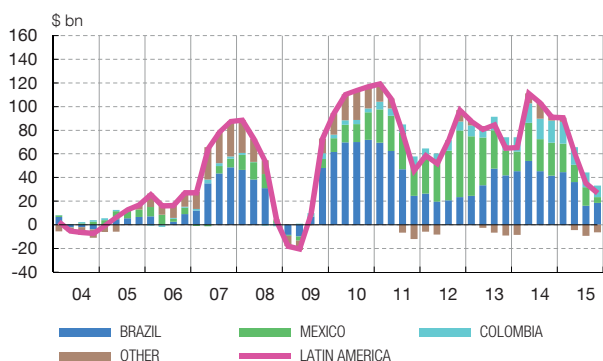


SOURCES: Datastream and JP Morgan.

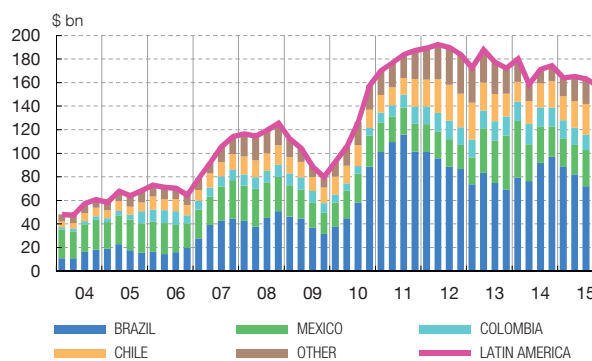
- a Latin American, Asian and Eastern European rates have been constructed by adding the US 10-year government bond yield and EMBI spreads.
- b Bolivia, Colombia, Ecuador, Venezuela, Mexico and Trinidad and Tobago.
- c Argentina, Brazil, Panama, Peru, Jamaica, Belize, Chile, Dominican Republic, El Salvador and Uruguay.
- d MSCI Latin America index in local currency.

\$ bn

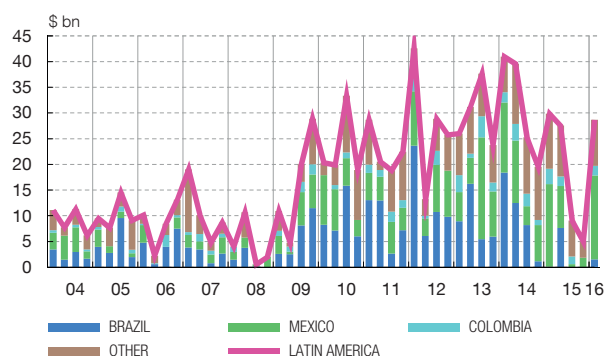
1 LATIN AMERICA: 12-MONTH CUMULATED PORTFOLIO INVESTMENT FLOWS



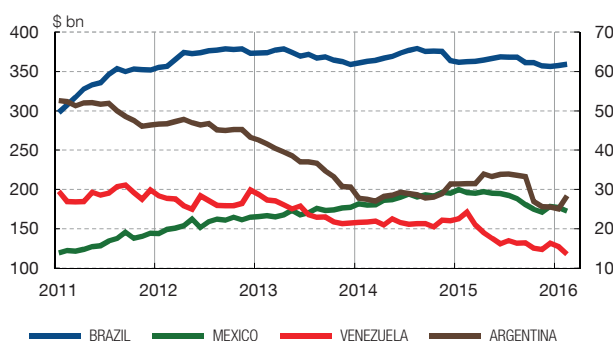
2 LATIN AMERICA: 12-MONTH CUMULATED FDI FLOWS



3 LATIN AMERICA: BOND ISSUES ON INTERNATIONAL MARKETS



4 LATIN AMERICA: INTERNATIONAL RESERVES



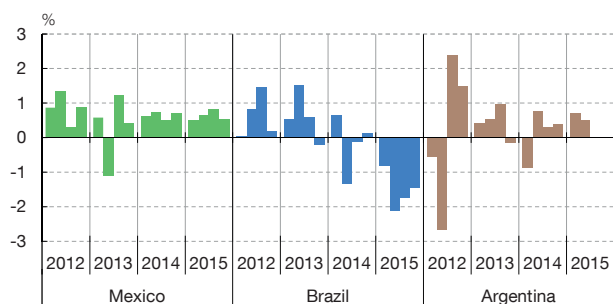
SOURCES: Datastream, Dealogic, JP Morgan, IMF and national statistics.

In this setting of debilitated funding sources, domestic credit to the private sector remained moderate on average in the region, with a year-on-year rate of growth close to 4% in real terms, a 15-year low. In Brazil, lending has been flat since late 2015, with a sharp contraction in mortgage lending and directed credit as a result of restrictions on public-sector bank lending. In Peru, Colombia and Mexico, however, lending expanded, with growth rates over 11% in real terms in Peru and Colombia and of 6% in Mexico.

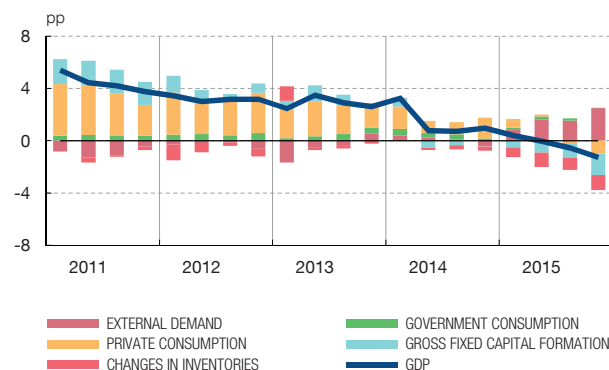
ACTIVITY AND DEMAND

The global shocks discussed above had an adverse effect on the activity of the Latin American economies in the second half of 2015 and in the first few months of 2016. The one with the greatest impact was probably the further fall in the oil price (and in the prices of other commodities), which affected mainly countries like Venezuela, Ecuador, Colombia, Mexico and Brazil, through a significant decline in nominal exports and government revenues, and also raised doubts regarding the financial situation of the major oil companies. From the local viewpoint, there was a notable worsening of the political uncertainty in Brazil, which has hampered the adoption of the economic policy measures required to correct its significant fiscal imbalance. Brazil is a relatively closed economy, which limits the scope of potential cross-border spillovers, but its size and the scale of the fall in activity have meant that the adverse impact on its main regional trading partners (Argentina, Uruguay and Paraguay) has been marked.

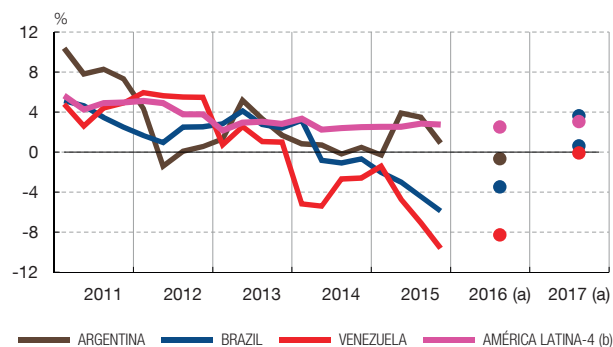
1 GROSS DOMESTIC PRODUCT
Quarter-on-quarter rate



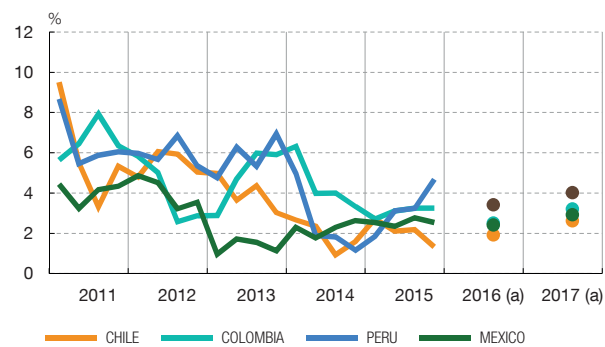
2 CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH. LATIN AMERICA-5



3 GROSS DOMESTIC PRODUCT
Year-on-year rate



4 GROSS DOMESTIC PRODUCT
Year-on-year rate



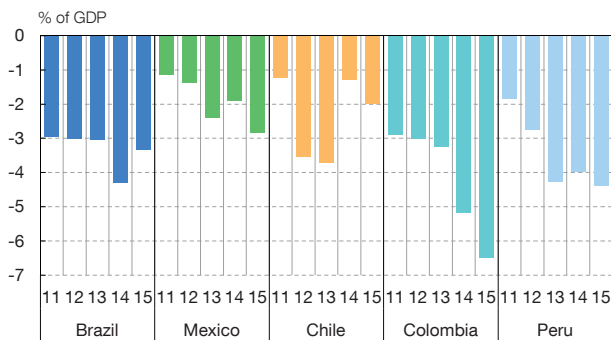
SOURCE: National statistics.

a Latin American Consensus Forecasts projections, March 2016.
b Mexico, Chile, Colombia and Peru.

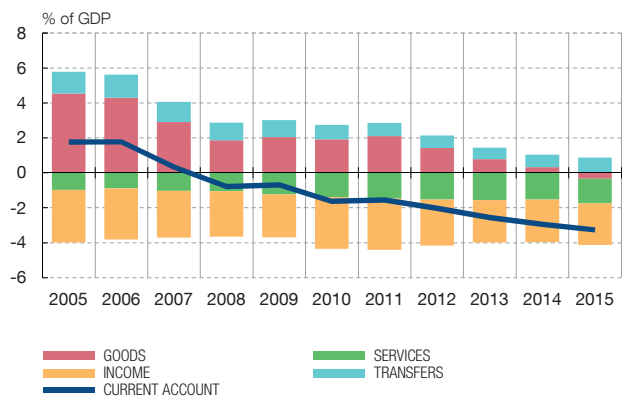
The fall in GDP in 2015 stemmed from the negative behaviour of investment (across the region), which intensified in the second half of the year, as well as from the weakness of private consumption in some countries. The contraction of gross capital formation linked to the drop in commodity prices, the decline in capital inflows and the fall in confidence reduced investment-to-GDP ratios to below 20%, their lowest levels for ten years. Private consumption, meanwhile, fell at unprecedented rates in Brazil (-4%) and Venezuela (-7.8%) (countries with high inflation, weak labour markets and political uncertainty), but showed greater strength in Mexico, Colombia and Peru, where it grew by around 3%.

The adjustment of domestic demand (which contracted in Brazil and Venezuela, and slowed in the rest of the countries) and the competitiveness gain from exchange rate depreciation are bringing about a rebalancing of spending in the region, in terms of a broadly positive contribution of net external demand to growth (of 2.5 pp in 2015 Q4, see Chart 4). This positive contribution was chiefly a result of the contraction in imports (-8.9% year-on-year in Q4), while exports began to recover gradually (7.9%) in Brazil, Peru and also, despite some fluctuation, in Chile. In principle, the cumulative real exchange rate depreciation over the last five years should have had a stronger impact on exports. However, the limited diversification of the production of most Latin American countries, the weakness of the recovery in the world economy and the smaller gain in competitiveness

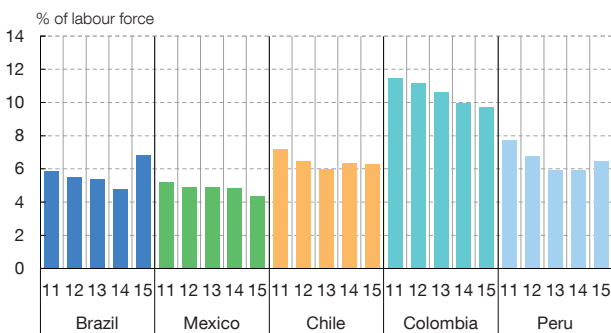
1 CURRENT ACCOUNT BALANCE



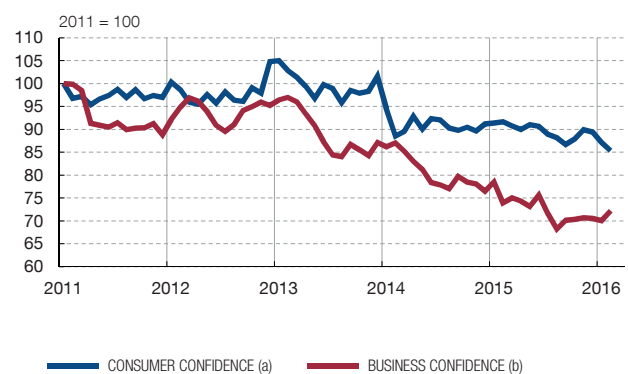
2 CURRENT ACCOUNT BALANCE BY COMPONENT



3 UNEMPLOYMENT RATE



4 CONSUMER AND BUSINESS CONFIDENCE INDICES



SOURCE: Datastream.

- a Argentina, Brazil, Chile, Mexico and Peru.
b Brazil, Chile, Mexico y Peru.

relative to regional trading partners (whose exchange rates also depreciated) have reduced the power of this channel. That said, the improvement in competitiveness offset, to some extent, the impact of the fall in commodity prices on the balance of payments and the significant increase in the external deficit entailed.

In fact, the current-account deficit of the region, as measured in US dollars, tended to narrow in 2015, a change with respect to previous years. This correction was not reflected in the deficit measured relative to GDP (the aggregate deficit of the five countries with inflation targets increased to 3.5% in 2015), due to the fall in nominal GDP. By country, the most marked correction in 2015 took place in Brazil, where the deficit narrowed to -3.3% of GDP in 2015. By contrast, countries like Colombia (where the current-account deficit widened to -6.5% of GDP), Venezuela (-5.6%) and Peru (-4.4%) continue to show heightened external vulnerability (see Chart 5).

A key factor when assessing how resilient domestic demand will be in the coming months in Latin America is the labour market situation. Recent labour market developments have continued to show deep cross-country disparities, similar to those observed in relation to

| Country | 2015 | | | 2016 | | 2017 |
|----------|---------|----------|-------------|-------|------------------|------------------|
| | Target | December | Fulfillment | March | Expectations (a) | Expectations (a) |
| Brazil | 4,5 ± 2 | 10.7 | No | 9.4 | 7.3 | 5.7 |
| Mexico | 3 ± 1 | 2.1 | Sí | 2.6 | 3.4 | 3.4 |
| Chile | 3 ± 1 | 4.4 | No | 4.5 | 3.6 | 3.0 |
| Colombia | 3 ± 1 | 6.8 | No | 8.0 | 5.1 | 3.5 |
| Peru | 2 ± 1 | 4.4 | No | 4.3 | 3.4 | 2.9 |

SOURCES: National statistics and Consensus Forecasts.

a March 2016 Consensus Forecast for the end of the year.

activity. In Brazil, indicators showed a significant deterioration: the unemployment rate rose by 3 pp between the beginning of 2015 and February 2016, to reach 8.2% of the labour force, job losses in the formal sector of the economy intensified (except in the case of self-employment) and the decline in real wages steepened (to -5%). In addition, the labour force tended to increase, interrupting the downward trend that had prevailed since 2011, associated with the increase in secondary education and the less immediate need during the boom years for household members to enter the labour force as soon as possible. By contrast, in Chile, Peru, Colombia and Mexico unemployment rates remained close to their historic lows, against the background of a labour market that performed favourably and better than GDP.

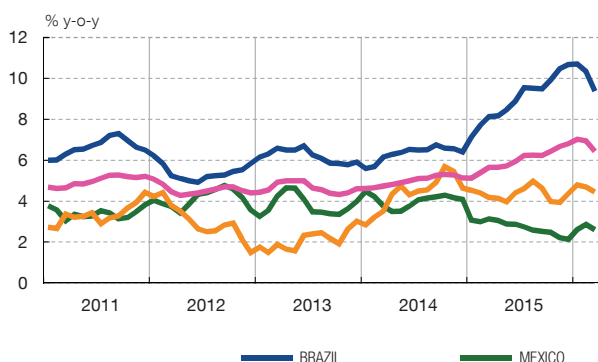
The higher-frequency indicators generally show a relatively weak economic performance at the start of 2016. The decline in industrial production has accelerated, largely due to developments in Brazil, while in countries such as Peru and Colombia these indicators have strengthened. Retail sales have continued to moderate and household and business confidence indicators seem to have stabilised, but at very low levels. The growth estimates for 2016 Q1 obtained from short-term forecasting models point to very moderate quarterly growth rates in Mexico (0.3%-0.4%), more buoyant rates in Chile (a quarterly rate of 1.3%), and a further – albeit more moderate – contraction of GDP in Brazil (at a quarterly rate of -0.5%). The recent behaviour of market indicators points to an improvement in sentiment towards the region, in line with other emerging countries.

ECONOMIC POLICIES AND
PROSPECTS FOR 2016

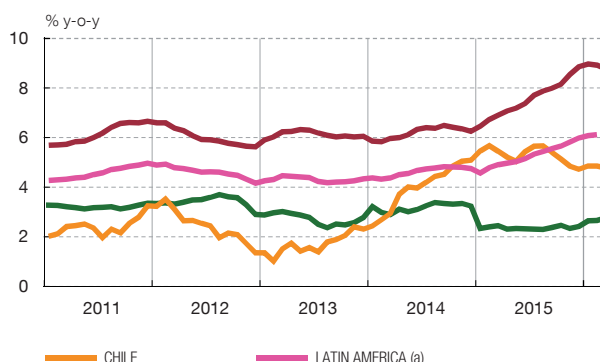
Despite the cyclical weakness, inflation stood at around 6.5% in the five countries with inflation targets in 2015 Q4. In Venezuela inflation was above 170% and in Argentina above 30% (10.4% according to the official figures). Inflation surprises were one of the distinctive features of macroeconomic developments in Latin America in 2015. For the first time in ten years only one country, Mexico, achieved its inflation target, while Brazil, Chile, Colombia and Peru recorded end-year inflation rates above their target ranges (see Table 2). In addition, in Brazil and Colombia, the deterioration in inflation expectations was very marked in the second half of 2015 (see Chart 6). Against this background, there were widespread official interest rate increases, and in Brazil, where the upward cycle started earlier, the Selic rate remained stable at a high level from the middle of the year. Inflation developments and how they relate to exchange rate appreciation, are analysed in greater detail in the third section.

The adjustment of fiscal policies to a scenario of lower commodity prices continued in most cases. In Brazil, however, the fiscal adjustment envisaged for 2015 was not implemented and the budget deficit stood at 10.4% of GDP at the end of 2015, as a

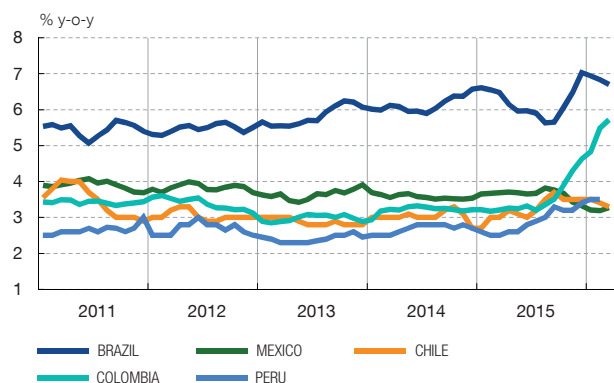
1 INFLATION RATE



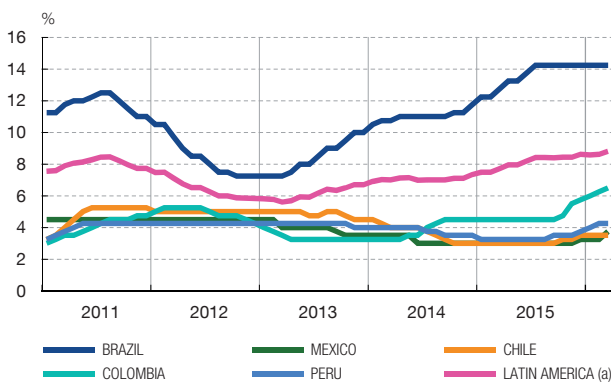
2 CORE INFLATION RATE



3 12-MONTH INFLATION EXPECTATIONS



4 OFFICIAL INTEREST RATES



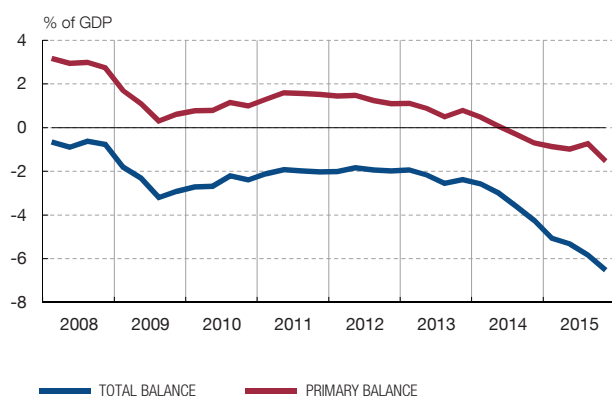
SOURCES: Datastream.

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

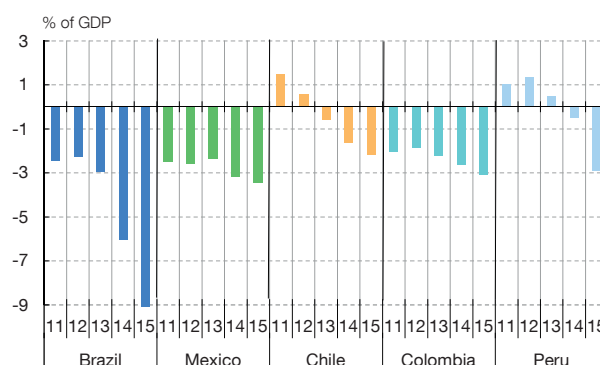
consequence of the fall in revenues and the sharp increase in the cost of debt. It has continued to widen since, reaching 11% in February 2016, when the primary deficit was -2.1% of GDP. In Peru, the stimulus plan applied caused the fiscal deficit to widen by more than 2 pp, to -2.9%. In the other countries budget deficits also increased with respect to their 2014 levels, although the targets set at the beginning of the year were met (see Chart 7).

In Chile, Colombia and Mexico fiscal adjustments have been announced for 2016 (equivalent to 0.2% of GDP in the first case and to 0.7% in the other two). The existence of fiscal rules in these three countries has enabled the adjustment of the level of spending to the much lower fiscal revenues resulting from the fall in commodity prices to be gradual and fiscal policy to have a moderately expansionary stance in recent years. Also, important in offsetting the fall in revenues associated with commodity prices (by as much as one third in the case of Mexico) have been the fiscal reforms approved in various countries (Colombia, Mexico and Chile) with the aim of diversifying public revenue sources. These have succeeded in raising receipts, mainly through personal and corporate income taxes, by between 1 and 3 pp of GDP. In any event, the continued decline in commodity prices and the need to meet structural deficit stabilisation targets in the medium term will make fiscal policy less expansionary in 2016. A cut in public spending has also been announced in Venezuela.

1 BUDGET SURPLUS (+) OR DEFICIT (-) IN LATIN AMERICA-5



2 BUDGET SURPLUS (+) OR DEFICIT (-)



SOURCES: IMF Fiscal Monitor September 2011 and national statistics.

In Brazil, in line with the foregoing, the fiscal consolidation targets have been successively relaxed (from a primary surplus of 0.5% to a deficit of -1.6% in 2016). Public spending cuts have been announced, but the proposed pension system reform, the establishment of a spending limit without the endorsement of parliament, the fragile the political situation, the debt dynamics (with an implicit interest rate of more than 12%) and the deep recession make for a worrying fiscal outlook.

The growth outlook for the region in 2016 has not only been revised downwards in recent months, but also is subject to downside risks. The cross country heterogeneity continues to exist: according to the central scenario, Chile, Colombia and Mexico will record sustained growth, although at lower rates than in 2015; Peru is the main exception, since growth is expected to be somewhat stronger than last year; by contrast, the recession may continue in Brazil, Venezuela and Argentina. Inflation may begin to subside, reflecting the delayed effect of the tightening of monetary and, in some cases, fiscal policies. From an external viewpoint, the main risks arise from the possibility of a further fall in commodity prices, the instability that may be generated by the economic adjustment process in China, or from a less gradual than expected tightening of global financial conditions. The fiscal and external vulnerability displayed by some economies are the main domestic risk factors. However, if the recent recovery in Latin American financial markets and the change in the trend of capital flows continue, the authorities may have more room for manoeuvre.

The pass-through of exchange rate depreciation to inflation in Latin America.

The exchange rate essentially determines consumer prices in open economies. The price of the local currency directly influences the prices paid by consumers for imported consumer goods. It also has an indirect influence since it affects the prices of goods manufactured in the country through imported intermediate goods and the prices of domestic products which compete with imports. The connection between the exchange rate and domestic prices - the so-called Exchange Rate Pass-Through - has received considerable attention in economic literature and is an important factor that should be taken into account by monetary and exchange rate policymakers. To the extent that a high degree of pass-through is associated with a less credible monetary policy, it is key to perceive correctly both the scale and the persistence of the effect of depreciation on

domestic prices. The case of Latin America is particularly interesting since the bouts of depreciation in the 1980s and 1990s resulted in high inflation rates, which is currently happening again to some extent against a backdrop of globally low inflation rates.

In fact, since 2014 Q1, inflation in the aggregate of the five Latin American countries with inflation targets rose by around 2 pp, albeit with significant cross-country variations. In Brazil and Colombia it rose by 4.6 pp and 4 pp, respectively, while in Peru and Chile it climbed by 0.7 pp and 0.9 pp, respectively; in Mexico, by contrast, it fell by 1.9 pp. Indeed, except for Mexico, price developments in 2014 and 2015 were marked by upward inflation surprises. In Chile, Colombia and Brazil, expectations were systematically lower than the inflation figure finally observed; furthermore, since early 2015 expected inflation ranges widened, indicating greater uncertainty.

Certain idiosyncratic factors contributed to exerting upward pressure on domestic prices in this period. For instance, there were significant increases in inflation: in Brazil owing to the rise in certain administered prices; in Colombia due to higher food prices on account of problems with crops; and in Chile, albeit to a lesser degree, because of higher indirect taxes. Mexico, once again, is the exception since the structural reforms introduced by the government (in particular, the telecommunications and energy reforms) helped to reduce inflationary pressures significantly.

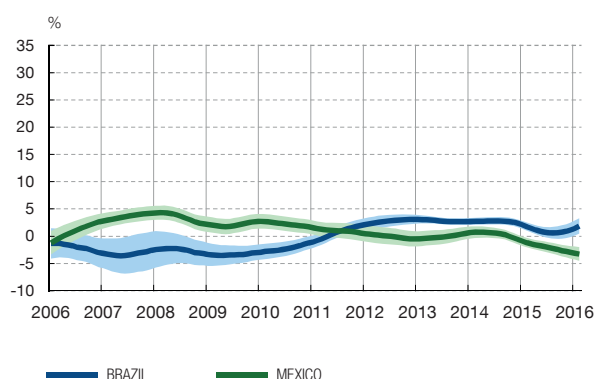
However, in this respect, in the last two years, global factors have substantially influenced inflation in the region. The ongoing depreciation of the main Latin American currencies against the dollar since 2011 - which stepped up in 2013, in certain cases, with the announcement of the normalisation of monetary policy in the United States - was one of these factors. For example, the Colombian peso and Brazilian real depreciated against the dollar by 36% and 43%, respectively; the depreciation against the dollar of the nominal exchange rates of other countries with inflation targets averaged 30% (see Chart 2). Conversely, the sharp fall in oil prices as from 2014 Q4 had a downward impact on consumer prices in certain countries, although in most it was offset by the depreciations. Lastly, in certain countries production was below potential which may have alleviated the intensity of the inflationary pressures³.

Given the positive correlation between upward inflation surprises and exchange rate depreciations in the region since 2014, this section analyses the contribution of exchange rate depreciation to inflation in four of the five countries in Latin America with inflation targets, differentiating between the effect of an increase in the pass-through - associated with a loss of monetary policy credibility - and the effect arising from the scale of the depreciation. In fact, the intensity of the exchange rate adjustment was one of the main reasons given by central banks in the region for raising their benchmark interest rates.

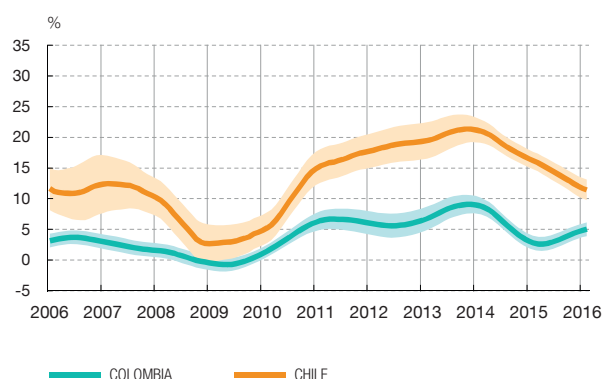
In order to evaluate the pass-through of depreciation to consumer prices, the same regression model was estimated for the four countries, with five-year rolling windows. It is a standard empirical approximation where inflation depends on exchange rate depreciation and a set of control variables which approximate internal costs and pressure from demand in line with the papers of Campa and Goldberg (2005) and of Gopinath and Rigobon (2008). The specification is as follows:

³ However, certain recent papers suggest that improvements in the anchoring of inflation expectations have tended to ease the reaction of inflation to temporary output gaps. See, for example Moccero *et al.* (2011) and BIS (2014).

1 CONSUMER PRICES. BRAZIL AND MEXICO



2 CONSUMER PRICES. COLOMBIA AND CHILE



SOURCE: Banco de España.

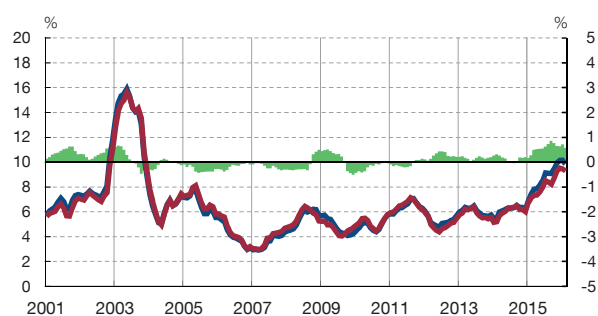
$$\Delta_{12}\ln P_t = \alpha_t + \sum_{t=1} \gamma \Delta_{12}\ln E_t + 1 + \beta \Delta_{12}\ln D_{t,t-h} + \theta \Delta_{12}\ln i_{t,t-h} + \rho \Delta_{12}\ln \text{Comm}_p_{t,t-h} + \varepsilon_t$$

where, Δp is annual inflation, ΔE is the rate of change in the bilateral nominal exchange rate against the dollar, ΔD denotes the change in domestic demand, approximated by the countries' monthly economic activity indexes (for example, the general economic activity index - IGAE by its Spanish abbreviation - for Mexico), Δi is the change in the official interest rate and finally, Δcomm_p is the commodity prices index. The coefficient γ associated with the change in the exchange rate measures the degree of pass-through of exchange rate changes to domestic prices. The equations were estimated with a sample of monthly data for the period between January 2000 and February 2016.

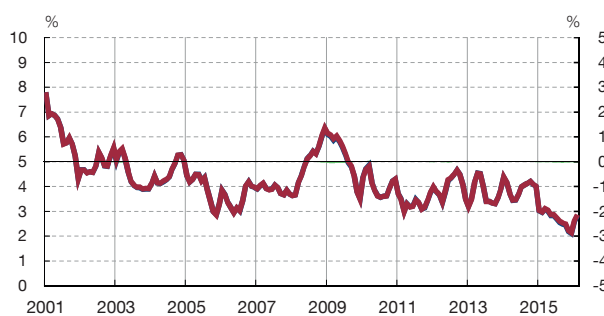
As can be seen in Chart 8, the pass-through accumulated in one year averages 8% for the set of countries analysed. However, the estimations show substantial dispersion across countries from 1% in Mexico to 12% in Chile as well as considerable fluctuations over time. These estimations of the exchange rate pass-through are lower than those in other papers, such as Albali *et al.* (2015), who places it at an average of 19% for the five countries in Latin America with inflation targets. Certain methodological aspects may explain the differences: for example, considering the multilateral exchange rate instead of the bilateral exchange rate against the dollar or the different set of control variables included in the inflation equation. The sensitivity of results to the methodological approach used means that the results of the analysis should be considered with caution. With this safeguard, the findings reject that the pass-through tended to increase in recent years in the countries analysed but, on the contrary, a slight downward trend was shown in some of them. Consequently, if the effect of the exchange rate depreciation on inflation was greater in recent quarters, it is estimated that it was not due to a stronger pass-through but to greater currency depreciation.

The differences in the size of the pass-through, together with the varying scale of the depreciations recorded explain the different impact of exchange rate movements on developments in inflation in each country. Chart 9 shows the contribution of the recent bout of currency depreciation to inflation surprises, calculated on the basis of the inflation model estimated. The contribution was highest in Chile and Colombia. In Chile, the country with the highest exchange rate pass-through of those analysed, the exchange rate

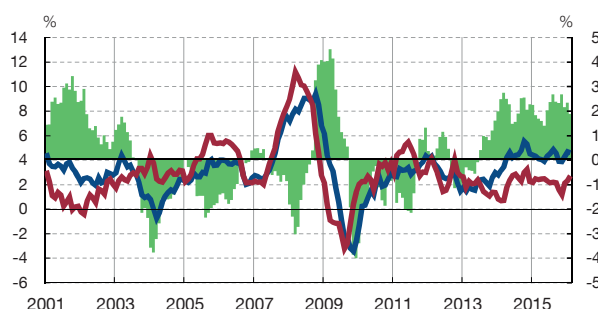
1 BRAZIL



2 MEXICO



3 CHILE



4 COLOMBIA



■ CONTRIBUTION OF THE EXCHANGE RATE (right-hand scale) ■ ANNUAL INFLATION ■ INFLATION EXCLUDING CONTRIBUTION OF EXCHANGE RATE

SOURCE: Banco de España.

depreciation accounts for approximately 2 pp of the inflation observed in the last two years, a period in which this variable fluctuated between 4% and 6%. In Colombia, although the pass-through is significantly lower, the scale of the depreciation against the dollar (36% since early 2014) explains the high contribution of this factor of around 1.5 pp to the inflation rate of 7.5%. In both cases, without the contribution of the exchange rate to domestic prices, it is estimated that the inflation targets set by the central banks would have been achieved in 2014 and in 2015⁴.

In the case of Brazil, a high percentage of the goods included in the CPI are regulated, which possibly explains the lower estimated response rate of inflation to the exchange rate. Regulated prices rose substantially from 2015 as part of the fiscal consolidation undertaken and coincided with a sharp depreciation of the real against the dollar. That said, the inflation rate on tradeable goods also climbed rapidly to 9.8% in March 2016 (its peak since 2003). The estimates obtained show that the exchange rate depreciation would explain only 0.6 pp of the inflation rate during the year and a half (a period in which it ranged from 8% to 10%), suggesting that a more thorough analysis of this effect is needed. In any case, it should be remembered that the import content of household consumption in Brazil is relatively low and averaged 8% between 1997 and 2012 according to data from input-output tables.

⁴ In both cases: 3% per year with fluctuation bands of +/- 1%.

Finally, in keeping with other papers the pass-through rate of exchange rate fluctuations to consumer price inflation is statistically zero in Mexico.⁵ Thus, notwithstanding the notable depreciation of the Mexican peso in the last two years, it is estimated that its contribution to inflation would have been zero.

In short, the recent depreciations of Latin American currencies are exerting pressure on consumer goods inflation, except for in Mexico. The analysis presented here seems to indicate that this contribution of exchange rate movements to inflation is not as responsive to an increase in the exchange rate pass-through as it is to the intensity of the depreciations in the region's currencies against the dollar. Furthermore, other idiosyncratic factors have affected price developments (domestic food prices, regulated prices, indirect taxes, structural reforms, etc.) In any event, the scope and persistence of the recent bout of depreciation in Latin America could lead to increases in the exchange rate pass-through to inflation and, consequently, this process will require close monitoring by central banks in the region.

Argentina's new economic policy approach: assessment and risks

Following the 2001 crisis, Argentina embarked on a phase of rapid economic expansion, with average annual GDP growth close to 7% between 2005 and 2011. However, since 2011, the economy has slowed significantly, with GDP growth rates falling to below 1.5%. Also, in recent years, the economy's main macroeconomic strengths, the "twin surpluses" (fiscal and external), have waned. Public finances posted a surplus of 0.2% of GDP in 2010, which, in 2015, became a deficit of 4.2%. The external accounts fell by more than 2 pp, with a deficit of -2.7% of GDP in 2015 (see Chart 10).

These developments were influenced by a series of external factors, such as the fall in commodity prices and the lack of international financing as a result of the blocked payments of Argentina's foreign debt owing to the "holdouts"⁶ dispute. Thus, against a background of strong growth in public spending, with subsidies and State aid more widely available, the budget deficit had to be largely financed through monetary financing, which led to a rise in inflation from 20%-40%, according to available private-sector estimates. Also, the loss of competitiveness abroad, the much overvalued official exchange rate and the impossibility of raising external funding severely drained international currency reserves, which required the introduction of exchange controls (the so-called "foreign exchange trap"), and curbed imports. The restricted access to dollars and the misalignment of the official exchange rate gave rise to a parallel foreign exchange market, where the Argentinian peso stood at 50%-60% below the official rate (see Chart 10). In this environment, there were growing concerns as to the reliability of official data on GDP, inflation or unemployment, which did not allow an accurate picture of the country's macroeconomic situation to be had.

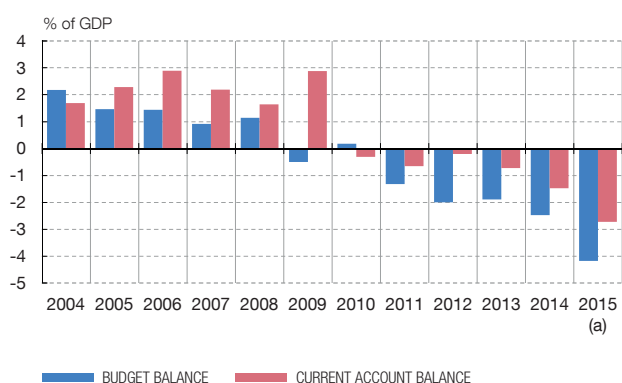
The change of government in December 2015 led to a shift in economic policy in five fundamental areas. First, priority was given to foreign exchange liberalisation in order to correct the overvalued official exchange rate and remove the distortion created by having several exchange rates. Along with liberalising imports, this measure provides for the adjustment of relative prices of tradable and non-tradable goods. Given the risk of overshooting, the level of reserves, which stood at \$25 billion in December 2015⁷, with only

5 Similar findings are obtained by Garcés (2001), Sidoui and Ramos-Francia (2008), Capistrán *et al.* (2011), Cortés-Espada (2013) and Guillermo-Peón and Rodríguez-Brindis (2014).

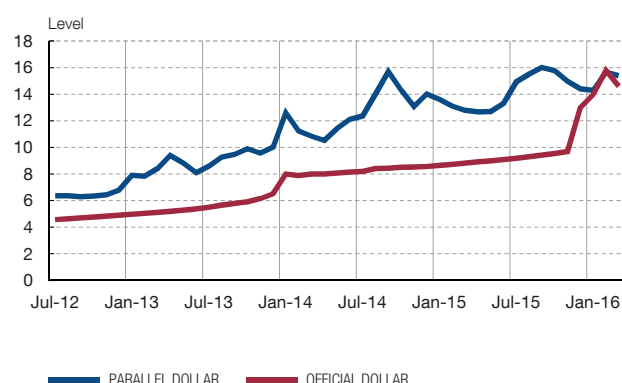
6 This term is used to refer to the creditors who did not participate in the 2005 and 2010 restructured debt swap, and in whose cases the New York courts had issued final rulings recognising their right to be paid on the same terms (*pari passu*) as the bondholders who had accepted restructured debt.

7 Of these reserves, somewhat more than \$10 billion related to a one-year swap with China, and just over \$2 billion to the restructured debt payments blocked by the New York courts.

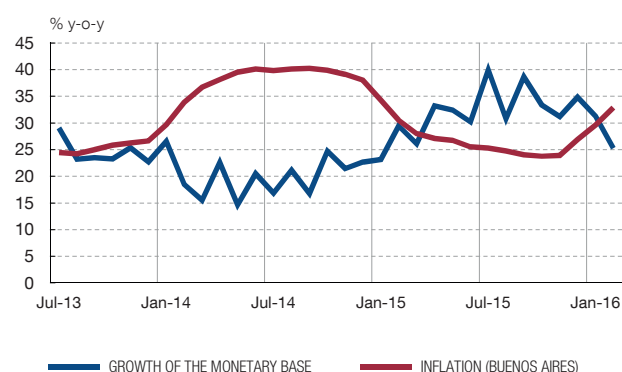
1 CURRENT ACCOUNT BALANCE AND BUDGET BALANCE



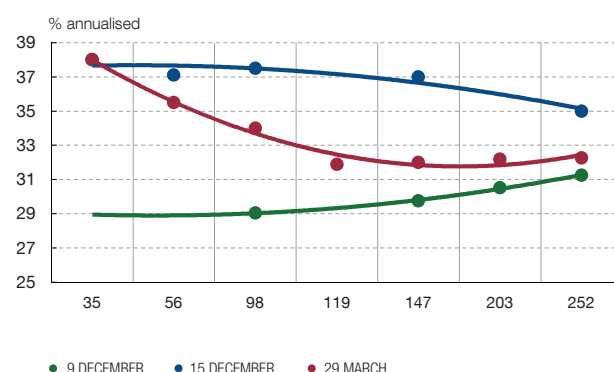
2 EXCHANGE RATE AGAINST THE DOLLAR



3 INFLATION AND GROWTH OF THE MONETARY BASE



4 INTEREST RATES ON CENTRAL BANK BILLS (LEBACS)



SOURCES: National statistics, Thomson Reuters, Central Bank of Argentina and Dirección General de Estadística y Censos de la Ciudad Autónoma de Buenos Aires.

a Estimate.

four months of import coverage, had to be built up first. To this end, the tax on corn, wheat and meat exports was removed and the tax on soya exports was lowered by 5 pp, facilitating the sale of agricultural crops, which had been constrained owing to the expected exchange rate devaluation, and increasing US-dollar income in the free market. Also, the authorities negotiated a loan with a group of international banks for approximately \$5 billion. All of these developments created favourable conditions for announcing the partial withdrawal of exchange controls and the transition to a “managed float” exchange rate regime.

Second, the monetary base growth rate, which exceeded 35% at end-2015 owing to the need to finance the public sector, slowed down (see Chart 10). Official interest rates rose by more than 10 pp, to 38%, meaning the yield curve took on a negative slope, since the longer-dated interest rates were based on the expectation that inflation would fall during the year. In fact, the Government explicitly established an inflation-targeting framework for the coming years, aimed at achieving inflation rates of below 10% by the end of the current Government’s term of office.

Third, a gradual approach was adopted to put public finances back on an adjustment path. The most significant short-term measures consisted of removing certain energy and transport subsidies, which were accompanied by an announcement that there would be income tax cuts and other expansionary fiscal measures. Although this has driven the

deficit up in the short term, by slightly over 1 pp of GDP, it also implies a structure of government revenue and spending that is less likely to distort private-sector decision-making, and is thus more conducive to economic growth. In this setting, the Government also announced a medium-term fiscal consolidation plan which would include annual decreases of 1.5 pp in the fiscal deficit until 2019, although no specific saving measures beyond 2016 were specified.

Fourth, the Government sought to restore access to foreign capital markets, reaching an agreement with the “holdouts”. This agreement, which has already been approved by the legislative chambers, includes the repeal of laws that prevented payment to bondholders (see Box 1) and will require the issuance of bonds for around \$12.5 billion on the domestic and international markets.

Lastly, the Government undertook to meet international quality standards on economic statistics. This is fundamental not only for decision-making but also for gauging the effectiveness of the measures adopted and to raise international credibility. In this respect, the new statistics on national accounts, inflation, public finances and the external sector have already been published or will foreseeably be so in the coming months.

Some of these measures are similar to those adopted in January 2014 by the previous Government when, as a result of the sharp fall in international reserves, a major devaluation of the official exchange rate was announced, along with higher interest rates and the intention to renegotiate outstanding debts subject to international litigation, leading ultimately to the agreement with the Paris Club in April 2014. However, the maintenance of exchange controls and import restrictions and, more importantly, the scant credibility of the reforms, resulting from the lack of measures to redress the fiscal imbalance, prevented delivery of the intended effects.

The current package of measures adopted by the new Government has been received with optimism in the financial markets. Although the exchange rate has depreciated substantially (see Chart 10), there has been no overshooting and nor have significant adverse effects been noted (such as prices spiralling upwards or massive capital outflows). In fact, the adjustment process has been moderate and orderly, bearing in mind the country’s external vulnerability. The sovereign risk premium has fallen significantly, despite the unfavourable context of international financial markets, with widening sovereign debt spreads in the emerging economies, particularly those in Latin America (see Chart 11); currently, the sovereign spread is at levels similar to Brazil (slightly over 400 bp), although the default record of the two countries differs greatly.

Assessment and risks

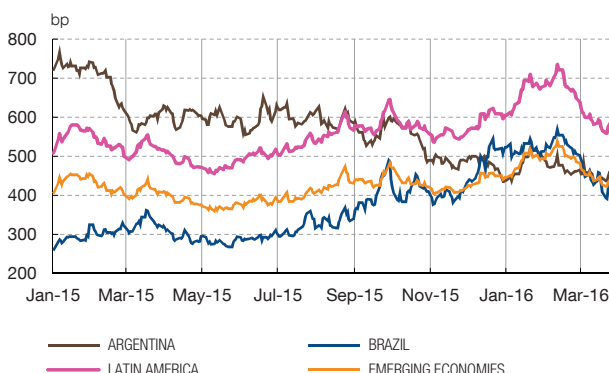
The culmination of the foreign exchange liberalisation process has managed to erase the gap between the official and parallel exchange rates, which was a source of major distortions for the economy, while also providing access to international capital markets. Following these initial steps, the Government’s priority will be to control inflation. In this respect, given that the immediate effect of the currency’s depreciation, along with the elimination of subsidies and the increase in regulated tariffs, has been inflationary, monetary policy will foreseeably remain restrictive. From this standpoint, wage increases set under collective bargaining are key to achieving inflation targets, and are a most significant indicator of agents’ confidence in the effectiveness of policies to check inflation expectations.

As regards economic activity, the expected inflow of foreign capital, in an economic setting more conducive to private investment, to improving infrastructures in the medium term

1 NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



2 ARGENTINE SOVEREIGN SPREAD AND COMPARISON WITH EMERGING COUNTRIES



3 GLOBAL COMPETITIVENESS INDEX PILLARS OF ARGENTINA (2015-2016): SCORES AND COMPARISON WITH LATIN AMERICA (a)



4 ARGENTINA AND BRAZIL: EXPORTS AND AUTOMOBILE INDUSTRY



SOURCES: Datastream and Global Competitiveness Index.

a Scores range from 1 (lowest) to 7 (highest).

and to greater financial development (bank lending to the private sector accounts for 15% of GDP, the lowest level in the region), should provide a boost to the long-term growth rate. The aim would be to draw closer to the foreign investment ratios of the countries in the region, attracting external financing. This process might be hampered in the coming years by the foreseeable tightening of financing conditions for the emerging economies, against the backdrop of the normalisation of monetary conditions. More generally, it is not to be expected that the external environment will be a major underpinning of activity in the short term, chiefly owing to the weakness of Brazil, its main trading partner (and that of other neighbouring countries), which will check manufacturing exports and, in particular, those from the automobile industry (see Chart 11).⁸ Further, the low prices of primary exports, in particular soya, will reduce foreign currency earnings. Conversely, Argentina may be expected to be less affected than other Latin American economies by the ongoing rebalancing of the Chinese economy towards sectors more closely linked to consumption, as it is not an exporter of mining products.

⁸ Land transport equipment exports to Brazil account for around 30% of Argentina's total manufacturing industry exports.

In terms of fiscal policy, mention should be made of the country's low level of debt from an international standpoint (public debt accounted for 43% of GDP in 2014, 61% of which was held by public agencies, and external debt was 27% of GDP, half of which related to the public sector). Nonetheless, the path of the budget deficit is a major risk to fiscal sustainability. Insofar as deficit financing should cease to be based on monetary financing, with access to international markets, inflation might decline, lessening the upward pressure on local interest rates.

Unknowns remain regarding the performance of the Argentine economy in this transition scenario, owing principally to the local recessionary scenario, the recent increase in consumer prices and a complex external environment for the country, given the situation of its main trading partners. However, the medium-term outlook will improve to the extent that more predictable institutional arrangements are set in place, that the economy opens up to international markets and that there is political readiness to reduce the imbalances that have built up.

19.04.2016.

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Argentina has reached an agreement with the main funds that were in litigation in the case of the holdouts, a dispute that dates back to the debt restructurings of 2005 and 2010 and that triggered the country's decline into selective default at the end of 2014 when the courts blocked the restructured debt payments. The agreement entails a reduction of some 25% in the amounts recognised (principal plus interest) in favour of the creditors, in a final judgment from the New York courts, while for all other creditors it stipulates payment of 100% of principal plus 50% of principal in the form of interest. If all bondholders involved in litigation (including court cases in various jurisdictions and claims in various currencies) accept the agreement, the Government estimates that the payments would amount to approximately \$11.7 billion. For the agreement to be valid, the Government has had to repeal legislation approved by its predecessors that prevented payments being made on conditions other than those envisaged in the debt restructurings in 2005 and 2010.

In this respect, the settlement of the dispute involves significant differences in treatment from some creditors to others, both among the holdouts and among those who took up the restructurings offer¹, and those who did not. Thus, depending on the jurisdiction in which the dispute was lodged and on the time involved, creditors will receive a return on the principal of the debt that may differ substantially. Accordingly, the resolution of the conflict entails a return for the strategy of the holdouts that may impact future debt restructuring processes if the bonds do not include the necessary safeguard clauses.²

- 1 In the restructurings in 2005 and 2010, the offer made to creditors included a haircut on the principal together with non-recognition of the interest accrued following the default.
- 2 See "Report on the Latin American Economy: Second Half of 2014", Economic Bulletin, Banco de España, October 2014.