REPORT ON THE LATIN AMERICAN ECONOMY. SECOND HALF OF 2009

Introduction

During the first half of 2009, economic developments in Latin America followed a very similar pattern to that of the world economy. As a result of the impact of the international financial crisis and the abrupt fall in world demand, there was a sharp decline in Q1, on a similar scale to that in 2008 Q4, and a slight quarter-on-quarter recovery in Q2. In year-on-year terms, GDP for the region as a whole contracted by 2.8% in Q1, followed by a fall of 3.9% in Q2 (see Table 1).

Seen in perspective, it has been the most marked contraction in activity in the region in the past three decades, exceeding that recorded in 2002 Q1, and similar to the fall in 1983, with the external debt crisis. Indeed, only in 1932, during the Great Depression, can a more pronounced decline in GDP (-4.7%) than that observed in the first half of 2009 be found (see Chart 1). Yet despite its intensity, the real adjustment in Latin America has not had particularly severe and lasting consequences in terms of financial instability as were seen on other occasions, which attests to the reduction in vulnerabilities in recent years and the soundness of the starting position of these economies. This relative solidity in the face of the current crisis distinguishes Latin America from other emerging regions - in particular from some Eastern European countries - and augurs a brighter outlook about the region's capacity for recovery. In this respect, although the signs of recovery are less generalised than those observed in emerging Asia, the higher-frequency indicators have shown signs of stabilisation that would suggest that the trough of the cycle was reached in Q2.

Inflation eased significantly in all the countries, resuming a year-on-year rate of 5.9% in September for the region as a whole. That means the highs reached in late 2008 have been contained, albeit to a lesser extent than seen in other advanced and emerging economies. Against this background, the region's financial markets have behaved favourably since March, which might be attributed not only to positive developments on international markets, but also to the lesser impact of the crisis on Latin American financial systems. Growth projections for 2010 have begun to be revised upwards, following an entire year of downward revisions.

It is worth asking to what extent the recovery that is beginning to be discernible in Latin America may be self-sustained, or whether it depends on improvements in the external environment or on economic policies applied to shore up domestic demand. In the first two quarters of the year, external demand alone contributed positively to growth, as a result of the fact that the decline in imports exceeded that in exports. In terms of its year-on-year rate, the contribution of domestic demand was very negative, although in quarter-on-quarter terms it behaved relatively better in past months in certain countries (Brazil). In this setting, the recovery is likely to continue depending on the economic policies applied (whereby the withdrawal of the stimuli should be gradual), but, to a greater extent, on the external environment improving. In this respect, the recent pick-up in trade and financial flows, the rise in commodities prices and the start of the stockbuilding cycle at the global level should provide some support to the recovery. As to economic policies, monetary policy in Latin America has arguably played a predominant role in responding to the crisis, although it has not been necessary to resort to the non-conventional instruments deployed in the industrialised countries, as analysed in Box 1. Conversely, fiscal policy has played a more limited role (with the exception of Chile), because the starting conditions offered little room for manoeuvre and, also, because a lesser or slower degree of implementation than that foreseen in the initially announced plans was apparent in several countries.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

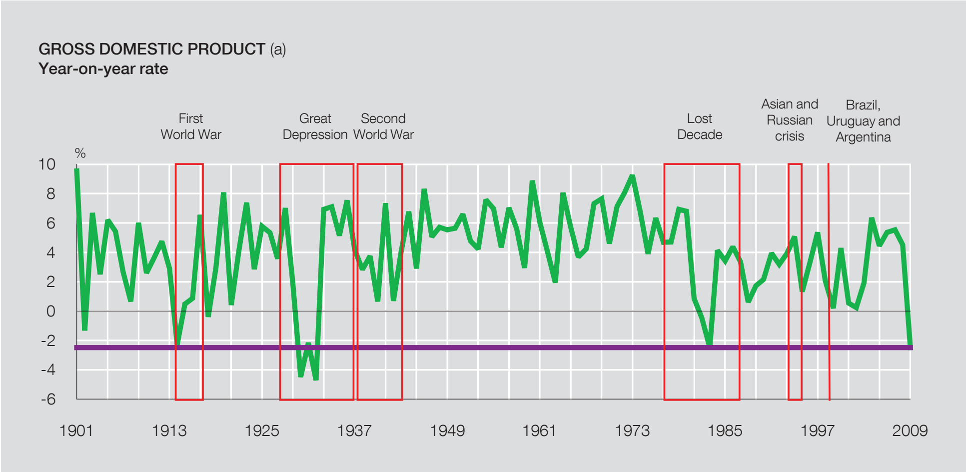
	2006	2007	2008	2007		2008				2009		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
GDP (year-on-year rate)												
Latin America (a)	5.6	5.7	4.1	5.7	6.3	5.2	5.6	5.1	0.9	-2.8	-3.9	
Argentina	8.5	8.7	7.0	8.8	9.1	8.5	7.8	6.9	4.1	2.0	-0.8	
Brazil	3.7	5.4	5.1	5.6	6.2	6.1	6.2	6.8	1.3	-1.8	-1.2	
Mexico	4.9	3.2	1.3	3.4	4.2	2.6	2.9	1.7	-1.6	-8.0	-10.3	
Chile	4.6	4.7	3.2	3.6	3.8	3.4	4.6	4.6	0.2	-2.3	-4.5	
Colombia	6.9	7.5	2.5	6.5	8.0	4.2	3.7	3.3	-1.0	-0.4	-0.5	
Venezuela	10.3	8.4	4.8	8.6	8.5	5.0	7.3	4.1	3.2	0.3	-2.4	
Peru	7.6	9.0	9.8	8.9	9.8	10.3	11.8	10.9	6.5	1.8	-1.1	
Uruguay	7.0	7.8	12.1	9.6	9.5	9.8	16.0	13.2	9.5	2.3	0.2	
CPI (year-on-year rate)												
Latin America (a)	5.2	5.4	7.9	5.4	5.9	6.6	7.7	8.5	8.5	7.7	6.8	5.9
Argentina	10.9	8.8	8.6	8.6	8.5	8.5	9.1	8.9	7.8	6.6	5.5	6.2
Brazil	4.2	3.6	5.7	4.0	4.3	4.6	5.6	6.3	6.2	5.8	5.2	4.3
Mexico	3.6	4.0	5.1	4.0	3.8	3.9	4.9	5.5	6.2	6.2	6.0	4.9
Chile	3.4	4.4	8.7	4.8	7.2	8.0	8.9	9.3	8.6	5.6	3.1	-1.1
Colombia	4.3	5.5	7.0	5.3	5.4	6.1	6.4	7.7	7.8	6.6	4.8	3.2
Venezuela	13.6	18.8	31.4	16.2	20.0	26.3	31.0	34.6	33.4	29.5	28.2	28.9
Peru	2.0	1.8	5.8	2.4	3.5	4.8	5.5	6.1	6.6	5.6	4.0	1.2
Uruguay	6.4	8.1	7.9	8.7	8.6	7.7	7.6	7.6	8.6	8.2	6.7	6.9
BUDGET BALANCE (% of GDP)												
Latin America (a) (c)	-0.7	-0.5	-0.3	-0.2	-0.2	0.0	-0.3	-0.2	-0.5	-1.6	-2.1	
Argentina	1.8	1.1	1.4	1.7	1.1	1.5	1.6	1.9	1.4	1.0	0.0	
Brazil	-2.9	-2.2	-1.6	-2.2	-2.2	-1.6	-2.2	-1.8	-2.1	-2.9	-3.3	
Mexico	0.1	0.0	-0.1	0.1	0.0	0.0	-0.3	0.0	-0.1	-1.4	-1.7	
Chile	8.0	8.7	5.0	8.7	8.7	9.2	7.2	6.1	5.0	1.4	-1.4	
Colombia	-3.7	-3.3	-1.7	-2.4	-2.8	-2.2	-2.5	-2.3	-1.8	-2.7	-3.0	
Venezuela	0.0	3.0	-1.2	0.9	3.0	3.4	1.7	0.9	-1.2	-2.2	—	
Peru	1.4	1.1	2.2	1.7	1.8	2.3	3.1	2.1	2.2	1.3	-0.1	
Uruguay	-0.6	-0.3	-1.5	1.0	0.0	1.1	0.0	0.9	-0.3	—	—	
PUBLIC DEBT (% of GDP)												
Latin America (a) (c)	39.1	33.7	29.9	33.9	33.7	31.7	31.6	30.4	31.0	32.1	34.8	
Argentina	64.2	55.5	44.6	55.8	55.5	52.4	50.4	45.8	44.7	41.9	44.2	
Brazil	44.7	42.7	35.8	43.2	42.7	40.8	41.8	40.0	38.8	40.6	43.2	
Mexico	23.2	21.1	24.5	21.2	21.1	21.0	20.7	20.8	24.5	25.5	26.8	
Chile	5.3	4.1	5.2	4.4	4.1	3.6	3.9	4.5	5.2	5.1	5.0	
Colombia	44.8	32.9	33.4	35.6	32.9	32.6	32.6	32.8	33.4	36.9	35.3	
Venezuela	41.9	22.7	13.5	21.2	22.7	20.9	13.6	12.6	13.2	11.5	—	
Peru	32.7	29.7	24.1	31.4	29.7	27.6	25.3	23.9	24.1	24.5	26.1	
Uruguay	68.4	67.2	51.2	68.7	67.1	65.4	62.2	56.2	51.0	52.8	53.4	
CURRENT ACCOUNT BALANCE (% of GDP)												
Latin America (a) (b)	2.0	0.8	-0.4	1.1	0.9	0.7	0.5	0.4	-0.4	-0.7	-0.7	
Argentina	3.6	2.7	2.3	2.8	2.7	2.8	2.2	2.8	2.2	2.1	3.3	
Brazil	1.3	0.1	-1.8	0.6	0.1	-0.6	-1.1	-1.5	-1.8	-1.5	-1.2	
Mexico	-0.2	-0.6	-1.4	-0.7	-0.6	-0.5	-0.6	-0.9	-1.4	-1.6	-1.5	
Chile	4.7	4.4	-2.0	5.0	4.4	3.1	1.9	0.0	-2.0	-2.9	-2.4	
Colombia	-1.8	-2.8	-2.8	-3.0	-2.9	-2.2	-2.0	-2.1	-2.7	-2.7	-2.6	
Venezuela	14.7	8.8	14.3	8.8	8.8	11.5	13.4	16.4	12.3	7.6	3.4	
Peru	3.0	1.4	-3.3	2.1	1.4	0.3	-1.2	-2.2	-3.3	-3.0	-1.7	
Uruguay	-2.0	-0.3	-3.9	-1.1	-1.0	-0.3	-3.2	-3.3	-3.8	-3.0	-0.9	
EXTERNAL DEBT (% of GDP)												
Latin America (a) (b)	22.1	20.1	17.8	22.4	21.6	19.9	19.0	18.2	17.8	19.2	20.0	
Argentina	51.1	47.8	38.2	49.2	47.6	46.6	44.6	40.6	39.2	39.1	38.7	
Brazil	15.8	14.5	12.6	15.9	14.7	14.1	13.3	12.8	12.4	12.7	18.2	
Mexico	12.3	12.1	11.5	11.5	11.0	12.1	11.6	11.3	11.4	14.8	15.8	
Chile	32.4	34.0	38.3	33.9	34.0	33.4	35.1	37.5	37.6	40.8	42.7	
Colombia	29.5	21.6	19.1	25.3	25.9	18.9	19.0	19.0	18.8	19.1	21.1	
Venezuela	33.7	24.4	18.2	24.1	24.4	22.7	20.2	18.5	19.6	17.4	17.4	
Peru	31.0	26.4	27.1	29.7	29.8	30.1	28.2	27.1	27.2	27.3	27.8	
Uruguay	52.6	50.3	37.2	55.2	52.8	47.7	43.6	39.4	37.0	37.4	38.3	

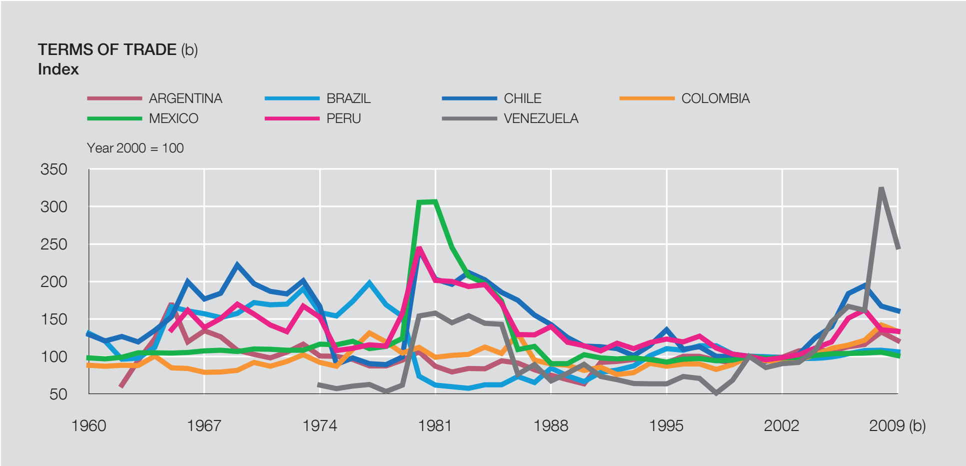
SOURCE: National statistics.

a. Aggregate of eight represented countries, except Uruguay.
b. Four-quarter moving average.
c. Excluding Venezuela.

GDP AND TERMS OF TRADE
Year-on-year rate and index

CHART 1





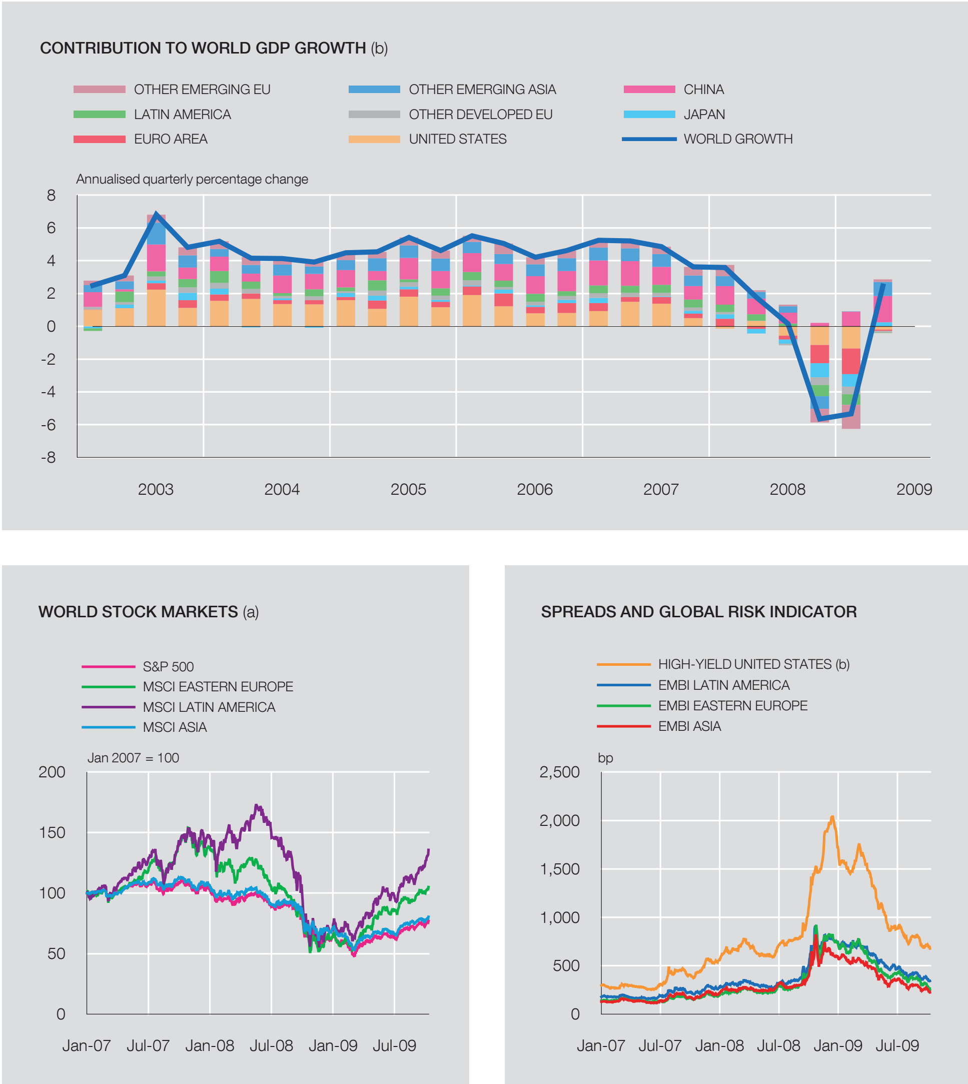
SOURCES: Oxford Latin American Economic History Database, Consensus Forecast, Datastream, World Bank and Economist Intelligence Unit.

a. Aggregate of the seven main economies.
b. Economist Intelligence Unit forecasts.

In these circumstances, the outlook for the Latin American economies is less negative than six months ago, when the previous half-yearly report was published. However, as for the rest of the world economy, the outlook remains shrouded in notable uncertainty looking ahead. In particular, the possible entrenchment of lower potential growth rates in the United States, a key trade and financial partner, is a factor of concern for the region given the consequences this would have on developments in some countries - especially the Central American economies - in the coming years. The crisis may also have left its mark on the formerly sound fundamentals of some economies. In particular, there has been a weakening in public finances and a particularly marked deterioration in the labour market in some countries, and lagged effects of the crisis on financial systems should not be ruled out in a setting of foreseeable rises in default rates. There has also been a rise in poverty, after nine years of uninterrupted declines. On the contrary, expectations that world growth may be led by countries such as China, whose demand for commodities is most sizeable, would be an important source of support to the countries in the region that are exporters of these products. Finally, the risk of a prolonged contraction in capital flows towards Latin America has fallen most significantly, and financing conditions and confidence are recovering more quickly than envisaged, which might give some momentum to growth.

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Basis points and indices

CHART 2



SOURCES: Bureau of Economic Analysis, Eurostat, Bloomberg and JP Morgan.

a. Indices in dollars.

Economic and financial developments: external environment

Following the global recession that characterised 2008 Q4 and 2009 Q1, the world economy began to show signs of picking up in Q2 this year. The signs were initially evident in certain Asian economies, in confidence indicators and in the behaviour of the financial markets, but in recent months the positive symptoms have gradually spread towards the indicators of economic activity, such as industrial production, stockbuilding and demand (exports and retail sales), and towards other geographical areas (Japan, the United States and the euro area). In sum, almost one year after the financial collapse triggered by the bankruptcy of Lehman Brothers, the global economy appears to be heading towards a slow exit from recession (see Chart 2).

In the United States, GDP picked up from a negative annualised quarter-on-quarter rate of -6.4% in 2009 Q1 to -0.7% in Q2. Using comparable rates, growth in Europe moved from -9.7% to -0.5%, and in Japan the economy grew by 2.3% in Q2, following the strong fall in Q1. In the case of emerging Asia, the rebound has proven particularly sharp owing to the impulse provided by China, the impact of the various fiscal stimulus plans, stockbuilding in these economies and the resumption of capital flows. By contrast, in Eastern Europe the ongoing adjustment of macroeconomic imbalances continued to bear negatively on growth. Overall, the brighter outlook for the world economy drove an appreciable recovery in commodities prices, a factor that particularly favours Latin America in its capacity as an exporting region.

The improvement on international financial markets came about against the background of a resumed appetite for risk, as the risk of financial collapse and of a prolonged depression in the world economy faded in light of the effectiveness of the numerous public measures to support the financial system and activity in general. As a result, prices in some segments of the financial markets have regained their levels prior to the collapse of Lehman Brothers. The Federal Reserve has kept its official interest rate in the range of 0%-0.25%, although it has withdrawn some of the facilities launched during the crisis as these have progressively become unnecessary. The European Central Bank cut its official rate on two occasions, in April and May, to 1%, while the Bank of Japan held its rate of 0.1%. Against this backdrop there have been signs of a return to relative normality, such as the slight rise in US 10-year interest rates, to around 3.5%, and the reversal of the previous appreciation of the dollar against the main currencies of the emerging and developed countries, insofar as US government paper and the dollar have ceased to have the safe-haven status they assumed in the period of greatest financial stress.

The emerging markets benefited particularly from these developments and have maintained the upward trend initiated in March (see Chart 2). Drawing on the EMBI+, sovereign spreads can thus be seen to have narrowed to around 340 bp, a similar level to that prior to September 2008. By region, the EMBIs for Latin America, Eastern Europe and Asia have trended very similarly (see Chart 2). This same favourable behaviour can be seen for stock markets, drawing on the MSCI indices in dollars, which have held at highs since late summer 2008.

Activity and demand

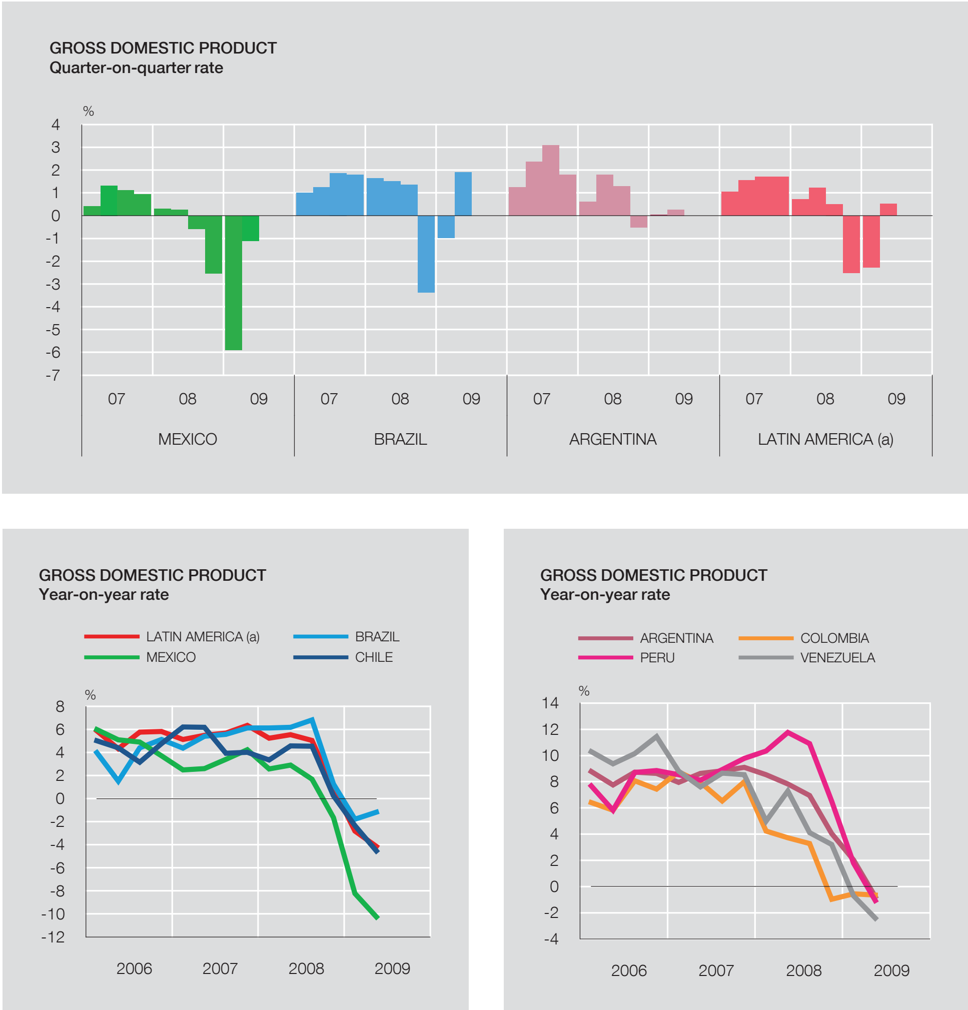
The aggregate national accounts data[1] for the region as a whole confirm Latin America was in recession between 2008 Q4 (-2.5% quarter-on-quarter) and 2009 Q1 (-2.3% quarter-on-quarter), following the definition of two consecutive quarters of decline (see Chart 3). In 2009 Q2 there was a slight recovery (0.5% quarter-on-quarter), although this was not across the board since only Brazil (1.9%) and, with less intensity, Argentina (0.5%) and Colombia (0.7%) posted positive quarterly growth, while the other countries making up the aggregate recorded negative quarter-on-quarter rates (some of which high, as was the case with Mexico, at -1.1%). In year-on-year terms, activity continued to contract in Q2, to a rate of 3.9%, 2.9 pp of which are accounted for solely by the decline in GDP in Mexico.

The contraction in the region's economic activity continued essentially to be reflected in the decline in domestic demand, the year-on-year rate of which dipped from -3.4% in 2009 Q1 to -5.6% in Q2. Among the domestic demand components, the biggest adjustment was in gross capital formation (-14.1% year-on-year, against -9.1% in Q1; see Chart 4), which is the most volatile component and that which is habitually most affected directly by confidence effects, in addition to changes in the availability and cost of financing. The fall in investment was across the board, with no significant differences observable between those economies that have proven most resilient to the crisis and those least. In particular, in Brazil, where the recession has been shorter and relatively shallow, the year-on-year decline in gross capital formation in Q2 was 17%. Meantime, in Mexico, where the adjustment is proving sharper and more protracted, it fell by 15.2%, against a background of weak foreign direct investment and despite the increase in public investment (almost 30%). Private consumption also fell appreciably, albeit less markedly so than investment, as evidenced by the year-on-year growth rates of

1. Argentina, Brazil, Mexico, Chile, Colombia, Venezuela and Peru.

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

CHART 3

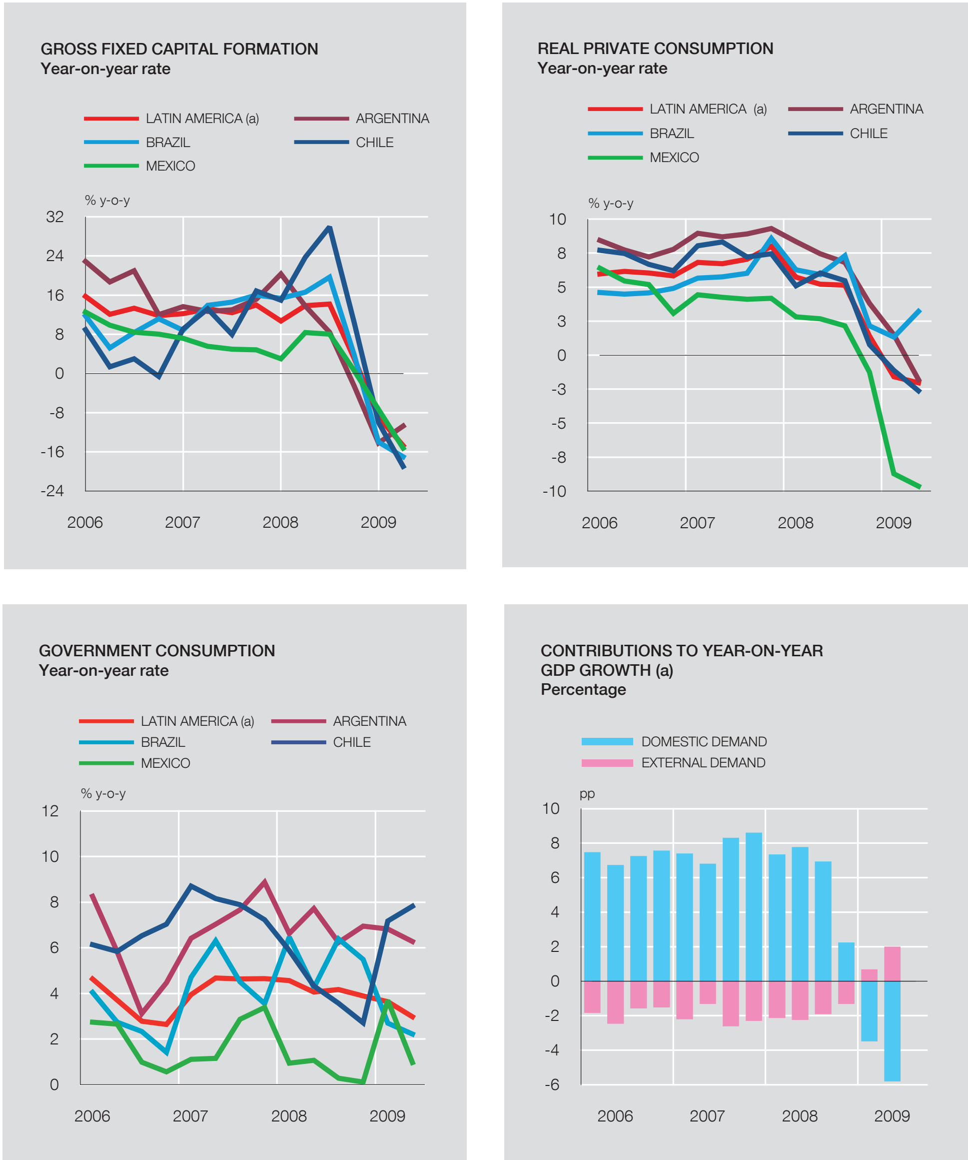


SOURCE: National statistics.

a. Aggregate of the seven main economies.

-1.6% and -1.9% in Q1 and Q2, respectively (see Chart 4). Indeed, this is the domestic demand component where the biggest differences across countries are seen: in Brazil, consumption sustained positive growth rates throughout the period (1.3% and 3.2% year-on-year in Q1 and Q2), while in Mexico the contraction was -8.7% and -9.6% year-on-year, respectively. Contributing to explaining this greater resilience of private consumption are three factors: the relatively sound behaviour of the labour market in Brazil, where the unemployment rate has fallen in recent months to around 8%, from 9% in March; the application of temporary measures offering tax incentives for car purchases; and, generally, the authorities' success in easing the credit tightness derived from the international financial crisis. Conversely, in Mexico, the series of shocks impacting the country (including the decline in remittances and swine flu), its greater exposure to the United States, the sharp deterioration in its labour market and the relative stickiness of inflation would help explain the collapse of this demand component. Government consumption was the only component to show positive growth rates in the two quarters (3.7% and 2.8% year-on-year; see Chart 4), although here too there are cross-country differences. In Chile, Peru and Argentina, government consumption grew at a rate of over 6% year-on-year, while in Brazil and, above all, Mexico and Colombia, it did so at much lower rates.

PRIVATE CONSUMPTION, GOVERNMENT CONSUMPTION AND INVESTMENT CHART 4
Year-on-year rates and percentage points



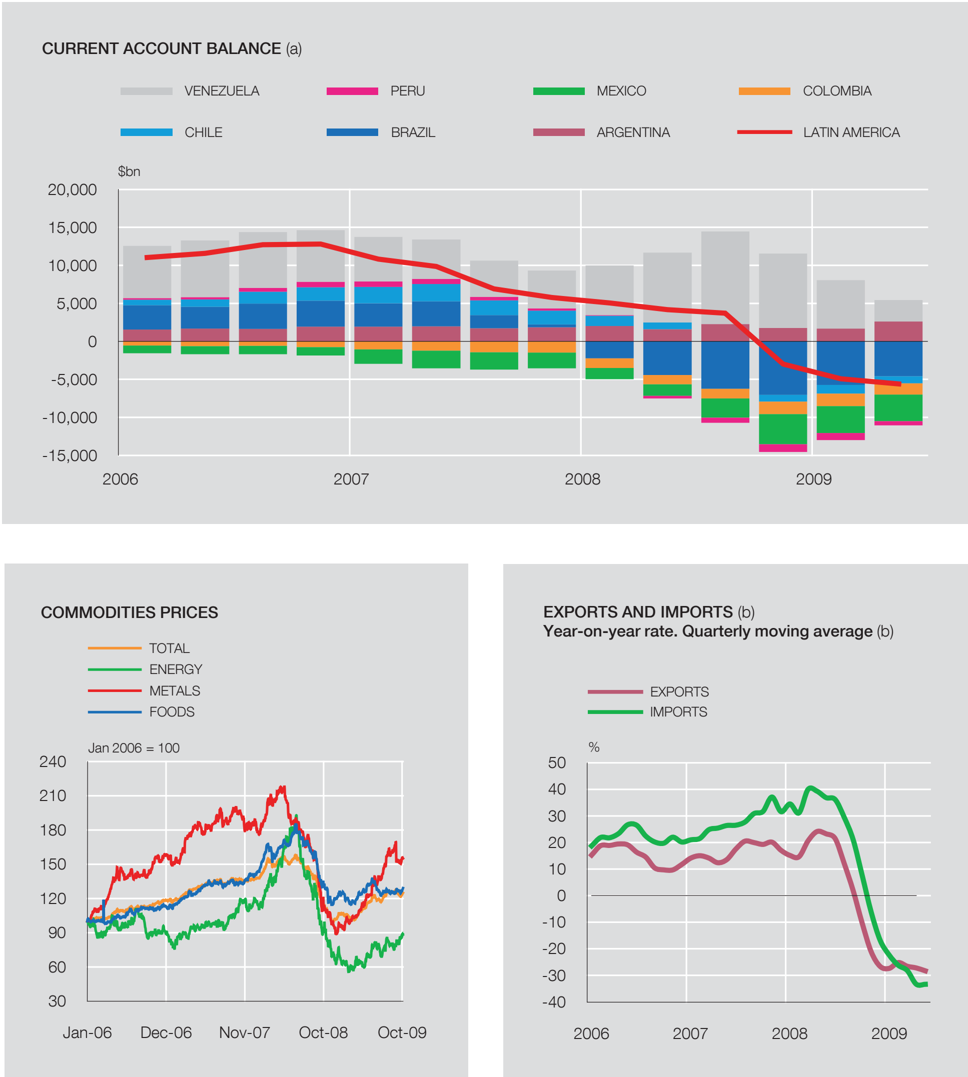
SOURCE: National statistics.

a. Seven biggest economies.

In the first half of 2009 there was, moreover, a notable shift in the composition of growth compared with the pattern of the last five years; there was a positive contribution of up to 2 pp to the year-on-year change in GDP in Q2 by external demand, as a result of the collapse in imports, and a strongly negative contribution by domestic demand (see Chart 4). Since real exports continued falling at double-figures rates in the first two quarters of the year (-14.2% and -12.3% year-on-year), the positive contribution of external demand simply reflects the intensity of the domestic adjustment and its impact on imports, in real terms (-16% and -20% year-on-year, respectively). The current account balance, which had continued on a worsening trend since early 2007 and had moved into deficit in late 2008, has begun to correct itself. Indeed, some re-balancing of current-account balances is taking place at the regional level, with a decline in the current surplus in some of the net creditor countries (Venezuela) and a reduction in the current deficits of Brazil and Mexico (see Chart 5). As regards the trade balance, the pick-up in commodities prices has at least helped contain the decline in export in value terms since the end of last year. However, the signs of recovery are still tenuous.

EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rates of change, indices and billions of US dollars

CHART 5



SOURCES: National statistics and Banco de España.

a. Four-quarter moving average.
b. Customs data in dollars, aggregate of the seven biggest economies.

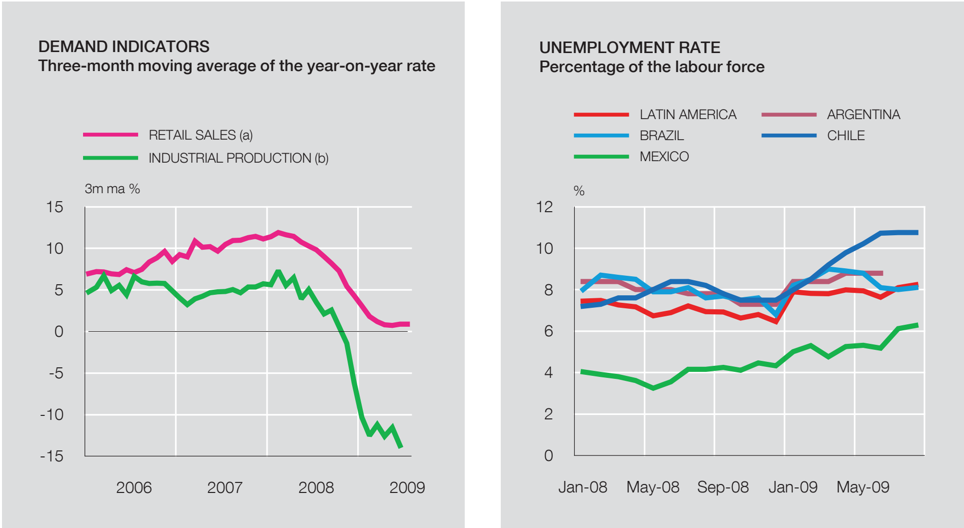
The higher-frequency supply and demand indicators, which provide more updated information, appeared to give credence to the idea that the turning point was reached towards Q2, followed by some recovery in activity in recent months. Thus, for example, retail sales have stabilised at moderately positive growth rates (see Chart 6). The collapse in industrial production has been checked and several months of positive growth recorded, although in year-on-year terms it remains very weak. Conversely, the labour market indicators, which habitually lag the cycle, have worsened considerably. The unemployment rate for the region as a whole drew close to 8% of the labour force, an increase of more than 1.5 pp on the end-2008 level. Of note, too, is the heterogeneity across countries, since in Chile and Mexico the unemployment rate continued to rise in Q2, to 10.8% and 6.1% of the labour force, respectively, while in Brazil, Argentina and Peru, the performance was more favourable.

Financial markets and external financing

Although the macroeconomic indicators for Latin America were generally negative for much of the last six months, financial markets trended most favourably from March as a result of global factors and, possibly, of the resilience the banking sector has shown in Latin America in the

CHART 6

DEMAND, CREDIT AND EMPLOYMENT INDICATORS
Year-on-year rate and its three-month moving average, and percentages



SOURCE: National statistics.

a. Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
b. Eight biggest economies.

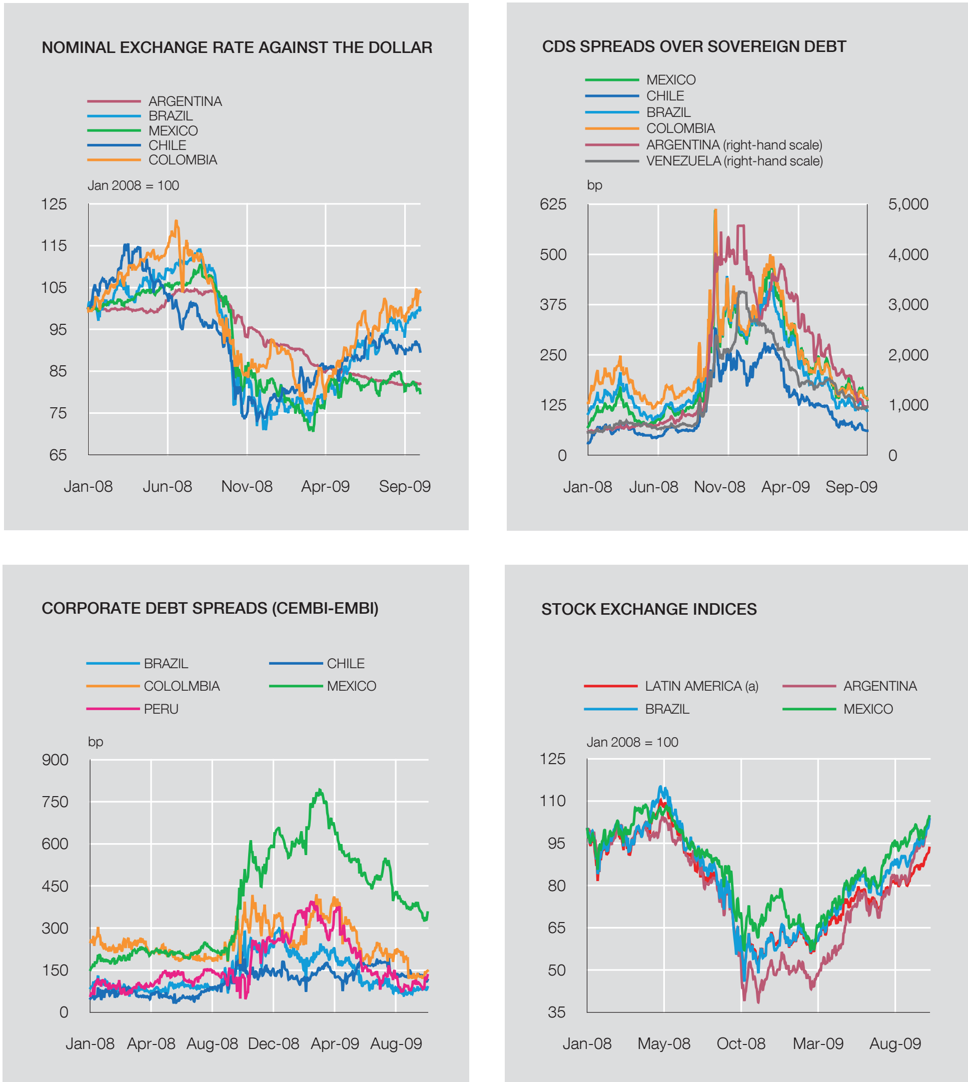
face of the financial crisis. These developments have translated into an uptrend in asset prices, which has been virtually uninterrupted and indeed more accentuated than that of international markets, against a background of rising commodities prices. This trend, which suggests a resumption of capital flows, has been generalised across countries and markets (stock, debt and foreign exchange markets alike). This has allowed for a substantial replenishment of foreign currency reserves, which had fallen during the worst months of the crisis, though it has also aroused some concern over the potential volatility of reserves and the emergence of signs of overvaluation.

Against this backdrop, most exchange rates moved on an appreciating trend (see Chart 7), which in the case of the Brazilian real and the Colombian peso was close to 30% from April. In Brazil, the appreciation was the result of the improved economic outlook (the country was accorded investment grade status by Moody's), although the resumption of carry-trade operations, given the interest rate spread in place, may also have played a significant role. The appreciation of the Chilean and Peruvian currencies against the dollar was more moderate, at around 6%, but sufficient so that reserves could be replenished in the case of Peru. In contrast, the Mexican peso has shown high volatility against the dollar, although its level at present is similar to that at the start of the half-year period, and the Argentine peso has tended to depreciate, albeit more moderately than during the six previous months, and has stabilised. The trend of exchange rates in general was sufficiently favourable so that the authorities could unwind (Mexico, Peru) or that the market could cease to use (Brazil, Colombia, Chile) some of the dollar-denominated liquidity-provision mechanisms set in train with the crisis.

As regards the debt markets, there was a notably strong narrowing in sovereign spreads and in CDS, most acutely so in those countries considered as posing a higher risk in the crisis (Ecuador, Venezuela, Argentina; see Chart 7). The sovereign spread for the region measured by the EMBI+ index diminished from mid-March (more than 300 bp), standing in early October at the levels prior to the bankruptcy of Lehman Brothers (365 bp). The reduction was generalised across the region's countries, although the sovereign spread that most contributed to the reduction in the EMBI+ was that of Ecuador (chiefly for technical reasons, most

CDS SPREADS OVER SOVEREIGN DEBT, STOCK MARKETS, DOLLAR EXCHANGE RATE AND CORPORATE DEBT SPREADS
Basis points, indices and level

CHART 7



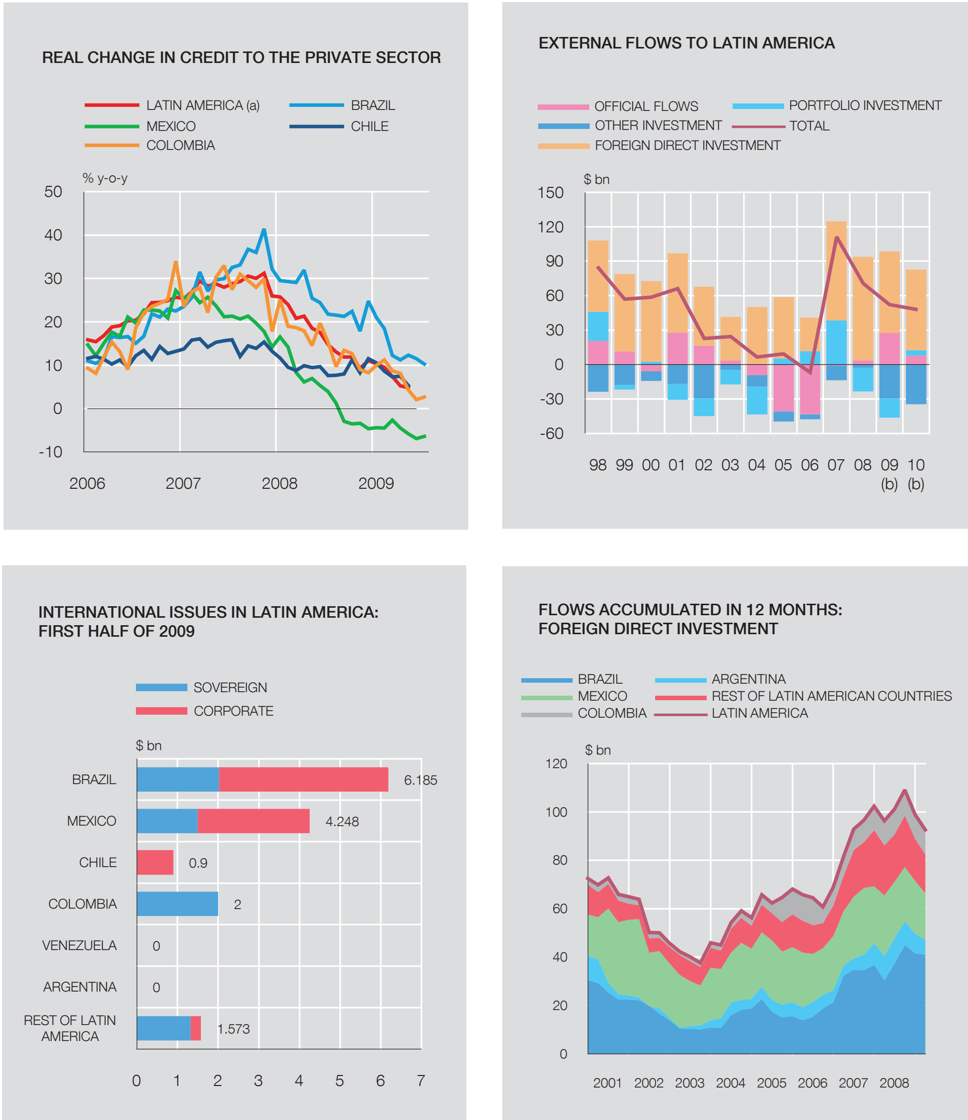
SOURCES: Datastream and JP Morgan.

a. MSCI Latin America Index in local currency.

specifically the stripping out from the index of the unpaid debt of the Global 2012 and Global 2030 bonds). The sovereign spreads of Argentina and Venezuela narrowed by around 1000 bp and 450 bp, respectively. In the former case, the narrowing was underpinned by the perception of a change in attitude by the government towards the IMF, partly as a result of the general elections in late June, but also by the resolving of the issue of holdouts and the Paris Club. In Mexico the spread narrowed only by around 120 bp, despite the extension of the swap agreements with the Federal Reserve to February 2010 and the expenditure-containment measures taken by the government in the 2010 budget. Finally, the remaining countries (Brazil, Chile, Colombia and Peru) showed reductions in their sovereign spreads of between 150 bp and 200 bp. One notable aspect is the rather unfavourable behaviour of corporate debt spreads, as evidenced by the region's CEMBI indices, which are currently at levels not too far below those at the start of the crisis in some countries (see Chart 7). That highlights the continuity of problems related to the refinancing of the corporate private sector.

EXTERNAL CAPITAL FLOWS AND FINANCING
$ bn and percentage

CHART 8



SOURCES: JP Morgan, IMF and national statistics.

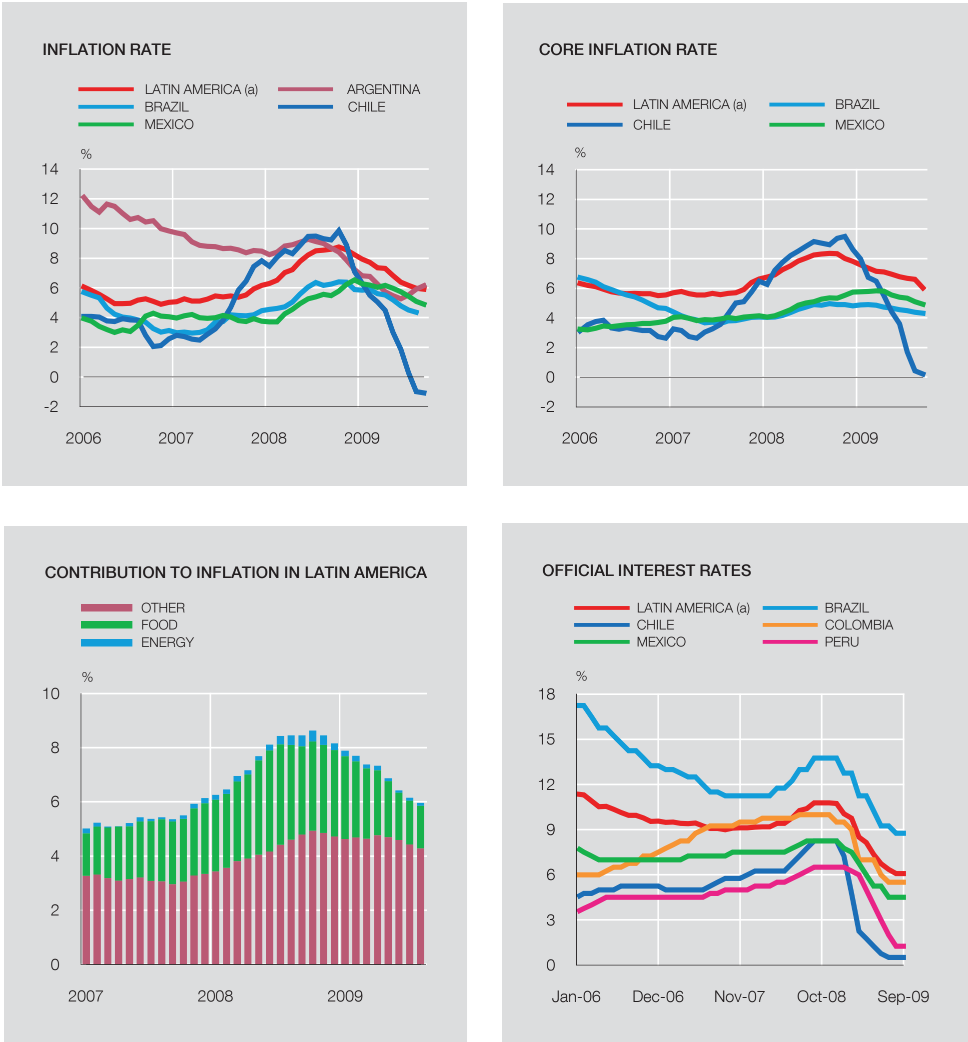
a. Seven biggest economies.
b. Years 2009 and 2010: IMF estimate (October 2009).

Turning to stock markets, the local currency-denominated regional index (MSCI) for Latin America ended the period with gains exceeding 35%, a similar movement to that for other emerging regions and higher than for most developed countries. Across the Latin American countries, the main regional stock markets ended the last six months with gains. The biggest increases were in Argentina, with a rise of over 85%, followed by the Lima stock exchange (see Chart 7). In the other economies in the region, stock market indices have increased by between 30% and 40%.

Against this backdrop, domestic credit to the private sector continued to slow, in line with the trend followed since late 2007. But it held at a positive year-on-year growth rate, even in real terms, in most countries (at around 5% on average for the region). The main exception to this trend was Mexico, where credit to the private sector fell moderately in real terms, although the rate of decline appears to have stabilised in recent months (see Chart 8).

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

CHART 9



SOURCES: National statistics and Banco de España.

a. Aggregate of the seven main economies.
b. Weighted average of the official rates of the five countries with inflation targets.

The latest forecasts on capital flows show something of an upward revision, but in any event they will continue to be very moderate in 2009. Foreign direct investment is expected to continue to be the main capital flow towards the region ($60 billion), and there will foreseeably be a capital outflow of portfolio and banking flows, in net terms, for 2009 as a whole, despite their recent recovery. It is estimated that the shortage of private flows will be offset, in part, by the increase in official financing, which would resume its levels at the beginning of the decade (see Chart 8). Overall, there should be a continuing net moderate flow towards the region in 2009. In this setting, issues on international markets picked up notably in the first half of 2009, continuing into Q3 and the start of Q4 (with various sovereign debt issues such as those of Brazil, Mexico, Colombia, Peru and Uruguay under very favourable conditions). In the first half of the year, corporate issues slightly exceeded sovereign ones, although they were concentrated solely in the most liquid markets, namely Brazil, Chile and Mexico.

Prices and macroeconomic policies

The incipient moderating trend of inflation rates observed in Latin America in late 2008 has stepped up over the course of the following months, placing the overall index at a year-on-year rate of 5.9% in September, i.e. 1.5 pp below the level at the beginning of the year and 2.8 pp below the highs reached in October 2008 (see Chart 9). Core inflation has also trended down-

INFLATION
Year-on-year rates of change

TABLE 2

Country	2008	2009		2010	
	Fulfillment	Target	December (a)	Target	Expectations (a)
Brazil	Yes	4.5 ± 2	4.3	4.5 ± 2	4.4
Mexico	No	3 ± 1	4.2	3 ± 1	4.4
Chile	No	3 ± 1	-0.7	3 ± 1	2.6
Colombia	No	5 ± 0.5	3.5	3 ± 1	4.2
Peru	No	2 ± 1	1.3	2 ± 1	2.3

SOURCES: National statistics and Consensus.

a. Latinfocus, October 2009.

wards, although initially it showed greater stickiness (6% year-on-year, 2.3 pp below its high). However, this moderation was less than in other emerging regions.

The decline in inflation was marked in most of the Latin American countries, though Chile was a particular case in point; in August it posted a negative year-on-year rate, for the first time since April 2004, and in September it stood at -1.1%, a low since the series began. In Peru and Colombia, too, the inflation rate eased appreciably, to 1.2% and 3.2%, respectively. Accordingly, in recent months inflation in the countries with explicit inflation targets has stood within the tolerance band or, in the cases of Chile and Colombia, below the established floor. The only exception is Mexico. There, although inflation has fallen by 1.4 pp since January (4.9% in September), it remains almost 1 pp above the target range ceiling. Generally, inflation expectations in the five countries with inflation targets have firmed at rates in keeping with the targets set for 2009 and 2010 (see Table 2), which would denote a high degree of credibility of these targets and of the functioning of the monetary policy framework in these countries, against the background of a strong financial and real shock. Elsewhere, prices showed downward stickiness in Venezuela, standing at a year-on-year rate of 28.9% in September, while in Argentina official inflation, after having reached its lowest level since August 2004 in June, rose in September to 6.2%.

From a broader perspective, recent inflation developments in Latin America help better understand the relative significance of two opposing factors: the pass-through effect arising from the sharp depreciation exchange rates underwent from September 2008 to March 2009, and the price-moderating impulse stemming from the opening up of output gaps in all the countries, as a result of the crisis. In this respect, it would seem that in most cases the first factor has not materialised, probably owing to the fact that the depreciation has largely proved to be temporary, although the second effect would not have managed to significantly reduce the core inflation rate at the regional level (see Chart 9). Among the countries with inflation targets, Mexico would be the most significant case since, although its inflation has eased, it has not done so to the extent expected, given the widening of the output gap (the biggest in the region; see the section “Economic developments by country”).

In terms of components, the main factor behind the easing in consumer prices has been the price of food and, to a lesser extent, of energy. As Chart 9 shows, the fall in food prices accounts for around 80% of the decline in overall inflation rates. This decline reflects the base effects of the strong rise in commodities prices the previous year, and also the fact that the recovery seen in these prices since March has coincided with an appreciation of exchange rates. The contribution of the remaining CPI components diminished moderately, despite the strong slowdown in domestic demand and the moderation in administered prices.[2]

All the central banks with inflation targets have cut their official interest rates in the past six months, and some introduced additional interbank liquidity support measures (see Box 1). The biggest cut in interest rates was in Chile (775 pp to 0.5%), followed by Colombia (600 bp to 4%), Peru (525 bp to 1.25%), Brazil (500 bp to 8.75%) and Mexico (375 bp to 4.5%) (see Chart 9). From the summer onwards, and with some degree of synchronisation, there was a change in the tone of the central banks' communication, which pointed to the end of the cycle of rate cuts. In most of the countries, the reduction in nominal rates has entailed a significant reduction in real interest rates (with the odd exception such as Chile). The cuts in official rates have tended to pass through - with less intensity - to the long-term interest rates on local currency-denominated government debt, which have fallen by between 50 bp and 200 bp, depending on the country. As a result, the long-term yield curves have maintained a strongly positive slope in general, which has been highlighted as worrying by some central banks (Chile, Brazil). In Mexico, long-term interest rates have proven notably reluctant to fall and are holding virtually at the same levels as six months ago.

The weakness of the recovery expected for the coming months and the appreciating trend of exchange rates should prevent renewed upward pressures on prices; however, the rise in commodities prices will also restrict the leeway for inflation to fall. Accordingly, as the signs of recovery in the economy firm, central banks will foreseeably begin to withdraw the monetary stimulus. In most countries, the market is discounting official rate increases as from 2010 Q1, increases that will be relatively significant in some cases. Yet as there is a risk that in emerging economies such as the Latin American countries a rise in interest rates may increase financial inflows in the short term, it is possible that the tightening of monetary conditions may be underpinned initially by other measures such as, for instance, the withdrawal of some of the extraordinary liquidity-provision measures applied during the crisis (ratios, reserve requirements). Indeed, Brazil appears to have begun to act along these lines. In this respect, the appreciation of exchange rates is causing growing concern in some countries. Brazil has reintroduced its 2% tax on cross-border transactions, while Colombia has announced the purchase of reserves and has suspended the repatriation of State-owned companies' dollars.

In the fiscal policy realm, the key development was the sharp deterioration in public finances in the first half of the year, which was across the board and which in most countries was due principally to the abrupt decline in primary revenue (-10% year-on-year in the region as a whole), more than to the expansion in expenditure, although this did continue to increase (see Chart 10). Government revenue was reduced owing to the weakness of activity, to lower commodities prices (see Box 2) and, in some countries, to specific tax cuts. In Brazil and, above all, in Argentina, revenue increased, but the expansion of spending was greater, giving rise to a reduction in the primary surplus. In the region as a whole, this translated into the emergence of a total deficit of 2% (from a position of a balanced budget one year earlier) and an increase in public debt/GDP ratios (although this increase is comparatively lower than the increases in public debt occurring in the industrialised countries, as a result of the response to the crisis. A special case is that of the countercyclical fiscal policy pursued by Chile, harnessing the funds built up in previous years, which have enabled it to increase public spending in real terms by

2. In Brazil, government-regulated prices dipped from a year-on-year rate of increase of 4.1% in April to 3.9% in August; in Mexico, administered prices were growing at a year-on-year rate of 6.3% in January and are now doing so at 0.8%; in Chile, the items that have most contributed to the slowdown in inflation have been financial charges and urban transport; in Colombia, the year-on-year rate of regulated prices fell from 8.5% in January to 2.5% in September.

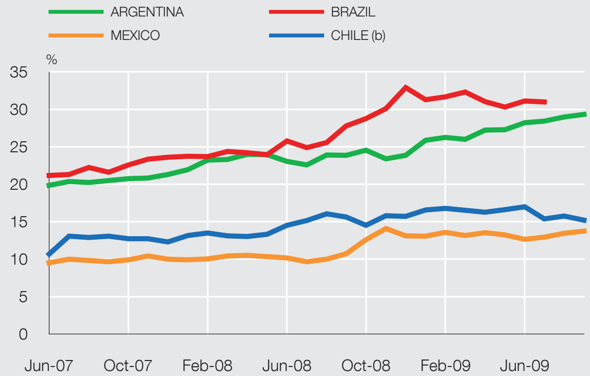
The monetary policy response to the crisis at global level has been extraordinary and unprecedented. Not only have official interest rates been reduced to historical lows in the vast majority of countries, but also this easing has been supplemented in many advanced economies by unconventional monetary policy measures, such as the provision of unlimited long-term liquidity, lending to sectors in difficulty and the purchase or swap of private and public assets. These unconventional measures were taken against a background of near-zero official interest rates, i.e. when the leeway for using the traditional monetary policy instrument had been exhausted.

As can be seen in the panel, these measures brought a spectacular increase, and change in the composition, of the balance sheets of the main central banks, which, in the particular case of the Federal Reserve and the Bank of England, more than doubled and tripled their size measured in terms of GDP, respectively. In the case of the emerging countries, and of Latin America in particular, there has also been an expansion of balance sheets (which, measured in terms of GDP, was larger than in the industrialised economies), although in a lesser proportion.

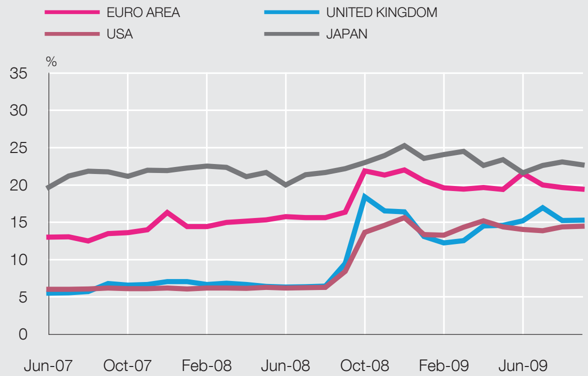
This Box analyses the increase in the balance sheets of the central banks of Mexico, Brazil, Chile and Argentina, and the extent to which it was due to unconventional measures analogous or comparable to those taken in the advanced economies, or whether, on the contrary, this increase is explained by other factors specific to these countries, although also related to the impact of the crisis. The conclusions of the analysis support the second hypothesis.

In Mexico, the assets of the central bank increased by 9% to 13% of GDP between mid-2007 and mid-2009, particularly from Sep-

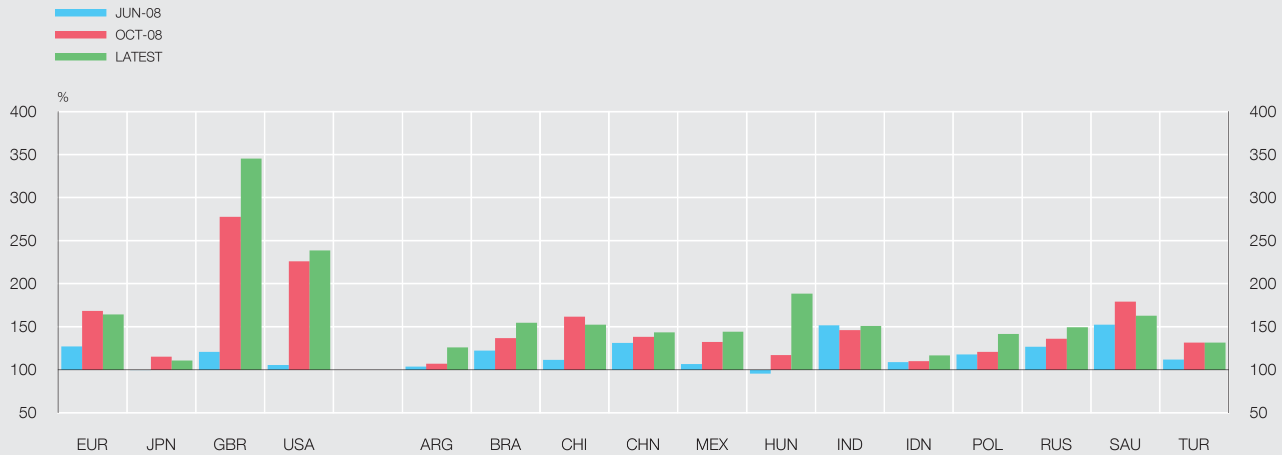
1 CENTRAL BANK ASSETS / GDP (a)
Percentage



2 CENTRAL BANK ASSETS / GDP (a)
Percentage



3 CENTRAL BANK BALANCE SHEETS



SOURCE: Central bank balance sheets.

a. As a percentage of 2008 GDP.
b. For Chile, approximated by international reserves.

tember 2008. This change is only partly explained by the measures taken by the Bank of Mexico to provide liquidity to the financial markets as a result of the impact of the crisis. Among the measures taken, mention may be made, on the assets side, of the exchange market interventions to sell US dollars, the creation of new peso-denominated liquidity facilities and the repurchase, from October 2007, of "savings protection bonds" by the Bank of Mexico (20% of the outstanding balance of these bonds). However, a very significant part of the balance sheet increase (around 50%) can be explained by the rise in the equivalent peso value of the foreign exchange reserves, despite the fact that, being denominated in dollars, they were reduced by the exchange market interventions.

In the case of Brazil, the numerous central bank initiatives to provide liquidity in local currency and in US dollars from October 2008 did not have a substantial impact on the size of the central bank's balance sheet, which remained around 30% of GDP (although, as a result of the accumulation of reserves, this had expanded strongly in the previous year). In addition, as in other countries, the balance sheet was affected by the reserve valuation adjustments derived from exchange rate fluctuations. The measures taken by Brazil altered, however, the composition of the central bank's balance sheet on the liabilities side, through the reduction and flexibilisation of bank reserves. This led to a significant reduction in the volume of funds compulsorily deposited at the central bank, both in cash and in securities, and to a simultaneous release of liquidity.

In the case of Chile, the central bank's decision to strengthen its foreign currency position from April 2008 (months before the failure of Lehman Brothers) interrupted the downward trend in its balance sheet since the adoption of the floating exchange rate in 1999. Thus foreign exchange reserves were accumulated (from 9.8% to 15.8% of GDP) from April to September 2008, although the associated money issue was largely sterilised through the placement of central bank notes. From September 2008 measures were adopted to ensure the dollar and peso liquidity of the local financial system from the assets side. These measures included the sale of dollars under repurchase agreement (swaps), the expansion of peso-denominated credit lines and the establishment of a term liquidity facility for granting 90-and 180-day fixed-rate loans. In addition, the central bank suspended the issuance of debt securities with maturities of one year or more in the second half of 2009 and repurchased its own debt securities (in total, around 9% of the outstanding balance), in order to mitigate the upward pressure on interest rates at those maturities, as a result of the increase in long-term Treasury issues. Notable on the liabilities side was the sharp increase in commercial bank deposits with the central bank as a result of the climate of financial instability.

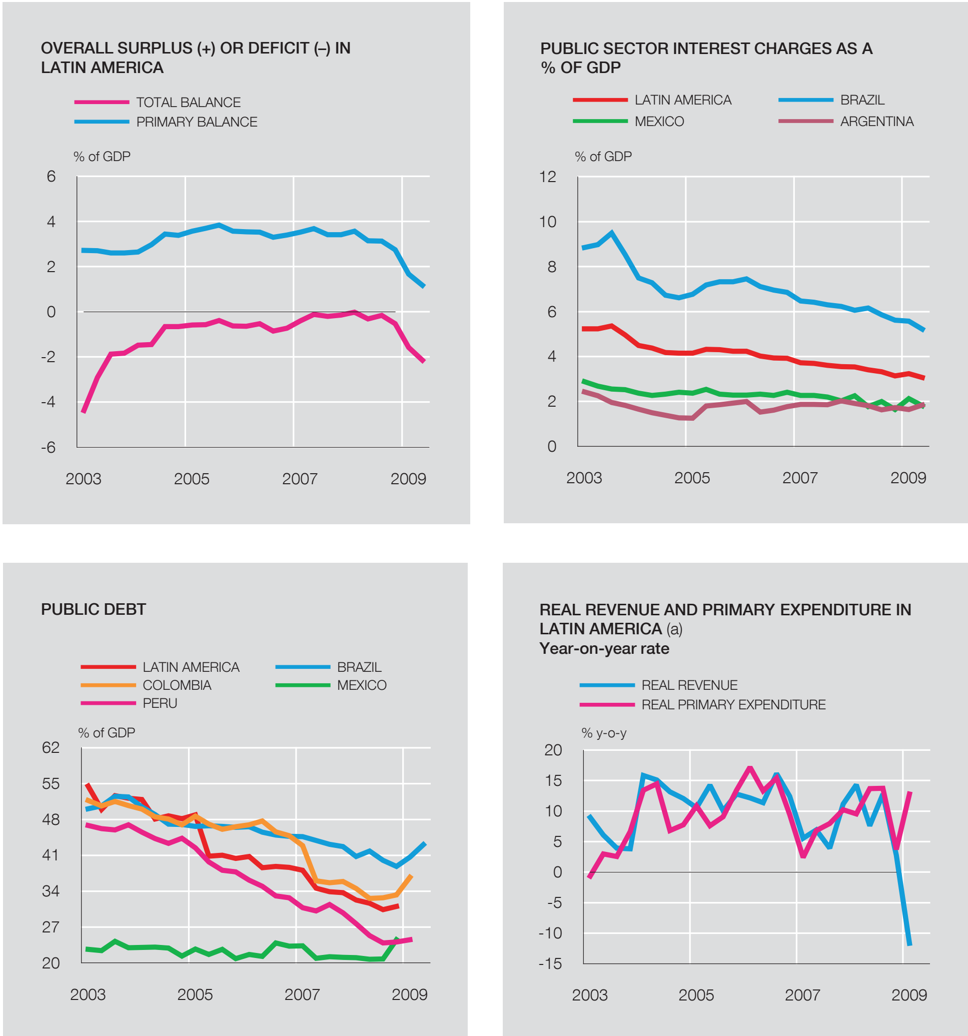
Lastly, the balance sheet of the central bank of Argentina increased considerably to around 27% of GDP. Half of this increase is explained by reserve valuation effects derived from the exchange rate depreciation (since dollar-denominated reserves decreased slightly). The other half basically reflects the increase in temporary advances to the Government and the increase in public-sector securities held by the central bank of Argentina, in order to help provide liquidity. In this respect, although the central bank of Argentina's intervention in the exchange market to support the peso was of a lesser amount than those of other central banks in the region, it took a series of measures in response to the worsening of the crisis in September 2008. Those measures aimed to ensure the provision of liquidity to the markets both from the assets side and from the liabilities side. They included the lowering of foreign reserve ratios, the increased availability of liquidity at a fixed interest rate and more flexible periods for complying with reserve requirements.

This review of changes in balance sheet volumes and composition suggests that, although the measures taken by some central banks were extraordinary (such as the abundant provision of liquidity in dollars and local currency), few can be described as " unconventional" as this term is understood in the advanced economies. The measures that can be considered unconventional include the asset purchases by the Banco de México (of a relatively small amount for the size of the debt market) and the securities repurchases by the central bank of Chile, although some of these measures are associated with fairly routine operations between central banks and Treasuries in Latin America. Furthermore, a significant part of the increase in balance sheet size was an automatic result of valuation affects (derived from the increase in the local currency equivalent of foreign exchange reserves) resulting from exchange rate depreciation, despite the fact that the dollar-amount of reserves decreased during the crisis due to the interventions.

The difference in cause and size of the increases in the balance sheets of the Latin American monetary authorities compared with those of developed economy monetary authorities has a twofold explanation. First, the size and characteristics of the financial crisis were very different from country to country; the main problems in Latin America relate to a blockage of foreign currency liquidity and the instruments were designed to counteract this situation. Second, the leeway for more conventional policies had not been exhausted: on one hand, only in Chile had interest rates approached the zero limit; on the other, unlike in the industrialised countries, most of the central banks had used other available instruments (particularly bank reserves) to boost the flow of liquidity in the economy. Given these circumstances, the reversal of the measures taken in this period will foreseeably be more automatic and less complex than in the industrialised economies.

MAIN INDICATORS OF PUBLIC SECTOR PERFORMANCE
Year-on-year changes and percentage of GDP

CHART 10



SOURCE: National statistics.

a. Deflated by the CPI.

over 20%, despite the decline in revenue of close to 35% in the first half of the year. In this respect, it should be mentioned how the countercyclical capacity arising from the application of fiscal rules has renewed interest in this instrument, not only in the region but also globally. In several countries, however, the implementation of fiscal stimulus plans has run behind schedule. Mexico has set out a new fiscal reform, which is still pending parliamentary approval, after its fiscal deficit climbed to 1.7% of GDP, the worst figure since 1990 (see the section "Economic developments by country").

Other economic policies

In recent months, trade integration processes in Latin America have continued to be "two-speed" in the sense that, on one hand, in the Pacific basin, new bilateral trade agreements have proliferated, mainly with Asia, while on the other hand, MERCOSUR and the Andean Community have continued to come up against serious obstacles. Contrary to expectations, the change of administration in the United States has not entailed any amendment to the North American Free Trade Agreement, and the discussion of new environmental and labour clauses has been deferred until after the crisis. The initiative to use local currency in trade between Argentina and Brazil, launched in October, covers very few transactions; despite this, it

The region's latest growth cycle was largely driven by the prices of commodities, and, among them, oil, the main export of some Latin American countries. This boom also significantly improved the fiscal and external position of some countries, to the extent that, in the absence of fiscal and export revenue from oil, Mexico, Ecuador, Venezuela, Colombia and Peru would have marked external and fiscal imbalances.[1]

Despite this price rise, oil production and export in Latin America has been declining in recent years, with a few exceptions, particularly Brazil. The following chart shows the supply and demand for four large Latin American oil producers. It can be seen that, whereas the net exports of Venezuela, Mexico and Ecuador have been falling sharply, the amount of oil that Brazil has to import has tended to decrease. This suggests that the oil reserves of some countries in the region are gradually being exhausted and points to the risk that some countries, such as Mexico, may become net importers of oil in the near future, while others, such as Brazil, may become exporters due to the discovery of new reserves in the past year.

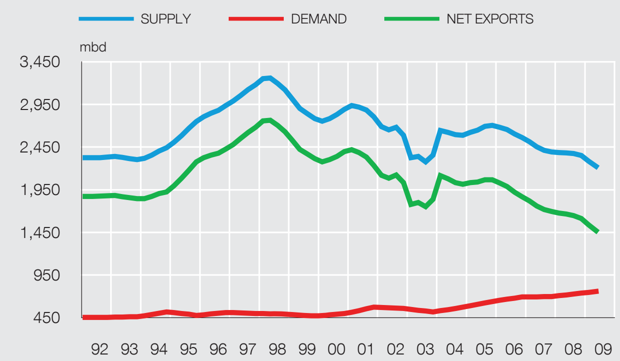
Whether a country or region is a net exporter of oil is determined by the difference between the production and the domestic consumption of this fuel. The supply and demand depend on the existence of and capacity to exploit reserves, the oil extraction technology and the effort made to undertake oil exploration and extraction projects. These variables can be used to determine the course of future production and, in particular, the point of peak production, after which extraction decreases at a rate dependent on the age of the deposits, their physical characteristics and their exploitation profile.[2] The behaviour of demand is another factor to be taken into account, and one which has generally not received sufficient attention when examining a country's export potential. When oil prices are high, producing countries tend to raise their production and thus their exports. Simultaneously, however, the increase in domestic revenue significantly stimulates economic growth and energy demand in the producers themselves. If, moreover, the domestic energy price is subsidised, as is customary in producing countries, domestic demand increases all the more.

In a situation of this type, in which the production growth rate is expected to be low or even negative, while internal demand is liable to grow at a notable place, net exports tend to decrease and, what is more, more sharply than production. Thus a country which is cur-

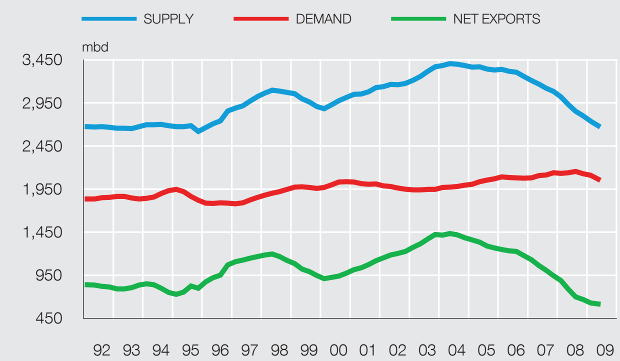
1. Without oil revenue, Mexico's balance of trade would be -4.8% of GDP, as compared with -1.1%, and its public sector balance would be -7.8%, instead of -0.4%, on average between 2003 and 2009. The figures for Venezuela would be a trade balance of -12% without oil, against 15.5%, and a non-oil government deficit of 12.8%, against -1%.

2. The first studies of oil extraction limits and production peaks were by K. Hubbert (1956), "Energy from Fossil Fuels", *Science*, who predicted that the oil peak would be reached in the US in 1970, as exactly occurred. The world's largest oilfields are currently in the aforementioned stage of decline, after peaking in the 1970s and 1980s (Middle East) and in 2003 (Cantarell, in Mexico). Only the large fields in the ex-Soviet union reached their peak production in the last three years.

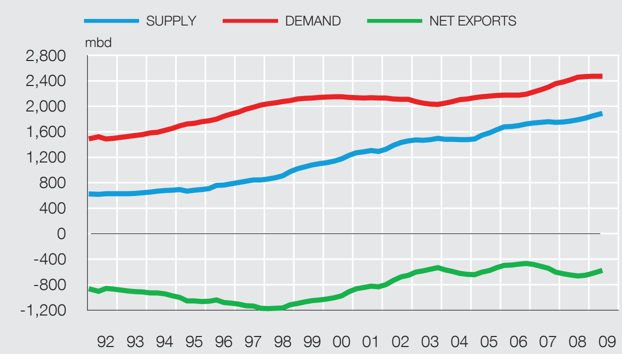
1 VENEZUELA (a)



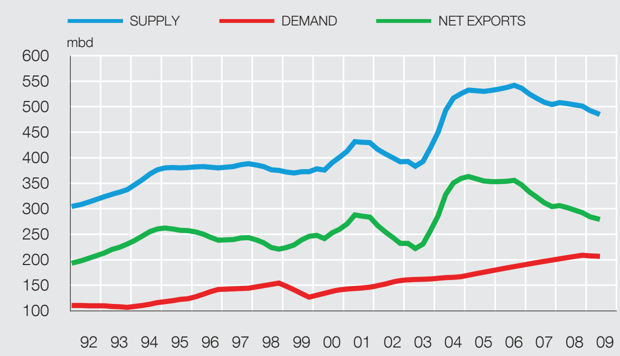
2 MEXICO (a)



3 BRAZIL (a)



4 ECUADOR (a)



SOURCES: IEA and BE calculations.

rently a net oil exporter will eventually become a net importer if supply decreases or if it increases more slowly than demand does.[3] By contrast, countries where production is expected to rise much faster than demand may, sooner or later, become oil exporters. The production and demand data published monthly by the IEA (International Energy Agency), updated until 2009, can be used to carry out an illustrative exercise. It consists of projecting future exports and estimating when countries will cease or start to be exporters.[4]

The exercise has obvious limitations, such as the automatic extrapolation of production and demand growth rates from when the production peak is reached, without taking into account possible changes in oil prices stimulating or discouraging new investment, changes in domestic consumption subsidies, variations in global demand due to large new customers like China entering or leaving the market or the discovery of new reserves. Nor does it take into consideration changes in energy efficiency in importers or in the producers themselves which reduce world or domestic demand, respectively, regulatory changes in exporters, improvements in extraction efficiency in declining oil fields or other factors.[5] It should therefore be regarded merely as illustrative of the matter at hand, i.e. the possible exhaustion of the source of external funds for these Latin American countries.

The accompanying table lists the oil-producing countries in Latin America, divided into exporters and importers, and shows, from the production peak, the growth rates of production and demand. As can be seen, since the production peak was reached, all net exporters have seen a decrease in production and growth in demand, except Colombia, where, however, demand is decreasing more slowly than supply. It can be inferred from these data that all the Latin American countries that are currently net exporters will become net importers in the coming decades,[6] while Brazil seems clearly set to take over from them as a net exporter (see panel 1 of the chart below.[7]

Panel 2 compares the Latin American countries with the other large oil exporters. The y-axis sets out the rate of change of demand from

3. One of the clearest examples of this is Indonesia. This country reached its peak production in 1996 Q2, after which output fell off at an average rate of 2.2% per year. With an increase in domestic demand of 4.6% on average, Indonesia became a net importer in 2002 Q3, since exports were decreasing at an average rate of 29.3%, much higher than the compound sum of the rates of change of supply and demand. A similar result would be obtained if production fell at a higher rate than demand, as in the United Kingdom, the production of which peaked in 1999 Q4 and which became a net importer five years later, with demand stagnant (-0.02%) but an extremely sharp fall of -7.1% in production, which resulted in an average decrease in exports of 44.5%. **4.** The exercise does not take into account the IEA's short-term (2010) or medium-term (2014) forecasts, but the qualitative conclusions are the same. For example, in the case of Mexico, the gap between the supply and demand forecast for 2010 by the IEA is narrower than that estimated using the extrapolation, i.e. Mexico would be a net importer before the date suggested by the exercise.

5. In the case of Colombia, for example, improved security in the country made it possible to exploit the potential of the oilfields when production seemed to have gone into decline. **6.** For example, the IMF predicts that Mexico will become a net oil importer around 2012 [see *Mexico: 2008 Article IV Consultation, Staff Report; Staff Supplement, and Public Information Notice on the Executive Board Discussion, FMI (2009)*, and *Mexico: Arrangement Under the Flexible Credit Line - Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion, IMF (2009)*]. **7.** Taken as a whole, Latin America is estimated to put on the market 1,621 million barrels in 2009 and will become a net importer with a highly significant change in composition; Brazil will become the largest exporter of the region, with 8% of total net sales, followed by Colombia, while Venezuela, Mexico and Chile will be the region's largest importers. Having said that, the cases of Peru, Cuba and Guatemala illustrate the simplicity of the model since, based on the average rates from 1992 to 2009 or from 1997 to 2009, they would also become net exporters. In Peru, the discoveries in Camisea have pushed the growth rate of supply from 1997 to 2009 up to 12.7%.

	Net exports (a) (m bpd)	From production peak to 2009			
		Peak date	Net exports	Change in supply	Change in demand
NET EXPORTERS					
Venezuela	1,529	98 Q1	2,884	-3.5	4.6
Mexico	646	05 Q2	1,326	-5.5	0.4
Colombia	345	98 Q4	527	-1.4	-1.2
Ecuador	288	06 Q1	362	-2.8	4.2
Trinidad and Tobago	79	06Q1	118	-7.5	4.9
Argentina	15	98 Q3	322	-2.6	1.8
NET IMPORTERS					
Bolivia	-24	05 Q3	-2	-6.0	6.2
Guatemala	-61	03 Q2	-40	-9.2	2.3
Peru	-77	93 Q4	-1	-0.6	2.4
Cuba	-110	03 Q1	-100	-3.6	-0.4
Chile	-351	92 Q1	-139	-7.7	5.1
Brazil	-600	09 Q2	-515	7.7	0.3
MEMORANDUM ITEM:					
Latin America	1,678	05 Q2	3,231	-2.1	2.6

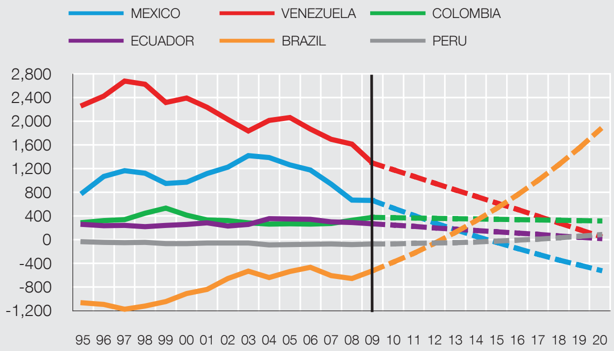
SOURCES: International Energy Agency and BE calculations.

a. Mid-2007 to 2009 Q2

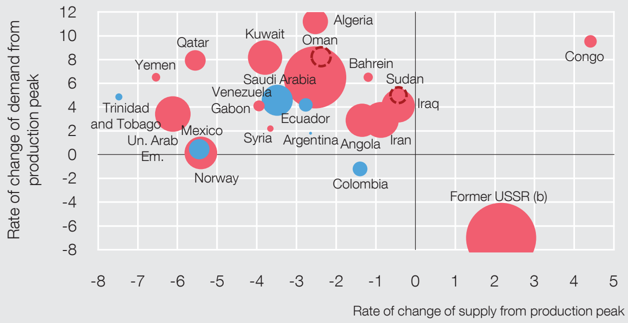
the production peak and the x-axis gives the rate of change of supply from that time, while the size of the circles represents the current net exports of each country. Thus the higher and the further to the left a country appears on the chart and the smaller its circle, the more unfavourable is its situation. It can be seen at Latin American countries are in a relatively unfavourable position with respect to other exporters, since they will become net importers in the near future.

Despite the limitations of the exercise, it shows that the fiscal and external revenue from oil exports may decrease significantly over time for many Latin American countries. Against this background, measures taken to raise exploration and extraction efficiency and to contain the rise in demand (for example, by reducing price subsidies) may be vital in prolonging the period during which this revenue will be received.

1 LATIN AMERICA: NET EXPORTS, MILLION BPD



2 MAJOR OIL PRODUCERS (a)



SOURCES: IEA and BE calculations.

a. The size of the circles represents the net exports from 2007-2009; the x-axis sets out the average rate of change of supply from the production peak and the y-axis gives the rate of change of demand in the same period.
b. Russia, Azerbaijan, Kazakhstan and Turkmenistan.

is wished to re-launch the initiative in 2010. The constituent agreement for the Single Regional Clearing System (SUCRE) was announced following the summit meeting of the ALBA (Bolivarian Alternative for the Americas) heads of State. Lastly, Venezuela has restricted its trade with Colombia owing to a diplomatic conflict (Colombian exports to Venezuela fell in July 2009 by more than 28%), seeking to divert its purchases to Argentina.

As regards structural reforms, there were no substantial advances in a setting in which economic policy decisions continued to be conditioned by the crisis. In Brazil, proposals were made to change the arrangements for the exploitation of the new oil wells in order to grant greater resources to the State-owned company, Petrobras, and in Venezuela state control of the oil sector was reinforced with the nationalisation of related activities, and headway was made in the nationalisation of the steel sector. On the financial integration front, Chile, Colombia and Peru reached an agreement in September to integrate their equity markets in late 2010, in an attempt to increase the volume of investment in each market and their liquidity. Meanwhile, Argentina, Brazil, Venezuela, Paraguay, Bolivia, Ecuador and Uruguay signed the constituent act of the Banco del Sur, with capital of $20 billion, although to date only $7 billion have been subscribed.

Turning to measures adopted internationally, mention may be made of the allocation of Special Drawing Rights (SDRs) which was concluded in late August and in early September, in compliance with the G-20 decisions taken in April ($283 billion in total, $16 billion of which related to

SDR ALLOCATION
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TABLE 3

	General allocation SDRs	Special allocation SDRs	% allocation of tax revenues	% allocation of international foreign exchange reserves
Argentina	2,454	207	3.1%	5.8%
Brazil	3,520	434	1.0%	1.9%
Colombia	897	79	1.5%	4.0%
Chile	992	94	2.4%	4.6%
Ecuador	350	49	2.9%	12.7%
Mexico	3,655	350	1.6%	5.5%
Peru	740	71	3.5%	2.5%
Uruguay	355	25	4.6%	5.1%
Venezuela	3,083	399	4.5%	11.5%
Latin America	16,046	1,708	1.8%	4.0%

SOURCES: Datastream and IMF.

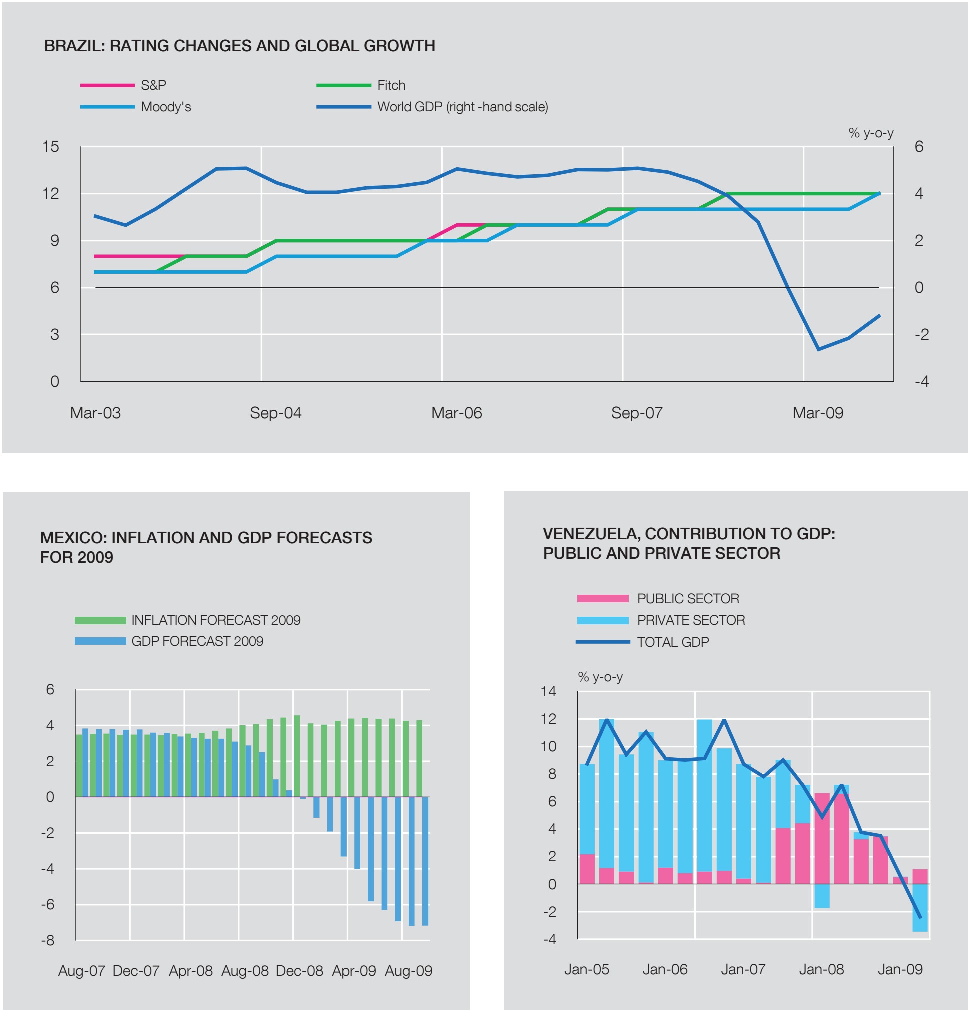
the nine main Latin American economies; see Table 3). This allocation involves a reinforcement of international reserves (between 2% and 10% of the current stock, depending on the country) and, insofar as they are freely exchangeable for other international currencies (dollar, yen, sterling, euro), through voluntary agreements between governments, they entail a greater availability of funds for each country (between 1% and 5% of tax revenue). However, to date only Ecuador and Argentina have shown their readiness to exchange SDRs for other currencies (Argentina, in principle, with the aim of repaying maturing short-term debt).

Economic developments by country

The contraction in economic activity that began in *Brazil* in 2008 Q4 ran into 2009 Q1, although the scale of the quarter-on-quarter decline eased, moving from -3.4% to -1%. The year-on-year fall in the economy in Q1 was 1.8%, the result of a decline in domestic demand (which subtracted 1.9 pp from growth), in particular in investment. In Q2, GDP expanded by 1.9% compared with the previous quarter (falling by 1.2% year-on-year), although the fall in domestic demand was similar to that of the previous quarter in year-on-year terms (-1.7%, against -1.9% in Q1) and private consumption quickened notably (from 1.3% to 3.2%). The positive contribution of external demand to growth was 0.3 pp in the first half of the year, the lowest among the economies in the region. The indicators for 2009 Q3 suggest that growth in the economy has continued during this period. This pick-up in activity has been underpinned by a countercyclical monetary policy, through official interest-rate cuts (a total of 500 bp since January, to a 8.75%, the lowest level under the current monetary framework) and through promoting the activity of public commercial banking and of development banking. Monetary easing has progressively fed through to market interest rates and this, combined with the reductions in bank reserve requirements to ease banks' liquidity tensions during 2008 Q4, has contributed to making bank credit notably cheaper. The easing of monetary policy was possible due to the ongoing moderation in inflation, against the background of the weakening of the economy, so that the inflation rate stood at 4.3% in September, 0.1 pp below the central bank target for this year (although the base effects stemming from the high increases in food prices in the first half of 2008 also contributed to this result). On the fiscal front, public finances worsened notably as a result of the reduction in revenue and the increase in spending, meaning that the primary surplus in the twelve months to August accounted for 1.6% of GDP, far below the 2008 figure of 3.7% and the revised target for 2009, namely 2.5%. The deterioration in public finances, combined with the appreciation of the real and with the contraction in GDP, contributed to the increase in (net) public debt, which stood at 44.1% in August (against 38.8% in December 2008). As regards the external sector, there was a slight reduc-

BRAZIL, MEXICO AND VENEZUELA

CHART 11



SOURCES: Central Bank of Mexico, Central Bank of Venezuela.

tion in the current account deficits, owing to the slight rise in the balance on trade and to the lower deficit on the income and services balance. The rapid recovery in the economy is one of the main factors behind Moody's upgrading Brazilian sovereign debt to investment grade (see Chart 11).

In the first two quarters of 2009, economic activity in *Mexico* contracted significantly, with year-on-year declines of -8% and -10.3%, respectively, although in quarter-on-quarter rates the fall in Q1 was much greater (-5.8%, against -1.1% in Q2). Activity was further affected in Q2 by swine flu, which is expected to have subtracted 1 pp from growth. The weight of the adjustment fell on domestic demand, which contracted by -8.9% and -11.7% year-on-year in Q1 and Q2, respectively, with a notable decline in private consumption exceeding -9%. The contribution of external demand was positive, albeit in a setting where both imports and exports fell substantially. The higher-frequency data for Q3 would point to positive quarterly growth rates of economic activity being resumed. The inflation rate has fallen, albeit to a lesser extent than in other countries in the region, especially if regard is had to the size of the output gap that has arisen in recent quarters. Inflation in September stood at 4.9%, 0.9 pp above the central bank's maximum range. Inflation expectations continue to exceed the targets set for 2009 and 2010, and wage settlements are expected to be running at over 4%. Among the explanatory factors of this downward stickiness are the sharp depreciation of the peso (20%

since October), which has proved more persistent than in other countries and which has been reflected in a rise in merchandise prices[3]; the high degree of hysteresis in inflation when it stems from an exchange rate shock[4]; and the lack of competition in certain markets. Furthermore, the foreseeable rise in taxes may entail a further rise in the inflation rate in the coming months. Despite these relatively unfavourable developments (see Chart 11), the central bank continued on the path of official interest-rate cuts until the July monetary policy meeting, when it signalled the end of the cycle of cuts, which have totalled 375 bp since January 2009. Turning to the external sector, the current account balance in the first half of 2009 posted a deficit 40% lower than the related period in 2008. The trade balance moved into surplus in 2009 Q2 owing to the increase in the value of oil exports. Public finances worsened substantially in the first half of the year, moving from a virtually balanced budget in 2008 (-0.1% of GDP) to a deficit of -1.7%, the worst figure since 1990. However, one of the challenges facing the country is fiscal consolidation; the government has unveiled two government expenditure-cutting plans for 2009 equivalent to 0.7% of GDP, and the 2010 budget provides for further spending cuts and tax changes which, following Parliamentary discussion, will probably involve rises in excise duties, in VAT and in the top rates of personal income tax.

In *Argentina*, GDP in 2009 Q2 grew at a quarter-on-quarter rate of 0.3%, compared with 0.1% in Q1. According to these figures, the Argentine economy would only have posted a decline in quarterly terms in 2008 Q4 (-0.5%), thus avoiding the situation of technical recession. In year-on-year terms, the economy recorded a decline of -0.8% in Q2, the first since 2002, following growth of 2% in Q1. The key feature was the fall-off in domestic demand, which declined by -4.8% year-on-year in Q2. In terms of components, the fall in investment totalled 10.7%, and that in private consumption -1.8%. The external sector made a positive contribution to growth of close to 4.1 pp, compared with 2 pp in 2009 Q1 as the contraction in imports deepened and exports picked up, partly because they benefited from a positive base effect. The current account surplus increased notably in the first half of 2009 thanks to the bigger trade surplus. As a result of this, reserves did not fall significantly despite the fact that the financial account posted a much bigger deficit, linked to foreign asset formation. Capital outflows were higher than $8.6 billion in the first half of 2009 and have topped $43 billion since mid-2007, although the latest data would suggest they have been checked. Inflation (officially 6.2% in September) fell in line with economic activity, although it remains high.[5] Set against the greater demand for pesos in the last two months, the central bank cut its seven-day repo interest rate by 150 bp between July and October to 9.5%, which has translated into a significant decline in market rates, and it began to repurchase reserves. With regard to public finances, the primary surplus fell notably in the first nine months of the year, since spending grew to a much greater extent than revenue. There has also been a deterioration in the finances of the provinces. This public finances situation and the financing difficulties of the Argentine government have meant that only a small part of the fiscal stimulus plan announced at the end of 2008 has been implemented. Likewise on the fiscal front, the government conducted another debt exchange which

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3. According to the Bank of Mexico survey, 87% of companies said that their costs had increased due to the exchange rate movement, owing to the fact that a large proportion of the imports they use are either directly imported (39%) or are tradeable goods whose domestic prices are also affected by the exchange rate. The same survey indicates that 28% of the companies affected opted to raise prices in light of the depreciation of the peso, and, of these, more than 50% did so in the first half of 2009. **4.** Past evidence suggests that the resumption of low inflation rates following an episode of strong exchange-rate depreciation in the country is slow. Following the 35% devaluation of the peso against the dollar in December 1994, inflation did not return to levels comparable with previous rates until May 1998, some 40 months later, while the 37% September 1976 devaluation gave rise to higher-than-previous inflation rates for over 27 months. Nonetheless, some recent papers demonstrate that the pass-through has tended to lessen (see Devereaux and Yetman (2003) and, for Mexico, Sidaoui and Ramos Francia (2008). **5.** After more than two and a half years during which the measurement of inflation has been questioned, the government is seeking to take measures to improve the credibility of the Argentine Statistics Institute, including the creation of two advisory boards that will assess the agency's figures and methodologies.

had a level of acceptance of 76% and which involved exchanging inflation-indexed debt for debt indexed to a market interest rate. According to government figures, the exchange entails a saving of almost $2 billion to 2012 in debt service, at the cost of a longer repayment period. In recent months there has been a perceptible change in the government's attitude towards the IMF, in particular regarding the revision of article 4, the first since 2006, the resolution of holdouts - where the reopening of the debt exchange has already been announced - and the Paris Club.

In *Chile*, GDP contracted by 2.3% and 4.5% year-on-year, respectively, in the first two quarters of 2009. However, although 2009 Q2 is the fourth consecutive quarter to post a negative quarter-on-quarter figure, there has been an easing in this rate to -0.4%. The decline in domestic demand was due chiefly to investment in machinery and equipment, although private consumption also contracted. Conversely, the positive contribution of external demand amounted to 6.6 pp in the first half of 2009, the biggest among the region's economies, as a result of a much greater fall in imports than in exports. The higher-frequency data for Q3 would suggest that Chile has emerged from the technical recession, and is expected to post positive growth in quarter-on-quarter terms. As regards the external sector, the current account balance moved into surplus in 2009 Q1, widening in Q2 to 2.9% of GDP. The income balance showed a smaller deficit, as the reduction in the prices of mining products affected the profits accruing to foreign investment in this sector. Foreign direct investment in the first half of the year amounted to $6.23 billion, a year-on-year decline of 20%, although it was at a peak in 2008. In the first half of 2009, the central government balance showed a deficit equivalent to 2.6% of total GDP for 2009. This resulted from the fact that real revenue fell by 34.6% year-on-year (revenue relating to the copper prices fell by almost 90%) and real expenditure grew by 18.1%. On official figures, 58.4% of the fiscal stimulus plan envisaged for 2009 is estimated to have been implemented in this first half of the year. To finance this plan, the government decided to withdraw $4.38 billion from the sovereign fund and announced that the Treasury would issue bonds on the local market for the equivalent of $1.7 billion in the second half of 2009. Inflation continued to fall sharply, meaning that the CPI in September stood at a year-on-year rate of -1.1%. Behind this development lie the abrupt decline in domestic demand since late 2008, the high basis for comparison of the previous year, the swift pass-through of lower international prices and the change in the CPI measurement methodology which the Chilean statistical agency implemented in early 2009. The central bank continued cutting its official interest rate (775 bp were shaved off from January to July), taking it to 0.5%, and it announced certain measures intended to influence the level of long-term interest rates (see Box 1).

There was a slight recovery in the *Colombian* economy, which expanded at a quarter-on-quarter rate of 0.3% and 0.7% in Q1 and Q2, respectively, although compared with the same period a year earlier, the growth rate was slightly negative in the two quarters (-0.4% and -0.5%, respectively). The slight pick-up in GDP in the first half of the year arose partly from the improvement in net external demand, owing to the decline in imports, with domestic demand remaining generally weak, particularly private consumption. The indicators of activity that have been released would suggest a persistence at the start of Q3 of the weakness dating back to before the global financial crisis. Against this background, inflation fell strongly from 8% at end-2008 to 3.2% in September, below the central bank's target range (5% + 0.5%) for the fourth month running. The inflation target for 2010 has been revised downwards to 3% with an interval of + 1%. The central bank, which was the first in the region to initiate cuts in official interest rates in December 2008, continued to lower them, placing them at 4.5% in June (a cumulative cut of 550 bp). It kept these rates unchanged at the subsequent meetings until September, when it unexpectedly announced a fresh cut of 50 bp to 4%. The current account deficit eased in the first half of the year as a result of the narrowing of the income and services deficit, and it was amply covered by long-term financial inflows. Tense relations with Venezuela pose the risk of reduced exports and probably contributed to the strong decline in August. On the fiscal front, revenue was lower than expected. In these circumstances the government has opted to maintain expenditure and revise the deficit objective for 2009 upwards to 4% (from 3.7% previously); the consolidated public sector objective rises from 2.4% to 2.6% of GDP.

In *Peru*, the economy was in recession in the first half of the year, as indicated by the quarter-on-quarter declines of 1.1% and 0.9% in the first two quarters of the year. In year-on-year terms, there was a negative rate of change (of -1.1%, the first since 2001 Q2) only in Q2, due to the collapse of domestic demand (-5.5%), whose source is the fall in private investment. The contribution of the external sector was positive (3.7 pp in the first half of the year). There was a current account surplus of 0.1% of GDP in 2009 Q2, following the deficit recorded in the five previous quarters, in light of the higher trade surplus and the lower income deficit attributable to the lower amounts of mining companies' profits transferred abroad. The ongoing reduction in inflation has become more accentuated in recent months, and in the first nine months of 2009 inflation for the year stood at -0.08%. Although core inflation has fallen, the main explanatory factor here is food prices. In this setting, the central bank continued cutting its official interest rate, shaving off a total of 525 bp from February to August to take it to 1.25%. Nonetheless, the monetary authority has indicated that it does not envisage further cuts. In the fiscal arena, the non-financial public sector posted a primary surplus of 1.8% of GDP (5.4% in the same period in 2008) in the first seven months of the year. Further, there has been a delay in the implementation of the fiscal plan announced at the end of 2008, because the regional governments are not making public investments at the rates envisaged. In September, Moody's upgraded Peru's rating to investment grade.

There was a year-on-year contraction of 2.4% in economic activity in *Venezuela* in 2009 Q2, due especially to the contraction in private consumption and investment. As can be seen in Chart 11, the public sector has been the driving force of growth over the last eight quarters. The current account balance was once again in surplus in Q2, thanks to the increased value of exports (where oil-related products accounted for 94% of the total) and the reduction in imports. Inflation remains very high (28.9% in September), partly as a result of the effects of the rise in VAT (3 pp in April). In more structural terms, the difficulty in obtaining foreign currency on the regulated market explains part of the inflationary tensions, and government policy continues seeking to focus on closing the gap between the official and parallel exchange rates. There was an easing in monetary policy, with successive cuts in the top interest rates for credit and the minimum rates for deposits, and in legal reserve requirements in domestic currency, but this did not translate into increases in lending. On the fiscal front some tightening is discernible, since public spending in real terms contracted to a greater extent than revenue. Finally, in the policy field, the government reactivated its nationalisations plan and issued a series of laws reinforcing its control over the oil, petrochemical and steel industries, in addition to finalising the acquisition of the Banco de Santander subsidiary.

23.10.2009.

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