Editorial

Economic activity in Latin America remains more buoyant than expected some months ago. This is despite monetary policy tightening, the withdrawal of some fiscal stimulus measures and the loss of purchasing power owing to persistently high inflation, although this loss has been partly mitigated by the good performance of the region's labour markets.

Despite this greater than expected resilience, economic growth forecasts for 2023 (which are significantly lower than for 2022) have been revised up just a few percentage points. This suggests that weak economic momentum is still expected for the second half of 2023 and for 2024. One of the reasons for this is that Latin America is expected to face a rather more adverse international environment, with slightly lower growth worldwide and a drop in energy and food commodity prices (which are, however, still above their historical average), considering that several of the region's economies are net exporters of these commodities. Moreover, the picture is also shrouded in uncertainty and the medium-term outlook is discouraging, given the potential growth rates calculated by various international institutions for the region.

Inflation in Latin America has continued to moderate overall, standing at 6% year-on-year in May, 4.2 percentage points off its June 2022 peak. Yet the pattern is uneven across the region and there are no clear signs of services inflation heading down. Inflation is expected to continue to decline gradually in the coming quarters, to reach the inflation target ranges of the region's main inflation-targeting central banks by end-2024. In addition, long-term inflation expectations remain anchored around the inflation targets and bear little relation to past inflation.

The region's clearly restrictive monetary policy stance appears to be warranted, according to standard monetary policy rules, in view of the present inflationary episode. Despite the high policy interest rates, the financial markets are factoring in a slow and feeble cycle of monetary easing in Latin America. Yet monetary policy developments in the region will largely depend on how monetary policy evolves in the main advanced economies, especially in the United States.

During the first half of 2023, financial conditions in Latin America held quite steady, despite the financial stress episodes witnessed in the US and Swiss banking systems. Indeed, the region's financial markets outperformed those of other emerging market economies, given the positive performance of factors that have historically had more impact on the Latin American markets, such as the reopening of China when it ended its zero-COVID policy, the better economic data in the United States, the favourable carry-trade[1] in the countries of the region and commodity prices that are still high in historical terms. However, the uncertainty surrounding economic policies and the social and political unrest in the region has remained high overall in recent quarters.

1 The difference between the cost of borrowing in a low-interest rate currency and investing in financial assets in a high-interest rate currency, in this case the Latin American currencies.

The public debt-to-GDP ratio fell slightly in 2022, owing to the strong economic growth, high inflation and the withdrawal of fiscal stimulus measures. But it is still high, in historical terms and compared with other emerging market economies. In this regard, the region's chief vulnerabilities remain concentrated in public finances. For instance, the likelihood of the public debt-to-GDP ratio remaining above its pre-pandemic level over a ten-year horizon has increased significantly for some countries, such as Colombia.

This report includes two boxes. Box 1, in collaboration with the SECMCA,[2] offers an overview of the key monetary policy developments in Central America and the Dominican Republic (where some countries have embarked on policy rate cuts) and of the banking system (where lending has remained strong, despite both local and global financial conditions having tightened in previous quarters). Box 2 sets out the recent developments in the Latin American banking systems that are of material significance to the Spanish banking system. In this respect it highlights that the profitability indicators of the region's banking systems show no significant signs of worsening (despite the widespread slowdown in lending to the private sector and the increase in non-performing loans) and that capital levels have held steady above the regulatory minimum. In addition to the common risks analysed in this report, the box also highlights the main country-specific risks to financial stability in Latin America, according to the regular financial stability reports published by the region's central banks for the first half of 2023. Compared with the previous half-year, two points stand out: the increase in credit risk, associated with the worsening of the financial position of households and some firms; and the decrease in exchange rate risk.

2 Secretaría Ejecutiva del Consejo Monetario Centroamericano.