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REPORT ON THE LATIN AMERICAN ECONOMY. SECOND HALF OF 2019

ABSTRACT

This article analyses the recent performance of the main Latin American economies (Brazil, Mexico, Argentina, Colombia, Chile and Peru). In the first three quarters of 2019 the region's growth was once again lower than expected and below that of other emerging areas of reference. This lower growth is essentially explained by domestic factors (political and economic policy uncertainty and structural problems of low potential growth), although the external environment has not been favourable either in terms of developments in world demand and in the terms of trade. Most central banks in the region have reduced policy interest rates given the absence of inflationary pressures, the existence of negative output gaps and the relatively stable performance of exchange rates. Fiscal space is limited in most of the economies and certain risks to the sustainability of their public finances persist in some of them. The main international organisations and private institutions expect activity to rise in the coming quarters, especially domestic demand. This would be based on looser financial conditions and improved external conditions (lower trade tensions) and domestic conditions (agents' confidence). In this setting, the balance of risks is tilted downwards, given the persisting doubts about economic policies in the main countries in the region and about the dissipation of political uncertainty, and about the improvement of the international economic situation.

This report includes two boxes. Box 1 analyses the channels which could be transmitting global trade tensions to Latin America. Box 2 describes the economic situation in Argentina after the worsening of the financial turmoil last summer.

Keywords: low growth, political and economic policy uncertainty, trade tensions, monetary policy, fiscal space.

JEL codes: F01, F21, F30, F41.

Introduction

During the first half of 2019 the main Latin American economies continued to show weak growth which was lower than that of other emerging economies and below that projected at the beginning of the year. Noteworthy is the situation of Argentina's economy, which continued to contract. The main features of the external environment were a slowdown of the activity of the main trading partners, commodity prices that were generally below their pre-2014 highs and continued accommodative financial conditions, aside from some isolated bouts of volatility. Domestic demand, especially investment, was adversely affected by the uncertainty surrounding economic policies and the domestic tensions in several countries in the region. The current account deficit was corrected in Argentina and widened in other countries.

As for demand-side economic policies, almost all of the central banks decided to reduce policy interest rates and further cuts are expected against a backdrop of global monetary policy easing. The more accommodative stance has been possible since inflation remains in line with targets, inflation expectations are generally anchored, exchange rates remain relatively stable and there is spare capacity in the economies. Fiscal policy has limited scope, should the above-mentioned risks to growth materialise, and, in certain cases, there is concern about the sustainability of public finances.

The available projections of the main international organisations and private institutions continue to indicate that in coming quarters activity, especially domestic demand, will recover, albeit to a limited extent. This would be based on looser financial conditions and improved external and internal conditions (a recovery in agents' confidence). In this setting, the balance of risks is tilted downwards, and the risks stem from the external environment (insofar as trade tensions do not dissipate and there is a greater slowdown in the global economy) and from specific problems in certain countries arising from potentially more protracted political and economic policy uncertainty in the main countries in the region.

Recent macro-financial developments and the outlook for the region are analysed below. The report includes two boxes. Box 1 examines the potential effects of global trade tensions on Latin America and the attendant transmission channels are underlined. Box 2 analyses the economic situation in Argentina after the worsening of the financial turmoil in August.

The economic and financial setting of Latin America

Weak global activity

Since the publication of the last half-yearly report on the Latin American economy, in May 2019, the world economy has remained weak, which has prompted a downward revision of global growth expectations for this year (see Chart 1.1). This is the lowest growth rate since the international financial crisis, which reflects weak manufacturing sectors, on the supply side, and weak investment and foreign trade (see Chart 1.2), on the demand side. The heightening of geopolitical and trade tensions is one of the main factors present behind this weakness, in particular, the increase in bilateral tariffs between the United States and China,[1] the effects of which on the Latin American economies are analysed in Box 1 of this report.

As a result of lower global growth, the prices of commodities, the main exports of the Latin American economies (as shown by Chart 1.3), have remained considerably lower than the highs recorded in 2013-14 (see Chart 1.4).

Absence of inflationary pressures and more accommodative monetary policies

This slowdown of activity in recent quarters together with commodity price developments, subdued profit margins and the absence of significant wage increases have eased inflationary pressures in most advanced and emerging economies (see Chart 1.5). Developments in activity and inflation, and future risks to these variables have led the central banks of many of the advanced economies to adopt a more accommodative monetary policy. This has made it easier for many emerging economies to cut policy interest rates (see Chart 1.6), given that their exchange rates are also relatively stable.

Relaxed financial conditions

This more accommodative monetary policy stance contributed to continued accommodative financial conditions globally, which were partly supported by lower bond yields. Nevertheless, the main financial markets were notably volatile in recent months, which was probably linked to the ups and downs in trade negotiations.

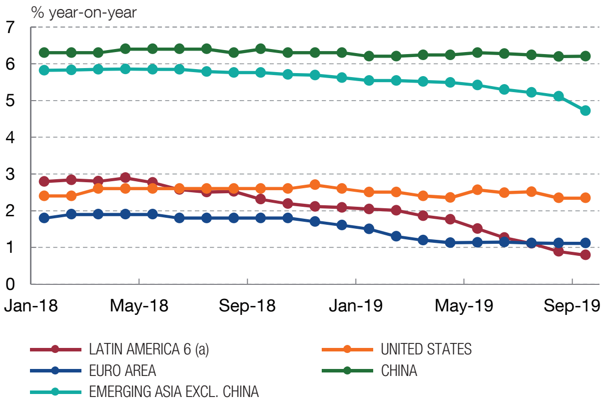
1 Banco de España (2019), "Rising protectionism between the United States and China and its effects on the global economy", Box 2, "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2019.

Chart 1

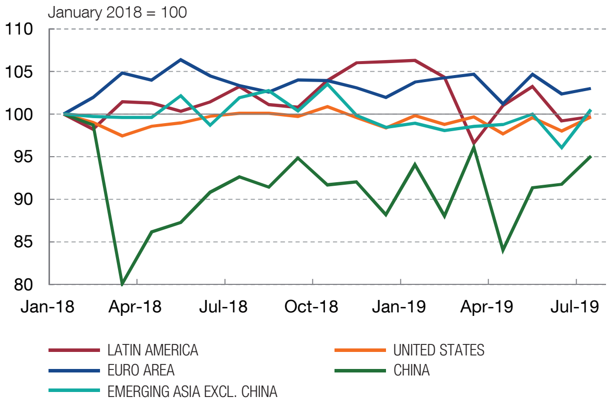
GLOBAL ECONOMIC ENVIRONMENT

The weakness of the world economy, partly explained by the negative performance of trade, led to the downward revision of growth for this year. Prices of commodities (the main exports of most Latin American economies) generally held below their levels in the period 2005-2017. As a result of the absence of inflationary pressures and weak activity, the central banks of developed and emerging economies adopted more accommodative monetary policies.

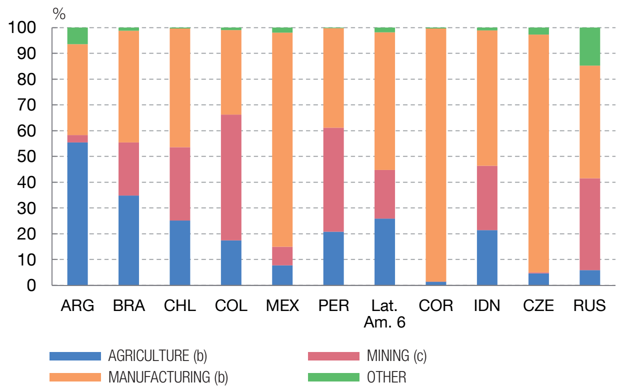
1 GROWTH FORECASTS FOR 2019



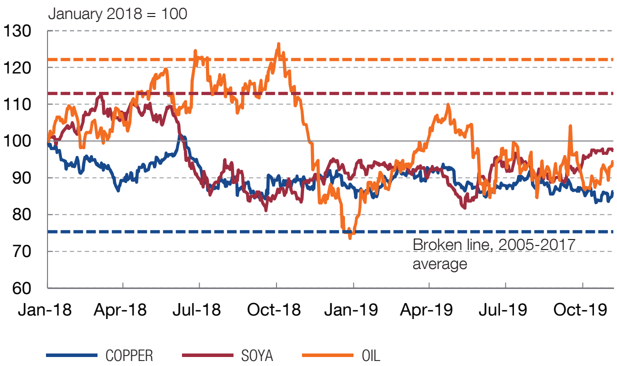
2 WORLD TRADE. EXPORTS



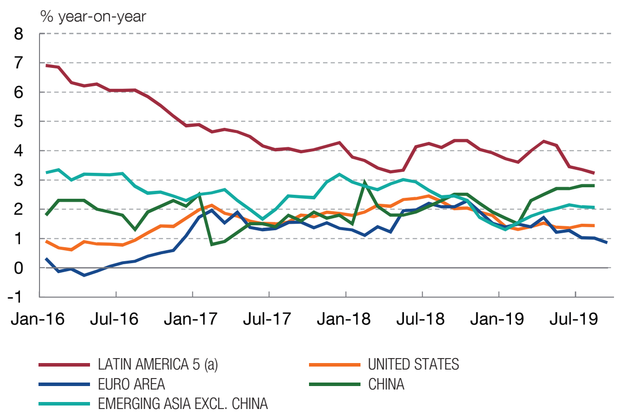
3 BREAKDOWN OF EXPORTS BY PRODUCT TYPE



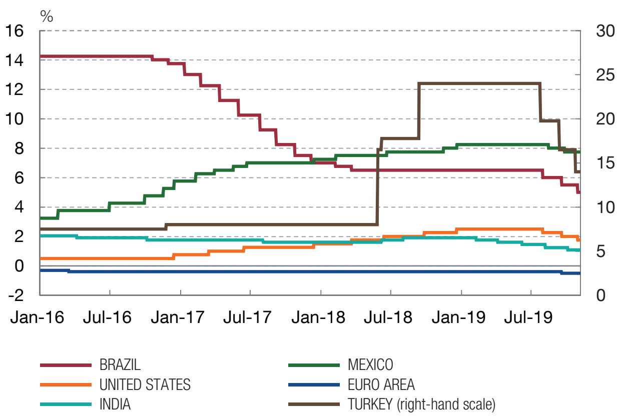
4 COMMODITY PRICES



5 INFLATION



6 OFFICIAL INTEREST RATES



SOURCES: *Consensus Forecasts,* CPB World Trade Monitor, OECD and Thomson Reuters.

a Latin America 6: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Latin America 5: Brazil, Chile, Colombia, Mexico and Peru. Weighted by the purchasing power parity method.
b The food, beverages and tobacco heading is included in the agriculture aggregate and not in manufacturing, unlike in the original source (OECD).
c Mining includes oil extraction.

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Macro-financial developments in Latin America

Financial markets in Latin America were less affected by the ups and downs in trade negotiations

Although they share the general features of the financial market developments of other emerging economies, stock market indices in Latin America were less affected by external factors relating to the ups and downs in trade negotiations (see Chart 2.1). This could be linked to the region having a lower degree of trade openness than other emerging areas, as well as to the higher proportion of commodities, as opposed to manufactured products, in foreign trade. Likewise, portfolio capital flows performed more benignly than in other emerging economies (see Chart 2.2). Other notable aspects in financial market developments in Latin America are that they were not specifically affected by the negative performance of Argentina's economy (see Charts 2.3 and 2.4) and that exchange rates remained relatively stable (see Chart 2.5). In fact, financial conditions[2] eased for almost all the countries in the region during 2019, which was also the case in the developed economies (see Chart 2.6).

The growth rate of activity continues to disappoint owing to the stall in domestic demand

The overall activity of the main Latin American economies continued to grow at low rates in general in the first half of 2019, with the region posting quarter-on-quarter growth rates of -0.1% and 0.4%, respectively, in the first two quarters of the year (see Table 1 and Chart 3.1).[3] Thus, GDP once again stood below the projections of various institutions and it was the emerging region where growth for 2019 was revised downwards most (see, again, Chart 1.1). As in 2018 Q4, in the first half of 2019 the region's scant growth was due to the positive contribution of external demand (as can be seen in Chart 3.2). A significant share of this performance of external demand is explained by the fall in imports. This was mainly as a result of the weakening of all domestic demand components: private consumption since mid-2018; government consumption, which began to post negative growth rates; and investment, which plummeted in Argentina, has not recovered in Brazil (after falling more than 25% in the 2015-2016 recession) and has not taken off in Mexico.

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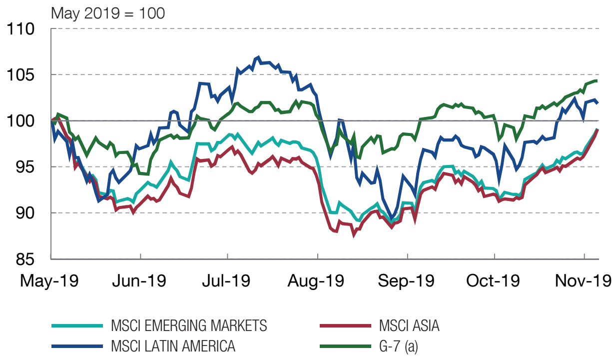
2 See Banco de España (2018), "Report on the Latin American economy. First half of 2018", Analytical Articles, *Economic Bulletin*, 2/2018, for a description of how these indices are calculated for Latin American economies.

3 In Venezuela, where official data on activity reach 2019 Q1, the higher-frequency indicators indicate that the economy remains immersed in a deep recession.

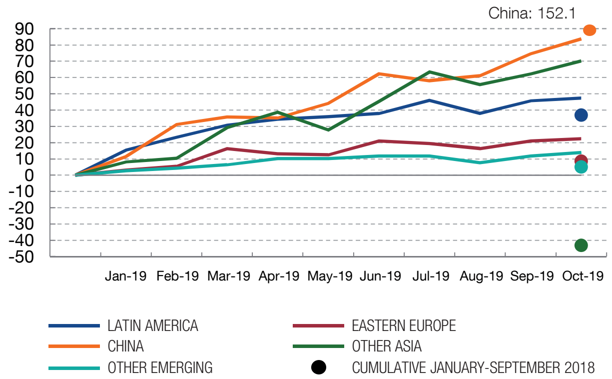
Chart 2
FINANCIAL CONDITIONS

Financial markets in Latin America were less affected by the ups and downs in the US-Sino trade negotiations than those in other emerging regions. The bouts of financial volatility in Argentina did not affect the other markets in the region. Financial conditions eased in all the countries and remained loose compared to previous financial conditions, except for in Argentina.

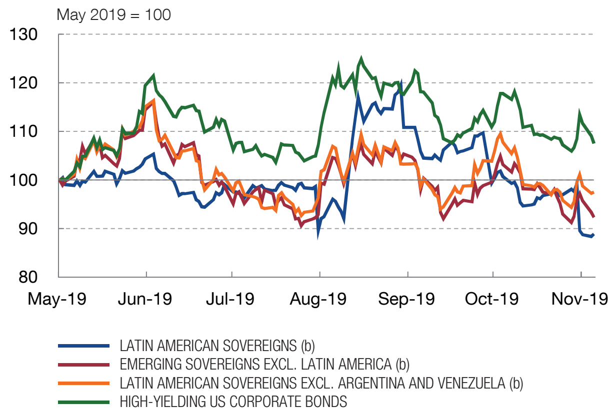
1 STOCK EXCHANGE INDICES



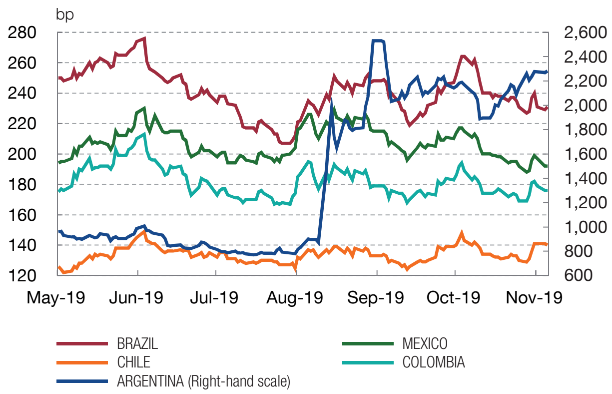
2 EMERGING MARKETS. PORTFOLIO CAPITAL FLOWS (CUMULATIVE)



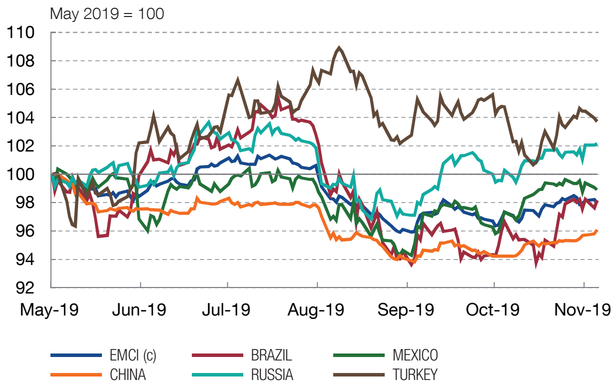
3 SPREADS



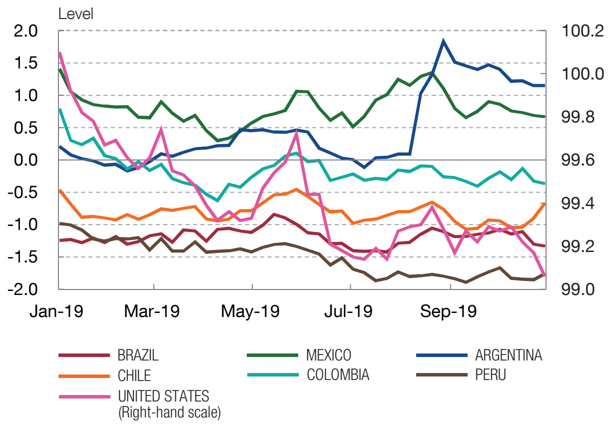
4 SOVEREIGN SPREADS FOR THE MAIN LATIN AMERICAN COUNTRIES



5 NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



6 FINANCIAL CONDITIONS INDICES (d)



SOURCES: Banco de España, Thomson Reuters and JP Morgan.

a Aggregate index of seven largest advanced economies in the world: Germany, Canada, United States, France, Italy, Japan and United Kingdom.
b Sovereign spread (EMBI+) in basis points.
c Aggregate index of exchange rate of emerging economies vis-à-vis the dollar. A fall indicates depreciation.
d An increase indicates a contraction of financial conditions. Weekly data. For greater details on the methodology, see “Report on the Latin American economy. First half of 2018”, Analytical Articles, *Economic Bulletin*, 2/2018, Banco de España, section 2.

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Economic policy uncertainty is a significant factor in weak domestic demand

Rising economic policy uncertainty in certain countries and doubts about global trade relations, in addition to certain temporary factors in some countries,[4] have played a significant role among the domestic factors which have had a negative effect on activity. In the case of Latin America, however, economic policy uncertainty (see Chart 3.3) seems to have been more significant, particularly in some countries, since the available indicators on the uncertainty over trade tensions showed more moderate developments than in the world economy as a whole (see Chart 3.4). The differentiating external factor with respect to other emerging economies which may have had a negative impact on Latin America is developments in commodity prices, which in almost all cases held at levels below those recorded in the years after the financial crisis (see again, Chart 1.4).

2019 will be another year of lower-than-expected GDP growth

Growth in 2019 will probably be lower than in 2018 (1.4%), at levels of less than 1% (see Chart 3.5 which includes the consensus forecasts of analysts). The downward revisions for this year are explained not only by the worse-than-expected performance in the first half of the year (only bar the positive surprises in Colombia) but also by the limited buoyancy of the higher-frequency indicators published for the second half and the plummeting of forecasts in the case of Argentina (see Box 2). Activity is projected to rise modestly in 2020 with domestic demand components estimated to perform more positively, underpinned by a degree of cyclical slack, continued relatively loose financial conditions, an assumed easing of global trade tensions and an improvement in domestic agents' confidence, as well as the absence of significant imbalances in several of these economies, as is analysed below.

Growth continues below potential and remains lower than in other emerging regions

The region's GDP growth in 2019 and 2020 is estimated to stand once again below potential, with the result that the negative output gap will continue to widen, although the latter differs in size across the different economies. Growth in Latin America has been below potential since 2012 and is currently even further off this potential than in other emerging regions (see Chart 3.6). This is especially the case in Argentina and Brazil in view of their deep recessions. The region's lower potential growth with respect

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4 For example, the Brumadinho dam disaster in Brazil in January, the strikes and fuel shortage in Mexico, and the adverse weather conditions which affected mining output in Chile.

Table 1

LATIN AMERICA: MAIN ECONOMIC INDICATORS

	2007-2017 Average	2018	2018				2019		IMF Projections (WEO October 2019)	
			Q1	Q2	Q3	Q4	Q1	Q2	2019	2020
GDP (year-on-year rate)										
Latin America 6 (a) (b)	2.5	1.4	2.2	1.2	1.4	1.0	0.1	1.0	0.7	1.8
Argentina	2.3	-2.5	4.1	-3.8	-3.7	-6.1	-5.8	0.7	-3.1	-1.3
Brazil	2.0	1.1	1.2	0.9	1.3	1.1	0.5	1.0	0.9	2.0
Mexico (c)	2.1	2.0	2.2	1.6	2.5	1.6	0.1	0.3	0.4	1.3
Chile	3.2	4.0	4.7	5.3	2.6	3.6	1.6	1.9	2.5	3.0
Colombia (c)	3.9	2.6	2.5	2.4	2.6	2.7	2.7	3.4	3.4	3.6
Peru	5.2	4.0	3.2	5.5	2.5	4.7	2.4	1.2	2.6	3.6
CPI (year-on-year rate)										
Latin America 5 (d)	4.9	3.8	3.6	3.5	4.2	4.1	3.7	3.9	3.6	3.2
Brazil	5.9	3.7	2.8	3.3	4.4	4.1	4.1	4.3	3.8	3.5
Mexico	4.1	4.9	5.3	4.6	4.9	4.8	4.1	4.2	3.8	3.1
Chile	3.5	2.7	2.5	2.6	3.1	2.9	1.8	2.2	2.2	2.8
Colombia	4.3	3.2	3.4	3.2	3.1	3.3	3.1	3.3	3.6	3.7
Peru	3.2	1.3	0.9	1.0	1.3	2.1	2.1	2.5	2.2	1.9
Budget balance (% of GDP) (e)										
Latin America 6 (a) (b)	-3.0	-4.5	-4.9	-4.8	-4.7	-4.5	-4.2	-3.9	-4.6	-4.1
Argentina	-1.8	-5.0	-5.7	-5.1	-4.8	-5.0	-4.7	-4.3	-4.0	-2.7
Brazil	-4.6	-7.1	-7.4	-7.3	-7.2	-7.1	-7.0	-6.5	-7.5	-6.9
Mexico	-2.3	-2.1	-2.8	-2.7	-2.5	-2.1	-1.7	-1.6	-2.8	-2.6
Chile	0.0	-1.7	-2.7	-2.6	-2.1	-1.7	-1.8	-1.8	-2.2	-2.1
Colombia	-2.8	-3.1	-2.9	-3.3	-4.1	-3.1	-2.8	-1.9	-1.7	-0.9
Peru	-0.3	-2.0	-3.2	-2.3	-2.0	-2.0	-1.9	-2.0	-1.5	-1.4
Public debt (% of GDP)										
Latin America 6 (a) (b)	44.9	60.7	56.0	58.5	60.3	59.4	60.5	—		
Argentina	44.5	85.9	54.3	66.3	83.8	73.9	80.3	66.5	93.3	80.8
Brazil	58.7	77.2	75.4	77.4	77.7	77.2	78.8	78.7	91.6	93.9
Mexico	36.9	46.9	46.7	47.4	46.5	46.9	46.5	46.5	53.8	54.6
Chile	12.3	25.6	24.0	24.4	25.0	25.6	26.0	27.8	27.5	29.2
Colombia	36.5	47.1	43.5	45.0	45.9	46.9	47.6	—	51.0	49.0
Peru	23.6	25.7	23.8	23.6	23.9	25.7	25.3	25.8	26.9	27.2
Current account balance (% of GDP) (e)										
Latin America 6 (a) (b)	-2.0	-2.2	-1.8	-2.0	-2.2	-2.2	-2.1	-1.9	-1.6	-1.5
Argentina	-0.9	-5.3	-5.2	-5.6	-5.9	-5.1	-4.4	-3.4	-1.2	0.3
Brazil	-2.3	-1.2	-0.9	-1.1	-1.3	-1.2	-1.2	-1.5	-1.2	-1.0
Mexico	-1.6	-1.8	-1.6	-1.7	-1.8	-1.8	-1.6	-0.9	-1.2	-1.6
Chile	-1.1	-3.1	-1.6	-1.8	-2.2	-3.1	-3.3	-3.6	-3.5	-2.9
Colombia	-3.5	-3.9	-3.0	-3.2	-3.3	-3.9	-4.2	-4.2	-4.2	-4.0
Peru	-2.7	-1.6	-1.3	-1.4	-1.8	-1.6	-1.7	-1.9	-1.9	-2.0
External debt (% of GDP)										
Latin America 6 (a) (b)	26.7	36.8	34.8	34.1	34.7	36.8	38.1	—		
Argentina	34.5	53.4	38.8	41.2	43.2	51.6	55.7	60.8		
Brazil	25.5	35.6	33.3	32.2	33.3	35.5	37.3	38.5		
Mexico	20.1	27.9	28.4	28.1	27.9	27.9	28.0	28.1		
Chile	48.8	61.8	63.3	59.2	60.1	61.8	63.6	—		
Colombia	27.5	39.9	39.9	38.9	38.5	39.9	40.5	41.7		
Peru	32.2	34.5	34.5	33.2	33.3	34.5	35.8	36.5		
MEMORANDUM ITEMS - Aggregate of Latin America and the Caribbean (International Monetary Fund):										
GDP (year-on-year rate)	2.4	1.0								
CPI (year-on-year rate)	5.1	6.2								
Budget balance (% of GDP)	-3.6	-4.9								
Public debt (% of GDP)	49.9	67.8								
Current account balance (% of GDP)	-1.8	-1.9								
External debt (% of GDP)	32.8	48.0								
Weight in world GDP, in PPP (%)	8.5	7.5								

SOURCES: International Monetary Fund, Thomson Reuters and national statistics.

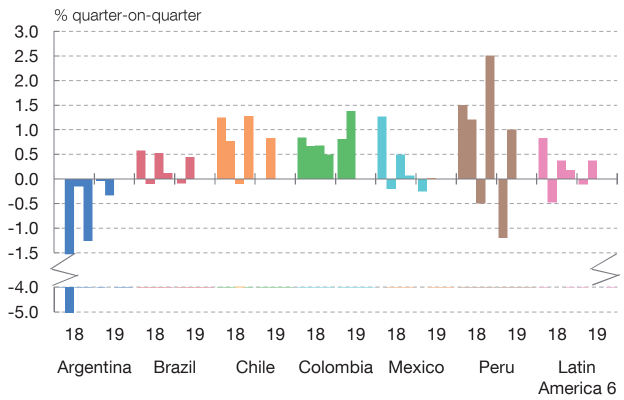
a The six economies shown represent 84% of the total of Latin America and the Caribbean (IMF).
b GDP of Latin America 6 weighted using the purchasing power parity method. The weightings for 2018 are: Brazil, 39.4%; Mexico, 30.1%; Argentina, 10.7%; Colombia, 8.7%; Chile, 5.6%, and Peru, 5.4%.
c Seasonally adjusted.
d Latin America 5: Brazil, Chile, Colombia, Mexico and Peru. Argentina is not included because its central bank does not have inflation targets.
e Four-quarter moving average.

Chart 3

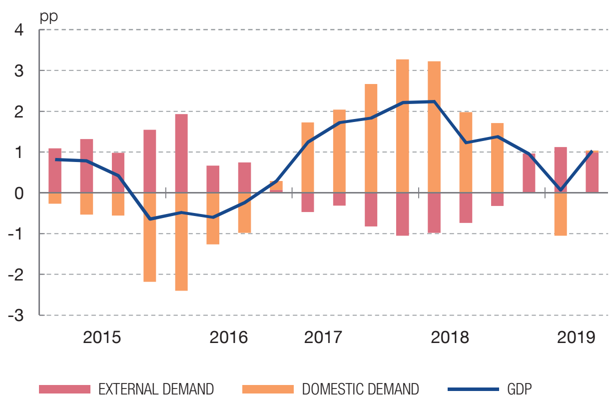
ECONOMIC ACTIVITY IN LATIN AMERICA

Activity in the main Latin American economies grew at a low rate in the first half of 2019, as a result of subdued domestic demand, partly owing to the effect of greater uncertainty over economic and trade policies. Growth forecasts were revised downwards again, especially in 2019. This year and next year, the region's growth rate will be below potential, increasing the spare capacity of the economies, which is much larger than in other emerging regions.

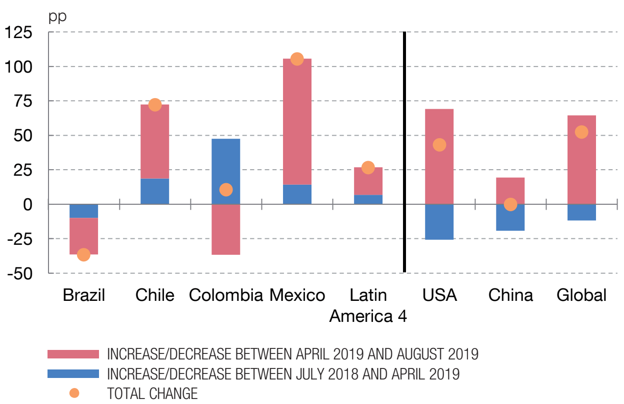
1 GROSS DOMESTIC PRODUCT. RECENT QUARTERS



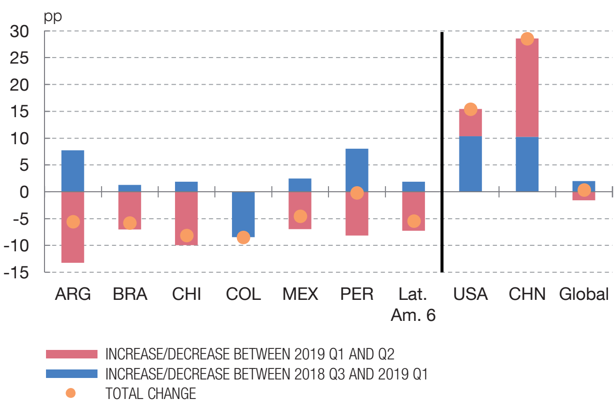
2 CONTRIBUTIONS TO GDP GROWTH. LATIN AMERICA 6 (a)



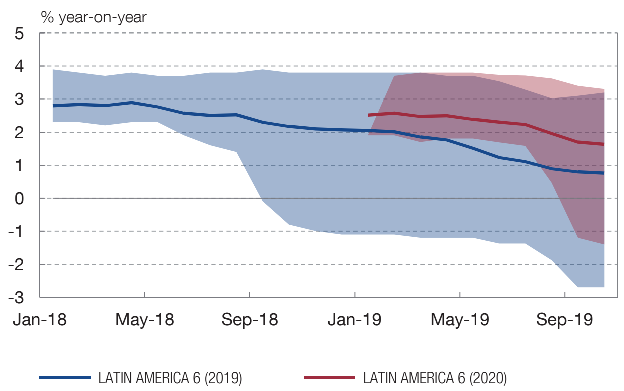
3 ECONOMIC POLICY UNCERTAINTY INDEX



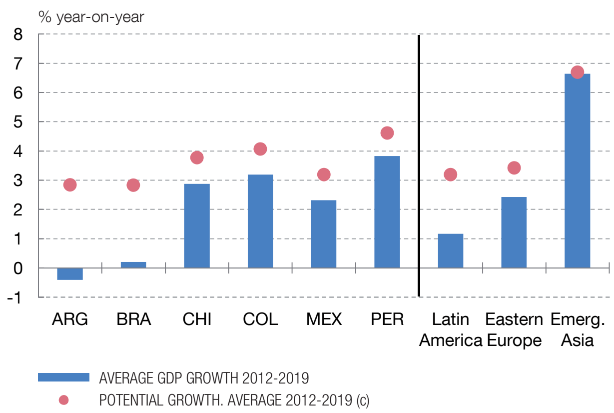
4 INTERNATIONAL TRADE UNCERTAINTY INDEX



5 PRIVATE INSTITUTIONS' GROWTH FORECASTS (b)



6 GDP GROWTH AND POTENTIAL GROWTH



SOURCES: IMF, Economic Policy Uncertainty, World Trade Uncertainty, Latin American Consensus Forecasts and Thomson Reuters.

a Latin America 6: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Latin America 4: Brazil, Chile, Colombia and Mexico. Weighted by the purchasing power parity method.
b The shaded areas relate to the country with the highest or lowest growth forecast at any given time.
c The longest-term IMF forecast available at that time (five years) is taken for each year to estimate potential growth.

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to other emerging areas (especially in comparison with Asia) is associated with lower commodity prices[5] and a slower pace of implementation of structural reforms in Latin American economies in recent years.[6] These developments are hindering and even reversing income per capita convergence with the group of developed economies.

Balance of risks tilted downwards

The baseline scenario for developments in activity in the coming quarters is subject to several downside risks. On the domestic side, Argentina's situation is uncertain, especially due to the incoming government's lack of specification of economic policies. Political uncertainty also affects Chile, following the recent social tension, and Peru, given the ongoing institutional crisis. In Mexico uncertainty also remains high about the course of the economic policies to be implemented, for example, the type of private-sector participation in oil extraction and the approval of a new free trade agreement with the United States and Canada. As for Brazil, after the approval of the pension reform needed to avoid government debt from following an unsustainable course, it is still not clear how the Government's reform agenda will unfold in controversial areas such as tax reform and greater openness to trade. In addition to domestic economic policy-related risks, developments in trade tensions and a possible deepening of the global slowdown, particularly of the US and Chinese economies, are sources of risks which are difficult to quantify and which could alter international financial conditions and commodity prices.

The absence of inflationary pressures in most countries in the region has led central banks to cut policy interest rates

In countries with inflation targets, inflation has been within the target range (see Table 2 and Chart 4.1). Inflation expectations remain anchored around this range. Also taking into account the negative output gaps in all these countries[7] as well as the easing of monetary policy in the main advanced countries, the logic behind the central bank's decision to cut policy interest rates in recent months in Brazil, Chile, Mexico and Peru is understandable (see Chart 4.2). As a result of these monetary policy actions, the real interest rate is lower than the natural rate of

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5 I. Kataryniuk and J. Martínez-Martín (2019), "TFP Growth and Commodity Prices in Emerging Economies", *Emerging Markets Finance and Trade*, show that the performance of total factor productivity (TFP) is partly explained by changes in commodity prices: on average, a fall of 10% in commodity export prices would be associated with a fall of 0.4 to 0.7 percentage points (pp) in short-term TFP growth. That is, potential growth would have been overestimated in the periods of rising commodity prices which, furthermore, were higher than their historical averages.

6 See Chapter 3 of the IMF's *World Economic Outlook*, October 2019.

7 According to the habitual statistical calculation methods using Hodrick-Prescott filters and the inflation reports published by various central banks.

Table 2
LATIN AMERICAN INFLATION
Year-on-year rates of change (%)

	2018			2019		2020
Country (a)	Target	December	Fulfilment	September	Expectations (b)	Expectations (b)
Brazil (c)	4.5 ± 1.5	3.8	Yes	2.9	3.4	3.7
Mexico	3 ± 1	4.8	No	3.0	3.1	3.5
Chile	3 ± 1	2.6	Yes	2.1	2.6	2.8
Colombia	3 ± 1	3.2	Yes	3.8	3.7	3.4
Peru	1 – 3	2.2	Yes	1.9	2.0	2.2

SOURCES: Thomson Reuters, national statistics and *Consensus Forecasts.*

a Argentina suspended its monetary policy framework based on inflation targeting and adopted a monetary policy based on monetary base growth limits.
b October 2019 *Consensus Forecasts* for the end of the year.
c Brazil's inflation target is 4.25% ± 1.5 pp for 2019 and 4.00% ±1.5 pp for 2020.

interest,[8] except for in Mexico, where inflation held for many quarters above the upper bound of the target range, and in Colombia. Further cuts in official interest rates are expected in the coming months, except for, once again, in Colombia. However, this expected scenario of greater monetary easing requires some stability in exchange rates since, if international financial conditions became tighter, compliance with inflation targets may be jeopardised, apart from the potential risks to financial stability.

The main challenges facing the Latin American economies

Correction of the external imbalance in Argentina and widening of the external imbalance in Colombia and Chile

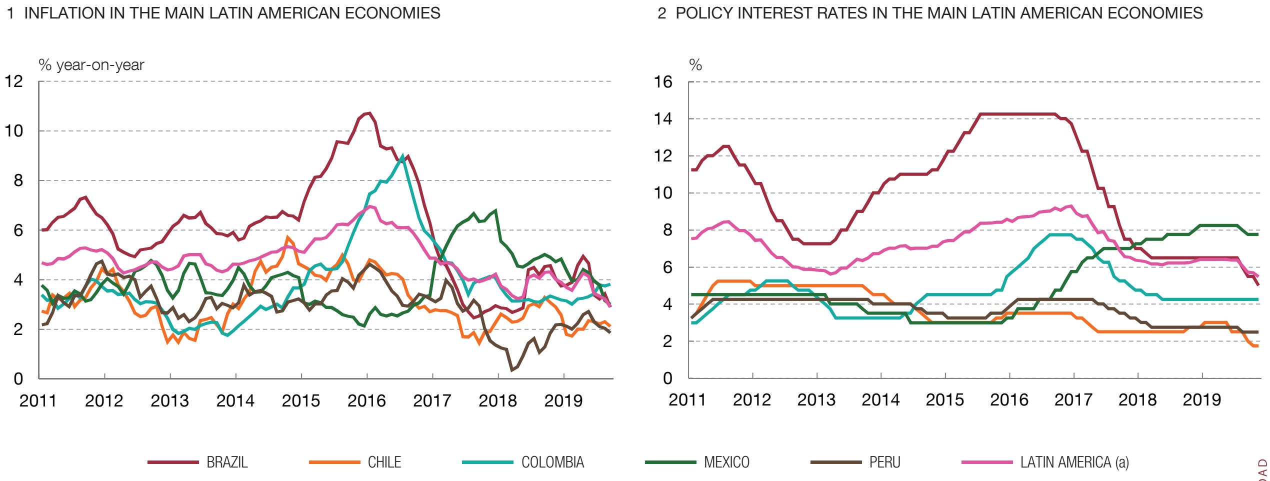
The total current account deficit of the Latin American economy stood at similar levels to those of the previous year, whereas other emerging economies strengthened their surplus (see Chart 5.1). By country, the current account deficit narrowed sharply in Argentina in recent quarters, which could be linked to the recession in this country since the beginning of 2018 and the notable depreciation of its currency, whereas in Chile and Colombia, it is widening and stands close to 4% of GDP, against a

8 According to the estimates of the region's various central banks. See, inter alia: Banco Central de Brasil, Box entitled "Structural interest rates and monetary policy in Brazil", *Inflation Report,* September 2017; Banco Central de Chile, Box V.2 "Natural rate of interest", *Monetary Policy Report,* June 2019; Colombia, Box 2 "New Estimates of the Neutral Interest Rates in Colombia", *Inflation Report,* September 2018; Mexico, Box 4 "Update to the Estimate of the Long-Term Neutral Interest Rate in Mexico", *Quarterly Report,* April – June 2019; Peru, Box 4 "Re-estimations of the potential output and natural interest rate" *Inflation Report,* September 2019.

Chart 4

INFLATION AND POLICY INTEREST RATES IN LATIN AMERICA

Inflation stands close to the target range and is expected to continue to do so in the coming quarters since inflation expectations are well anchored, exchange rates are relatively stable and spare capacity remains in the economies. In recent months, the central banks, in tandem with the more accommodative monetary policy stance in the developed economies and, bar Colombia, have cut policy interest rates and are expected to continue to do so in the coming quarters.



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SOURCES: Thomson Reuters.

a Aggregate of the five countries with inflation targets: Brazil, Chile, Colombia, Mexico and Peru, weighted by the purchasing power parity method.

background of negative output gaps in both economies. The external debt of all the large economies continued to grow in the last quarter (see Table 1).

The current account balance of Latin American economies is essentially determined not only by their relative position in the economic cycle but also by developments in commodity prices

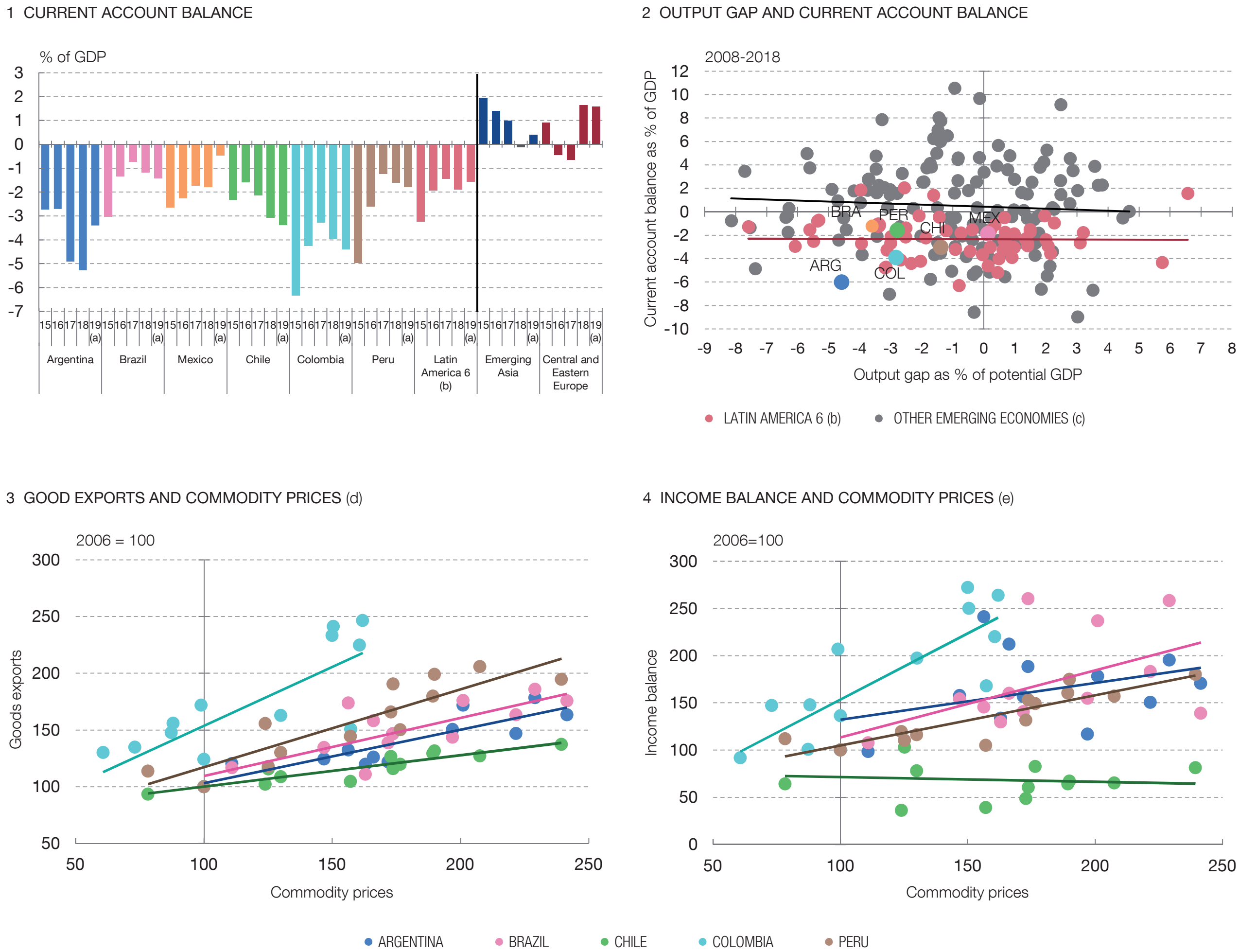
Unlike events in other emerging regions, in the last decade the usual negative correlation between the position in the economic cycle and the current account balance has not been observed in the main Latin American economies (see Chart 5.2). In these economies the trade and income balances are highly influenced by commodity prices (see Charts 5.3 and 5.4). Higher commodity prices increase domestic producers' exports, and income outflows, since the profits of foreign-owned producers rise. Therefore, commodity price developments constitute another crucial variable when explaining the current account balances of Latin American economies.

Fiscal space in the region is generally low

Despite the correction in recent quarters in the primary balances, Argentina and, especially, Brazil continue to run high government deficits, which are largely

Chart 5
EXTERNAL SECTOR IN LATIN AMERICA

The external imbalances in the main economies in the region continue.



SOURCES: IMF and Thomson Reuters.

a Four-quarter moving average, until 2019 Q2.
b Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru, weighted by the purchasing power parity method. The countries marked for Latin America refer to 2018.
c Includes China, India, Indonesia, Korea, Thailand, the Philippines, Turkey, Russia, Czech Republic, Poland, Hungary and Croatia.
d For each country, the price of the most significant commodity in exports and total goods exports in each year from 2006 to 2018 are shown. It is soya for Argentina and Brazil, copper for Chile and Peru, and oil for Colombia.
e For each country, the price of the most significant commodity in exports and the net income balance in each year from 2006 to 2018 is shown. An increase in the income balance represents a more negative balance.

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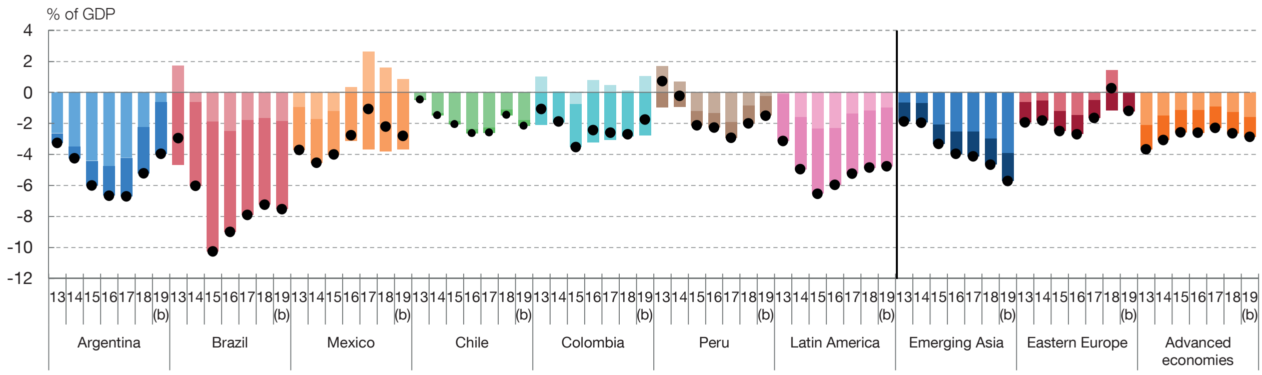
explained by debt servicing costs (see Chart 6.1). Furthermore, these two countries have very high public debt-to-GDP ratios (see Chart 6.2). In the case of Brazil, it is due to government deficits having built up in recent years and, in that of Argentina, it is on account of the depreciation of the Argentine peso since close to 80% of its debt is denominated in foreign currencies, mainly dollars. In order to address the situation in Brazil, the legislature approved a pension system reform given the projections of increased expenditure. However, the effects of that reform will be seen in public finances in the longer term and the reduction of the government

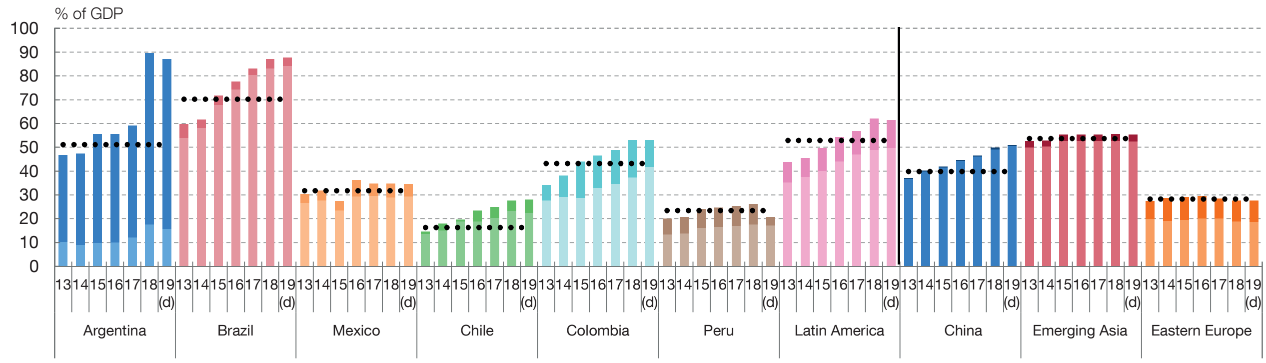
Chart 6
FISCAL POLICY IN LATIN AMERICA

Both the government deficit and government debt have remained very high in Brazil and Argentina; furthermore, Argentina's debt structure is highly dependent on the exchange rate. The ratios recorded in the other countries are comparable with those of emerging Asia and higher than those of Eastern Europe, although there are implicit risks such as the high debt of the state-owned oil company PEMEX in Mexico.

1 GOVERNMENT DEFICIT/SURPLUS (a)



2 GOVERMENT DEBT (c)



SOURCES: IMF, Institute of International Finance, Thomson Reuters and national statistics.

a Light shading, primary deficit; dark shading, interest burden. The dots represent the total government balance.
b IMF's estimates from the October 2019 WEO.
c Light shading, debt in local currency; dark shading, debt in foreign currency. The dotted line represents average total debt in the period 2000-2018.
d 2019 Q1.

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deficit, which will be linked to the expected improvement in the economy, may not be sufficient to correct the structural situation of public finances. In the case of Argentina, government debt maturities have been rescheduled for some bonds, as described in Box 2. This means a much smaller reduction in the present value of the debt than that implied by the market price of government debt securities. In short, the space for implementing expansionary fiscal policies, if necessary, seems highly constrained in these two countries.

Mexico's fiscal policy does not have significant room for manoeuvre either, given the delicate situation of the state-owned oil company PEMEX, which could ultimately affect the sustainability of government debt, as described in the previous half-yearly report on the Latin American economies.[9] In the case of Colombia, where government debt remains high in historic terms, the country has to address greater public expenditure arising from the significant increase in immigration (from Venezuela with a cost estimated by the Colombian government of around 0.5 pp of GDP in 2019). This is at odds with the application of the fiscal rule which would require a reduction of the structural government deficit in the coming years. Although government debt remains low in Chile, it has increased notably in recent years and will foreseeably continue to do so, as the Government has announced certain expansionary fiscal measures in response to social protest, which have yet to be determined. Finally, the approval of possible countercyclical fiscal policy measures in Peru could be hindered by its current complicated institutional situation.

Data cut-off date: 5.11.2019.
Date of publication: 7.11.2019.

9 Banco de España (2019), Box 1, "The measures proposed by the new governments of Brazil and Mexico", in the "Report on the Latin American economy. First half of 2019", Analytical Articles, *Economic Bulletin*, 2/2019.

Box 1

THE EFFECTS OF GLOBAL TRADE TENSIONS ON LATIN AMERICA

As from 2018, trade tensions have heightened, particularly between the United States and China, with adverse effects on the global economy.[1] In this setting, Box 1 describes the channels through which this situation could affect Latin America and estimates its possible effects.

The trade channel is the most salient of these channels. The lower activity in countries directly affected by the "trade war" may lead to a reduction in their demand for goods produced in the rest of the world, including Latin America. Likewise, the tensions may disrupt the global value chains (GVC) into which the Latin American countries are integrated. Furthermore, trade flows between the United States and China may be diverted through third jurisdictions, which could have a positive effect on certain exports. Finally, given the importance, in particular, of Chinese demand in determining commodity prices, a further slowdown of this economy may affect these markets with significant impacts on Latin America. In addition to the trade channel, negative effects may arise if the tensions affect agents' investment and consumption decisions by reducing their confidence in the economic situation, as a result of uncertainty over the future nature of multilateral trade relations or due to their lower expectations about the future course of activity.

Moving onto the possible materialisation of trade tensions in Latin America, it should be noted, first, that this region's economies, as a whole, are less open to international trade than other emerging areas: their goods exports account for slightly less than 20% of GDP, compared with figures of around 50% for emerging economies in Eastern Europe or South East Asia (see Chart 1.1). However, there is a high degree of heterogeneity in the region. The degree of openness of the Argentine, Brazilian and Colombian economies is below average, nevertheless, China and the United States are the destination of almost half of the total value of Colombia's exports (see Chart 1.3). By contrast, the degree of openness of the Peruvian, Chilean and Mexican economies is higher; Peru and Chile are considerably exposed to China, as is Mexico to the United States (see again, Chart 1.3).

The region's lower degree of openness is reflected in its lower integration into GVC compared with other emerging regions (see Chart 1.2), but the pattern is heterogeneous across the countries. Mexico is more closely tied to US industry, whereas regional links predominate in the structure of the South American economies.[2] However, since the breakdown of the exports of the Latin American economies, except for Mexico, largely comprises commodities (see again, Chart 1.3), they are more exposed to the possible effects of lower demand from the United States and China, as mining products and agricultural goods have considerably higher trade elasticities than manufactured products. Similarly, as mentioned above, the region's terms of trade are very closely tied to fluctuations in international commodity prices which are largely determined by the Chinese economy's activity and demand (see Chart 1.4).

Trade tensions seem to be negatively influencing the global goods trade, particularly since end-2018 (see Chart 1.5) by affecting exports of commodities and manufactured goods. In this setting, Latin America has followed the pattern of other emerging economies and its exports fell throughout 2019. However, Mexico, with an export structure more focused on manufactured goods, has continuously posted positive rates of change throughout the year (see again, Chart 1.5). A recent report by the Banco de México[3] attributes part of these developments to a slight substitution effect of those Chinese exports to the United States which are affected most by the new tariffs.[4] However, the Banco de México points out that in the medium and long term the trade tensions could also trigger adverse effects for Mexico's economy through the channel of uncertainty.

Accordingly, however, based on the available data it is difficult to estimate the specific economic impact of the various waves of tariff increases since certain measures have only come into force recently or are pending

1 In particular, both the IMF, in the *World Economic Outlook* of October 2018 and the OECD, in the *Economic Outlook* of April 2019, envisage negative impacts relating to the trade shocks. See also, "Rising protectionism between the United States and China and its effects on the global economy", Box 2, "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2019, Banco de España.

2 See CEPAL (2013), "América Latina y el Caribe en las cadenas internacionales de valor", Serie Comercio Internacional.

3 See Banco de México (2019), "Quarterly Report", January-March 2019.

4 These results are similar to those obtained by some international institutions. See UNCTAD (2018), "Key Statistics and Trends in Trade Policy – 2018".

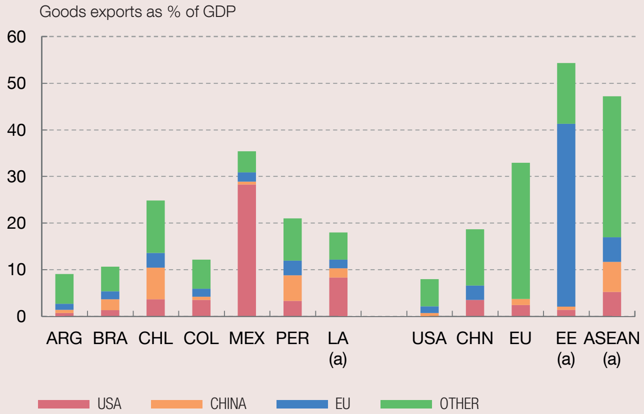
Box 1

THE EFFECTS OF GLOBAL TRADE TENSIONS ON LATIN AMERICA (cont'd)

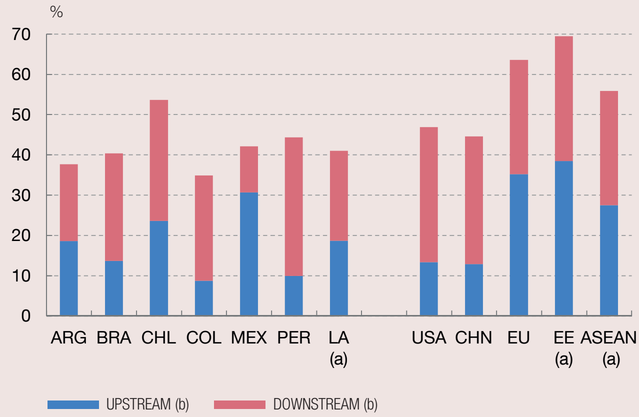
Chart 1
TRADE TENSIONS MAY GENERATE SPILLOVERS TO LATIN AMERICA THROUGH VARIOUS CHANNELS

In terms of the trade channel, the region shows considerable heterogeneity as regards the degree of trade openness, of exposure to the United States and China, and of integration into global value chains. The high proportion of exports of commodities is a particularly significant factor also on account of the importance of Chinese demand in determining their prices. In the short term, trade tensions are estimated to have negatively influenced developments in global trade activities and in Latin America. Mexico stands out for having maintained positive export growth rates. Also, higher uncertainty over trade policy and the global economic situation may have a negative effect on the financial markets of emerging economies, in general, and on the Latin American economies, in particular.

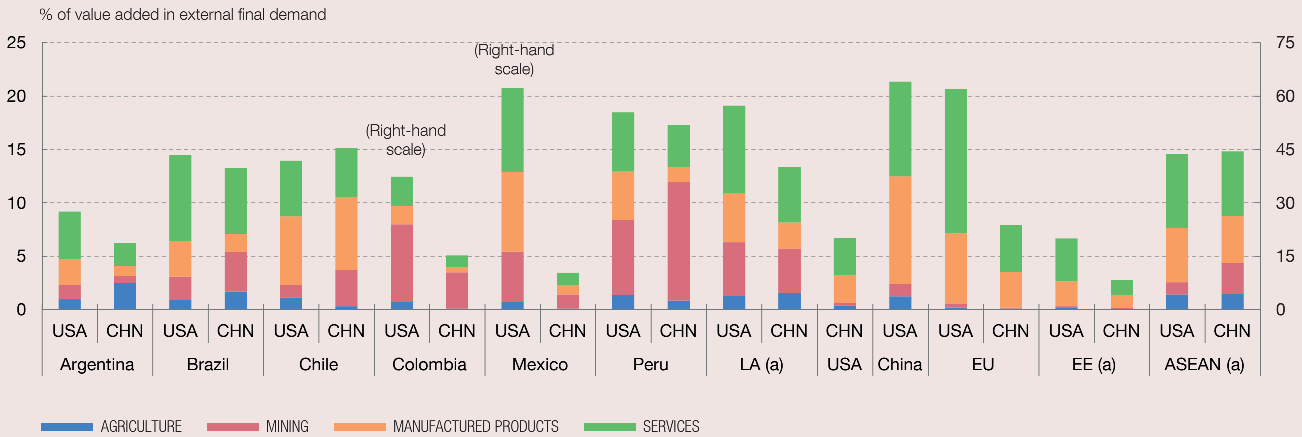
1 TRADE OPENNESS



2 RATE OF PARTICIPATION IN GLOBAL VALUE CHAINS



3 BREAKDOWN OF EXPORTS TO USA AND CHINA



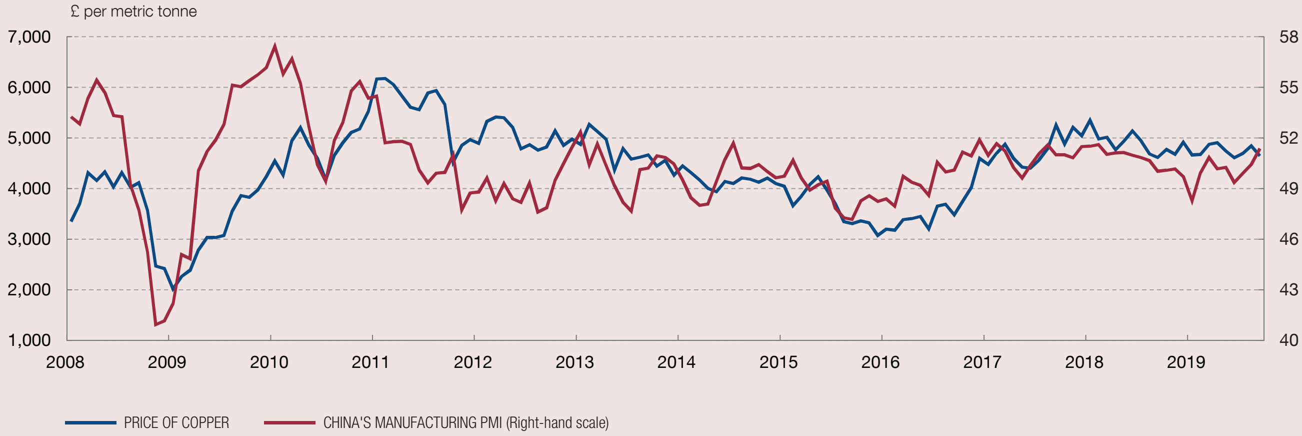
SOURCES: OECD, UNCTAD-Eora GVC database, WTO and Thomson Reuters.

a LA: aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru. EE: Eastern Europe (EU 13). ASEAN: Association of Southeast Asian Nations.
b Upstream: proportion of exports used as an input by industries in other countries, which produce goods or services for export to third countries (value-added indirect exports). Downstream: proportion of exports comprising the value added of foreign goods and services used as inputs to produce goods and services for export.

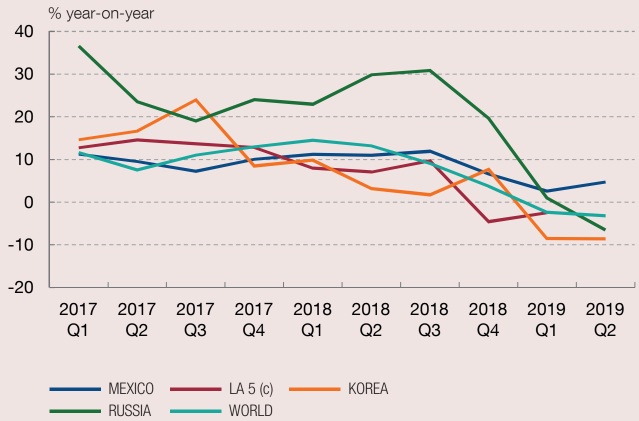
implementation. To approximate the possible economic impact on the Latin American economy a simulation exercise using a macroeconometric model[5] has been conducted. Chart 1.6 shows two scenarios. The first scenario includes the transmission channels of changes in global trade (arising from the increase in tariffs between the United States and China in various phases), whereas the second scenario adds as well the changes arising from

Chart 1
TRADE TENSIONS MAY GENERATE SPILLOVERS TO LATIN AMERICA THROUGH VARIOUS CHANNELS (cont.)

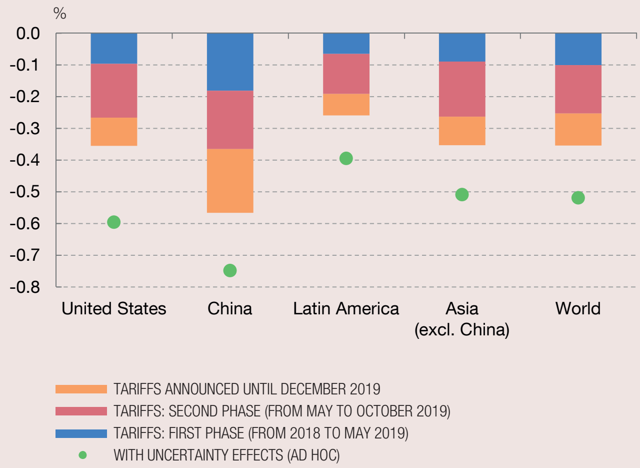
4 PRICE OF COPPER AND CHINA'S MANUFACTURING PMI



5 GROWTH OF GOODS EXPORTS



6 SIMULATIONS: EFFECT OF THE ESCALATION OF PROTECTIONISM ON GDP IN 2021 Q4 (d)



SOURCES: OECD, UNCTAD-Eora GVC database, WTO and Thomson Reuters.

c LA 5: aggregate of Argentina, Brazil, Chile, Colombia and Peru.
d All the tariff measures between the United States and China, which have been introduced or were announced until December, are included. The effect of uncertainty is approximated by increases in the risk premium of 25 basis points (bp) for the United States and China, and of 10 bp for the rest of the world.

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5 Specifically, the NiGEM model of the UK National Institute of Economic and Social Research. The effect of the tariffs announced by the United States and China since May this year was simulated, regardless of whether they have already been applied. For more details on the simulation framework, see "Rising protectionism between the United States and China and its effects on the global economy", Box 2, "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2019, Banco de España.

declining confidence and rising uncertainty.[6] According to the simulations, in the first scenario Latin America's GDP would decrease by 0.3%, in cumulative terms in 2019-2021, 0.1 pp less than that of the emerging Asia region, given its lower degree of trade openness and its lower integration into GVC. In the second scenario, the confidence effects could ultimately trigger additional adverse impacts (of 0.1 pp for both regions), not only owing to the direct effect of higher investment risk premia but also owing to the second-round effect on global activity.

Nevertheless, the uncertainty-related impacts are particularly difficult to calibrate and, therefore, must be regarded with more caution than those associated with the trade channel. Similarly, two factors should be noted among those that produce different effects to those presented. First, the simulations performed do not take into account the expansionary reaction of monetary policies globally and regionally, which has already begun, and which would tend to reduce the magnitude of the impact. Second, the macroeconometric model used includes commodity price elasticities that are lower than those estimated in the empirical literature[7] which, given Latin America's export specialisation discussed above, could introduce downward bias in the results.

6 This channel is approximated through an *ad hoc* increase of 25 basis points (bp) in the investment risk premium in the United States and China, and of 10 bp in the other economies.

7 See the discussion in X. Bin, D. Santabárbara and M. Roth (2019), "Global impact of a slowdown in China", Analytical Articles, *Economic Bulletin*, Banco de España, forthcoming. These authors refine the channel of the impact of changes in the economic situation on commodities in two main dimensions. First, they calibrate differently the reaction of commodity prices to a fall in China's industrial output. Second, they recalibrate the parameters of the NiGEM model on the elasticity of the supply of the various commodities, in order to calculate the fall in the value of output associated with lower prices, differentiating between oil and the various types of industrial metals, using the estimates available in the economic literature of reference.

Box 2
RECENT DEVELOPMENTS IN THE ECONOMIC SITUATION OF ARGENTINA

Capital inflows into Argentina came to a sudden halt in Spring 2018. When faced with the impossibility of raising funding on international markets, the Government decided to request financial assistance from the International Monetary Fund (IMF). The main reasons for this situation were:[1] i) the lack of progress in reducing the government deficit (mainly financed with foreign currency-denominated external debt) and inflation; ii) the widespread tightening of international financial conditions, and iii) a severe drought, which significantly reduced agricultural output temporarily in 2018 Q2, with an impact on the quarter-on-quarter rate of change in GDP of –2.2 percentage points (pp).[2]

The programme with the IMF, which was approved in June 2018 and modified in October 2018 to increase in size and bring forward the disbursement of the amounts committed (see Table 1), envisaged a fiscal and monetary adjustment geared at reducing the fiscal[3] and current account deficits (see Chart 1.1), and inflation. Similarly, far-reaching institutional changes were introduced in the monetary policy sphere. On the one hand, the political authorities sent a draft law to the Congress which modified the charter of the Banco Central de la República Argentina (BCRA), granting greater independence to the monetary authority and prohibiting the BCRA from financing the

Table 1
ARGENTINA'S STAND-BY ARRANGEMENT: DISBURSEMENTS AND AMOUNTS PENDING DISBURSEMENT (a)

Available from	Amount		Cumulative ($mn)	% of programme total
	$ (mn)	% of GDP		
Total disbursed	**43,945**	**9.9**		**78.4**
Fifth review, September 2019	5,370	1.2	49,315	9.6
Sixth review, December 2019	964	0.2	50,279	1.7
Seventh review, March 2020	964	0.2	51,243	1.7
Eighth review, June 2020	964	0.2	52,207	1.7
Ninth review, September 2020	964	0.2	53,171	1.7
Tenth review, December 2020	964	0.2	54,135	1.7
Eleventh review, March 2021	964	0.2	55,099	1.7
Twelfth review, June 2021	964	0.2	56,063	1.7
Total not disbursed	**12,118**			**21.6**
TOTAL	**56,063**	**11.6**		

SOURCES: Banco de España calculations, based on IMF, *Argentina. Fourth Review Under the Stand-by Arrangement,* IMF Country Report No. 19/232, July 2019.

a Argentina entered into a Stand-By Arrangement with the IMF which stipulates disbursement in 12 payments. The table was prepared based on the most up-to-date information available on the programme's progress (fourth review, June 2019). The percentages of GDP were calculated using the IMF's nominal GDP forecasts in dollars for each year taken from the *World Economic Outlook* of October 2019. The IMF's forecast of Argentina's nominal GDP for 2021 is used for the total percentage in the last row.

1 For the reasons which led to the request for financial assistance from the IMF, see the analytical article "Argentina: economic challenges in an adverse international setting", *Economic Bulletin,* 4/2018, Banco de España.

2 Exports fell by 14% in said quarter. This drop in exports anticipated falls both in expected foreign currency receipts and government revenue (see the monetary policy reports of the Banco Central de la República Argentina of October 2018 and January 2019).

3 The target for reducing the primary fiscal balance in 2018 and 2019, stood at 3.8 pp of GDP. Until the fourth review of the programme with the IMF (the latest review available) all the quantitative fiscal consolidation targets were met.

Treasury.[4] At the cut-off date of this report, the draft law is still pending approval. On the other, inflation targeting was abandoned, switching to a system in which the monetary base acts as a nominal anchor, so that the benchmark interest rate in the money markets becomes an endogenous variable of the economy (see Chart 1.2). Finally, as regards the Argentine peso/dollar exchange rate, an essential variable for inflation expectations, the "non-intervention zone", i.e. the exchange rate band within which the currency was initially allowed to float freely, was ultimately eliminated at end-April 2019, as a result of the financial market turmoil. Consequently, the non-intervention zone became known as the "exchange rate reference zone". The difference with the previous system of a non-intervention zone lies in the currency no longer floating freely within the exchange rate reference zone. The BCRA can intervene, even if the exchange rate is within the reference zone, if it considers that it is excessively volatile.[5]

Until July 2019, four reviews of the programme were completed (see again, Table 1). In these reviews, the IMF considered that the programme conditionality was generally met. In particular, the public debt sustainability analysis performed by the IMF was deemed satisfactory and the debt was considered "sustainable but not with a high probability".[6]

Against this economic and institutional backdrop, in August 2019, there was a bout of intense financial pressure. This triggered sharp falls in the value of Argentine financial assets and of dollar-denominated bank deposits (in the two subsequent months, until the end of October, by around $11 billion, 2.5% of GDP) (see Chart 1.3), and a significant depreciation of the peso/dollar exchange rate. One of the direct adverse effects of this negative reaction was the increase in the public debt/GDP ratio, since 80% of Argentina's public debt is denominated in foreign currency. This also resulted in an increase in the probability of default and caused Argentina's sovereign spread to widen by more than 1,000 bp during September.

According to private institutions, the reasons behind this bout of financial tension are linked to the result of the primary elections[7] held in August 2019, which differed considerably from the pre-election opinion polls.[8] It was interpreted that the election outcome could lead to the discontinuation of the economic policies pursued in the last year following the agreement signed with the IMF. Between August and September 2019, the Argentine Government adopted a series of economic policy decisions in response to this downturn in the financial markets. First, it unveiled a package of expansionary fiscal measures.[9] Second, it announced a plan to reschedule its debt,[10] with the objective, in particular, of deferring payments and reducing

4 Under the current legal framework, the BCRA can finance the Treasury through temporary advances charged to future profits, irrespective of whether or not these profits materialise. This possibility is eliminated in the draft law. The draft law also stipulates that the BCRA shall use any profits generated to settle the temporary advances granted in the past. Once the latter have been redeemed, it shall include the profits generated in a reserve fund until the balance of this fund reaches 50% of the BCRA's capital. Only at this time will the BCRA begin to distribute any profits generated to the Treasury's account.

5 Under current legislation, the BCRA may sell up to $250 million per day (which represents 0.4% of average international reserves in 2018-2019) when the peso/dollar exchange rate is above the upper bound of the exchange rate reference zone (which is set by the monetary policy committee).

6 IMF, Argentina. *Fourth Review under the stand-by arrangement,* IMF Country Report No. 19/232, July 2019.

7 These elections, which are also known by the Spanish acronym PASO (primary, open, simultaneous and compulsory), were tantamount to a survey whose sample is practically the same as the population, although participation in the primary elections is usually somewhat lower than in the presidential elections.

8 "El Frente de Todos" (in opposition at that time) obtained more than 47% of the votes, 15 pp more than "Juntos por el Cambio", the coalition which supported the Government.

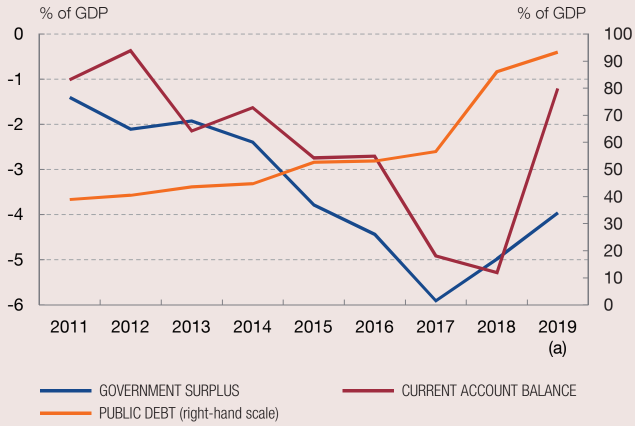
9 The cost of the package is estimated at 0.3 pp of GDP. At the cut-off date for this report, the package was still in passage through Congress.

10 The measures announced included: 1) obligatory rescheduling of "Letes" dollar-denominated treasury bills, "Lecaps" peso-denominated treasury bills, "Lecer" peso-denominated inflation-linked treasury bills and Lelink dollar-linked treasury bills for institutional investors (15% will be paid on the date stipulated, 25% after 3 months and 60% after six months); 2) commencement of a legislative process to introduce retroactively collective action clauses in government securities under national legislation, in order to only reschedule maturities (without haircuts); 3) commencement of agreements with bond holders subject to foreign legislation to reschedule debt maturities falling due in the next ten years (without haircuts).

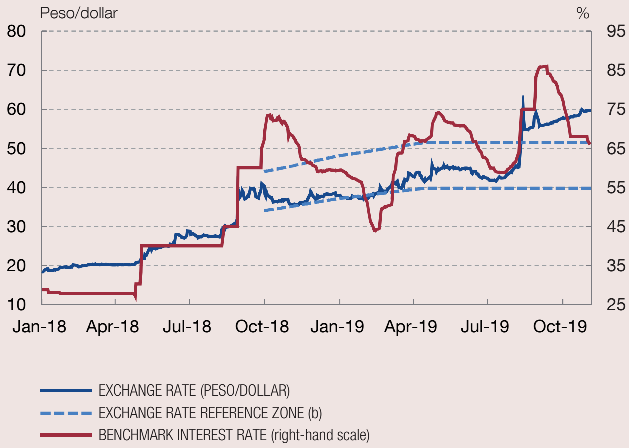
Chart 1
ARGENTINA FACES CONSIDERABLE CHALLENGES IN THE FUTURE WHICH IMPLY HEIGHTENED RISK

In addition to experiencing a protracted recession (six quarters of zero or negative growth), associated with the reduction of its high current account deficit, Argentina is in a situation of high inflation and interest rates. It is facing a sharp depreciation of the exchange rate (entailing an increase in public debt, mostly denominated in dollars), a fall in international reserves and a rapid contraction of dollar-denominated deposits.

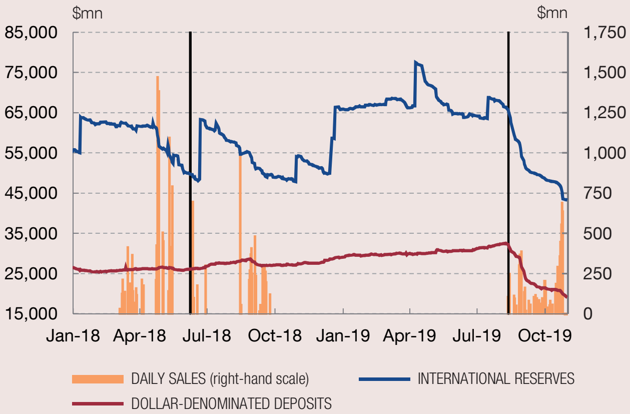
1 ARGENTINA: PUBLIC DEBT, BUDGET BALANCE AND CURRENT ACCOUNT BALANCE



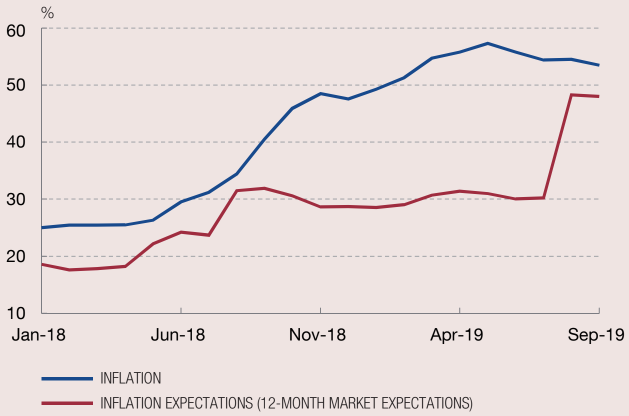
2 ARGENTINA: EXCHANGE RATE AND INTEREST RATE



3 ARGENTINA: INTERNATIONAL RESERVES AND DEPOSITS (c)



4 ARGENTINA: INFLATION



SOURCES: BCRA, INDEC, IMF and Thomson Reuters.

a WEO October 2019 forecasts.
b Until 29 April 2019, "non-intervention zone".
c The first vertical line refers to the signing of the arrangement with the IMF (8 June 2018) and the second vertical line refers to the holding of primary elections (11 August 2019).

the loss of international reserves as a result of the depreciation of the peso. The subsequent implementation of capital controls[11] pursued the same objective. As is customary, these controls have induced the emergence of parallel markets with weaker exchange rates than the official exchange rate.

The presidential elections at end-October confirmed the election of Alberto Fernández (Frente de Todos) as the new president of Argentina as from 10 December. The negative financial market reaction was of a smaller magnitude on this occasion since it had already been discounted.

The significant downward revisions of economic growth forecasts in recent months, and the upward revisions of inflation forecasts (mainly as a result of the exchange rate pass-through) (see Chart 1.4) have increased concern about the sustainability of Argentina's public debt which is mainly denominated in foreign currency. The introduction of capital controls[12] and the rescheduling of the shorter-term debt could allow time to be gained for designing an economic programme, but they do not address the absence of funding which would allow the Argentine government to repay its debt to private agents, as from 2020, as well as to the IMF in the period 2021-2023. Accordingly, the fifth review of the programme, originally scheduled for 15 September, did not take place and the IMF did not disburse the $5.4 billion envisaged for that date. According to statements made by the First Deputy Managing Director of the Fund, the IMF is waiting for the new government to be formed in order to recommence negotiations.

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11 The capital controls contained three main measures: 1) the obligation for exporters to repatriate income obtained in foreign currency within five days at most (15 days at most in some cases); 2) foreign currency purchases by residents are limited to $10,000 per month and by non-residents to $1,000 per month, and 3) companies need a permit to repatriate earnings abroad or to purchase foreign currency in the markets. Furthermore, in order to limit speculation increasing the risks of transactions which took advantage of the gap between the implied dollar value in securities trades in the stock market and the official exchange rate, the central bank and the National Securities Commission imposed the obligation of holding the dollars and securities purchased for at least five days before each trade.

12 The day after the elections (28 October), the central bank notably reduced the ceiling on currency purchases by residents (to $200 per month, if charged to a peso-denominated account and to $100 for cash purchases) and by non-residents (to $100 per month).