

HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

Introduction

The Latin American economies have continued to show dynamic growth to date in 2007, fuelled by the favourable financing conditions in place to mid-July (see Chart 1) and by continuing high prices for the main commodities exports. So far, the turbulence that has recently affected global financial markets has had but a limited impact on the region, despite the fact that it has traditionally been very exposed to episodes of financial volatility. Improved economic and financial fundamentals have placed Latin America in a much sounder position than in the past to withstand this turbulence, though it cannot be ruled out that it may have an impact on growth.

Aggregate GDP growth in the region was 5.2% year-on-year in Q1 and 5.6% in Q2, in line with average growth for 2006, though slightly below that posted in Q3 and Q4 last year. This slight easing of growth has been foreseeable, given the maturation of an expansionary cycle dating back over five years and which marks the longest growth phase since the 60s in Latin America. Further, much of this slowdown originated in the sluggishness of activity in Mexico, which felt the impact from Q1 of lower growth in its main trading partner, the United States. Brazil also posted unexpectedly low growth at the start of the year, but this was offset by robust activity in Q2. In the remaining countries economic activity continued to be very buoyant (see Table 1), which, judging by the higher frequency indicators, has run into the start of Q3.

Inflation continued to behave favourably throughout the period, although it rose moderately from April, mainly as a result of higher food prices, which pushed aggregate inflation up to a year-on-year rate marginally over 5% in the summer months. Nonetheless, core inflation held stable at around 4.5%. Against this background, monetary policies, which had moved on divergent paths until March, tended to tighten in most countries, with the notable exception of Brazil, which suggests a firming of the upward interest rate cycle in the region. Overall, inflation developments may continue to be viewed as favourable, in a setting in which many of the recent pressures on prices can be explained by the rise in the more volatile components. However, given the high weight of these prices in consumption patterns, the narrowing of output gaps in several countries and a more complex financial setting, the more cautious bias to monetary policy stance appears to be fully warranted, so as to avoid second-round effects.

The change in international financial markets in July and August curtailed the benign trend seen until then, which had only been punctuated by brief bouts of higher volatility. The sharp increase in risk aversion in mid-July, originated by the crisis on the US sub-prime mortgage market, affected virtually all risk-bearing assets, including those on emerging markets. The Latin American financial markets had performed particularly favourably since the start of the year, with capital inflows stepping up in some countries. However, they did not prove immune to the process of risk reappraisal and the flight to quality. This change in tack translated into a more pronounced decline in stock markets than on the developed markets, a relatively limited widening of sovereign spreads (except in Argentina and Venezuela) and a rapid reversal of the appreciation by the main currencies since the start of the year, in a movement which initially showed elements of contagion. Nonetheless, the deterioration in the main financial indicators was contained in the subsequent weeks, marking a substantial change from similar bouts of instability in the past.

The comparatively favourable performance of Latin American financial markets reflects the perception of less vulnerability to external shocks that stems from the improved fundamentals

LATIN AMERICA: SOVEREIGN SPREAD AND ACTIVITY
Basis points and quarterly moving average of the year-on-year rate

CHART 1



SOURCES: JP Morgan and national statistics.

a. Change in spread between the high and the low reached between 18 July and 7 September.

in most of the economies in the region. The greater credibility of economic policies, the decline in inflation rates, improved fiscal positions, external surpluses, the reduction in exchange-rate exposure of financial liabilities, the flexibility of exchange rates and the substantial accumulation of reserves, which have in recent years been behind a very significant improvement in credit ratings, endow the Latin American economies with a sound base that should suffice to mitigate the effects of any future tightening of external conditions. In any event, an orderly re-appraisal of risk may be beneficial from the standpoint of financial and economic stability, insofar as it helps correct possible excesses in the valuation of certain assets and strengthen caution on the part of these countries' authorities and agents. A more balanced distribution of growth between the United States, Europe and Asia (where China is playing a leading role, with growing relevance for Latin America) is a further factor of strength in the face of greater financial volatility. All these factors suggest that economic growth in the region should be sufficiently sound as to accommodate, without excessive problems though probably with some slowing, the persistence of financial uncertainty on global markets. In this respect, it is no coincidence that the countries with less sound economic fundamentals have been penalised by the markets to a greater extent (see Chart 1).

Though it is still premature to evaluate accurately the scope of this new period of financial turbulence, it cannot be ruled out that, in the medium term, the difficulties in global credit markets will have a relatively lasting effect on qualitative – but crucial – matters for the functioning of financial market, such as risk aversion. A generalised increase in risk aversion, portfolio shifts as a result of losses on other markets or diminished availability of credit may check the volume of capital inflows into the region. Latin America, as a commodities exporting region, is particularly vulnerable to a scenario characterised by a sharp slowdown in world growth and the simultaneous tightening of financing conditions.

Economic and financial developments

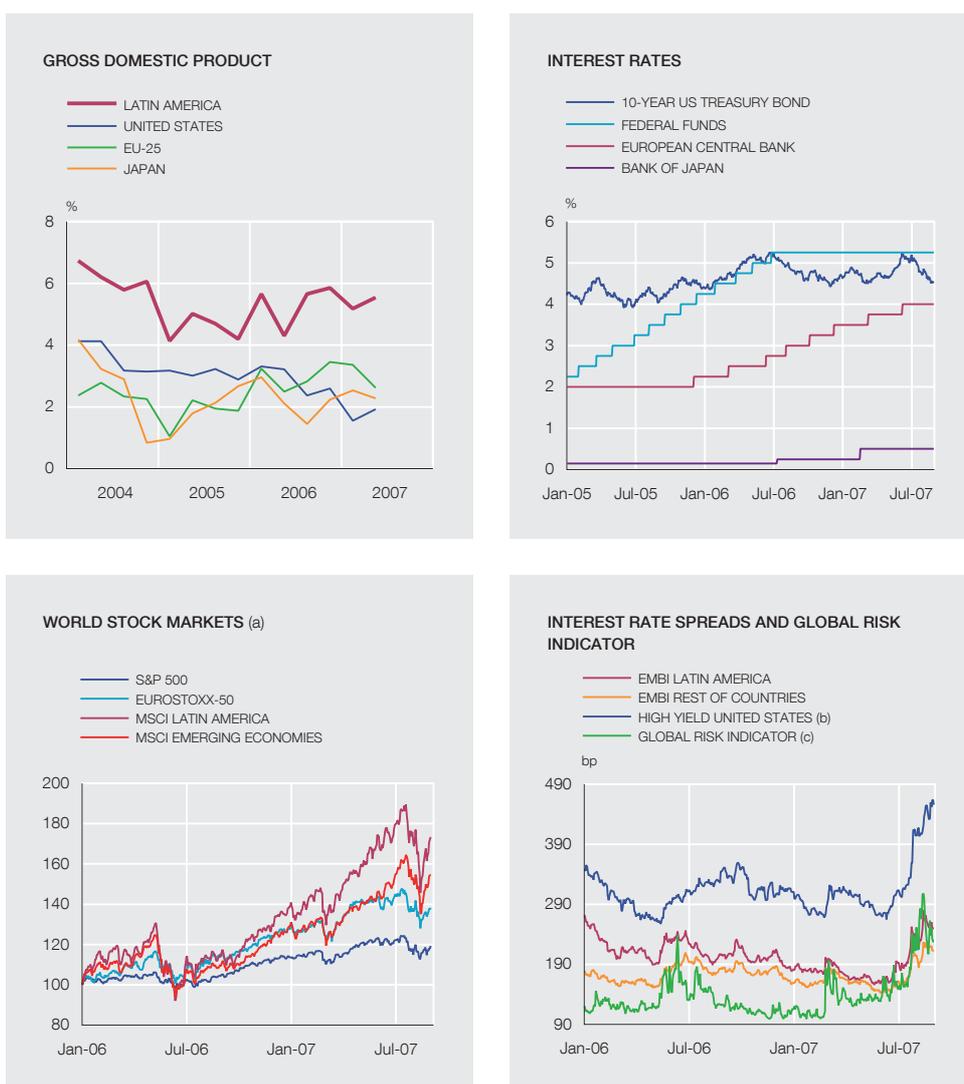
EXTERNAL ENVIRONMENT

Until July, the external environment remained clearly positive for developments in the Latin American economies, against a backdrop of sound growth in the world economy (see Chart 2) and favourable financial conditions. In the United States, GDP quickened substantially in Q2, though it continued to reflect the depth of the real estate adjustment and it did not dispel doubts over the possible continuation of lower private consumption growth in the sec-

	2003	2004	2005	2006	2005		2006			2007		
					Q3	Q4	Q2	Q2	Q3	Q4	Q1	Q2
GDP (year-on-year change)												
Latin America (a)	2.3	6.2	4.5	5.4	4.7	4.2	5.6	4.3	5.6	5.8	5.2	5.6
Argentina	8.8	9.1	9.1	8.5	9.2	9.0	8.8	7.7	8.7	8.6	8.0	8.7
Brazil	1.2	5.7	3.0	3.7	3.1	3.1	4.0	1.5	4.5	4.8	4.4	5.4
Mexico	1.4	4.2	2.8	4.8	3.1	2.5	5.5	4.9	4.5	4.3	2.6	2.8
Chile	4.0	6.0	5.7	4.0	5.2	4.2	5.0	4.0	2.6	4.3	5.8	6.1
Colombia	3.8	4.9	6.7	6.7	5.9	1.5	5.3	6.3	7.6	7.7	8.3	7.2
Venezuela	-7.6	19.4	10.3	10.3	10.2	10.9	9.8	9.4	10.1	11.8	9.1	8.9
Peru	4.1	5.1	6.7	7.6	6.5	7.9	7.9	5.8	8.6	8.1	8.0	7.6
Uruguay	2.3	12.0	6.6	7.1	5.6	6.9	7.1	7.9	7.2	6.1	6.7	4.8
CPI (year-on-year change)												
Latin America (a)	10.9	6.0	6.3	5.2	6.0	6.0	5.8	5.1	5.0	4.8	4.9	5.0
Argentina	14.9	4.4	9.6	10.9	9.8	11.7	11.6	11.4	10.6	10.1	9.5	8.8
Brazil	14.8	6.6	6.9	4.2	6.2	6.1	5.5	4.3	3.8	3.1	3.0	3.3
Mexico	4.6	4.7	4.0	3.6	4.0	3.1	3.7	3.1	3.5	4.1	4.1	4.0
Chile	2.8	1.1	3.1	3.4	3.3	3.8	4.1	3.8	3.5	2.2	2.7	2.9
Colombia	7.1	5.9	5.1	4.3	4.9	5.1	4.3	4.0	4.6	4.3	5.3	6.2
Venezuela	31.4	21.7	16.0	13.7	15.4	15.2	12.6	11.2	14.6	16.1	19.1	19.5
Peru	2.3	3.7	1.6	2.0	1.2	1.3	2.4	2.3	1.8	1.5	0.4	0.8
Uruguay	19.4	9.2	4.7	6.4	3.9	4.8	6.4	6.4	6.6	6.2	7.0	8.1
PUBLIC-SECTOR BALANCE (% GDP) (b)												
Latin America (a) (b)	-1.9	-0.7	-0.6	-0.5	-0.5	-0.6	-0.7	-0.6	-0.4	-0.5	-0.2	-0.2
Argentina	0.4	2.5	1.4	1.7	1.2	1.4	1.4	1.5	1.8	1.7	1.5	1.4
Brazil	-3.3	-2.3	-2.8	-2.9	-2.2	-2.8	-3.2	-3.0	-3.1	-2.9	-2.4	-2.1
Mexico	-0.7	-0.3	-0.1	0.1	0.0	-0.1	0.2	0.4	0.4	0.1	0.7	0.3
Chile	-0.8	2.4	4.7	8.0	4.4	4.7	6.1	6.6	7.9	8.0	7.9	8.7
Colombia	-2.6	-0.6	-0.5	-0.5	-1.7	-0.5	0.2	0.6	1.8	-0.5
Venezuela	-4.4	-2.0	2.4	-1.5	4.1	2.4	-1.3	-5.5	-3.7	-1.5
Peru	-1.8	-1.3	-0.7	1.4	-0.3	-0.7	-0.1	0.7	1.0	1.4	1.5	1.2
Uruguay	-2.9	-2.0	-0.8	-0.6	-1.6	-0.8	-0.2	-0.6	-0.6	-0.6	-1.0	0.2
PUBLIC DEBT (% GDP) (b)												
Latin America (a) (b)	52.0	48.0	40.3	38.6	40.9	40.3	40.4	38.6	39.0	38.6	38.6	...
Argentina	129.9	120.3	66.8	59.8	66.6	66.8	69.0	59.1	59.9	59.8	62.0	...
Brazil	52.4	47.0	46.5	44.9	46.6	46.5	46.6	45.5	45.0	44.9	44.8	44.3
Mexico	22.9	21.3	20.8	22.7	22.6	20.8	21.7	21.3	23.9	22.7	23.1	5.0
Chile	12.5	10.0	6.8	5.2	7.6	6.8	6.2	5.5	5.4	5.2	4.9	5.0
Colombia	50.7	47.0	46.6	44.9	46.1	46.6	46.9	47.7	45.6	44.9	43.6	...
Venezuela	56.9	53.3	48.2	41.9	50.1	48.2	36.1	38.2	40.0	41.9	39.0	37.3
Peru	47.0	44.3	37.8	32.6	38.1	37.8	36.1	35.0	33.1	32.6	30.8	30.0
Uruguay	108.2	100.7	83.8	70.9	82.5	83.8	73.1	74.9	75.5	70.9	74.7	...
CURRENT ACCOUNT BALANCE (% GDP)												
Latin America (a)	1.0	1.4	1.8	1.9	1.6	1.8	2.0	2.0	2.0	1.9	1.7	1.6
Argentina	5.9	2.2	2.9	3.5	2.4	2.9	3.6	3.3	3.2	3.5	3.5	3.1
Brazil	0.8	1.8	1.8	1.3	1.7	1.8	1.5	1.3	1.4	1.3	1.3	1.4
Mexico	-1.4	-0.9	-0.6	-0.3	-0.9	-0.6	-0.2	-0.2	-0.3	-0.3	-0.7	-0.8
Chile	-1.0	2.2	1.1	3.6	0.9	1.1	1.7	2.8	3.9	3.6	4.8	5.4
Colombia	-1.2	-0.9	-1.5	-2.3	-1.5	-1.5	-1.7	-2.0	-1.9	-2.3	-2.9	...
Venezuela	13.8	15.3	22.3	19.5	20.7	22.3	23.6	24.2	22.5	19.5	17.1	14.6
Peru	-1.5	0.0	1.4	2.8	0.9	1.4	1.0	1.3	2.2	2.8	2.9	2.9
Uruguay	-0.8	0.0	0.2	-2.2	-0.1	0.2	0.2	-0.3	-1.0	-2.2	-1.9	...
EXTERNAL DEBT (% GDP)												
Latin America (a)	45.1	38.5	26.5	22.4	28.8	26.5	25.4	23.2	23.2	22.4	23.4	...
Argentina	119.6	107.6	59.1	47.5	61.4	59.1	56.1	48.1	49.1	47.5	51.0	...
Brazil	36.7	28.9	19.2	16.2	22.5	19.2	17.6	15.8	15.4	16.2	16.5	...
Mexico	21.6	18.9	15.4	13.0	17.2	15.4	15.2	15.4	15.3	13.0	13.6	...
Chile	50.9	41.7	33.5	32.0	37.2	33.5	32.8	31.5	33.1	32.0	30.1	29.6
Colombia	43.4	35.0	28.4	26.5	28.9	28.4	30.0	28.9	28.2	26.5	29.0	...
Venezuela	50.3	42.5	39.3	29.6	38.6	39.3	31.3	28.9	29.2	29.6	31.3	33.6
Peru	47.1	42.0	35.3	28.2	36.4	35.3	34.3	28.8	29.3	28.2	29.4	27.6
Uruguay	98.0	87.6	68.6	54.6	67.3	68.6	58.6	59.3	59.0	54.6	56.7	...

SOURCE: IMF, Banco de España and National Statistics Offices.

a. Aggregate of 8 represented countries
b. 2006 estimated.



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

- a. Indices in dollars.
- b. B1 rated bonds.
- c. Implied volatility of CBOE options.

ond half of the year. Prices eased and core inflation dipped to rates deemed comfortable by the monetary authority. In Japan, economic growth moderated appreciably in Q2, while in the euro area the pace of growth also eased somewhat. The counterpoint was in the emerging economies, and particularly in China, where the already dynamic rate of expansion stepped up further, although the rise in inflation prompted a progressive tightening of Chinese monetary conditions. In the developed economies – with the exception of the United States – the upward interest rate cycle was only interrupted further to the recent financial problems, while central banks injected sizeable amounts of liquidity into money markets. Japan, the euro area and the United Kingdom froze their scheduled rises, and the Federal Reserve brought forward the start of the cuts with a 50 bp reduction at its September meeting (see Chart 2).

One of the key aspects of international financial developments in the months prior to the turbulence was the rising trend of long-term interest rates. This was particularly marked in the

United States, where 10-year yields rose to levels above 5.25% in June. The movement was chiefly attributable to an increase in the term premium stemming from the improved growth outlook and, in part too, to heightening uncertainty over the course of official rates. Subsequently, in July and August, the deterioration in the US sub-prime mortgage market segment prompted a flight towards quality which, although it particularly favoured risk-free, very short-dated securities, also had a bearing on the decline in long-term yields to levels of 4.50%. Even more significant were the increases in credit spreads (see Chart 2), especially in the case of the corporate bonds of weaker-quality companies (over 150 bp between July and August), which extended, albeit with less intensity, to the sovereign bonds of emerging countries, especially in Asia and Latin America. Stock markets, which had moved on a strong rising trend to end-July, underwent significant corrections, markedly so in the case of emerging markets where the rise had also been on a greater scale (see Chart 2). The Standard & Poors index and the Eurostoxx declined by around 10% from mid-July to mid-August, while the dollar-denominated MSCI emerging markets index fell by more than 15%, and by even more in the case of the Latin American MSCI index. Nonetheless, following the recovery in recent weeks, stock markets have regained positive territory in relation to the start of the year.

The turbulence on financial markets was also reflected in the foreign exchange markets. The exchange rate of the dollar against the euro was temporarily bolstered by the dollar's status as a safe-haven currency. The yen appreciated by 7% against the dollar, in mid-August, and strengthened even more against the currencies of many countries with high interest rates, such as the Australian dollar, the Brazilian real or the Turkish lira, on a reversal of carry trade. Finally, another key aspect of the last quarter was the oscillation in oil prices which, after falling to \$68 per barrel in the face of uncertainty over the extent to which financial instability would affect growth in the world economy, picked up to their previous highs, close to \$80 per barrel. Commodities, especially metals, trended similarly to oil, while the prices of agricultural products from which biofuel is prepared (wheat, maize and soya) rose strongly in the summer months.

ECONOMIC ACTIVITY AND DEMAND

Economic growth in Latin America ran at 5.4% in the first half of 2007, in line with the average growth for 2006, but at a slightly more moderate rate compared with the second half of last year. The slowdown was notable in Q1, but was offset in Q2 by a quarter-on-quarter increase of 1.7%, far higher than the figures recorded in late 2006 (see Chart 3).

Country by country, growth rose significantly in Brazil and Chile, and fell in the others, albeit moderately in general and starting from very high rates. This was the case for Argentina, Colombia, Venezuela and Peru. Developments were particularly significant in Mexico, whose growth rate was virtually halved from a rate of close to 5% in 2006 to 2.6% in Q1 and 2.8% in Q2, as a result of the lower growth in its main trading partner, the United States, and of the slowdown in domestic demand. Indeed, practically the entire slowdown in activity in the region in the first half of the year may be attributed to Mexico. While Brazil contributed 1.9 pp to growth and Argentina 1.2 pp, the contribution of Mexico was only 0.7 pp, 0.4 pp down on the second half of 2006.

In terms of components, the contribution of domestic demand to growth increased relative to the second half of 2006, rising to 7.9 pp in Q2, while external demand worsened somewhat, with a negative contribution of 2.3 pp (see Chart 4). This deterioration was fairly widespread across the region, with the significant exception of Chile. Private consumption quickened, attaining a year-on-year growth rate of 6.8% in Q2 (see Chart 5), driven by the growth of this variable in Argentina and Chile, and by its take-off in Brazil

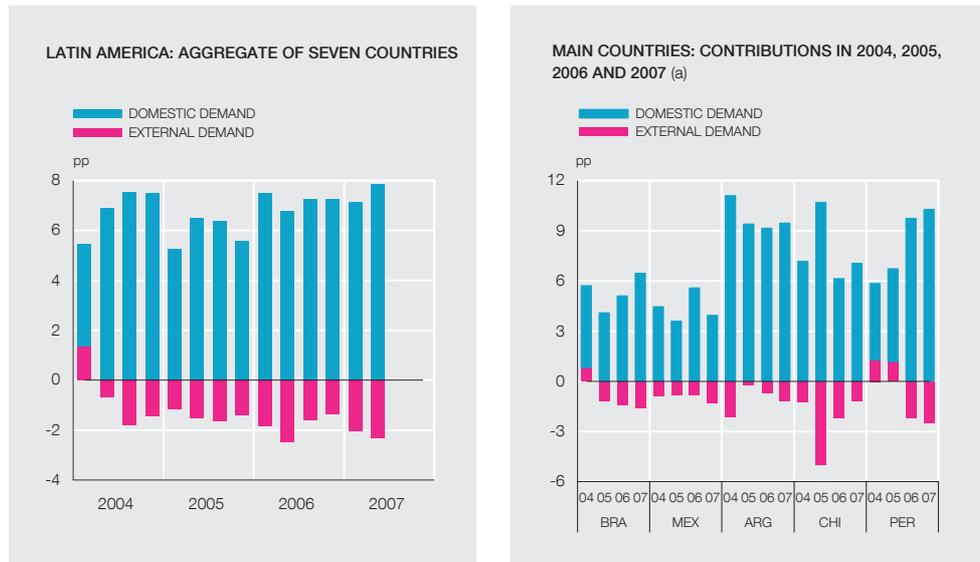
Year-on-year change, unless otherwise indicated



SOURCE: National statistics.

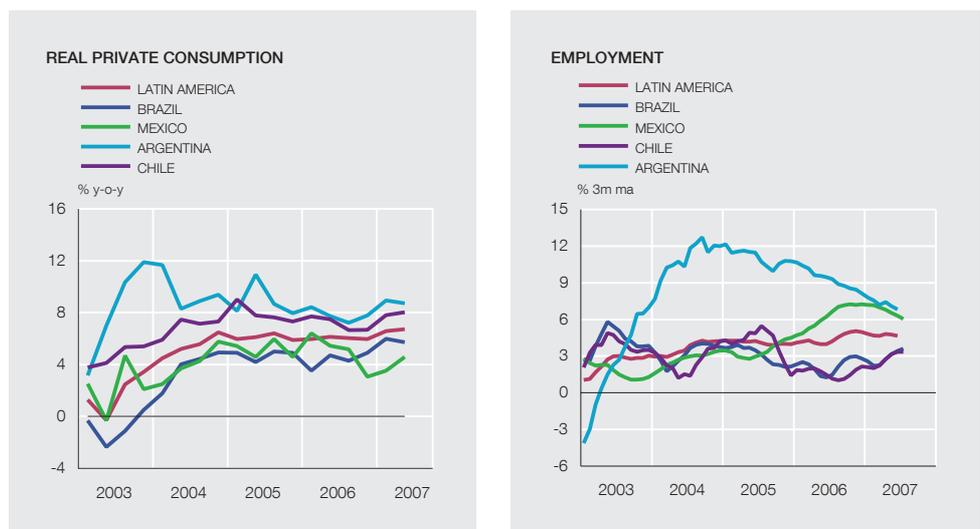
following a year of relative slackness. This behaviour reflects the favourable situation of the region's labour market, where employment grew at a rate higher than that posted in 2006 (around 5% in Q1) and real wages increased by around 5.4%, although they slowed in Q2. The unemployment rate held at a relatively low level (7.7% of the labour force) in Q2. The growth of credit, which increased across the board (20.5% year-on-year in real terms), and the maintenance of real interest rates at low levels also continued to underpin consumption and investment (see Chart 6). The growth rate of investment held at around 14% year-on-year in Q2, at a very similar level to that in the second half of 2006, and it proved to be the most dynamic component of domestic demand in most countries. Indeed, in Chile, Colombia and – in Q2 – in Brazil and Peru, gross capital formation tended to quicken substantially (see Chart 6). Government consumption eased, especially during Q1, posting a year-on-year increase of 2.7% in Q2, a relatively low rate compared with the past two years.

The trend of the higher frequency indicators – such as retail sales (see Chart 7) – corroborates the continuing sound performance of private consumption at the start of Q3. However, the



SOURCE: National statistics.

PRIVATE CONSUMPTION AND LABOUR MARKET
Year-on-year rate and three-month moving average



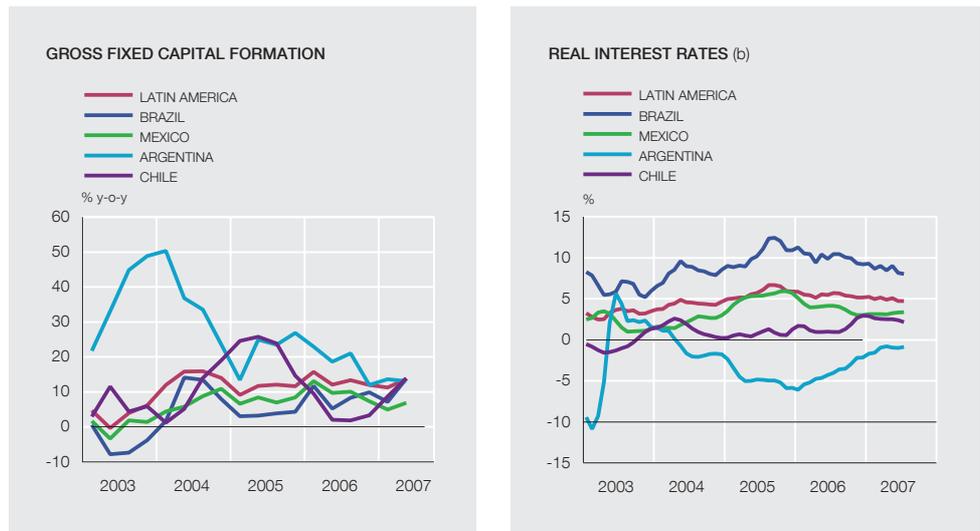
SOURCE: National statistics.

deterioration in consumer confidence indices (in many countries), the slowdown in the pace of job creation and the increase in instability on financial markets are factors meriting caution when looking ahead.

The external sector continued to post positive results, thanks to the favourable behaviour of the terms of trade (see Chart 8), despite the increase in the negative contribution of external demand to growth. The trade balance stood at 3.7% of GDP in Q2, which is a substantial surplus at a mature stage of the cycle, despite being 0.8 pp down on the high reached in 2006 Q2. Exports slowed in the region as a whole to a rate of 11% in Q1, picking up strongly in Q2 to 16%. Imports, meanwhile, grew steadily at a rate of over 20% throughout the first half of the year, reflecting the momentum of domestic demand.

GROSS FIXED CAPITAL FORMATION AND REAL INTEREST RATES
Year-on-year rate and annual percentage

CHART 6

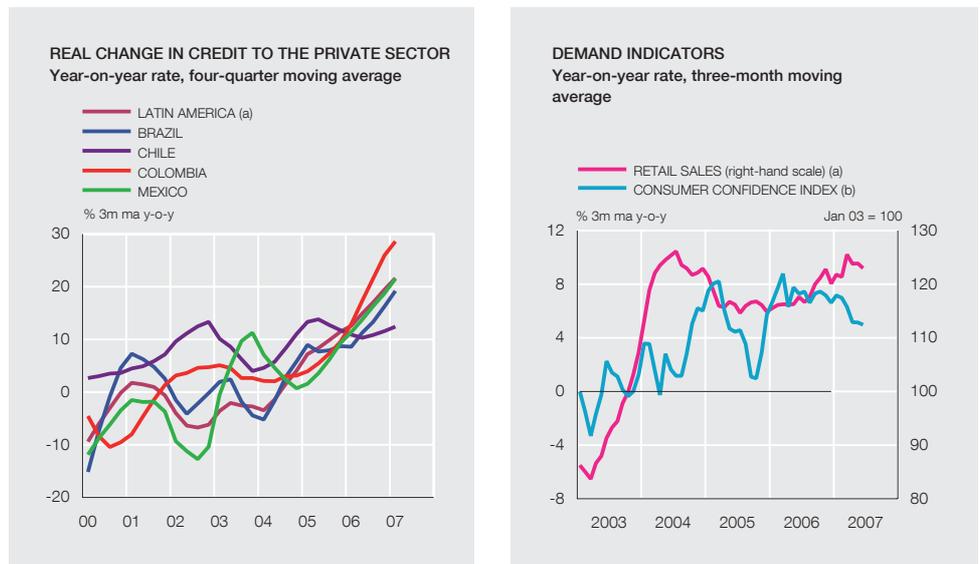


SOURCE: National statistics and IMF.

- a. Eight biggest economies.
- b. Short-term interest rate minus inflation.

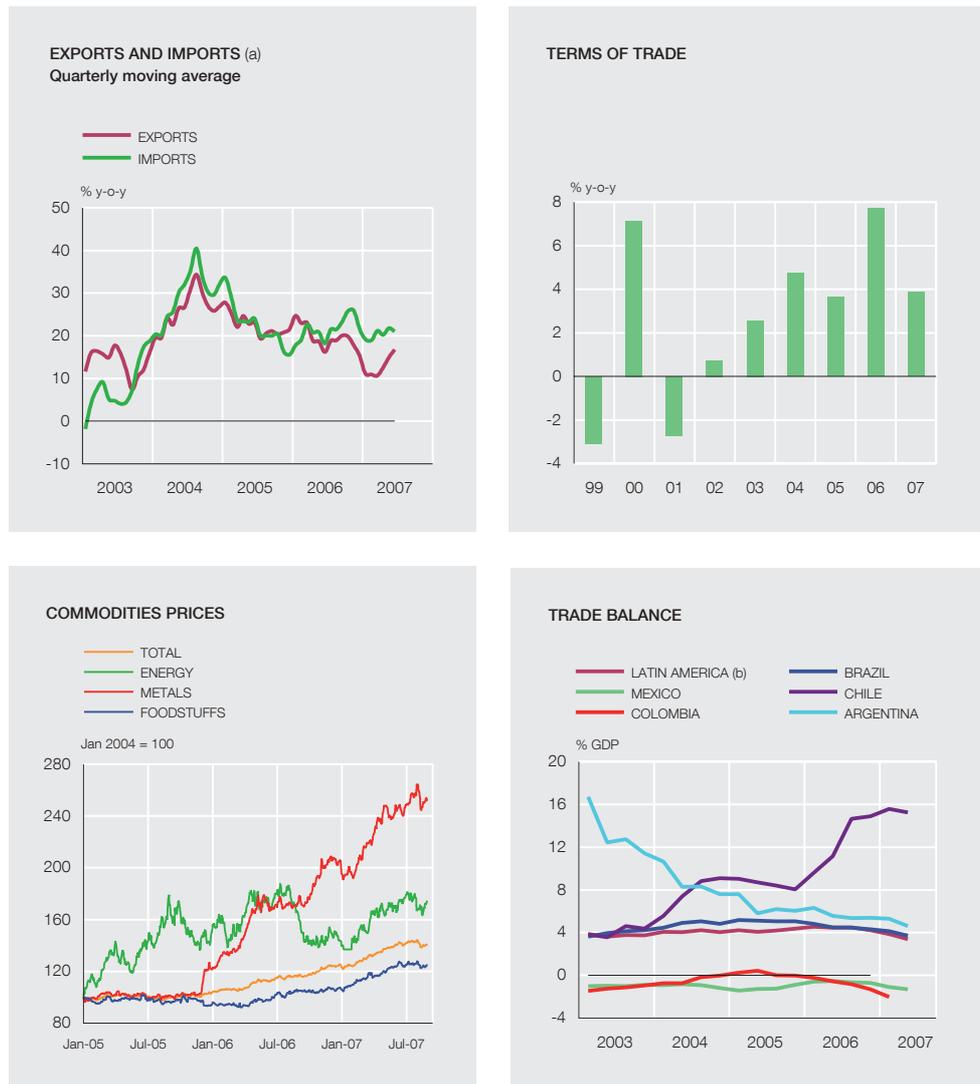
DEMAND
Three-month moving average of year-on-year rate and levels

CHART 7



SOURCE: National statistics.

- a. Eight biggest economies, without Peru and Uruguay.
- b. Argentina, Brazil, Chile, Mexico and Peru.



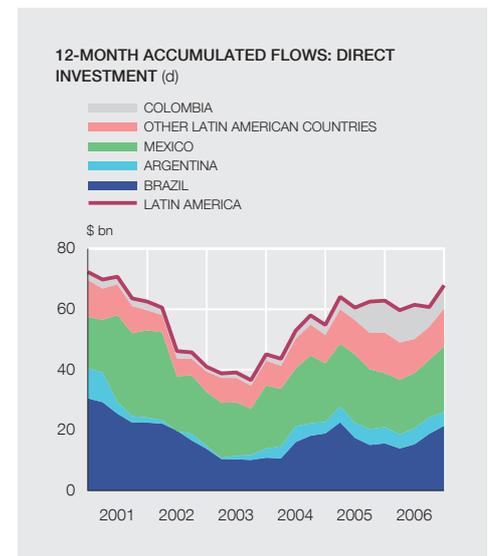
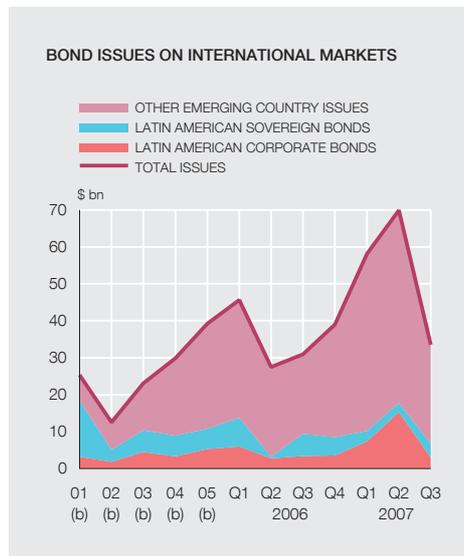
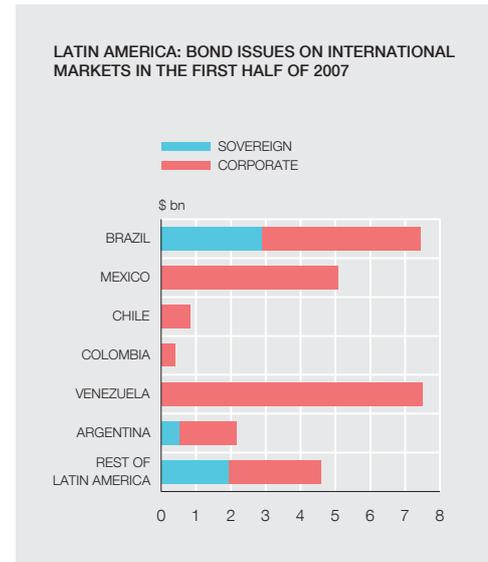
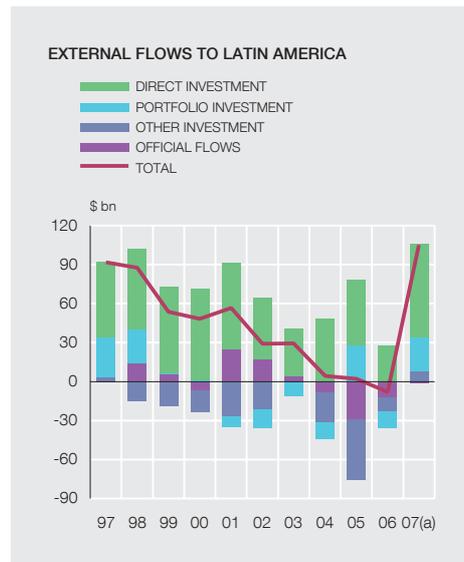
SOURCES: National statistics and Banco de España.

a. Customs data in US dollars.
b. Aggregate of nine largest economies.

Among the region's countries, Chile was to the fore, with a trade surplus of 16% of GDP (see Chart 8). In the remaining countries, Brazil and Argentina, which are running a trade surplus, saw a moderate worsening in terms of GDP. This deterioration was more marked in countries such as Colombia and Mexico, which posted deficits. That said, the current account balance remains strongly positive in the region as a whole (1.6% of GDP in Q2), although it is on a clearly declining trend from the high of 2% of GDP reached in mid-2006.

FINANCIAL MARKETS AND
EXTERNAL FINANCING

In the past six months, financial markets have undergone two clearly differentiated stages. From April to end-July, there was an increase in net capital inflows into the region which, following years of moderation, returned to levels similar to those prior to 1998 (see Chart 9); in contrast, in the past two months there has been an appreciable adjustment in financial asset prices, as a result of the impact of the recent financial turbulence.



SOURCES: JP Morgan and IMF.

- a. 2007: estimate
- b. Quarterly average.
- c. Data to August and estimate for September 2007.
- d. To 2007 Q1.

During the first half of 2007 there was a sizeable increase in net capital flows to Latin America and, in general, to emerging financial markets. In Latin America, a large portion of capital inflows were in the form of foreign direct investment, which was probably attracted by the region's improved economic outlook, its greater stability and the benefits arising from globalisation. There was also a change in sign in net portfolio investment flows, which turned positive, although it is uncertain how permanent this will be in the current phase of financial instability. Short-term capital inflows in the first half of the year help explain the rising course of most of the region's currencies in the period to July, along with the step-up in the purchase of reserves by some central banks, most notably so in the case of the Central Bank of Brazil. These developments gave rise to the emergence of certain dilemmas and difficulties in monetary policy management, which are analysed in Box 1 in the cases of Brazil and Colombia.

The general upward pressure on Latin American exchange rates induced for several years by the buoyant economic conditions has been exacerbated in the opening months of 2007. The strong nominal appreciation in recent years has affected real exchange rates, with potential adverse implications for the competitiveness of certain export sectors. For this reason, despite the prevalence of flexible exchange rate regimes, most Latin American central banks have attempted to mitigate the nominal appreciation through the accumulation of reserves, and to this end they have engaged in notable activity in the currency markets (see panels 1 and 2). Colombia and Brazil are probably the two countries in the area where these pressures have been most pronounced, although recently these have been interrupted by the global financial turbulence.

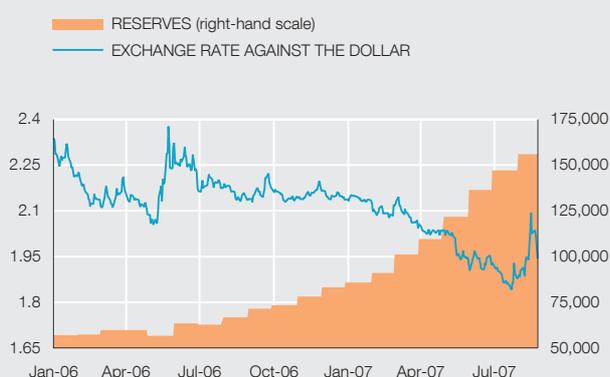
This box describes what implications the strong exchange rate appreciation has had for these two countries, analysing the attendant causes and impact on monetary policy.

The upward pressure on Colombia's exchange rate from 2004 were a consequence of the strong financial inflows of mostly long-term funds (direct investment and some portfolio investment) against a background of greater political stability and the improving growth

prospects of the Colombian economy. By contrast, the upward pressure on the Brazilian real in the last three years was fuelled mainly by the large current account surpluses, although from 2006 there have been net inflows of funds of considerable size (see Chart 3). In the first half of 2007, the strong appreciation of the real and of the peso against the dollar (16% and 18%, respectively, to July) was due to the sharp increase in financial inflows, as shown by panels 3 and 4.

The central bank of the Republic of Colombia thus intervened regularly in the foreign exchange market from 2004, mostly to prevent the exchange rate from appreciating. Purchases of reserves accelerated notably in the early months of 2007, during which period they reached \$20 billion, up 31% on the end-2006 figure. Until June, however, this policy of reserve accumulation did not manage to contain the appreciation of the peso against the dollar and, moreover, clashed with the monetary policy objectives. Indeed, the fact that the purchases of reserves in 2006 were not sterilised led to a sharp expansion of the monetary base in that year. Despite this, inflation remained relatively contained. However, at the end of that year inflation began to rise substantially and has remained outside the central bank's inflation targets since the beginning of 2007. The purchases of reserves in 2007 were sterilised as official interest rates continued to rise (a cu-

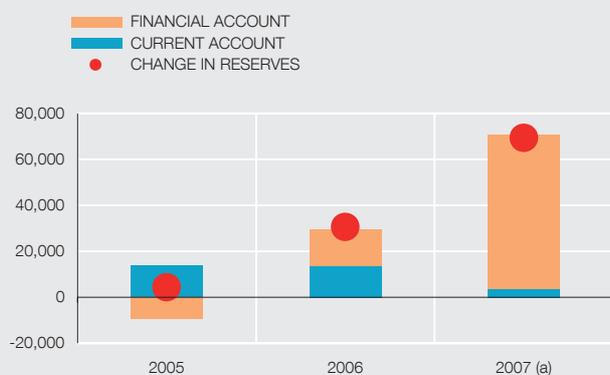
1 BRAZIL



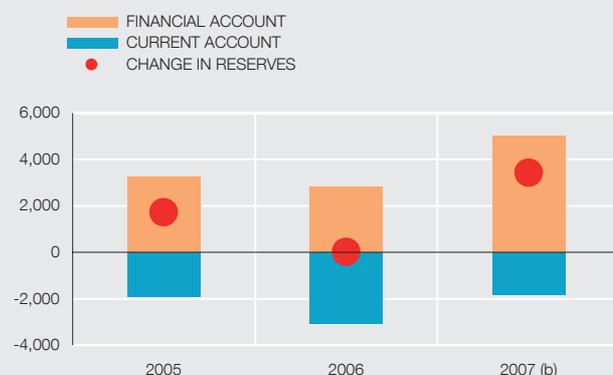
2 COLOMBIA



3 BRAZIL



4 COLOMBIA



SOURCES: Banco Central de Brasil and Banco de la República.

a. To July.
b. To March.

mulative rise of 325 bp from April). The higher interest rates, along with the introduction in early March of an unlimited interest-earning deposit facility at the central bank probably contributed to feeding short-term financial inflows and to raising upward pressure on the currency. In this way a vicious circle with negative consequences was set in train: the Colombian central bank was faced with a monetary policy dilemma, since the inflation and exchange rate control objectives had been decoupled from one another. In this situation, the central bank took exceptional measures, such as: the imposition of reserve ratios to reduce liquidity; an obligatory 6-month deposit equal to 40% of loans obtained abroad; and limits to the leverage of foreign exchange market intermediaries in their derivatives transactions (measures designed to reduce the attractiveness of short-term financial inflows). In addition, the government took capital control measures consisting of the introduction of a 6-month local-currency deposit at the central bank for 40% of the value of all inward portfolio investment. Also, to compensate the sectors hardest hit by the appreciation, an export assistance package was introduced.

For its part, the Brazilian central bank made sizeable sterilised reserves purchases in 2006. They were stepped up significantly in the first half of 2007 and, as a result, reserves rose from \$85 billion to \$136 billion. Unlike in Colombia, the purchases of reserves did not clash significantly with monetary policy conduct because the Brazil-

ian central bank was in the midst of a long cycle of interest rate cuts which helped to mitigate upward pressure. However, this is not to say that those pressures did not affect the conduct of monetary policy. Indeed, at the beginning of 2006 the central bank had opted to reduce the pace of interest rate cuts from 50 bp to 25 bp within its expansionary monetary policy cycle. In June, following a period of substantial short-term financial inflows, it opted to cut interest rates by 50 bp, and did so again in July. The step-up in the pace of interest rate cuts was largely an attempt to slow the inflows of short-term funds and to respond to an increasing appreciation of the real. Furthermore, as in Colombia, the Brazilian Ministry of Economy designed export credit and subsidy programmes to provide compensation to certain sectors affected by the appreciation. Also, prudential regulations were changed in order to prevent excessive exchange rate exposure and to enable financial inflows to be reduced.

These events show the growing difficulty in reconciling exchange rate appreciation with monetary policy management, including in the cases in which a significant appreciation of the real exchange rate is consistent with favourable behaviour of the economic fundamentals. Although the upward pressure on the exchange rate was interrupted when the recent global turbulence broke out, the Latin American economies may again have to face the dilemmas and issues associated with large capital inflows and their impact on monetary and exchange rate variables.

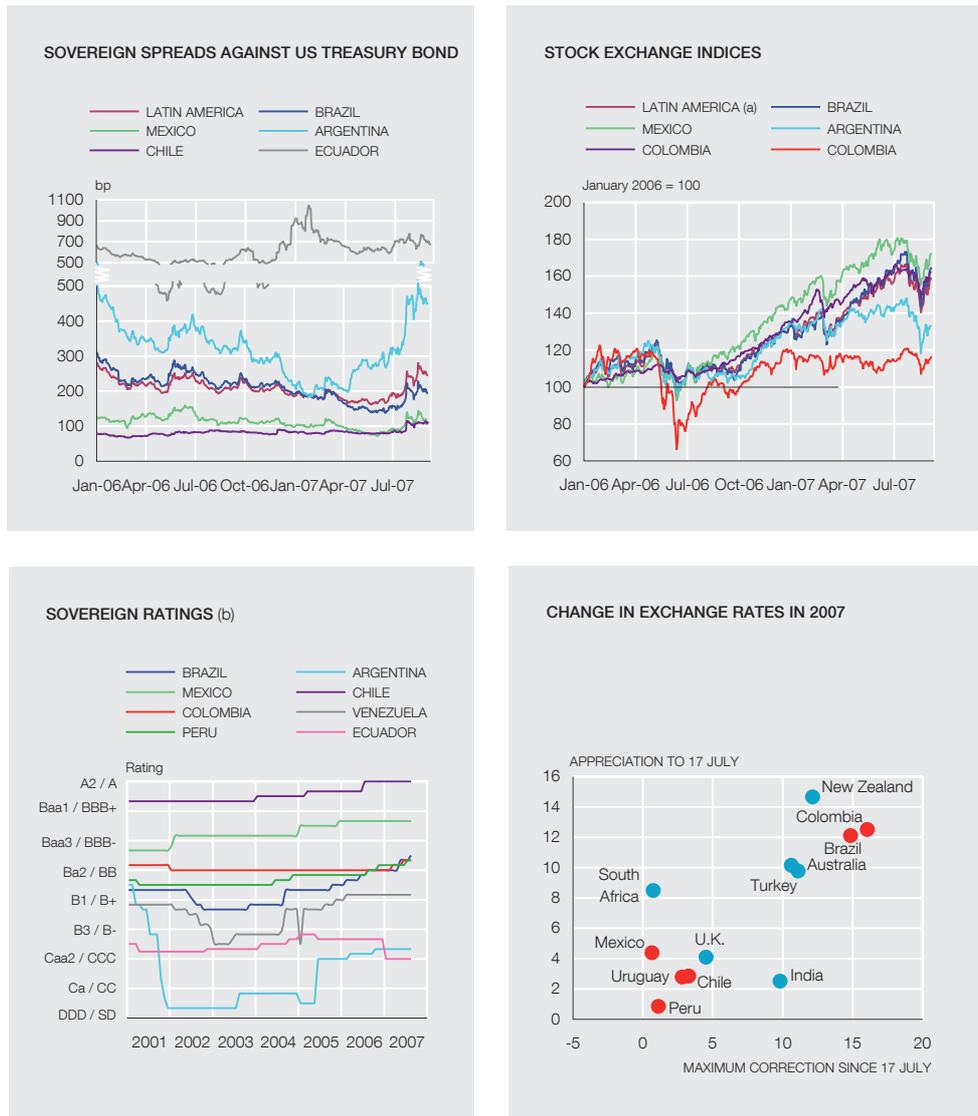
Against this background, corporate issues on international markets remained buoyant throughout the first half of the year, totalling over \$22 billion. This figure was much higher than the total volume of sovereign issues, which continued to diminish over the same period. Indeed, Chile, Mexico, Colombia and Venezuela made no sovereign issues on international markets during the first half of the year.

From mid-July to August there was a strong adjustment in Latin American financial asset prices (see Chart 10). Sovereign spreads measured by the EMBI index, which had stood at a historical low of around 150 bp in June, tended to widen by more than 100 bp. This widening, which was similar to that in other emerging areas but less than that of US high-risk corporate spreads, was significant, as it placed these spreads at an 18-month high. Initially, spreads widened across the board, and there was an increase in cross-market correlation, illustrative of the flight to quality and of a certain lack of discrimination between various risks. Nonetheless, taking a broad view, the sovereign spreads of Argentina and Venezuela – the countries with the highest credit risk – can be seen to have widened most (by more than 250 bp since April in both countries). The turbulence had a much more limited impact on Mexican and Chilean sovereign spreads, which only widened by around 30 bp from their respective lows; and nor was the widening in Brazil (approximately 50 bp) significant. Overall, sovereign spreads have held at very low levels, in relation to the historical average, although the widening of the yield spreads of local-currency-denominated debt was much more marked in practically all markets.

The increase in volatility had an appreciable impact on the equity and foreign exchange markets. The Latin American MSCI index posted losses of close to 20% from mid-July to August,

SOVEREIGN SPREADS, STOCK MARKETS, RATINGS AND NOMINAL EXCHANGE RATES AGAINST THE DOLLAR
Basis points and indices

CHART 10



SOURCES: JP Morgan, Bloomberg, Moody's, Standard & Poor's and Fitch.

a. MSCI Latin America Index, in local currency.
b. Simple average of Moody's, Standard&Poor's and Fitch IBCA ratings.

in line with other emerging markets, although subsequently it picked up appreciably (see Chart 10). This recovery meant that most local stock market indices were posting gains as at mid-September in relation to the start of the year.

On the foreign exchange markets the increase in risk aversion had a clear impact on those currencies with high interest rates that had been subject to carry trade in the preceding months. Noteworthy in this connection are the Brazilian real and the Colombian peso, the appreciation in which since the start of the year was largely reversed in August, against a background of heightening volatility (see Chart 10). This reversal led the Brazilian central bank to interrupt its purchases of reserves. But those currencies which had appreciated by a lesser amount, such as the Mexican peso or the Argentine peso, also depreciated moderately (by around 3%), the latter despite central bank and state-owned bank sales of dollars. The Chilean peso and the Peruvian sol held, however, relatively stable throughout the period. Regarding issues, certain

pre-announced sovereign debt issues had to be cancelled or postponed during the period of turbulence (Argentina, Brazil, Venezuela's "Bono del Sur"), as did also some private fixed-income issues.

In any event, the sound fundamentals of the Latin American economies and their lesser financial vulnerability, along with the lower direct exposure of their banking systems to high-risk structured assets, have meant that the impact of the financial channel has been relatively contained to date. In this respect, it is significant that Brazil saw its credit rating revised upwards in late August, to a notch below investment-grade. This revision followed those of Peru, in July, and Colombia, in June, along with the improved outlook for Mexico's rating in the same month. However, it is premature to rule out the possibility that any future increase in risk aversion or portfolio reallocation, further to the losses that may materialise in other markets, may worsen market financing conditions. In this sense, most sovereign issuers in the region have their financing requirements for 2007 covered, which enables them to isolate themselves temporarily from any potential squeeze on credit. But there are also countries, such as Argentina, where the Treasury still has sizeable borrowing needs. And these countries might be more exposed if the instability extends over time, which might entail an increase in recourse to the central bank. Others, such as Colombia or Mexico, are faced with greater dependence on foreign capital flows, as they are running a current account deficit, although this deficit has until now been financed with long-term capital inflows. Finally, mention should be made of the interaction of the financial channel with real transmission channels, the impact of which on Latin America might be very significant, especially if a slowdown in growth in the world economy were to cut back commodities prices, on which the region has based much of its recent expansion.

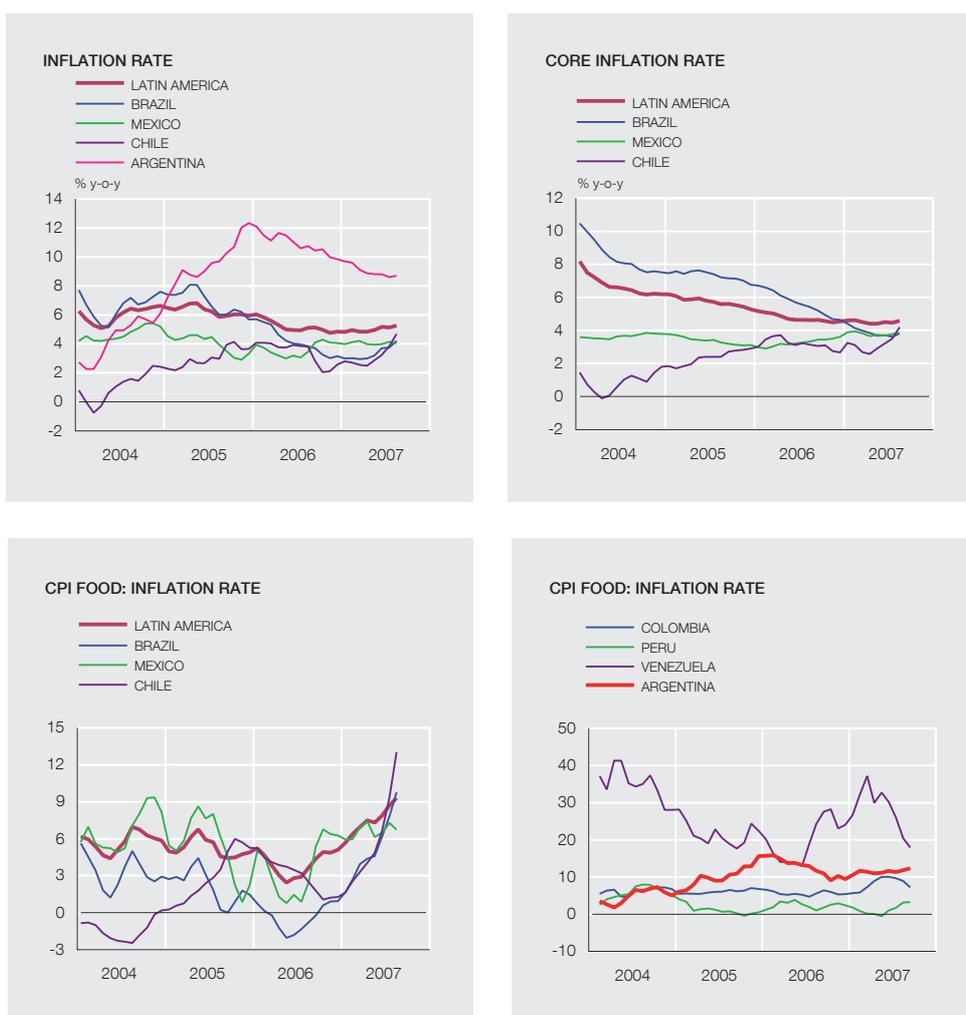
PRICES AND MACROECONOMIC POLICIES

Inflation rose moderately in the six-month period under analysis, standing at a rate of 5.3% in August, compared with the low of 4.7% posted in the second half of 2006 (see Chart 11). The rise was across the board in Brazil, Chile, Colombia, Mexico and Peru, with some dispersion regarding its intensity and the source of the pressures on prices, although the food component was present in most cases. Core inflation held stable at around 4.5% across the region.

The increase in inflation was particularly marked in Chile, where it stood at 4.7% in August, more than 2 pp up on the rate for Q1. The source of the increase was in the rise in food and fuel prices, and in the increase in electricity rates (see Chart 11). However, core inflation also rose appreciably to 4.2%, exceeding the central bank target, against the background of the likely closing of the output gap. In these circumstances, the Chilean central bank raised its official rate on three occasions by 25 bp, in July, August and September, placing it at 5.75%. In Mexico, the rebound in food prices was the main determinant of the rise in inflation to 4.1% in August, while core inflation was affected to a lesser extent (3.8%). That said, as the upper limit of the Bank of Mexico's target band was breached, the central bank raised its reference rate by 25 bp in April to 7.25%, subsequently maintaining an upward bias in its monetary policy communiqués. Inflation in Colombia, which had exceeded 6% in Q2, turned down to 5.7% following a notable tightening of monetary policy and the application of a series of administrative measures to control credit growth. Finally, inflation in Brazil stood at 4.2% in August, more than 1 pp up on the start of the year. However, core inflation continued to behave favourably, allowing fresh cuts in official interest rates to a historical low of 11.25% in September. In Argentina and Venezuela, inflation held at a very high growth rates. The doubts raised by the methodology used to calculate consumer prices in Argentina have called the decline in inflation to 8.7% in August into question, while in Venezuela the 5 pp cut in VAT had a temporary downward effect on inflation, which stood at 15.9%, a low for the year.

INFLATION
Year-on-year rate of change

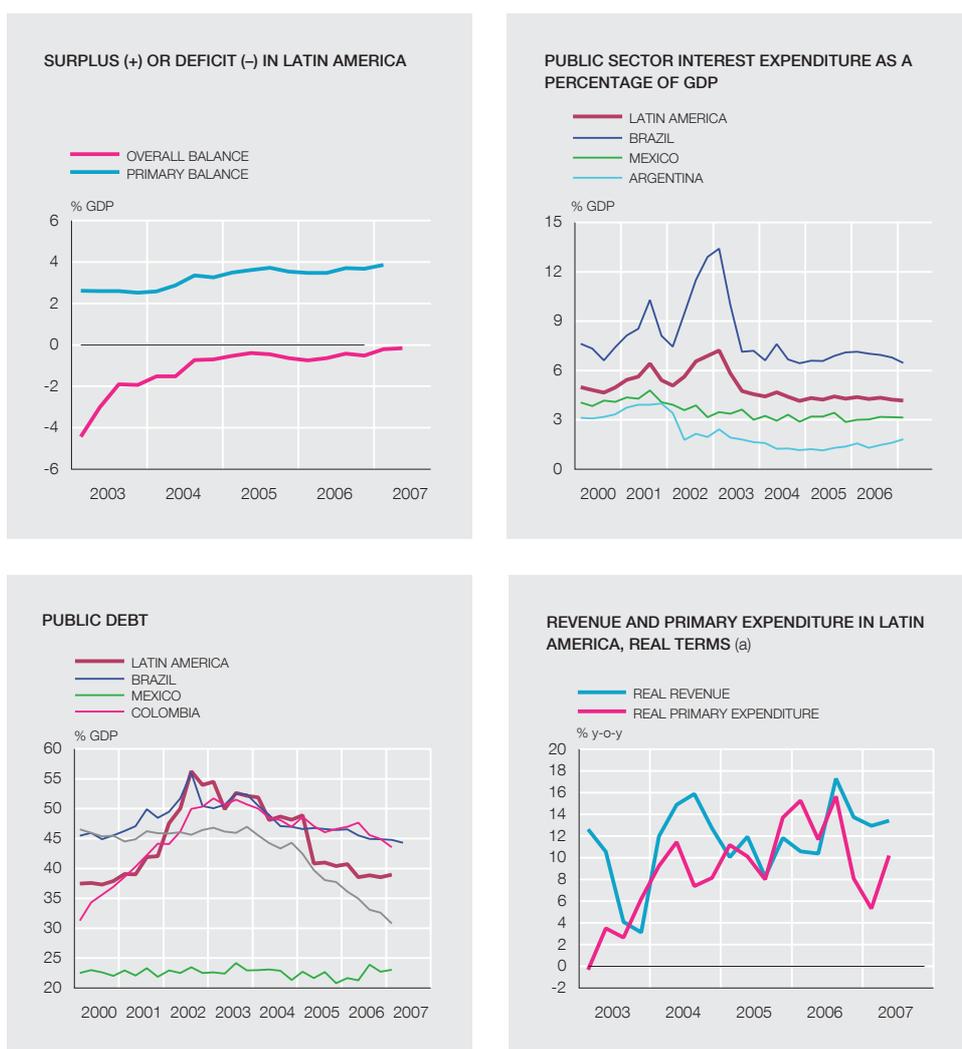
CHART 11



SOURCE: National statistics.

Overall, the course of inflation in the region can continue to be seen as favourable, given the maturation of the cycle and the dynamism of domestic demand. However, the sizeable weight of food in the consumption patterns of many countries and the signs of pressures in other components in some economies means that some change of tendency in the disinflation process of recent years cannot be ruled out. Accordingly, aspects such as the consistency of economic policies take on particular importance at this time, especially in a context of greater uncertainty over the effects of the global financial instability. The credibility gained by central banks in recent years, in particular those that maintain inflation targets, and the volume of accumulated reserves (which amounts to more than 11% of the region's GDP) should allow some degree of autonomy for monetary policies in respect of developments on foreign exchange markets, provided the financial impact of the turbulence does not become more acute. Nonetheless if, as a result of greater risk aversion, exchange rates were to tend to depreciate, one of the major channels for containing inflation in recent times would be curtailed.

There have been no major changes in the fiscal realm, given that the cyclical position and the positive contribution of commodities prices to tax receipts continued to provide for improvements in the fiscal balances of some countries (Chile and Uruguay) and the maintenance thereof in the rest (see Chart 12). The case of Chile is significant, where the government in-



SOURCE: National statistics.

a. Deflated by CPI.

creased the budget surplus forecast for the year from 4.4% to 7.1%, after raising the projected average price of copper for 2007 in July. In Mexico and Brazil, expenditure is proving very moderate, while in Venezuela the containment of public spending compared with previous quarters is notable, unlike in Argentina. For the region as a whole, the total budget balance was in equilibrium and the primary balance firmed at 4% of GDP, for the third year running, with some decline in the interest burden, with the exception of Argentina. Debt ratios held stable. Mexico unveiled its National Development Plan for the six-year period 2007-2012, including investment in infrastructure for a value of \$225 billion, \$35 billion of which would be earmarked for the energy sector. On official calculations, that would make for an increase in potential GDP of 0.6 pp per year. As a sign of Mexico's commitment to fiscal discipline, financing is linked to approval of the proposed tax reform, which is analysed in Box 2.

TRADE INTEGRATION AND
STRUCTURAL POLICIES

In the opening months of 2007, integration processes – the attainment of which appeared to be in sight at the end of last year – ground to a halt. First, the full-fledged accession of Venezuela to MERCOSUR did not come about on schedule, as the approval of two of the founding members' parliaments was not given. As a result, the Venezuelan executive considered re-

On 20 June 2007, the Mexican Secretary of Finance presented the proposed tax reform prepared by the new government. The basic aim of the reform is to reduce the country's dependence on the oil industry for fiscal revenue and achieve a leap forward in tax takings that will enable an ambitious public investment plan to be undertaken by the current legislature. At present, fiscal revenue in Mexico amounts to somewhat more than 22% of GDP, a very similar proportion to that of other countries in the region.¹ But if only the revenue from (direct and indirect) taxes is considered, this figure drops to 10%, which is the lowest proportion of all OECD countries and lower than that of many Latin American countries with a smaller income per capita (see panel 1). Nearly 37% of total budget revenue comes from the oil industry, compared with, for example, 22% in the case of copper revenue in Chile. The proportion evidences a dependence on oil compared with other sources of fiscal revenue, which becomes even more patent if it is considered that the oil industry represents only 8% of economic activity in Mexico. This signifies clear vulnerability bearing in mind that the volume of oil production has recently trended downward (see Chart 2) due to exhaustion of the main producing wells and to a lack of investment by the Mexican government oil company PEMEX.

The main objective of the reform is thus to raise government receipts by 2.8 pp of GDP by the year 2012, i.e. by nearly one-third of current tax revenue. It was intended to achieve this increase basically through the creation of a new company tax called the *Contribución Empresarial a Tasa Única* (flat business tax, or, by its Spanish acronym, "CETU"), which was expected to result in additional receipts of 1.85% of GDP. This tax, which was to replace that on business assets, was to be applied at an initial rate of 16% – rising to 19% in 2009 – on the difference between the income and payments flows relating to corporate expenses and investment. The tax would be calculated simultaneously with the current corporate income tax and the company would pay the larger of the two resulting amounts. To avoid double

1. In 2006 government revenue as a percentage of GDP was 17% in Argentina, 26% in Brazil, 25% in Chile, 17.8% in Colombia, 17.3% in Peru and 33.7% in Venezuela.

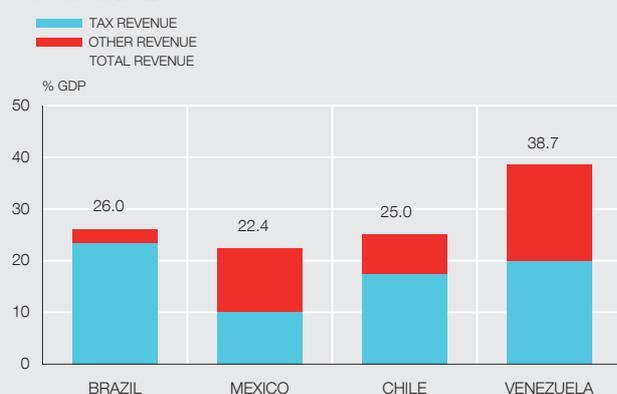
taxation, the tax deductions would include income tax withholdings on employee wages. The reform also notably includes the creation of a tax to combat the informal economy, which will consist of a surcharge of 2% on cash deposits exceeding 20,000 pesos per month and qualify as an income tax deduction. The aim of this tax is to discourage the payment instruments most commonly used in the informal economy.²

The proposed fiscal reform also included changes in the states' share of government receipts in that the states are permitted to levy surcharges on certain excise taxes, they are allocated one-third of the additional receipts created by the aforementioned tax measures, and the federal government contributions to the states are reformed, particularly those linked to the provision of educational services. As regards expenditure, a national assessment council (*Consejo Nacional de Evaluación*) was set up to concentrate the assessment of all government policies and the implementation of programmes, its guiding principle for this task being that investment expenditure is to be given priority over current expenditure.

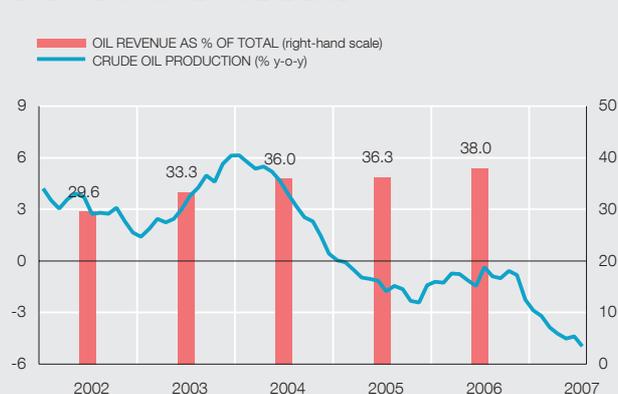
The reform was discussed in Congress in September and approved on September 14 with minimal changes from the original proposal. In the final text, the CETU changes its name to the *Impuesto Empresarial a Tasa Única* (IETU) and has a higher rate in 2008 (17.5%, as against 16%) and a lower one in the other years (17% in 2009 and 17.5% from 2010, against 19% in the proposed reform of the Executive). Also, a tax on petrol, which will be phased in gradually from 2008 and the proceeds of which will be received by the states and municipalities, as well as a tax on lottery and gambling have been introduced. One of the exemptions from the

2. Another two taxes have also been introduced, namely a tax on the sale of aerosols (of 50%) and one on lotteries (of 20%), although their impact on tax revenue is minimal. The rest of the increase in revenue will derive from more efficient tax collection, which will initially contribute 0.2 pp to GDP in 2008 and reach 1 pp in 2012. This improved efficiency will be based on the establishment of new facilities for complying with tax obligations, the strengthening of audit and control processes, etc.

1 FISCAL REVENUE



2 OIL PRODUCTION AND FISCAL REVENUE



SOURCES: INEGI and Secretaría de Hacienda.

tax on income from corporate acquisitions and sales made through the stock market has been repealed. Finally, Congress improved the tax regime of the Mexican government oil company PEMEX by reducing its federal contributions by 30 billion pesos. This will enable it to improve its financial solvency and invest more in operations and extraction. These changes mean that receipts in 2010 will increase by 2.5% of GDP instead of 2.8% as under the initial draft.

The reform, while less ambitious than would perhaps be desirable given the starting point and the recommendations of multilateral organisations (there are no changes to VAT or income tax) has been accepted at all administrative levels, unlike the reforms proposed by

previous governments.³ The increase in revenue is notable, since it would mean raising tax takings by 30% and would involve the states more in collecting and managing revenue, rather than just on the expenditure side. The initial assessment must therefore be positive, although it should be viewed as a first step on the way to more far-reaching reforms aimed at the long-term sustainability of greater public-sector investment and social spending.

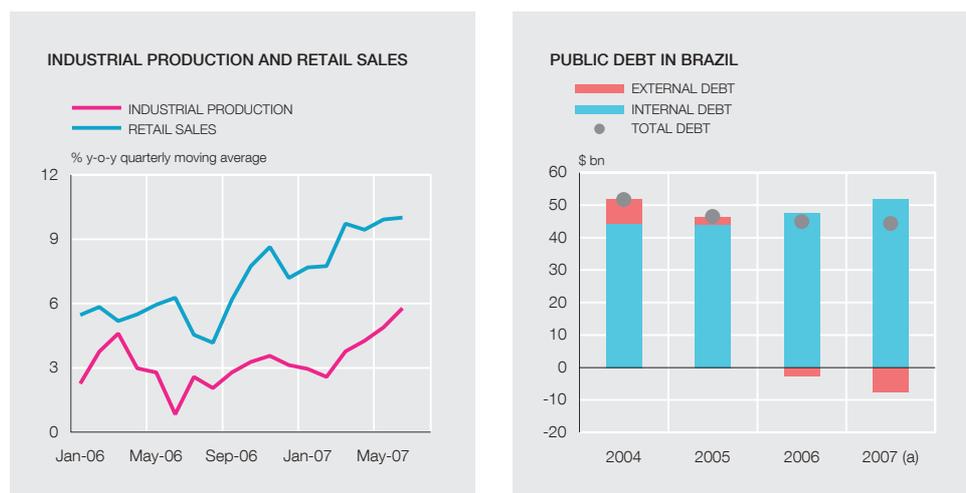
3. The previous government presented two tax packages which were rejected in Congress. The first sought to extend VAT to food, medicine and school enrolments, holding unchanged the rate of 15% and compensating certain prejudiced sectors for the increase in the cost of living. The second sought to increase the tax base of this tax by reducing the rate to 10%.

joining the Andean Community, which it had abandoned six months earlier. That illustrates the erratic nature of regional integration projects in South America, in a field which should be characterised by firm commitments. Against this background, the understanding reached between the United States and Uruguay might be the first step towards achieving a free trade agreement between both countries, which would endanger the continuity of MERCOSUR as it is currently structured. Further, the change in the parliamentary majority in the United States checked the free trade agreement approval processes, including those entered into with Panama, Peru and Colombia. However, the Andean Community countries managed to extend in June (for a further eight months) their preferential tariff arrangements with the United States. The extension took in Ecuador and Bolivia, which have no intention, for the moment, of negotiating trade agreements with the United States. In Chile, in June, the free trade agreement with Japan came into force, and it re-joined the Andean Community. The free trade agreement with Central America and the Dominican Republic (CAFTA + DR) took effect in this latter country on 1 March 2007, while Costa Rica's difficulties in securing Parliamentary approval for the agreement led to the calling of a referendum, scheduled for late September.

There has been no significant headway in structural reforms in the past six months. Indeed, only the Mexican government managed to push through certain reforms, such as that governing pensions for public-sector employees, which will contribute to alleviating the pension-related fiscal burden over a medium-term horizon, and the aforementioned tax reform. In Brazil, following the approval of the Growth Acceleration Plan (on which little progress appears to have been made), the unveiling of a draft tax reform is envisaged. Finally, Chile reformed its Fiscal Accountability Law, in order to reduce the public-sector structural target balance from 1% to 0.5% of GDP, thereby freeing up funds which will be invested essentially in education. In Colombia, the privatisation of the State oil company began in late August, while in the opposite direction, Venezuela took further moves to nationalise basic industries (telephony, electricity and oil prospecting operations in the Faja del Orinoco region) and Bolivia saw the entry into force of new agreements for the tapping of natural gas, one year after the nationalisation of the industry, and the nationalisation of the main telecommunications corporation.

Developments in the main countries

In *Brazil*, GDP posted a year-on-year growth rate of 4.3% and a quarter-on-quarter rate of 0.9% in 2007 Q1, marking something of a slowdown on previous quarters. However, there was a substantial pick-up in Q2 to 5.4% year-on-year, and 0.8% quarter-on-quarter, with a



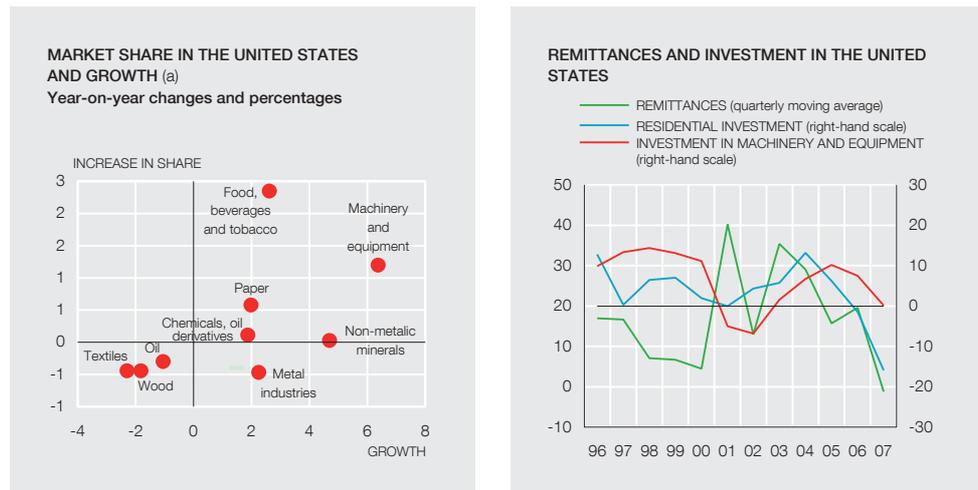
SOURCE: IBGE

a. To July.

strong acceleration in gross capital formation, which grew by 13.8% year-on-year, and by 7.3% in relation to the previous quarter, underpinned by lower interest rates and the strong appreciation of the real. Private consumption retained considerable momentum (5.7% year-on-year), as anticipated by the retail sales data (see Chart 13), although its growth rate dipped slightly on the previous quarter. The contribution of external demand improved, as exports quickened and imports slowed.

The current account surplus in the 12 months to July stood at marginally over 1% of GDP. This was slightly down on the previous year (1.3%) as a result of the lower trade surplus and the increase in the incomes deficit. The surplus on the financial account to July amounted to \$66.8 billion, more than tenfold the figure recorded in the same period in 2006. Of particular note were the gross inflows of FDI in this period (\$24.4 billion, outpacing the figure of \$18.9 billion for 2006 as a whole) and of short-term investment flows, partly linked to carry trade operations (see the panel in Box 1). Against this background, there were strong upward pressures on the real, prompting sizable purchases of reserves, which exceeded \$70 billion between January and July and which have doubled the outstanding balance of reserves in the space of a year. The strong appreciation of the real against the dollar (which was partly corrected in the July-August period, in the face of the turbulence on financial markets) contributed to specific prudential measures being adopted with the aim of restricting the incurrence of foreign exchange risk, in addition to establishing assistance programmes for exporters.

On the fiscal front, the primary surplus target for 2007 held constant, in real terms, but the revision of the National Accounts figures in March prompted a reduction in this target in terms of GDP for 2007 from 4.25% to 3.8%. The primary surplus in the 12 months to July was 4.3% of GDP, above target, and the budget deficit was 2.2% of GDP, as a result both of the increase in the nominal surplus and of the reduction in interest payments, which shows ample compliance with the fiscal targets for 2007 up to that point. Spending associated with the 2007-2010 Growth Acceleration Plan (the primary aim of which is to improve public infrastructure, through public works, and bilateral support programmes) was relatively limited in the first half of the year, and it is estimated that it might increase in the second half. Although net public debt held virtually stable, heavy purchases of reserves by the Brazilian central bank led to significant changes in its composition, boosting the public sector credit position in foreign currency, but also in-



SOURCES: INEGI, Bank of Mexico, US Census and Bureau of Economic Analysis.

a. Change between 2005 and 2007 in the percentage of US imports of each type of good from Mexico.

creasing local-currency-denominated public debt owing to sterilisation operations (see Chart 13). Despite the improvement in the composition of debt (which is now less exposed to exchange rate fluctuations), its high outstanding balance remains a source of vulnerability in the face of a potential tightening of international borrowing conditions. Inflation, which held at around 3% to April, increased gradually to stand at 4.2% in August, within the central bank's target corridor (4.5% y-o-y, + 2 pp). During the six-month period, the downward interest rate cycle continued. There were two 25 bp cuts at the March and April meetings, two 50 bp cuts at the June and July meetings, and one further 25 bp reduction in September, to 11.25%. As a result, official interest rates have fallen by 850 bp since September 2005. Turning to reforms, the Brazilian Finance Ministry announced its intention to submit a proposal for tax reform that would simplify the current tax system, although there have been no further details to date in this connection.

In Mexico, activity slowed notably in the first half of 2007, placing the year-on-year rate at 2.5% in Q1 and at 2.8% in Q2, compared with average growth of 4.8% in 2006. In Q1, the slowdown stemmed both from the reduction in the positive contribution of domestic demand (owing to the scant increase in investment and the contraction in government consumption) and from the negative contribution of external demand. In Q2, meanwhile, government consumption and, above all, external demand were the most sluggish components. On the supply side, the construction and, especially, the manufacturing industries underwent a marked deceleration, in line with the slowdown in activity in the United States. Indeed, the correlation between the GDP growth of the two economies has increased in recent months, and it was the industries which most grew in the Mexican economy in 2006 that gained market share in the United States (see Chart 14).

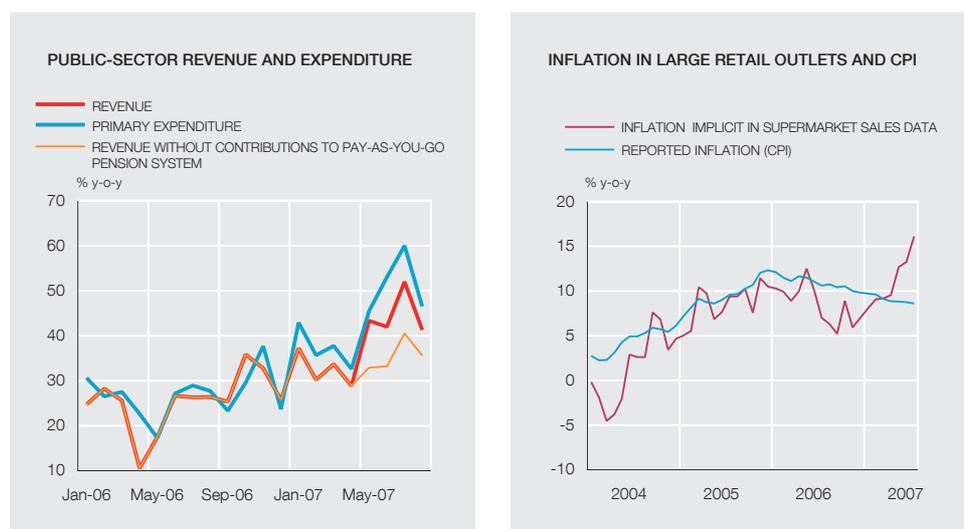
Turning to the external sector, the trade balance posted a deficit of close to \$5 billion in the first half of the year, somewhat lower than that recorded in the second half of 2006, and was on a slight declining trend owing to the acceleration in exports which, nonetheless, continue to grow less than imports. The current account balance deteriorated significantly in the first six months of the year (running a deficit of -0.8% of GDP in Q2, after having been practically in balance in 2006), as a result of higher dividend and interest payments and a decline in receipts from remittances. This decline became steeper in recent months, and would be a first effect of

the problems in the US construction industry and mortgage market on the Mexican economy (see Chart 14). Foreign direct investment flows were very high during the first six months, with a quarterly average of \$6.6 billion compared with the average of \$4.8 billion received in 2006. In the fiscal realm, there was a surplus of 0.3% of GDP in the six months to end-June, compared with 0.1% in 2006. The primary balance was 0.1 pp down on 2006, at 2.7% of GDP, owing to the rise in primary expenditure.

Inflation held close to the Mexican central bank's upper target for the year (4%), rising to a year-on-year rate of 4.1% in July and August. The course of prices has largely hinged on supply-side factors, particularly the rise in food prices. Core inflation remained stable, standing in August at 3.8%. To avoid a deterioration in inflation expectations, the central bank raised official interest rates by 25 bp in April to 7.25%, in what marks a change in cycle in the country's monetary policy. Since then official rates have not been changed, although the monetary authorities have maintained the contractionary bias. In any event, the slope of the interbank market yield curve has not altered during the half-year. Until late July, the country's financial variables behaved soundly, and the sovereign spread measured by the EMBI reached a historical low in early June. In recent weeks, these indicators have deteriorated, although Mexico has been relatively less affected by the financial turbulence than the other major Latin American countries. Insofar as the country's financial vulnerability has lessened significantly in recent years, the Mexican economy might suffer exposure principally through the trade channel and, possibly, through remittances flows, too. The correlation between the US cycle and remittances is much greater now than in the 2001 slowdown, whose source was a decline in investment in the technological sector, while the roots of the current deceleration are in the construction sector, in which the presence of Mexican immigrants is significant.

In *Argentina*, growth posted a year-on-year rate of 8% (1% in quarter-on-quarter terms, the lowest rate since the recovery began) in Q1, and 8.7% in Q2. Though high, these rates entail some slowing compared with the second half of 2006, and the fact that the rise in Q2 is essentially due to stockbuilding might suggest that the slowdown will continue in the coming quarters. The moderate deceleration in growth has been fundamentally due to the external sector, since in general all domestic demand components have continued to grow very robustly. Different trends are perceptible under investment: construction investment slowed and the growth of investment in equipment exceeded 23% in year-on-year terms. From the supply-side standpoint, the slowdown was attributable to industry and construction. In July, energy problems impacted the indicators of activity (diminished dynamism) and the trade balance (higher energy imports). These problems were partly due to weather-related factors, but structurally there will foreseeably be problems in this area in the future, since the demand for energy continues to outpace supply. Despite the improvement in the terms of trade, the trade surplus narrowed in the first half of the year (4.5% year-on-year), feeding through to a lower current account surplus (3.5% of GDP in Q1 and 3.1% in Q2). Public finances performed less favourably than in previous periods. While the primary fiscal surplus was 15% higher in year-on-year terms, public spending in the first seven months of the year grew by 46%, outpacing public revenue (39%), despite the fact that the latter includes extraordinary revenue linked to the pension system reform approved in April (see Chart 15).

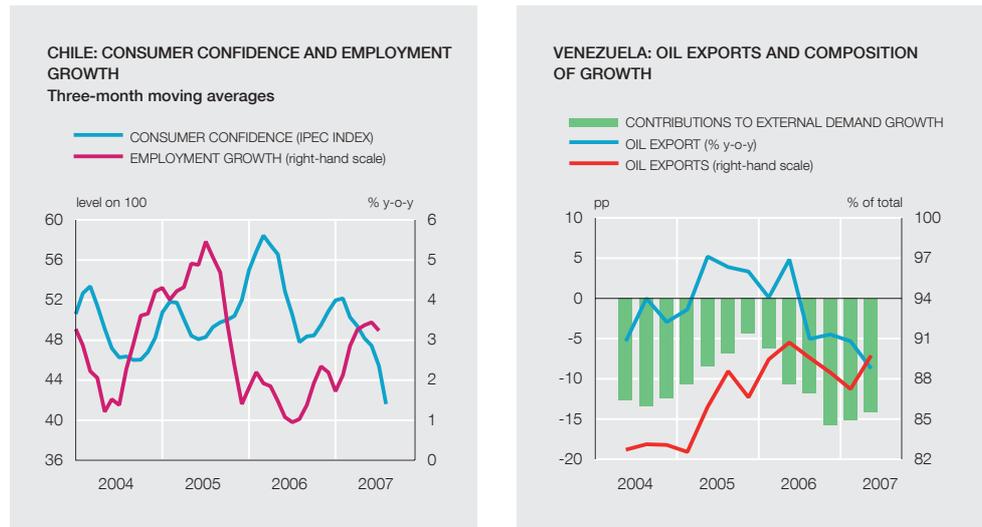
Both overall and core inflation fell, dipping to 8.7% and 9.4%, respectively, in August. However, there is notable scepticism over whether these data reflect the true cause of prices. Large retail outlet sales prices (see Chart 15) and various surveys suggest an underestimation of actual inflation, which would be standing some percentage points above the figure released by the statistics office. The central bank continued gradually to increase its benchmark interest rates, raising them, on seven occasions since the start of the year, by a total of 200 bp to



SOURCES: Secretaría de Hacienda and INDEC.

8.25%, although they remain below inflation. At the same time, the central bank maintained its exchange rate policy during the first half of the year, holding the currency stable at around 3.07-3.10 pesos to the dollar. That required a sizeable build-up in international reserves, totalling more than \$12 billion since the start of the year, which were sterilised in the main. In real effective terms there was a depreciation in the peso owing to the nominal depreciation against the real and the euro. The global financial turbulence at large since mid-July prevented the Treasury from issuing debt and intensified the widening trend of the sovereign spread, which had already begun before the summer for various domestic reasons (the credibility of the inflation figures, the energy crisis and the deterioration in public finances) and which was more considerable than that in most of the emerging economies. This situation prompted a rise in interest rates on the local market which, along with an increase in the demand for dollars, led the central bank to make the mechanisms for liquidity provision on the interbank market more flexible. Further, the downward pressures on the peso drove the central bank – together with other State-owned banks – to intervene selling dollars in sizeable amounts. In the institutional realm, and for the first time since the end of the convertibility arrangements, the government authorised increases at a gas utility under State jurisdiction in charges to residential users.

In *Chile*, GDP quickened significantly in the first half of the year, standing at year-on-year rates of 5.8% and 6.1% in Q1 and Q2, respectively, up from 4.3% in 2006 Q4 (it is estimated that the shortage of gas and water resources may have cut GDP growth in Q2 by around 0.3 pp). Despite the greater momentum of private consumption and investment, especially in capital goods, the reduction in the negative contribution of external demand was the main determinant of higher growth. This reduction was the result of the notable acceleration in exports, mainly of copper, which is taking the trade and current account balance (close to 8% of GDP) to new historical highs. There was also a strong acceleration in job creation and a reduction in the unemployment rate. However, consumer confidence underwent a slow – but sustained – deterioration throughout the half-year period (see Chart 16). Overall inflation held relatively stable to April (2.5% year-on-year), but it rose considerably thereafter to 4.7% in August, chiefly as a result of food and fuel prices, and the increase in electricity charges. The rise in core inflation was less, but equally significant, moving up from 2.6% in April to 4.2%, above the central bank's upper target band. Given this behaviour and the closing of the output gap, the central bank raised interest rates by 25 bp at its July, August and September meetings, placing them at 5.75%.



SOURCES: Banco Central de Chile and Banco Central de Venezuela.

The upward revision of the average price of copper in 2007 led the government, as in previous years, to raise its budget surplus forecast for 2007. In the first half of the year, the surplus was higher than in the related period in 2006. It should also be stressed that the government amended the counter-cyclical fiscal rule so that as from 2008, a structural surplus of 0.5% of GDP is required as opposed to the previous figure of 1%, which will lead to a more expansionary fiscal policy next year. The financial turbulence as from mid-July prompted a response in Chilean financial indicators of the same sign, but on a lesser scale than in the other emerging economies, given the country's exceptional fiscal and external position and the structural funds accumulated in recent years. As regards structural reforms, the legislative chambers approved an initiative to set the maximum ceiling for investment abroad for pension funds at 45% within a period of nine months (the previous ceiling was 30%), and in August the first step was taken, raising this ceiling to 35%.

Activity continued quickening in *Colombia* in Q1, posting year-on-year growth of 8.3% and of 7.2% in Q2, thanks to the acceleration in private consumption and to the strength of investment, as a result of the buoyancy of domestic demand. The strong growth in imports led to an increase in the trade deficit, which stood at -2% of GDP and also prompted a further widening of the current account deficit to -2.9%. However, the financial account posted a notable surplus, associated in part with the sizeable inflows of foreign direct investment, but also of short-term capital. From the fiscal standpoint, the buoyancy of the economy was reflected in higher public revenue and improved public finances, particularly in Q2. Inflation exceeded the initial central bank target band (3.5%-4.5% for 2007) as from January, standing above 6%. This overshooting prompted a strong rise in benchmark interest rates, taking them up by a further 175 bp during the first half of the year to 9.25%, against the background of a strong appreciation of the peso, which exacerbated the monetary policy dilemma. The financial turbulence that began in late July resulted in a depreciation of more than 9% in the peso. In Q2 the upward trend of inflation was interrupted, and from June official interest rates held steady. In the field of reforms, the regional financing arrangements (*Sistema General de Participaciones*) for the period 2008-2016 were approved. These will govern transfers from central government to the territorial entities in order to assist the fiscal consolidation process.

In *Peru*, activity slowed slightly in the first half of the year, though it continued to post very high growth rates, of 8% and 7.6%, respectively, in Q1 and Q2 (8.5% in 2006 Q4). The source of

the deceleration lay in the diminished dynamism of domestic demand, as a result of the slow-down in investment (which, even so, remains the most dynamic component) and in government consumption, since private consumption quickened. In contrast, the negative contribution of external demand to growth fell during the six-month period. The trade balance continued to run a surplus during the first half of the year similar to that recorded in the same period of 2006 (9.1% of GDP), thanks to the increase in the terms of trade, since the volume of exports scarcely grew. Public finances recorded better results to July than the previous year, although the primary surplus was slightly lower. In the first four months of the year, inflation remained on a declining trend, holding below the central bank's inflation target band (1%-3%), but from June it stood once again within this band. Against this backdrop, and given the strong pace of activity, the central bank decided pre-emptively to increase official interest rates by 25 bp in July and by a further 25 bp in September, to 5%. The main rating agencies improved Peru's sovereign debt rating or outlook, and the government placed for the first time a sol-denominated bond (at 30 years) on the international markets for the prepayment of a portion of the country's debt with the Paris Club. The August earthquake might have an impact of the order of several tenths of a point on growth for 2007 (0.3 pp-0.4 pp on official estimates).

In *Venezuela*, GDP growth slowed by close to 1.5 pp on the previous half-year period, as a result of some easing in domestic demand. Even so, the respective year-on-year growth rates for Q1 and Q2 were 9.1% and 8.9%. The negative contribution of the external sector to growth increased (-14.6 pp during the half-year period) as a result of the decline in exports, mainly oil-related products (-7%) (see Chart 16), which might be connected both with the fall in OPEC quotas and with the withdrawal of foreign capital by certain corporations. As a result of the reduction in the trade balance, the current account surplus fell from 19.5% of GDP at end-2006 to 14.6%, while the deficit on the financial account widened. Reserves fell heavily (-21.5%) as a result of several transfers to State funds and public companies. On the fiscal front and with regard to revenue, the reduction in VAT was partly offset by the better performance of the non-oil-related tax takings. There was a particularly notable reduction in the pace of growth of primary fiscal spending. Inflation held at close to 20% throughout the first half of the year, but eased off towards 15% owing to the cut in VAT. The sovereign spread widened forcefully as a result of the heightened volatility on financial markets in August, increasing by more than 150 bp. Finally, the government has proposed divesting the central bank of its independence in the new draft Constitution.

In *Uruguay*, GDP quickened to a year-on-year rate of 6.9% in Q1, compared with 6.3% in 2006 Q4. It eased, however, in Q2 to a year-on-year rate of 4.8%. The composition of growth was more balanced, as there was a reduction in the positive contribution of domestic demand and the negative contribution of external demand. Financial inflows held steady as did central bank purchases of reserves for most of the six-month period. The increase in inflation continued until April, holding stable thereafter at around 8%, clearly above the central bank's (informal) target, despite the contractionary monetary policy measures. Further, it was announced that the implementation of monetary policy by means of a target based on monetary aggregates would be abandoned to make way for one based on interest rates, with an annual target inter-bank interest rate of 5%. In *Ecuador*, economic activity slowed strongly in late 2006 to a year-on-year rate of 2.2%. This deceleration steepened in 2007 Q1 as a result of the decline in the volume of exports. The executive called elections for a Constituent Assembly, which will be held in late September. In *Bolivia* there was also a significant slowdown in activity to 2% in Q1, against a background of quickening prices (10.4% year-on-year). The hydrocarbons extraction and operating contracts finally came into force one year after the industry was nationalised.

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