HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

Introduction

The year 2007 was the fifth consecutive one of economic expansion for Latin America. Across the seven main economies in the region, activity grew by 5.8%, up on 2006 and 2005 and only 1 pp below the high in the current cycle recorded in early 2004. Most significantly, there were no signs of the pace of growth easing in the Latin American economies in the second half of the year, despite the deterioration in the international economic and financial picture. Thus, underpinned by the sizable reduction in financial vulnerabilities in recent years and with the continuation of very high commodities price levels proving supportive, the Latin American economies have been able to bypass a period of deep-seated instability on the international financial markets. Indeed, the impact in terms of their internal financing conditions and the real economy has been very limited, especially when compared with past episodes (see Box 1). The slowdown in the US economy has not exerted any notable effect through the trade channel, not even in those economies with a higher level of integration with the United States, such as Mexico and Central America. Country by country, growth rates in 2007 were particularly robust in Peru (9%), Argentina (8.7%), Venezuela (8.4%) and Colombia (7.5%). Brazil posted its highest growth rate for the last three years (5.4%), while Chile grew by 5.1% and Mexico by 3.3%. Growth in all the countries, except Mexico and Venezuela, outpaced that in 2006, and in most it was higher than expected at the beginning of the year.

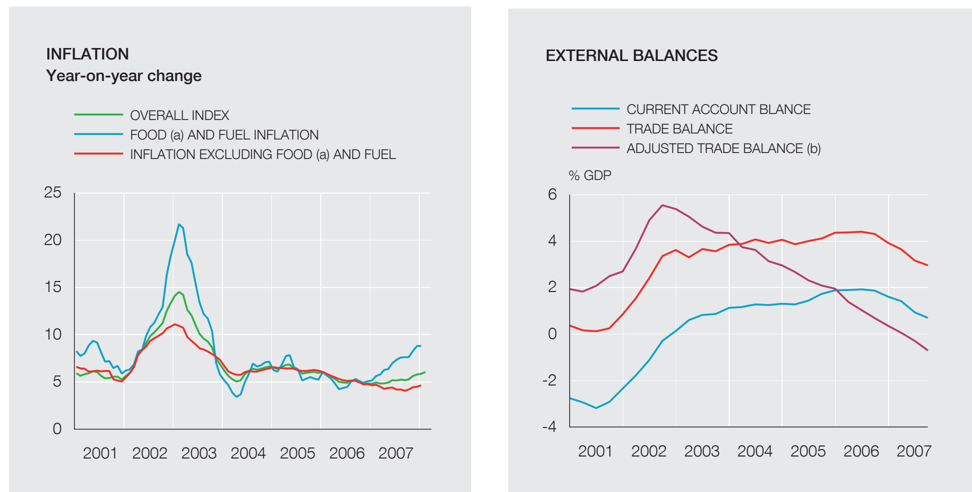
Against this clearly favourable backdrop, there were two differential features in regional economic developments over the past six-month period. First, there was a generalised rise in inflation (common to most of the economies, emerging and developed alike), due mainly but not solely to higher food prices, and which brought the prolonged period of low inflation over the past four years to an end. The rise in inflation from historical lows to a year-on-year rate of 6.4% for the seven main regional economies as a whole made for more complicated monetary policy management in some countries, in a setting in which the opening up of interest-rate spreads over the dollar has exerted extra pressure on exchange rates. These currencies had already appreciated substantially relative to the dollar. That said, inflation, excluding food (processed and unprocessed) and energy, held stable (see Chart 1). And while inflation expectations have rebounded in recent months, they remain relatively anchored, which is a positive factor given that the cycle is now maturing.

The second differential feature has been the reduction in the region's trade and current account surplus, for the first time in the last five years. This came about due to robust import growth, which far exceeded that of exports, despite commodities prices holding at highs. Albeit with notable cross-country differences, the outcome was a swift downturn in external balances in the second half of the year, cutting the trade surplus for the seven main countries as a whole by 2 pp (from 4.2% of GDP in 2006, to 2.3% in 2007), and placing the current account surplus at below 1% of GDP (see Chart 1).

The outlook for 2008 largely hinges on the international setting. Developments in recent months have offered sound proof that Latin America has been able to capitalise on the improvement in its macroeconomic fundamentals and on the reduction in its past vulnerabilities, showing notable resilience in the face of the worsening external environment. However, given the degree of trade and financial integration, it is unlikely that the region will not be affected by a significant slowdown in the world economy. China may prove to be key here since, thanks to its contribution to the global demand for exports, it is shaping up as an essential pillar not only for Latin America but also for other emerging economies, and it may moreover retain

LATIN AMERICA: INFLATION AND EXTERNAL BLANCES
Year-on-year change and percentage of GDP

CHART 1



SOURCE: National statistics.

a. Processed and unprocessed food.
b. Estimate of the trade balance setting import and export prices as an average from 1990 to the latest available figure.

some immunity to the financial turbulence. Yet notwithstanding this attenuating factor, Latin America's trade ties with the United States and the risk of the slowdown spreading to other industrialised countries mean that, unlike in 2007, activity may tend to decelerate moderately in 2008. Intensity will depend mainly on the scale of the slowdown in the United States, on commodities price developments and on the behaviour of the financial channel. Downside risks in the coming quarters may well stem from these three facets.

Economic and financial developments

EXTERNAL ENVIRONMENT

From September 2007 to March 2008, the external economic environment was marked by financial market strains, which spread progressively from the US subprime mortgage market to other segments and agents. In early 2008, the pressures on stock markets, private fixed-income markets and also – albeit to a lesser extent – on emerging financial markets became more significant. Faced with rising financial strains and a rapid macroeconomic deterioration, the Federal Reserve reacted by forcefully cutting its official interest rates, while the European Central Bank and the Bank of Japan held their rates unchanged. Interest rates on US 10-year Treasury bonds fell to around 3.50%, reflecting a "flight to quality", which has also contributed to containing the rise in the cost of financing in Latin America.

The signs of a weakening in global economic activity became clear in 2007 Q4. In particular, growth in the United States eased significantly as a result of the intensification of the real estate correction and of an incipient slowdown in consumption. However, growth remained dynamic in China and in other emerging economies. In parallel, inflationary pressures increased globally, coinciding with the rise in commodities prices (oil and food in particular), although core inflation remained contained.

The sluggishness of the US economy and the widening of interest-rate spreads with the United States prompted a continuous and generalised depreciation of the dollar (another key aspect of international financial developments in the past six months) against both the euro and the yen and, to differing degrees, against almost all the emerging economies' currencies. This weakness of the dollar has had a considerable effect on exchange rates in Latin America, accentuating the strength of certain currencies which, in many cases, had already appreciated significantly relative to the dollar.

COMPARISON BETWEEN THE RECENT EPISODES OF GLOBAL FINANCIAL INSTABILITY IN LATIN AMERICA

BOX 1

The evolution of the main financial variables in Latin America during the current episode of global instability shows that the impact of turbulence has so far been much more limited than in previous episodes. This box compares the evolution of such variables in recent months with two previous episodes of global financial instability: the Russian crisis (that began in August 1998) and the end of the technology bubble, from April 2000. Both these episodes played a fundamental role in spreading the serious financial crises that afflicted Latin America in the late 1990s and early 2000s.

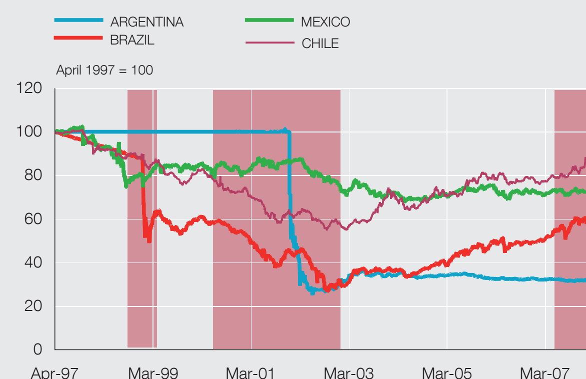
One of the main differences in developments on Latin American financial markets since summer 2007 is that on this occasion, in contrast to events in the two previous episodes, there have been no massive capital outflows triggered by "contagion" effects or dramatic risk repricing. Thus, as seen in panel 1, compared with the rise of some 100 bp in sovereign spreads in Latin America since last summer, the Russian crisis led to an increase of more than 900 bp and the end of the technology bubble some 750 bp. In fact, in Mexico and Brazil, the increase in sovereign spreads during the Russian crisis was around 15 times greater than the current increase, and after the bursting of the technology bubble, the increase in Brazil's sovereign spread was more than 20 times the current increase.

Meanwhile, the exchange rates of most of the countries of the region have tended to appreciate significantly against the dollar since the beginning of the current turbulence, or have remained steady, amid heavy accumulation of reserves. These developments contrast with the strong tendency for depreciation in the two previous episodes (see panel 2), and are key to explaining why monetary policies have been able to focus on their domestic objectives in recent months. Finally, stock exchange losses have been clearly smaller than during the Russian crisis, although similar in most cases to those recorded in the first stages of the bursting of the technological bubble.

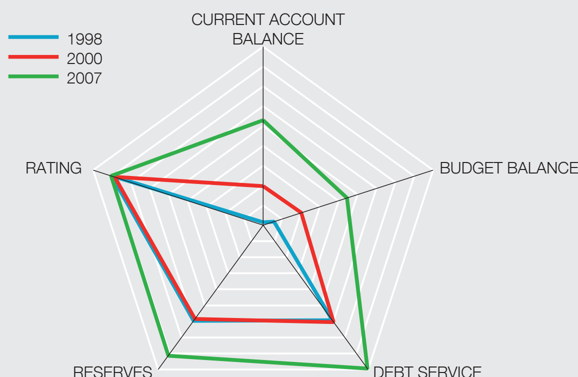
Overall, recent developments in financial markets support the perception of improvement in Latin America's economic fundamentals, which is also confirmed by the usual indicators of vulnerability. Thus, notably, Latin America's level of vulnerability is much lower than in the past, as seen in panel 3. This lower vulnerability is reflected in a better external position (a surplus, as opposed to the current account deficits in past episodes), lower public deficit and debt service levels than in the past, and a much more significant volume of foreign-exchange reserves. Sovereign ratings are, on average, no higher than in the two previous episodes of turbulence, although that is largely due to the downward pressure introduced by Argenti-

1 INTEREST RATE DIFFERENTIAL

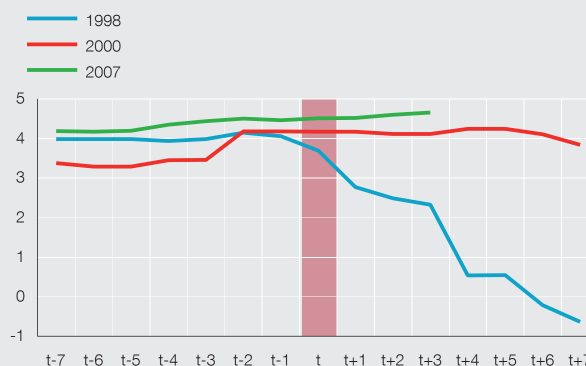
2 EXCHANGE RATES AGAINST THE DOLLAR



3 VULNERABILITY INDICATORS FOR THE REGION (a)



4 GROWTH FORECAST FOR THE FOLLOWING YEAR (b)



SOURCES: National statistics, Consensus Forecasts, Economist Intelligence Unit and Banco de España.

a. The variables are re-scaled to show an improvement in the situation as an increase in the distance of the figure from the origin.
b. Evolution of each variable during the quarters or months before or after the outburst of turbulence.

na's rating following the default on its debt, since most other countries have higher ratings.

In this respect, one of the most important differences is precisely the current account surplus. Both in 1998 and in 2000-2001 there was a large current account deficit in Latin America, showing the significant dependence of economic growth on external financing. In 1998, the adjustment took place through a sharp depreciation of currencies, which ultimately improved the external balance. By contrast, in 2000-2001, the contraction of activity in the United States led to lower demand for Latin American products and a fall in exports, which delayed correction of the external position, until the global recovery and the strong growth in commodities changed the sign of the current account balance, giving rise to the surplus that still prevails (see panel 3). Another significant difference in the current episode of instability is that capital inflows to the region have proved to be more robust and their adjustment has so far been much more limited than in the previous episodes. This development contributes to the continued availability of credit which, as indicated in the text, is also underpinned by the availability of considerable domestic savings.

All these factors may have contributed to ensuring that the growth forecasts for the region as a whole have barely changed during the current episode of global instability. This is in contrast to the period following the Russian crisis, when the downward revision to growth prospects was practically immediate and very significant (more than 4 percentage points after 6 months), as seen in panel 4. Following the end of the technology bubble, growth forecasts were hardly revised initially, but that did not prevent zero growth being recorded in Latin America in 2002. This should serve as a warning against excessive complacency regarding the eventual impact on Latin America of this episode of turbulence.

The emerging financial markets (and stock markets in particular) showed notable resilience in the second half of 2007. But January saw a significant correction, in parallel with the decline in stock markets in the industrialised countries, albeit on a lesser scale. Moreover, the equity market falls in Asia and in certain Eastern European countries were more marked than in Latin America (see Chart 2). Conversely, the widening of sovereign spreads was relatively uniform across the various emerging regions: in the last six months they increased by around 90 bp in Asia and in emerging Europe, only somewhat lower than the increase in Latin America. The widening of the spreads of the industrialised countries' corporate bonds with a similar rating to that of the emerging markets was comparatively greater, denoting a much more unfavourable assessment of credit risk since the start of the turbulence (see Chart 2).

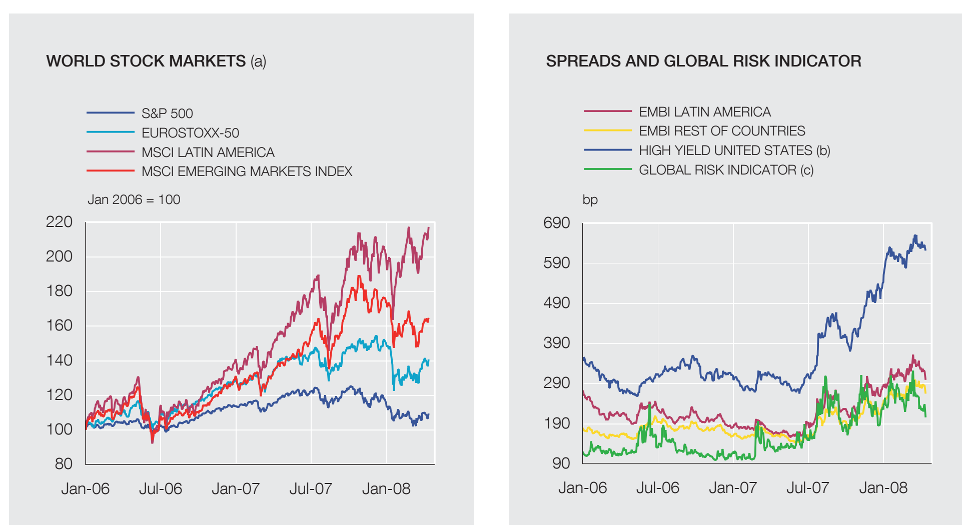
ECONOMIC ACTIVITY AND DEMAND

GDP growth in Latin America increased in the second half of 2007 to year-on-year rates of 5.8% and 6.2% in Q3 and Q4, respectively, after posting growth of somewhat less than 5.5% in the first half of the year. The quarter-on-quarter rates are consistent with this strengthening, averaging out at 1.6% in the last two quarters, compared with 1% in Q1 and 1.7% in Q2 (see Table 1 and Chart 3). The economic expansion continued to be underpinned by buoyant domestic demand, which posted the highest growth rate of the current upturn and contributed 0.8 pp to growth in Q4, up on its contribution in 2004, when the current cycle peaked (see Chart 3). Accordingly, the pattern of growth followed since 2005 intensified, involving increasingly robust domestic demand and with external demand detracting more from growth, albeit on a relatively limited scale. The dynamism of domestic demand was due both to the behaviour of investment and, above all, to the strength of private consumption. Conversely, the contribution of external demand worsened further, subtracting 2.5 pp from growth at the end of the year, against the background of some slowing in exports but, above all, of the strong momentum of imports. The contributions of the various countries to growth in the region changed somewhat in relation to 2006, with a bigger contribution by the major South American economies (Brazil and Argentina, which jointly accounted for 3.3 pp of regional growth) at the expense of Mexico, whose contribution to growth fell considerably to 0.9 pp.

The higher frequency indicators for the opening months of 2008 show certain disparities. Some of Mexico's consumption indicators (confidence, retail sales) have felt the impact of the

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Basis points and indices

CHART 2



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

a. Indices in dollars.
b. B1-rated bond.
c. Implicit CBOE options volatility.

weakening US economy, although industrial production and foreign trade do not clearly confirm this trend. Something similar is happening in Chile, though for different reasons (the rise in prices, the tightening of monetary policy during 2007 and the mounting cost of electricity generation). However, in several countries (Argentina, Brazil and Peru) the demand indicators have continued to display clear signs of robustness at the start of the year, which is substantiated by the aggregate consumption and confidence indicators for the region's seven main countries (see Chart 4) and by industrial production.

In the last two quarters, private consumption quickened practically across the board, with the exception of Chile, up to a year-on-year growth rate of 8% in Q4, 2 pp up on the average for 2006 (see Chart 4). Behind this development is the sound behaviour of the labour market in the past four years, which has made for a reduction in the unemployment rate to levels not seen since the early 90s (6.9% of the labour force), a moderate rise in real wages and a significant increase in the availability of consumer credit. Of particular note has been the course of private consumption in Brazil, which has been further supported by the strong interest-rate cuts in recent years.

During the period under study, investment remained the most dynamic component of domestic demand, posting growth of over 15% year-on-year in Q4. As a result, investment has grown above 10% for four years running in the region (see Chart 5). In most countries this dynamism is concentrated in the capital goods component, although construction has continued to play a very important role in Chile and Colombia. The investment process has continued to be financed by domestic saving, as demonstrated by the maintenance of a current (though diminishing) surplus, which may have contributed to a general deterioration in the economic picture not being seen in the second half-year period, despite the worsening global environment. Adding to this is the fact that credit granted by the banking system has continued to be financed essentially by the deposit base, which would provide leeway in situations marked by less access to external financing (see Chart 6). In this respect, although credit to the private sector has shown signs of easing in many countries since late 2007, its growth rate remains very high

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

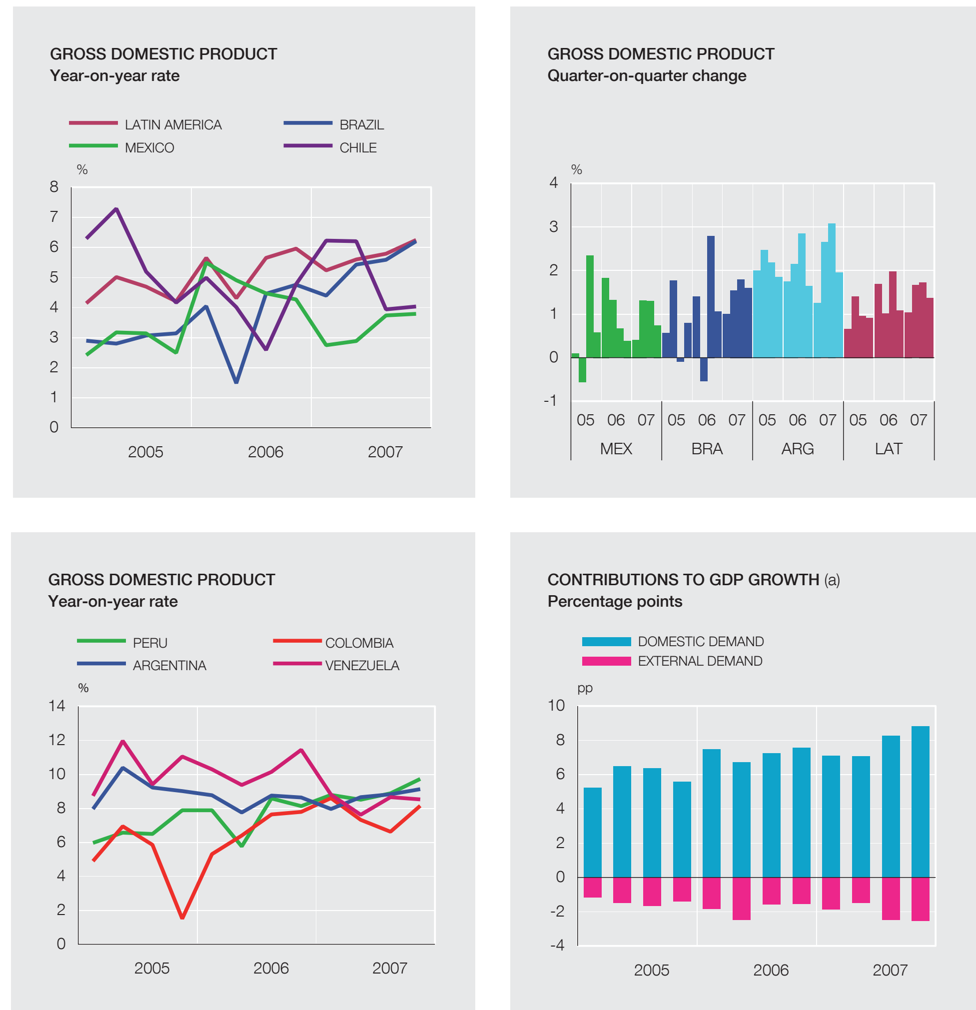
	2004	2005	2006	2007	2006				2007			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (year-on-year change)												
Latin America (a)	6.2	4.5	5.4	5.8	5.6	4.3	5.6	5.9	5.2	5.6	5.8	6.3
Argentina	9.1	9.2	8.5	8.7	8.8	7.7	8.7	8.6	8.0	8.6	8.8	9.1
Brazil	5.7	3.2	3.7	5.4	4.0	1.5	4.5	5.1	4.4	5.4	5.6	6.2
Mexico	4.2	2.8	4.8	3.3	5.5	4.9	4.5	4.3	2.7	2.9	3.7	3.8
Chile	6.0	5.7	4.0	5.1	5.0	4.0	2.6	4.3	6.2	6.2	3.9	4.0
Colombia	4.9	4.7	6.8	7.5	5.4	6.4	7.6	7.8	8.6	7.3	6.6	8.1
Venezuela	19.4	10.3	10.3	8.4	9.8	9.4	10.1	11.4	8.8	7.6	8.6	8.5
Peru	5.2	6.7	7.6	9.0	8.0	6.5	9.2	8.1	8.8	8.5	8.9	9.7
Uruguay	12.0	6.6	7.0	7.4	7.1	7.9	7.2	6.1	6.6	3.9	9.6	9.3
CPI (year-on-year change)												
Latin America (a)	6.0	6.3	5.2	5.2	5.8	5.1	5.0	4.8	4.9	5.0	5.2	5.5
Argentina	4.4	9.6	10.9	8.8	11.6	11.4	10.6	10.1	9.5	8.8	8.6	8.5
Brazil	6.6	6.9	4.2	3.6	5.5	4.3	3.8	3.1	3.0	3.3	4.0	4.3
Mexico	4.7	4.0	3.6	4.0	3.7	3.1	3.5	4.1	4.1	4.0	4.0	3.8
Chile	1.1	3.1	3.4	4.4	4.1	3.8	3.5	2.2	2.7	2.9	4.8	7.2
Colombia	5.9	5.0	4.3	5.5	4.3	4.0	4.6	4.3	5.2	6.2	5.3	5.4
Venezuela	21.7	16.0	13.6	18.8	12.6	11.2	14.6	16.2	19.0	19.5	16.2	20.0
Peru	3.7	1.6	2.0	1.8	2.4	2.3	1.8	1.5	0.4	0.8	2.4	3.5
Uruguay	9.2	4.7	6.4	8.1	6.4	6.4	6.6	6.2	7.0	8.1	8.7	8.6
PUBLIC SECTOR BALANCE (% GDP)												
Latin America (a)	-1.0	-1.0	-0.7	-0.5	-0.7	-0.6	-0.4	-0.7	-0.5	-0.2	-0.3	-0.5
Argentina	2.6	1.8	1.8	1.1	1.4	1.5	1.8	1.8	1.5	1.6	1.7	1.1
Brazil	-2.3	-2.8	-2.9	-2.2	-3.2	-3.0	-3.1	-2.9	-2.6	-2.1	-2.2	-2.2
Mexico	-0.3	-0.1	0.1	0.0	0.2	0.4	0.4	0.1	0.7	0.4	0.1	0.0
Chile	2.4	4.7	8.0	8.7	6.1	6.6	7.9	8.0	7.9	8.6	8.7	8.9
Colombia	-4.5	-5.0	-3.7	-3.3	0.2	0.6	1.8	-3.7	-3.2	-2.1	-2.7	-3.4
Venezuela	-2.1	2.0	0.0	—	-1.3	-5.5	-3.7	-1.5	-1.3	1.2	1.0	—
Peru	-1.3	-0.7	1.4	1.1	-0.1	0.7	1.0	1.4	1.5	1.2	1.7	1.8
Uruguay	-2.0	-0.8	-0.6	-0.3	-0.2	-0.6	-0.6	-0.6	-0.8	0.3	0.7	-0.3
PUBLIC SECTOR DEBT (% GDP)												
Latin America (a)	48.0	41.0	39.1	36.0	40.4	38.6	39.0	38.7	38.1	37.4	36.7	36.0
Argentina	120.3	70.7	64.2	55.5	69.0	59.1	59.9	59.8	61.5	59.1	55.8	55.5
Brazil	47.0	46.5	44.7	42.8	46.6	45.5	45.0	44.7	44.7	43.9	43.2	42.8
Mexico	21.3	22.4	23.2	24.1	21.7	21.3	23.9	23.2	23.3	23.9	24.3	24.1
Chile	10.0	6.8	5.3	5.5	6.2	5.5	5.4	5.3	5.2	5.1	4.4	5.5
Colombia	47.0	46.6	44.8	—	46.9	47.7	45.6	44.8	42.7	42.2	41.7	—
Venezuela	53.3	48.2	41.9	30.1	36.1	38.2	40.0	41.9	31.7	29.9	28.2	30.1
Peru	44.3	37.8	32.7	29.3	36.1	35.0	33.1	32.7	30.8	29.6	30.8	29.3
Uruguay	100.7	83.8	70.9	—	73.1	74.9	75.5	70.9	66.4	71.6	72.9	—
CURRENT ACCOUNT BALANCE (% GDP)												
Latin America (a)	1.3	1.7	1.8	0.7	2.0	2.0	2.0	1.9	1.6	1.4	0.9	0.7
Argentina	2.1	3.1	3.6	2.8	3.6	3.3	3.2	3.5	3.4	3.3	2.7	2.8
Brazil	1.8	1.6	1.3	0.3	1.5	1.3	1.4	1.3	1.2	1.3	0.7	0.3
Mexico	-1.0	-0.7	-0.3	-0.8	-0.2	-0.2	-0.3	-0.3	-0.6	-0.8	-0.9	-0.8
Chile	2.2	1.2	4.7	4.4	1.7	2.8	3.9	3.6	5.9	5.7	5.0	4.4
Colombia	-0.9	-1.5	-2.3	-3.4	-1.7	-2.0	-1.9	-2.3	-2.9	-3.2	-3.5	-3.6
Venezuela	15.3	22.2	19.5	11.7	23.6	24.2	22.5	19.5	15.9	13.3	11.7	11.7
Peru	0.0	1.4	3.0	1.4	1.0	1.3	2.2	2.8	2.9	2.9	2.1	1.5
Uruguay	-0.8	0.2	-2.2	-0.8	0.2	-0.3	-1.0	-2.2	-1.3	-0.7	-1.1	-0.8
EXTERNAL DEBT (% GDP)												
Latin America (a)	38.5	26.5	22.4	21.6	25.4	23.2	23.2	23.1	22.8	22.9	22.4	21.6
Argentina	107.6	59.1	47.5	47.3	56.1	48.1	49.1	47.5	50.6	50.8	48.9	47.3
Brazil	28.9	19.2	16.1	14.7	17.6	15.8	15.4	16.2	16.4	16.4	15.9	14.7
Mexico	18.9	15.4	13.4	12.6	15.2	15.4	15.3	13.4	13.8	13.3	13.2	12.6
Chile	41.7	33.5	32.0	34.0	32.8	31.5	33.1	32.0	32.3	33.0	33.9	34.0
Colombia	40.2	31.3	29.5	26.0	30.0	28.9	28.2	26.5	24.9	25.5	25.6	26.0
Venezuela	42.5	39.1	30.2	32.4	31.3	28.9	29.2	29.6	30.9	31.9	32.0	32.4
Peru	42.0	35.3	28.2	28.7	34.3	28.8	29.3	28.2	28.9	29.5	29.3	28.7
Uruguay	87.6	68.6	54.6	—	58.6	59.3	59.0	54.6	50.3	54.7	55.2	—

SOURCE: National statistics.

a. Aggregate of 8 represented countries, except Uruguay.

LATIN AMERICAN GDP CHART 3

Quarter-on-quarter and year-on-year changes, and percentage points



SOURCE: National statistics.

a. Aggregate of the seven main economies.

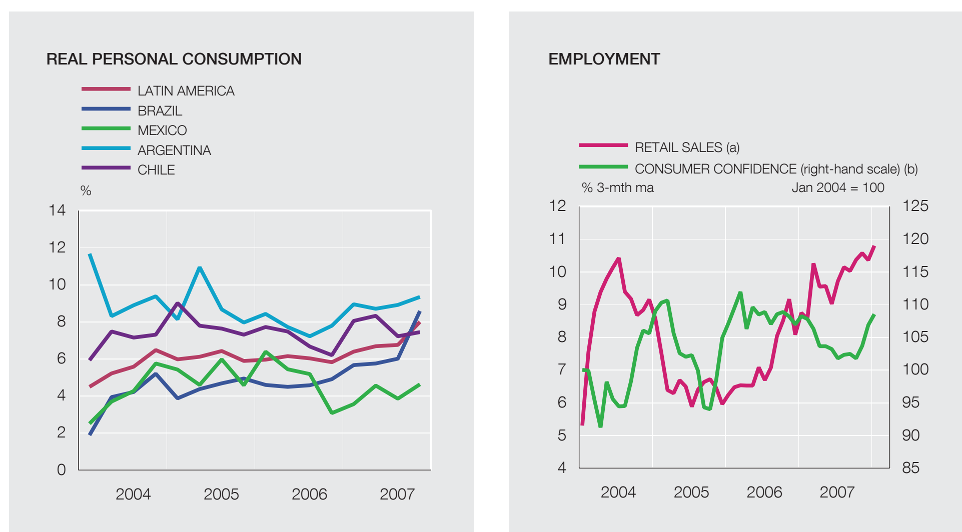
in real terms, averaging around 25% year-on-year in the seven main countries in the region (see Box 2). In the medium term, however, heightening uncertainty abroad and, on the domestic front, the consolidation of an upward cycle in interest rates may slow the growth rate of investment somewhat, which has been exceptionally high in recent years by the region's standards.

As regards external demand, there was a strong acceleration in imports in terms of volume, up to a year-on-year rate of close to 20% of the end of the year (2 pp up on 2006), amid the heightening dynamism of domestic demand and strengthening currencies. The export volume held at a similar growth rate to that in 2006, at around 6% (with the significant exception of Venezuela, where exports fell for the second year running). These developments help explain why the trade balance stood at 2.3% of GDP in Q4, 2 pp down on 2006, despite the prices of the main export commodities holding at record levels (see Chart 8). The current surplus underwent a parallel reduction, and stood at 0.7% of GDP at the end of the year, which was the case for most of the countries (except Chile). Mexico and Colombia posted a current account deficit of around 1% and 3.5% of GDP, respectively. In the case of Mexico, the reduction in remittances received in the second half of the year was a substantial factor behind the deterioration

PRIVATE CONSUMPTION AND DEMAND INDICATORS

CHART 4

Year-on-year rate, three-month moving average of the year-on-year rate and indices



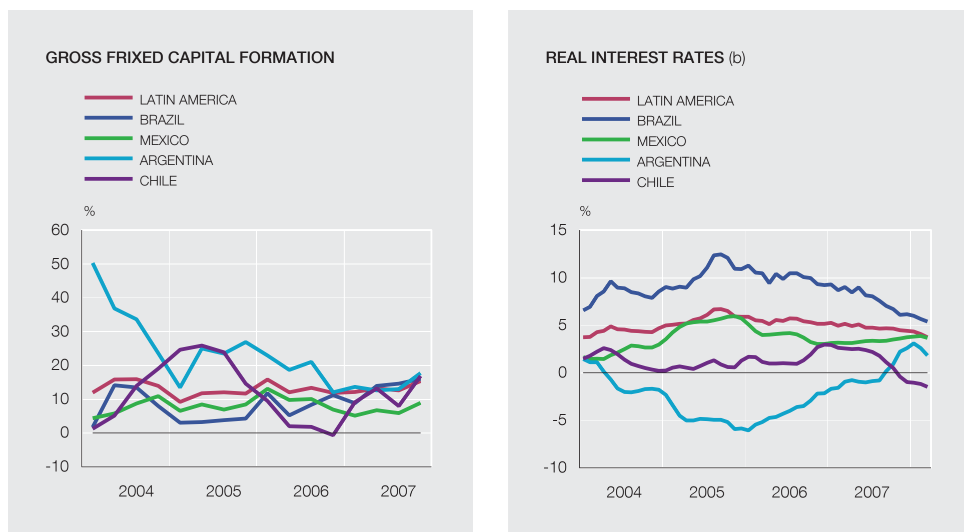
SOURCE: National statistics.

a. Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
b. Argentina, Brazil, Mexico, Chile and Peru.

GROSS FIXED CAPITAL FORMATION AND REAL INTEREST RATES

CHART 5

Year-on-year rate and level (%)



SOURCE: National statistics.

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

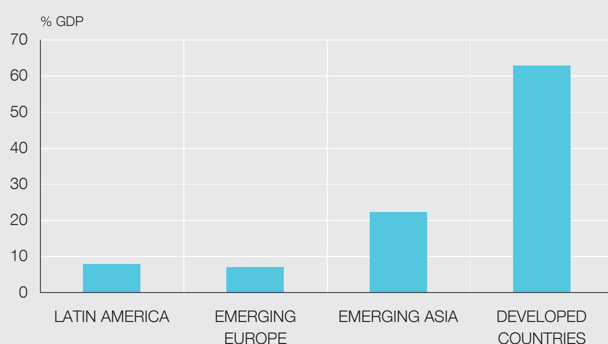
For housing finance to be viable and sustainable, it must offer returns to the lenders who participate in the market and must be adapted to the ability to pay of potential debtors over the life of the mortgage. These two objectives did not seem compatible in Latin America before the 1990s, so that the housing financing system in the region consisted essentially of State mortgage banks financed by compulsory savings funds arising from payroll taxes, compulsory contributions from the rest of the financial system, transfers from other public-sector entities and credit directed to housing finance. In addition, many governments of the region used subsidies to make mortgage credit more accessible to borrowers with fewer resources. These programmes were often administered inefficiently and regressively.

There is another set of reasons why housing finance has not developed sufficiently in Latin America in recent decades. First, macroeconomic and financial instability has prevented sufficient development of the long-term financial markets. In addition, as mortgage interest rates were officially determined (at a fixed, relatively low level), public-sector banks suffered a decline in their capacity to generate sufficient resources autonomously, sometimes without the possibility of recapitalisations given the fiscal restrictions on the governments. Second, inadequate regulation of property rights and creditors' rights (with legal protection favouring the debtor), as well as their interpretation by the courts, increased the cost of recovering collateral and hampered the enforcement of loan security. Finally, the unequal distribution of income and the high degree of labour market informality meant that potential house purchasers have not had or have not been able to demonstrate having sufficient income to be granted a loan.

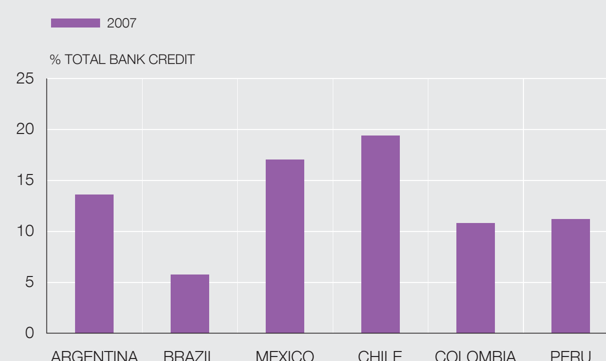
As a result, the volume of mortgage credit in Latin American countries has been much lower, relative to per-capita income, than in other regions (see panel 1). Moreover, as seen in panel 2, mortgage credit in most countries does not exceed 15% of total credit. The scant development of mortgage lending is highlighted by other indicators. Only one in four households in the region uses formal financing to acquire housing; most households build their homes informally and gradually over a period of five to 20 years, financing their construction using very different sources.

However, following the end of the economic and financial crises that beset almost all the countries of the region in the second half of the 1990s and in the early years of this decade, there has been a significant surge in credit in general, including mortgage credit. The key factors behind this surge include macroeconomic stability, the development of capital markets and the role of pension funds as suppliers of savings. In addition to these factors, other more structural, macr-

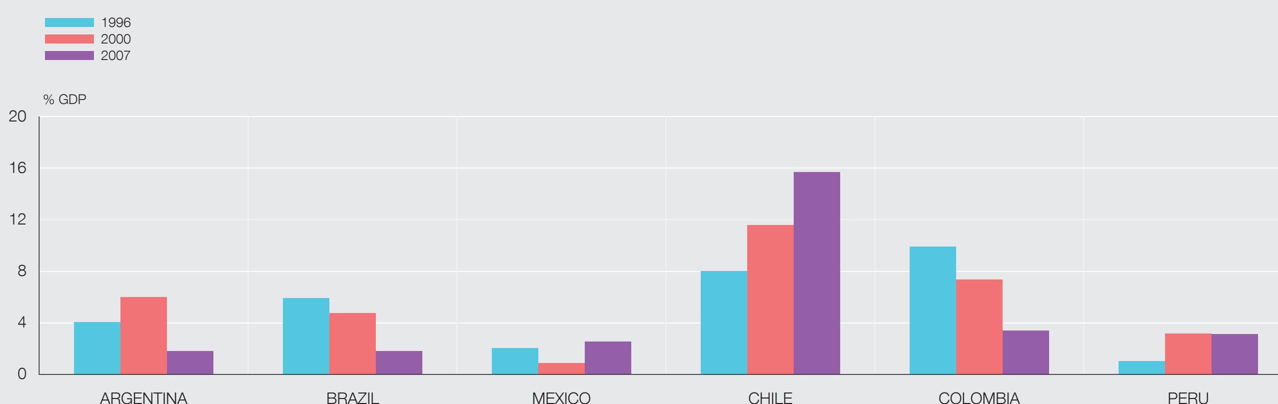
1 MORTGAGE CREDIT. INTERNATIONAL COMPARISON



2 MORTGAGE CREDIT



3 MORTGAGE CREDIT



SOURCES: Central banks and bank superintendence.

oeconomic-type factors have contributed, such as the liberalisation and privatisation of financial systems, the restructuring of financial institutions and the improvement in risk management, which are partly a consequence of the opening up of banking systems to foreign competition. At the same time, this development has also been assisted by the realisation that subsidy programmes should be transparent, progressive and conditional upon prior saving by the beneficiary households. As a consequence of all this, there has been a significant reduction in mortgage rates, an increase in loan maturities (to more than 25 years in some countries) and an increase in the availability of loans in local currency. However, given the region's past, inflation-indexed repayment arrangements are still very significant (Chile).

There are considerable differences in the degree of development of mortgage markets in the region. Countries that have had a sustained period of economic stability, such as Chile, have seen constant development of these markets and have higher mortgage-credit-to-GDP ratios than those that have suffered financial crises more recently (Colombia, Peru, Argentina), as seen in panel 3. However, these countries also have great possibilities for future development. Of great importance, in this respect, has been the lengthening in recent years of the government bond yield curve in some countries, since this is used as a benchmark for mortgage rates and, on the negative side, the persistence of distorting taxes, such as those on financial transactions, which are an obstacle to lending growth.

Finally, new types of mortgage lending have emerged in recent years in the region, such as loans against collateral consisting of remittances received (Mexico and Peru) and microcredit (aimed at the most disadvantaged sectors of the population, whose access to credit is severely restricted), and mortgage securitisation has begun to take off in some countries of the region, especially Mexico and Colombia.[1] However, this market is still very undeveloped in comparison with other emerging regions, such as Asia. The factors that explain why securitisation is not more developed in the region include the lack of depth in the capital markets, problems in the legal system and limited development of the investor base.[2]

1. A large part of the development of mortgage securitisation in Mexico since 2003 stems from the political drive that involved the setting up of a public institution (Sociedad Hipotecaria Federal, SHF), which acts as a partial guarantor of loan payments, while in Colombia development has been led by Titulizadora Colombiana, a private entity set up in 2001 by the Colombian mortgage industry and the International Finance Corporation of the World Bank. **2.** C. Tovar and M. Scatigna, "Securitization in Latin America", *BIS Quarterly Review*, September 2007, and J. Gyntelberg, J. E. Remolona and C. Tovar (2007), "Securitization in Asia and Latin America Compared", in L. Rob de Vries and P. Ali (eds.), Innovations in Securitization, Yearbook 2007, Kluwer Law international.

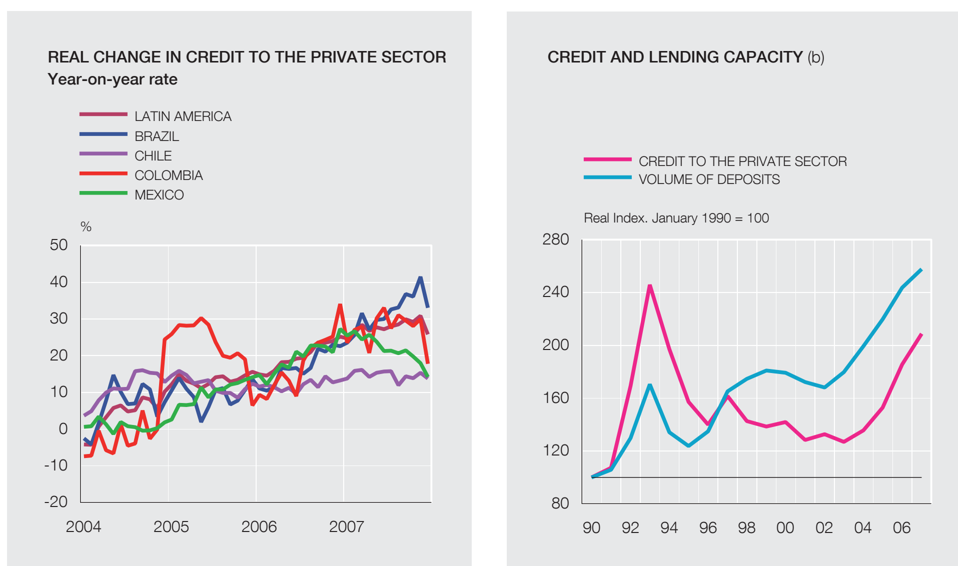
in the external balance. Both the buoyancy of domestic demand and the appreciation of exchange rates in effective terms, particularly in the cases of Brazil, Chile, Venezuela and Colombia (see Chart 7), explain the increase in imports in recent months, the recent trend in which opens up the possibility that the balance will reverse its sign in 2008 in a good number of countries. Capital inflows remained very robust in the second half of 2007, but the emergence of a current account deficit would mean that, in order to maintain the same growth rate, greater external financing would be needed; in a less favourable external environment, this need might set a limit on growth and even entail greater vulnerability in some economies.

FINANCIAL MARKETS AND EXTERNAL FINANCING

In the past six months, regional financial market developments have shown notable resilience in the face of the turbulence on international markets, especially in comparison with past crises. Indicative of this resilience were the improved credit ratings of Mexico, Chile and Peru, the continued access to international markets for sovereign and corporate issuers with the best credit ratings, and the favourable behaviour, in relative stock market terms, of exchange rates and sovereign spreads. However, as can be seen in Chart 8, the last six-month period saw a sizeable decline in the volume of issues from the exceptionally high levels in early 2007. This decline was initially interpreted as a temporary supply-side retraction, given the deterioration in financial market conditions. Yet the scale and duration of the drawback mean that consideration must be given to the possibility that demand has declined in recent months, especially for those issuers with the worst credit ratings, and that access to alternative sources of financing, such as bank credit, might, by contrast, be increasing. That said, private capital inflows reached an all-time high, in the course of the year, of $100 billion in net terms, and foreign direct investment flows, which are usually less procyclical, also stood at a high, or close to it, in countries such as Brazil, Colombia and Chile (see Chart 8). This favourable performance high-

CREDIT TO THE PRIVATE SECTOR
Year-on-year rate and real index

CHART 6



SOURCE: National statistics.

a. Seven main economies
b. Argentina, Brazil, Mexico and Chile.

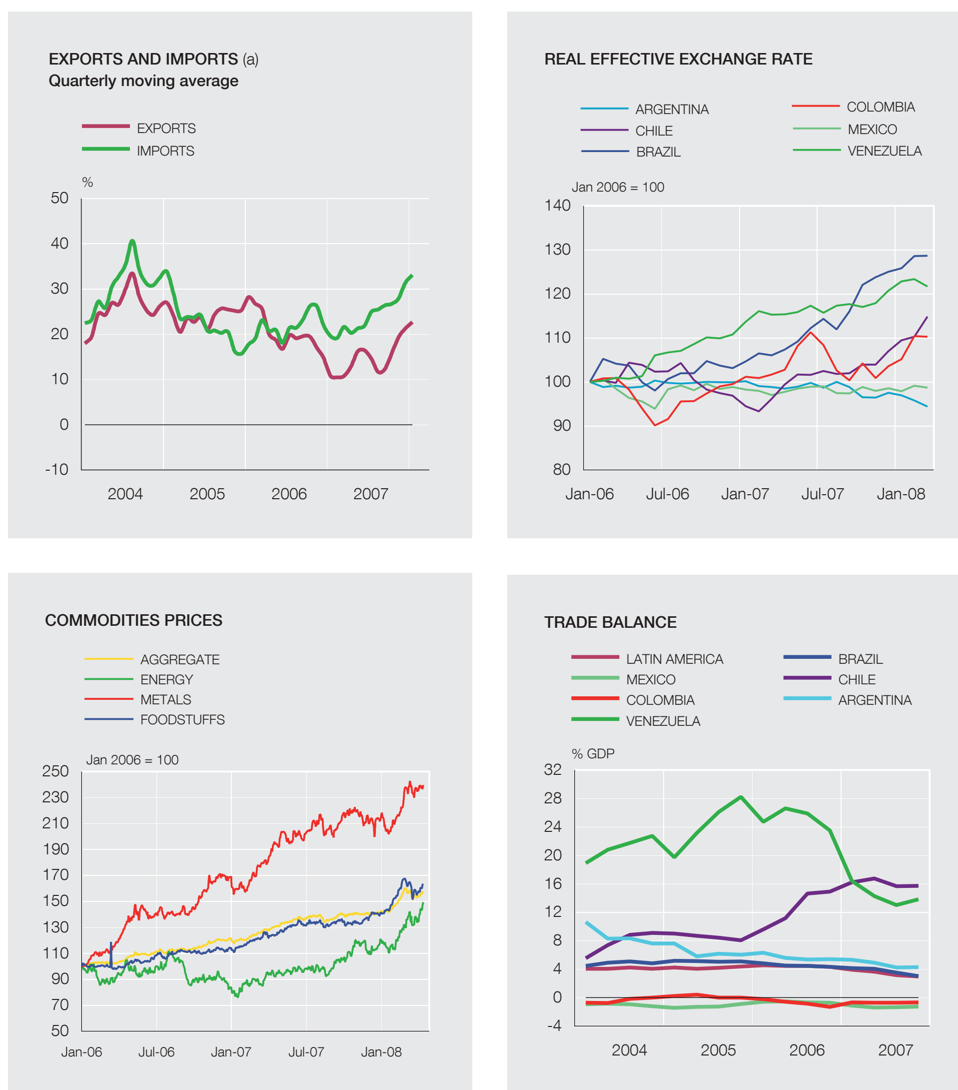
lights the reduction in vulnerabilities that has taken place in recent years (see Box 1). But it is also probably indicative of the absence of any relevant exposure of the Latin American financial systems to the US subprime mortgage market, either directly or through structured products, against the background of the incipient growth of the local mortgage securitisation markets (see Box 2).

Sovereign spreads tended to widen moderately as from November. The EMBI index for Latin America stood in mid-April at a level of 310 bp, about 100 bp above the end-September figure and at its highest since October 2005. Spreads on Argentine and Venezuelan credit default swaps[1] (premiums demanded to ensure protection against the credit risk of an issue) posted the biggest increases (up to 600 and 700 bp, respectively), which highlights notable risk discrimination compared with countries such as Chile and Mexico, where the spreads widened much less (see Chart 9). Stock markets performed relatively favourably during the second half of the year, underpinned by the perception of the attendant stocks being decoupled to a certain degree from the prevailing background of global turbulence, and by the strength shown by commodities prices. However, January marked a turning point in this trend, meaning that it is the Brazilian stock market that has posted the most positive result over the six-month period, followed by the Venezuelan bourse, which picked up strongly in April. Conversely, some stock markets underwent fairly sizeable cuts (5% in Chile and 15% in Peru), while the Argentine and Mexican stock exchanges ended the period without significant losses or gains. In any event, Latin America has been the only region in which stock markets have posted gains since the start of the turbulence.

1. Certain developments in recent years have tended to detract from the relevance of the habitual sovereign risk reference, the EMBI index. These include most notably the decline in the outstanding balance of external debt, the growing resource to local-currency financing (which by definition is not part of the EMBI) and the very composition of the EMBI index, which in some countries, such as Chile, has become biased towards quasi-sovereign issues, the spreads on which may move owing to considerations other than those strictly relating to sovereign risk. For example, in Chile bonds issued by the State copper company (CODELCO) account for 45% of its EMBI. This is why we include in the chart the reference to credit default swaps, which are not affected by these types of considerations.

EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rate, indices and percentage of GDP

CHART 7



SOURCES: National statistics and Banco de España.

a. Customs data in dollars.
b. Aggregate of the seven biggest economies.

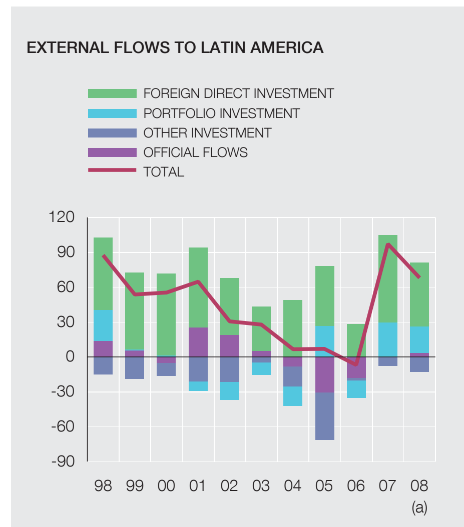
PRICES AND MACROECONOMIC POLICIES

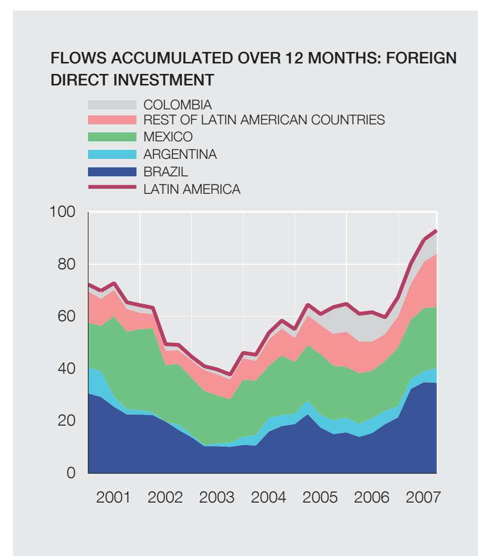
Inflation in the region rose from 5.3% in August 2007 to 6.4% in March 2008, meaning that the rising trend that began in the first half of 2007 intensified. The main driver here was the behaviour of food prices. Indeed, although several countries also experienced demand pressures pushing core inflation upwards[2] (to 6.5%), a portion of the rise in core inflation was due to the increase in unprocessed food prices. In all the countries, inflation, excluding all types of food (processed and unprocessed alike) and energy, posted a much smaller increase, and held at a relatively low and stable rate of around 4.5%. Yet it is interesting to note that for a good number of Latin American countries the rise in food prices is not only a negative supply-side shock that raises the prices of intermediate goods, but also a positive demand-side shock, owing to the improvement in the terms of trade it entails. In both these facets, the increase in food prices involves inflationary pressures.

2. The official measures of core inflation show some cross-country heterogeneity, and occasionally, therefore, they are not directly comparable.

EXTERNAL CAPITAL FLOWS
$US bn

CHART 8





SOURCES: JP Morgan IMF and national statistics.

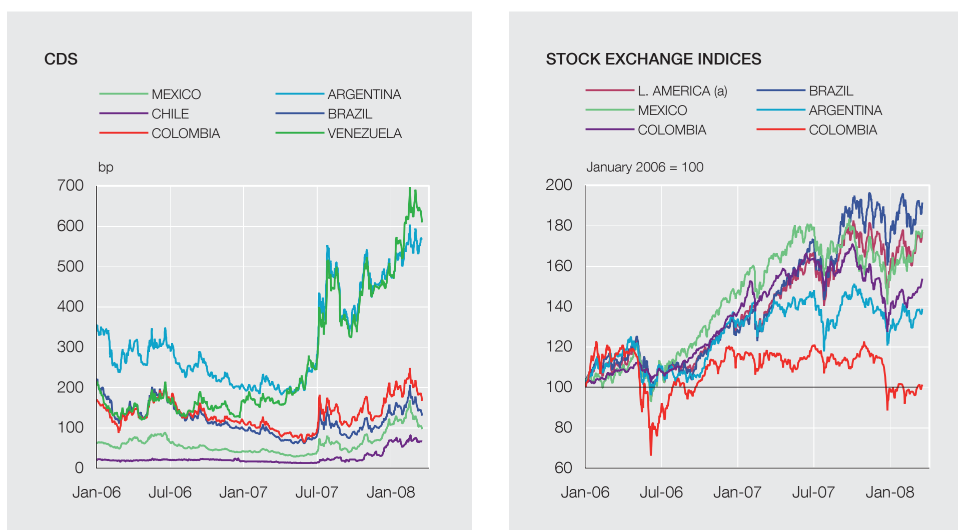
Country by country, the highest inflation rates were recorded, as in previous periods, in Argentina and Venezuela, though prices were also on a particularly marked rising trend in Chile, Peru and Colombia. Brazil and Mexico were at the opposite end of the scale and, as they are the countries with the most economic weight, they skewed the weighted regional average downwards.

The adverse inflationary performance is hampering the task of central banks. In fact, inflation stood at end-2007 outside the respective central bank targets (except in Brazil and Mexico), and its recent behaviour might once again compromise the inflation objectives for 2008. Generally, this performance might be said to have exerted a relatively moderate influence on inflation expectations, which may be positively assessed as a sign of central bank credibility (see Box 3). However, an increase in expectations has been discernible in recent months, which is a cause for concern.

The central banks of Chile, Colombia, Mexico and Peru raised their official interest rates moderately, while the Brazilian central bank held its interest rates unchanged from October, but

CDS AND STOCK MARKETS
Basis points and indices

CHART 9

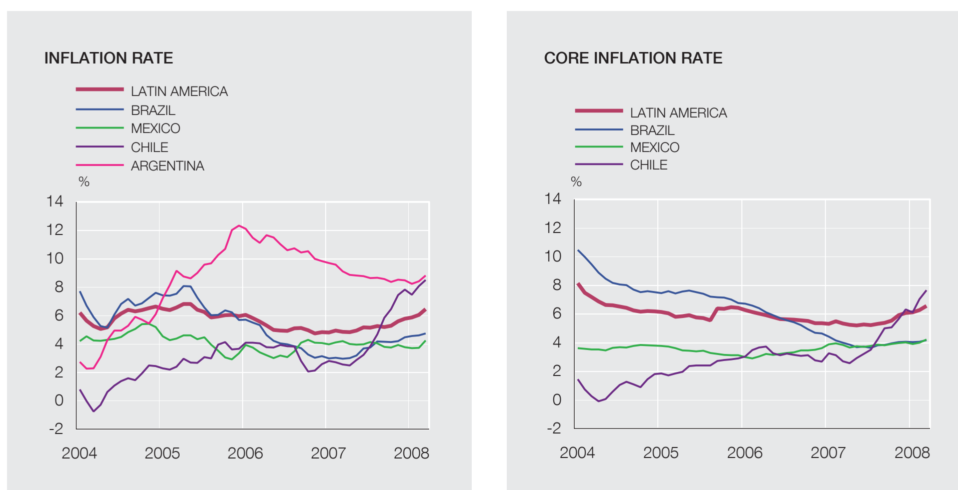


SOURCE: Datastream

a. MSCI Latin America Index, in local currency.

INFLATION
Year-on-year rate

CHART 10



SOURCE: National statistics.

raised its reference rate in April by 50 bp. These monetary policy decisions have come about against the background of growing downside risks to the international economic picture. That is a notable development, especially when compared with bouts of financial instability in the past, when official interest rate movements were subordinated by the need to avoid financial outflows and to stabilise the exchange rate.

During this episode, monetary policy conduct has also been influenced by the external environment, albeit in a different way. In 2008 Q1 in particular, there has been a notable widening of interest rate spreads vis-à-vis the dollar, mainly as a result of the official interest rate cuts in the United States, which has contributed to the appreciation of the currencies of countries

INFLATION TARGETS IN LATIN AMERICA: EVALUATION OF THEIR EFFECTIVENESS USING AN EMPIRICAL MODEL[1]

Price stability is a fundamental goal of economic policy, and has become a priority in Latin America in recent years. Monetary policies based on explicit inflation targets (ITs) have become increasingly widespread, both in the region and globally: in 2005, 21 countries had adopted inflation targets, of which 13 were emerging countries and 5 in Latin America [see IMF (2005)], but the number continues to rise gradually. This type of monetary policy mechanism was adopted early in Latin America, Chile being the second country in the world (after New Zealand) to adopt an IT in September 1990, although it was not until 1999 that an explicit IT was set. Following this pioneering experience, Colombia and Brazil adopted explicit ITs in 1999. In the case of Mexico, in the wake of the 1995 financial crisis, the Bank of Mexico began to publish its IT in 1999, although it was not until 2001 that the central bank announced the formal adoption of this monetary policy mechanism. Peru, the only highly dollarised economy of the five, started to adopt explicit ITs in 2002, and other countries of the region have adopted explicit ITs very recently (Guatemala and Costa Rica) or are in the process of incorporating such mechanisms (Paraguay).

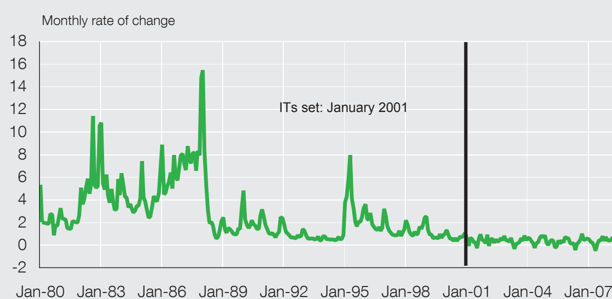
IT regimes are usually associated with greater monetary policy credibility, which is conducive to the anchoring of expectations and, ultimately, a reduction in the level and volatility of inflation. However, although the literature on ITs is very extensive, the empirical evidence (both for developed and emerging countries) is not entirely conclusive. On one hand, some authors have used diverse methodologies to confirm the usefulness of ITs in reducing the level and volatility of inflation; inter alia the IMF (2005) and Vega and Winkelried (2005). On the other hand, some authors, such as Ball and Sheridan (2003) conclude that the effect of introducing ITs is not significant, since the reduction in inflation and in its volatility has been a global phenomenon.

In the case of Latin America, the analysis of inflation and of the policies to reduce it is particularly important. During most of the past century this region experienced periods of high and volatile inflation (above two digits in some cases), along with periods of economic and financial crisis. Over the last five years, however, substantial progress has been made in reducing inflation, amid the adoption of IT strategies by numerous countries, under difficult circumstances (financial instability, strong downward exchange-rate movements and the abandonment of rigid exchange-rate regimes, which have served as nominal anchors for many Latin American countries in recent decades).

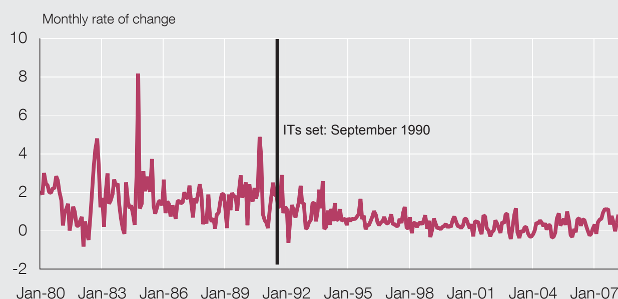
Nonetheless, this reduction was experienced in most Latin American countries, irrespective of the adoption of ITs. The adjoining table illustrates the decline in the means and standard deviations of month-

1. Based on C. Broto, (2008), *Inflation targets in Latin America. Empirical analysis using GARCH models*, a forthcoming Banco de España Working Paper.

1 MEXICO



2 CHILE



		Countries with ITs (a)					Countries without ITs		
		Brazil	Chile	Colombia	Mexico	Peru	Argentina	Ecuador	Uruguay
Since 1990	Average (b)	6.46	0.58	1.11	0.98	2.96	1.70	4.30	1.89
	SD (c)	12.10	0.69	0.91	0.99	12.98	6.20	33.69	2.05
Since 2000	Average	0.56	0.28	0.52	0.40	0.19	0.74	1.15	0.71
	SD	0.47	0.39	0.47	0.32	0.33	1.28	2.21	0.87
	Date IT adopted	06/1999	09/1990	09/1999	01/2001	02/1994			
Period before IT	Average	11.98	1.68	1.63	1.39	11.96			
	SD	14.87	0.69	0.89	1.06	24.22			
Period after IT	Average	0.57	0.54	0.52	0.35	0.40			
	SD	0.47	0.66	0.47	0.31	0.48			

SOURCES: International Monetary Fund (WEO 2005) and Vega and Winkelried (2005).

a. IT = inflation target
b. Non-seasonally adjusted monthly inflation rates.
c. SD = standard deviation.
d. For consistency with the literature, in Chile and Peru the date of adoption of the IT is taken and not the date of adoption of the explicit IT.

ly inflation rates in recent years in all the selected countries. By way of example, panels 1 and 2 show the course of monthly inflation rates during recent years for the two countries that have adopted ITs (Chile and Mexico).

To evaluate the effectiveness of the implementation of ITs in Latin America a regression analysis has been performed, using a generalisation of the model proposed by Broto and Ruiz (2006). This GARCH-type model takes into consideration the variation of volatility over time and enables possible structural changes in the level and in the volatility of the series to be incorporated, so that the effect of the adoption of ITs in these countries can be quantified. This specification has a number of advantages for inflation analysis: (i) it captures the short and long-term dynamics of the inflation rate; (ii) it identifies the dynamics of its volatility, so that a rigorous evaluation can be made as to whether adoption of ITs has given rise to changes in inflation volatility and in its persistence, and (iii) it enables the relationship between the volatility and level of the inflation rate and, in particular, the question of whether volatility responds symmetrically to shocks with different signs to be analysed.

The proposed model is adjusted to the inflation series of the five Latin American countries that have already adopted ITs, as well as to Argentina, Ecuador and Uruguay. The model is estimated for the complete inflation series[2] and (in the case of the five countries with ITs) it is also estimated for the period prior to the adoption of ITs, the subsequent period and, finally, to quantify the changeover to IT arrangements, a dummy variable has been incorporated into the estimation of both inflation and its volatility.

The conclusions of the empirical study of the impact of the adoption of ITs are as follows: (i) a reduction in the level of inflation is clearly identified in Chile, Colombia and Mexico, while in Brazil and Peru the result is not statistically significant (in the former case, owing to the effect of the 2002 crisis) (ii) there was a significant reduction in the persistence of volatility in all the countries except Colombia (where the statistical evidence is not conclusive). In the three countries that have not adopted ITs the persistence of volatility is greater, despite the decline in the level of inflation in recent years, and (iii) the reduction in inflation seems to have contributed to the entrenchment of low volatility in most of these countries. In short, the results obtained would support the usefulness of adopting ITs not only to anchor inflation levels, but also lower volatility.

2. The estimation procedure is pseudo maximum likelihood. The estimators are obtained after maximising the likelihood obtained using the relevant Kalman filter.

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BROTO, C., and E. RUIZ (2006), "Unobserved component models with asymmetric conditional variances", *Computational Statistics and Data Analysis*, 50, pp 2146-2166.

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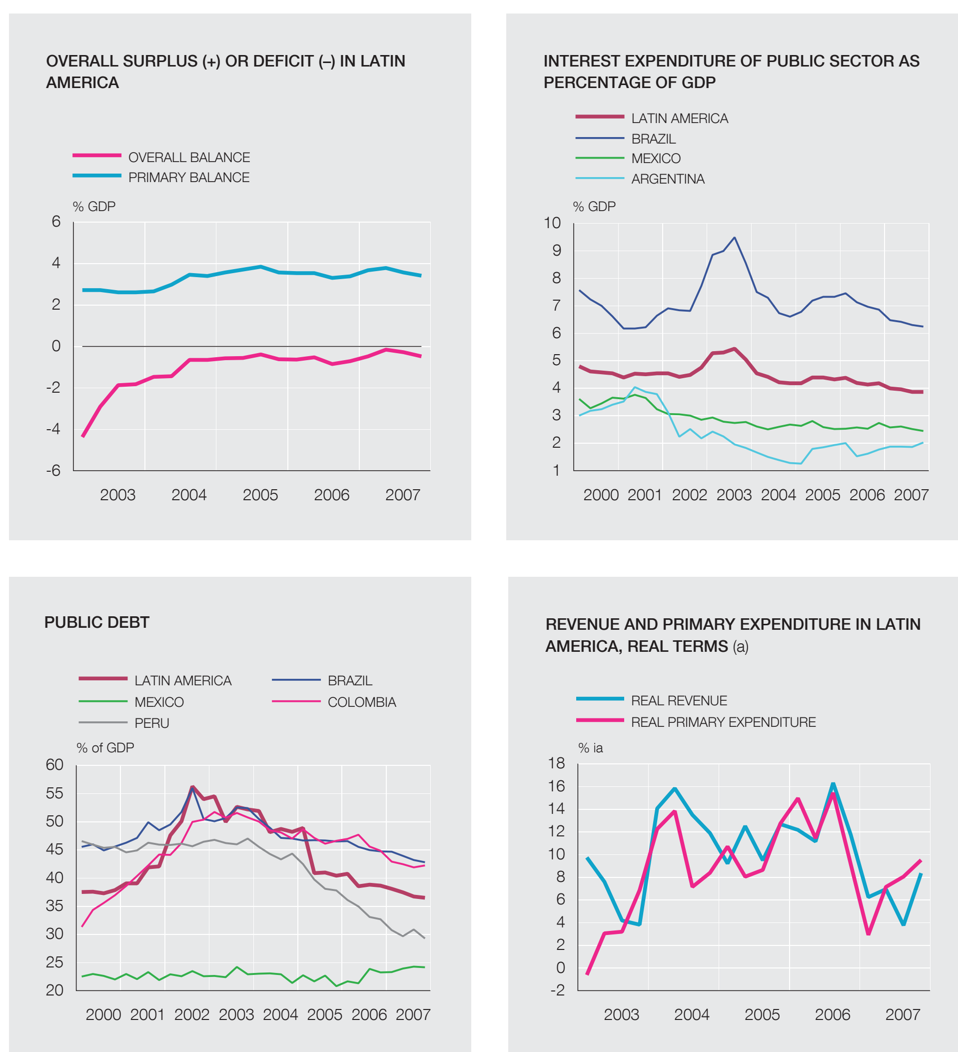
VEGA, M., and D. WINKELRIED (2005), "Inflation targeting and inflation behaviour: A successful story?", *International Journal of Central Banking*, vol. 1, 3, pp 153-175.

such as Brazil, Colombia, Peru and Chile. The scale of the appreciation has been insufficient to contain the rise in inflation. And that has generated a dilemma for the monetary authorities, between the need to make more aggressive interest rate rises and the potential rising pressures on their currencies that would ensue, against a background of concern over the risk of losses in external competitiveness.

The response to this dilemma has differed from country to country. On occasions, monetary tightening measures complementing the interest rate rises have been tried, such as raising reserve requirements (Peru and, to a lesser extent, Brazil). Attempts have been made elsewhere to check inflation through measures outside the monetary sphere, such as setting relatively widespread price controls (Argentina and Venezuela), or controls confined to certain products (Mexico). Other, less heterodox measures have included the lowering of import tariffs in Peru, or implicit energy price subsidies in Chile. Likewise, measures have been implemented to pre-empt appreciation, including most notably the reactivation of international reserves purchases by various central banks (Including Chile). In other cases, the authorities have adopted measures aimed at reducing the demand for local currency, by promoting exports and eliminating exemptions on specific financial assets (Brazil), or have amended legislation, as in the case of pension fund managers in Peru and in Chile. Finally, a plan was designed in Chile to try and compensate those in the export sector adversely affected by the appreciation of the currency.

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

CHART 11



SOURCE: National statistics.

a. Deflated by CPI.

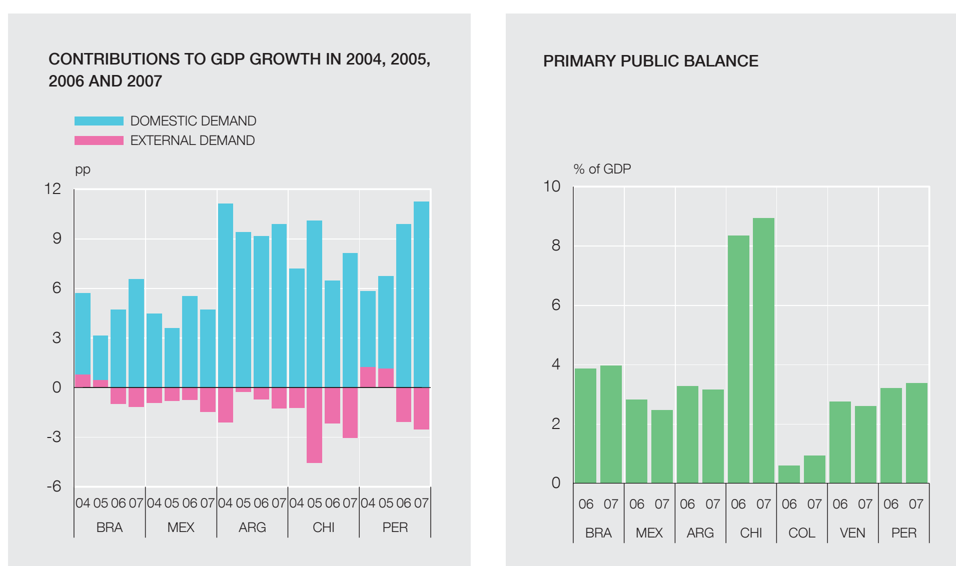
In the fiscal arena, the primary surplus held very high at 3.4% of GDP, a similar level to that in 2006, while the overall budget balance remained moderately in deficit at around 0.5% of GDP. In any event, one of the main features of the six-month period was the favourable behaviour of revenue, across the region, boosted by cyclical growth and the positive contribution of commodities prices. However, in a good number of countries the fiscal balances worsened slightly relative to 2006 (see Chart 11), given that the increase in spending exceeded that in revenue. Should this trend continue, it might be a cause for concern (with exceptions such as Chile) in the event of a greater economic slowdown. In Argentina there was some worsening in public finances owing to the electoral cycle, despite the increase in revenue resulting from the higher taxation on certain exportable goods. Chile ran a central government surplus equivalent to 8.7% of GDP, although in the second half of the year the surplus eased off owing to the decline in revenue, partly due to lower copper production, which reduced exports and the associated revenue.

TRADE INTEGRATION AND STRUCTURAL POLICIES

In the second half of 2007 and the opening months of 2008, there were no major changes in recent trade integration trends in relation to recent years. The South American trade blocks set

CONTRIBUTIONS TO GDP GROWTH AND PRIMARY SURPLUS
Percentage points and % of GDP

CHART 12



SOURCE: National statistics.

up in the 90s remained in a situation of stagnation, while bilateral trade agreements continue to prosper and proliferate. In this respect, in MERCOSUR, the European Union's consideration of Brazil as a "strategic partner", on a standing with the United States, Japan and India, might undermine to some extent the continuity of the customs union in its current form. Chile rejoined the Andean Community, and Brazil and Argentina contributed capital to the financial arm of the agreement, the CAF (Andean Development Corporation). Further, the free trade treaties between Peru and Panama with the United States were approved. Running counter to this, the US Congress suspended the vote on the free-trade treaty signed by the United States and Colombia, which may in practice postpone its approval indefinitely. However, the United States extended to late 2008 its preferential tariff agreements for Colombia, Ecuador and Bolivia, the latter two countries having no intention of negotiating trade agreements. Finally, on 1 January agricultural imports were fully liberalised under the North American Free Trade Agreement, the consequences of which for the agricultural sector in Mexico have yet to become clear.

There has been no major headway either in the past six months in structural reform. Nonetheless, three initiatives stand out: the reform of the pension system in Chile; the presentation in Brazil of a proposed tax reform; and the proposed reform of the energy sector in Mexico. The first initiative is the biggest change to the funded pension system since it was created in 1980, as it ensures a minimum non-contributory pension and encourages greater market competition. In the opposite direction, Venezuela took further steps in nationalising the oil sector, although it encountered legal problems stemming from claims from a US company which have not yet been resolved. The proposed reform of the Constitution, which would increase State intervention in the economy, was rejected in a referendum in early December.

Developments in the main countries

In *Brazil*, GDP accelerated significantly during the year, posting year-on-year growth rates of 5.6% and 6.2% in Q3 and Q4, compared with 3.7% in 2006. This acceleration was due to the greater dynamism of domestic demand, driven by private consumption (which grew notably by 8.6% in Q4) and by investment, while government consumption slowed. The contribution of external demand turned more negative in the second half of the year, subtracting 1.1 pp from growth in 2007 (see Chart 12). In the external sector, there was a rapid reduction in the trade

and current account surplus during the second half of the year. That placed the cumulative balance over the past 12 months in deficit in early 2008. Factors underlying this deterioration have been the strong increase in imports, driven by the strength of domestic demand and by the exchange rate (which has continued to appreciate). Financial inflows and purchases of reserves held up in the second half of 2007 and in the first two months of 2008, albeit at more moderate levels. The inflation rate increased from 4.2% in August to 4.5% in December, driven mainly by food prices, but also by demand pressures. Subsequently, inflation held constant at around 4.5%, in a setting in which the central bank held interest rates at 11.25% as from October, although it revealed an increasingly restrictive bias in its inflation report and in the published minutes of the monetary policy committee which culminated in a rise in rates in April. As regards fiscal policy, the budget targets were met for 2007 as a whole (a primary surplus of 4% of GDP, see Chart 12) and there was a series of changes in the tax system, such as the rise in the tax on credit, as a means of partially offsetting the non-approval of the tax on financial transactions, which generated an increase in the cost of credit. The most notable initiative was the presentation, in late February, of an ambitious draft tax reform, aimed at reducing the complexity of the system, improving its fairness and doing away with competition among regional government tax regimes. The main measures are the simplification of the federal indirect tax system, the re-design of the ICMS (the widest ranging State tax, essentially levied on commercial transactions), and the reduction of the tax burden, particularly on salaried income. The proposal is a very ambitious one that merits a favourable assessment, though there are doubts over its viability.

In *Mexico*, GDP also quickened in the second half of 2007, growing by 3.7% and 3.8% year-on-year in Q3 and Q4, respectively, compared with 2.9% in Q2. The acceleration came about despite the deterioration in the economic situation in the United States, Mexico's main trading partner and the destination of Mexican emigration, highlighting significant differences in relation to other past cycles. Firstly, the weight of domestic demand has increased, underpinned by macroeconomic stability, the greater supply of credit, and the dynamism of the services and house-building sectors. Secondly, a portion of Mexican exports to the United States are intermediate goods used in turn in the production of US exports to the rest of the world and, since the weak dollar has boosted US sales abroad, that may explain the greater strength of Mexican foreign trade in the second half of the year. Further, the US industrial production cycle, to which Mexico is most closely correlated, has not slowed down at the same rate as the rest of the economy. Thirdly, there is room to apply counter-cyclical measures, both on the monetary side (although here the concern over inflation developments has not dissipated) and, above all, on the fiscal front (the oil surpluses allow the momentum of public investment to be maintained and the primary surplus is holding at 2.4% of GDP, see Chart 12). In this respect, the government presented a series of measures in early 2008 to address the foreseeable slowdown in activity: cuts in certain taxes, the elimination of import restrictions, higher PEMEX spending, the financing of small companies through official institutions, and the reduction of electricity charges to companies. Another differential factor (this time of a negative nature) compared with previous slowdowns in the US economy, is the reduction in the remittances of Mexican immigrants in the United States, especially those previously employed in the construction sector, the effect of which on consumption may prove not to be negligible. Inflation dynamics were somewhat more benign than in other countries in the region, as inflation eased to 3.7% in February 2008, following the application of certain measures in respect of import quotas and price controls on specific products; however, in March inflation once again rose above 4%, the upper boundary of the target band. The central bank raised interest rates by 25 bp, in a move considered as pre-emptive and aimed at increasing the central bank's inflation-fighting credibility and at preventing contagion to inflation expectations.

In *Argentina*, the growth rate in 2007 (8.7%) stood above 8.5% for the fifth year running. Moreover, activity progressively quickened during the year, reaching a growth rate of 9.1% in Q4. Behind this dynamism was the increase in domestic demand, due essentially to the greater strength of private consumption. Conversely, the dynamism of the investment slackened in relation to 2006 (it increased by 14.4% in 2007, compared with 18.2% in 2006), although for the year as a whole the investment/GDP ratio stood at 22.7%, thereby regaining the highest figures since convertibility, and with a positive change towards a greater weight of investment in capital goods. The contribution of the external sector progressively deteriorated, subtracting 1.2 pp from GDP growth (see Chart 12), mainly as a result of the strong growth of imports. From the supply standpoint, there was a significant turnaround in 2007 as the services producing sectors outgrew the goods producing sectors for the first time since 2002. The higher frequency indicators currently available show that the strength of activity has held up in early 2008. Part of the economy's high growth can be attributed, for yet another year, to the improvement in the terms of trade which, in addition to contributing to sustaining the strong expansion in domestic demand, provided for greater fiscal solvency. The primary surplus stood at 3.1% in 2007, although it is biased upwards by the recording of transfers from pension fund management companies, following their reform in May 2007, as current revenue. Recently, export withholdings have increased. The comfortable current account balance position is also notable. Nonetheless, the dependence on the terms of trade is one of the chief vulnerabilities of the Argentine economy. To increase the economy's growth potential, which is notably lower than the growth recorded in recent years, it would appear essential to pursue a diversification drive, to overcome the constraints of the energy sector (which became patent at certain times in 2007) and to raise FDI, which stood at 2.4% of GDP in 2007, far below the levels attained during the years of convertibility and of those posted by other countries in the region. Official inflation held at over 8% (8.5% in March), although this figure probably underestimates actual inflation considerably. Furthermore, unlike in other countries, the official increase in food prices has remained relatively contained, but this is also the outcome of multiple price controls, and of the application of export restrictions and of cross-subsidies.

In *Chile*, GDP slowed significantly in the second half of 2007, standing at year-on-year rates of 3.9% and 4% in Q3 and Q4, respectively, down from 6.2% in the first half of 2007. This lower growth may be attributed to the growing negative contribution of external demand (–5.1 pp in Q4, see Chart 12), since domestic demand quickened to the extent of contributing 9.1 pp to growth. Behind the increase in domestic demand is the greater dynamism of investment (which, in terms of GDP, stood at a historical high, following the strong deceleration in 2006), since private consumption, though it remained strong, slowed slightly. This external demand drag can be explained by both the reduction in exports (due to the effect of the reduction in copper exports, owing to energy problems and the deterioration of mine quality, and to lower industrial goods exports, owing to energy and currency appreciation problems) and the increase in imports. The high price of copper has enabled the government to save more than 15 points of GDP in the past three years, using the mechanism of the structural surplus rule, which provides ample room to undertake counter-cyclical policies, and to keep the trade surplus close to 15% of GDP over the past two years. In both public finances and in the trade balance, the situation has been turning somewhat less positive in recent months. Conversely, the FDI/GDP ratio stood at 8.5% during 2007. Inflation climbed from 4.7% in August to 8.5% in March, accelerating the trend initiated in 2007 Q1 when it was at around 2%. This strong rise may have a significant cyclical component, but it is a challenge for the central bank, which raised interest rates by 25 bp on two occasions, placing the official rate at 6.25%. To alleviate the rising pressures associated with high interest rate levels, interventions have been made on the foreign exchange markets.

The pace of activity remained strong in *Colombia* in the second half of the year, with year-on-year growth of 6.8% and 8.2% in Q3 and Q4. This growth was boosted by domestic demand and, in particular, by investment, and government consumption could be seen to quicken. Inflation trended unfavourably, gradually rising from 5% in September to 6.3% in February, although it eased off in March (5.8%). Against this background, the central bank raised interest rates on two occasions, by 25 bp in each instance, taking them to 9.75%, while the Colombian peso continued appreciating notably. The current account deficit fell in the second half of the year, but widened by more than 1 pp on 2006, standing at 3.6% of GDP. The deficit was more than covered with long-term financial inflows, though there were net financial outflows in the short term, in clear contrast to the previous six-month period. The primary surplus held at around 1% (see Chart 12).

In *Peru*, activity was very buoyant in the second half of the year, and even quickened in Q4, up to a year-on-year growth rate of 9.7%. Surprisingly, domestic demand continued on an upward course (see Chart 12), owing especially to the highly favourable performance of investment. Inflation, after having eased notably during the first six months, posted a significant increase to 5.5% in March. In order to tackle the rise in inflation, the government reduced the tariffs on certain imports, and the central bank increased the official interest rate by 50 bp to 5.5%, and raised the reserve requirement. The intensification of rising pressures on the Peruvian sol in recent months, and especially from early 2008, led the central bank to intervene on the markets. The primary surplus held at above 3% of GDP.

Growth in Venezuela stood at around 8.5% in the second half of the year, a high rate but clearly down on 2005 and 2006. On the supply side, the oil sector, although it posted negative rates throughout 2007, performed better in the second period, while under non-oil activity, construction slowed and manufacturing accelerated. The contribution of domestic demand to GDP growth was below 25 pp and the negative contribution of external demand was around 15 pp, owing to the strong growth of imports and the year-on-year decline in real exports. These developments continued to show the extreme dependence of the growth model on oil prices. Inflation increased notably, standing in February at a year-on-year rate of over 26%. The most favourable feature in the period was, unlike in previous years, the moderation of public spending, which fell in real terms and which, therefore, accompanied the sluggishness of revenue, where the dependence on oil revenue once again increased. The primary surplus stood at 2.6% of GDP.

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