REPORT ON THE LATIN AMERICAN ECONOMY. FIRST HALF OF 2010

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Introduction

The Latin American economies are facing the first half of 2010 in a climate of firming economic recovery, after the region witnessed the biggest decline in activity of the past 30 years (–2.1%) in 2009. Despite this fall, there is a generalised view that the impact of the global financial crisis on Latin America has been comparatively limited, especially bearing in mind the propensity of the area to crises and the depth of such crises in the past. Further, the decline is largely due to the intensity of the recession in Mexico (–6.5%) and, to a lesser extent, in Venezuela (–3.3%), which biases the region's aggregate figure downwards. The fall in activity in Brazil and Chile was relatively slight, and in the remaining economies (Argentina, Colombia, Peru and Uruguay) GDP did not actually decline (see Table 1).

During 2009, Latin America underwent a progressive recovery, resuming a positive year-on-year growth rate of 1.3% in Q4, more than 5 pp up on the low recorded in Q2, although in quarter-on-quarter terms, positive growth could be seen from this quarter onwards. Underpinning this pick-up were two pillars. First, external demand-pull, stemming from the Asian economies, which has essentially benefited the commodities-exporting countries of South America and which has been added to in recent months by something of a recovery in other markets (such as the United States). And further, the progressive recovery in internal demand. This was based on the expansionary effect of the policies applied during the crisis, which continued operating throughout 2009, but also on the sound behaviour of labour markets, the inventory cycle and improved confidence. In line with this support, the latest data confirm a relatively swift recovery in a large number of countries (Brazil, Chile, Peru and also Mexico), while only Venezuela is expected to remain in recession. Undoubtedly, the fact that the global financial crisis has not translated into a financial crisis in the region is a key factor behind this recovery.

In step with these developments, the outlook for 2010 has been revised upwards in almost all the countries. Indeed, economic performance is expected to be more favourable than in the developed countries, though not as positive as in the Asian economies. However, it should be said that the crisis has entailed a significant loss in output in some countries (see Chart 1). The sound economic outlook, along with the continuing positive interest rate spreads vis-à-vis the developed economies, have allowed for the return of capital flows and a generalised improvement in financing conditions, accompanied by the reactivation of reserves-building (reserves are already above previous levels) and, in some cases, the restoring of capital controls. In contrast to this general picture, some factors of vulnerability remain. Cases in point are the substantial devaluation of the Venezuelan bolivar in January, against a persistent recessionary background, and the circumstances surrounding the use of international currency reserves for the payment of external debt in Argentina.

Inflation in the region has tended to rise moderately since the start of 2010, posting a year-on-year rate of 6.5% in March, following a year of continuous declines towards a rate close to 5%. The increase was due in part to base effects, to the pick-up in energy and food prices (affected in some countries by specific weather-related factors), and to the one-off effect of rises in indirect taxes and administered prices. Upside risks are also discernible in some countries, in a setting of more dynamic growth.

In the short run, the recovery phase poses two types of challenges for the region's economic authorities. The first concerns the design of an appropriate exit from the measures applied during the crisis and the re-adaptation of economic policy frameworks to a more normal envi-

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

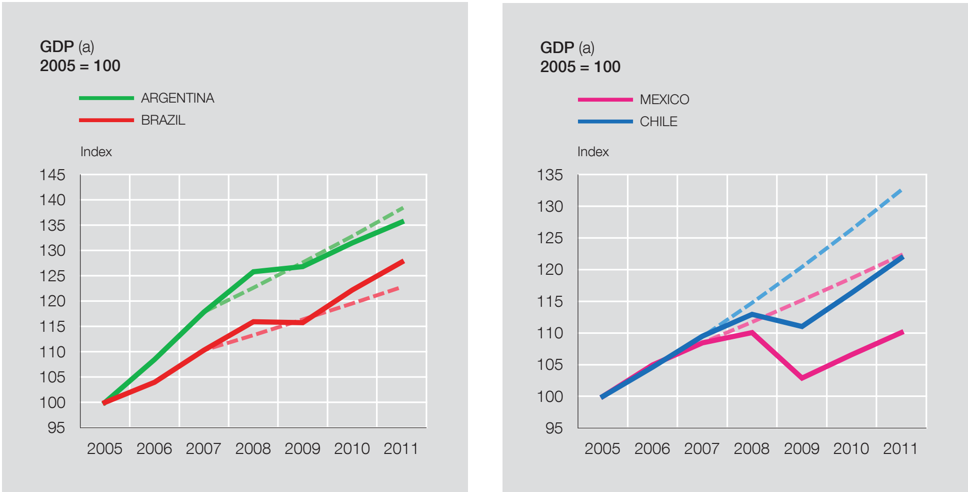
	2007	2008	2009	2008				2009				2010
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate)												
Latin America (a)	5.8	4.2	-2.1	5.3	5.6	5.0	0.8	-2.8	-4.0	-2.6	1.3	
Argentina	8.7	6.8	0.9	8.5	7.8	6.9	4.1	2.0	-0.8	-0.3	2.6	
Brazil	6.1	5.1	-0.2	6.3	6.5	7.1	0.8	-2.1	-1.6	-1.2	4.3	
Mexico	3.3	1.5	-6.5	2.6	3.0	1.6	-1.1	-7.9	-10.0	-6.1	-2.3	
Chile	4.6	3.7	-1.5	3.7	5.1	5.2	0.7	-2.1	-4.5	-1.4	2.1	
Colombia	7.5	2.4	0.4	4.2	3.7	2.9	-1.0	-0.5	-0.3	-0.2	2.5	
Venezuela	8.1	4.8	-3.3	4.9	7.2	3.8	3.5	0.5	-2.6	-4.6	-5.8	
Peru	8.9	9.8	0.9	10.3	11.8	10.9	6.5	1.9	-1.2	-0.6	3.4	
Uruguay	7.2	8.7	2.7	7.6	10.2	9.4	7.6	2.8	0.9	2.6	4.3	
CPI (year-on-year rate)												
Latin America (a)	5.4	7.8	6.4	6.6	7.7	8.5	8.5	7.6	6.7	5.9	5.4	6.5
Argentina	8.8	8.6	6.3	8.5	9.1	8.9	7.8	6.6	5.5	5.9	7.1	9.7
Brazil	3.6	5.7	4.9	4.6	5.6	6.3	6.2	5.8	5.2	4.4	4.2	5.2
Mexico	4.0	5.1	5.3	3.9	4.9	5.5	6.2	6.2	6.0	5.1	4.0	5.0
Chile	4.4	8.7	0.4	8.0	8.9	9.3	8.6	4.8	1.8	-1.9	-3.0	0.3
Colombia	5.5	7.0	4.2	6.1	6.4	7.7	7.8	6.6	4.8	3.2	2.4	1.8
Venezuela	18.8	31.4	28.6	26.3	31.0	34.6	33.4	29.5	28.2	28.7	28.1	28.2
Peru	1.8	5.8	2.9	4.8	5.5	6.1	6.6	5.6	4.0	1.9	0.4	0.8
Uruguay	8.1	7.9	7.1	7.7	7.6	7.6	8.6	8.2	6.7	7.1	6.3	7.1
BUDGET BALANCE (% of GDP)												
Latin America (a) (c)	-0.3	-0.5	-2.7	0.0	-0.3	-0.2	-0.5	-1.5	-2.1	-3.0	-2.7	
Argentina	1.1	1.4	-0.6	1.5	1.6	1.9	1.4	1.0	0.0	-1.0	-0.6	
Brazil	-2.6	-2.0	-3.2	-1.6	-2.2	-1.8	-2.0	-2.8	-3.1	-4.1	-3.2	
Mexico	0.0	-0.1	-2.3	0.0	-0.3	0.0	-0.1	-1.4	-1.7	-2.4	-2.3	
Chile	8.6	5.0	-4.6	9.2	7.2	6.1	5.0	1.3	-1.5	-3.9	-4.6	
Colombia	-2.8	-1.8	-4.0	-2.1	-2.5	-2.3	-1.8	-2.8	-3.0	-3.3	-4.0	
Venezuela	3.0	-1.2	—	3.4	1.7	0.9	-1.2	-2.2	—	—	—	
Peru	1.8	2.2	-2.0	2.3	3.1	2.1	2.2	1.3	-0.1	-0.8	-2.0	
Uruguay	0.0	-1.5	-1.7	1.0	-0.3	-1.0	-1.5	-2.1	-2.2	-2.2	-1.7	
PUBLIC DEBT (% of GDP)												
Latin America (a)	33.8	30.8	35.8	31.7	31.6	30.4	30.8	31.2	32.8	35.5	35.8	
Argentina	52.6	44.7	47.9	52.4	50.4	45.8	44.7	41.9	44.2	46.1	48.0	
Brazil	45.1	38.4	42.9	40.8	41.8	40.0	38.4	39.1	41.2	43.2	42.9	
Mexico	21.0	24.5	28.2	21.0	20.7	20.8	24.5	25.4	26.7	28.4	28.2	
Chile	4.1	5.2	6.1	3.6	3.9	4.5	5.2	5.0	4.9	5.8	6.1	
Colombia	32.9	33.4	35.5	32.6	32.6	32.8	33.4	36.8	35.2	34.0	35.5	
Venezuela	22.7	13.2	—	20.9	13.6	12.6	13.2	11.5	15.4	17.4	—	
Peru	29.8	24.1	26.7	27.6	25.3	23.9	24.1	24.8	26.1	26.9	26.7	
Uruguay	68.1	52.6	68.9	65.4	63.7	57.8	52.6	56.7	60.4	66.7	68.7	
CURRENT ACCOUNT BALANCE (% of GDP)												
Latin America (a) (b)	0.7	-0.5	-0.1	0.7	0.5	0.4	-0.5	-0.7	-0.6	-0.7	-0.1	
Argentina	2.8	2.2	3.7	2.8	2.2	2.8	2.2	2.1	3.3	3.6	3.7	
Brazil	0.1	-1.7	-1.5	-0.6	-1.1	-1.5	-1.7	-1.5	-1.2	-1.2	-1.5	
Mexico	-0.8	-1.5	-0.6	-0.5	-0.6	-0.9	-1.4	-1.4	-1.3	-1.3	-0.6	
Chile	4.5	-1.5	2.6	3.3	2.4	0.6	-1.4	-2.0	-1.4	0.7	2.6	
Colombia	-2.8	-2.8	-2.8	-2.2	-2.0	-2.1	-2.8	-2.8	-2.8	-2.8	-2.8	
Venezuela	7.9	11.7	2.2	9.7	12.8	15.9	11.7	7.4	2.8	-0.5	2.2	
Peru	1.3	-3.7	0.2	0.3	-1.3	-2.4	-3.7	-3.3	-1.9	-0.8	0.2	
Uruguay	-0.9	-4.8	0.8	-1.5	-4.2	-4.3	-4.8	-3.6	-1.0	-0.1	0.8	
EXTERNAL DEBT (% of GDP)												
Latin America (a) (b)	19.9	17.6	20.5	19.9	19.0	18.2	17.4	18.7	19.6	20.9	20.5	
Argentina	47.8	38.3	38.4	46.6	44.6	40.6	39.2	37.4	38.2	39.3	38.4	
Brazil	14.1	12.1	12.6	14.1	13.3	12.3	11.8	12.2	13.3	14.1	12.4	
Mexico	12.1	11.5	18.6	12.1	11.6	11.3	11.4	14.8	15.9	17.8	18.5	
Chile	34.0	38.0	44.7	33.4	35.1	37.5	37.6	40.0	42.1	45.3	45.0	
Colombia	21.4	19.1	23.2	18.6	18.7	18.7	19.1	20.2	20.0	22.1	23.2	
Venezuela	24.4	18.9	19.2	24.0	22.6	20.1	18.9	18.3	18.1	18.7	19.2	
Peru	30.6	27.3	28.0	31.6	30.0	28.2	27.3	27.5	28.0	28.4	28.0	
Uruguay	51.0	38.5	44.2	48.5	44.6	40.5	38.2	39.2	40.9	45.4	44.0	

SOURCE: National statistics.

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

GDP
Index

CHART 1



SOURCES: Oxford Latin American Economic History Database, Consensus Forecasts and Datastream.

a. Consensus forecasts for 2010 and 2011. The broken lines represent growth since 2008 if the trend of the historic average between 1990 and 2008 had held.

ronment. Generally, the stimuli applied in Latin America have not been of the exceptional nature of those applied in the industrialised economies. Accordingly, exit strategy discussions have focused on the stance to be adopted by conventional policies, i.e. monetary policy and, to a lesser extent, fiscal policy, and on the advisability or not of maintaining external financial support. The limited impact of the crisis in Latin America has seen plaudits for the economic policy framework applied in many countries and, in particular, for the inflation-targeting regimes, the build-up of reserves and the controlled flexibility of exchange rates, which during the crisis allowed interest rates to be reduced and exchange-rate volatility to be mitigated through interventions (see Box 1). A second challenge for economic policy concerns the management of capital inflows, with the dual aim of preventing the overvaluation of assets (and of the exchange rate) and the adverse effects of the volatility of these flows.

In the wake of the crisis, the region also faces other, longer-term challenges. First, the growth outlook in many countries will be adversely affected by the expected lower growth in the United States (albeit offset in part by trade diversification towards Asia) and by a potential rise in the cost of capital, once monetary conditions in the industrialised countries normalise. Further, it should not be forgotten that Latin America remains far behind as regards the level and growth of productivity, in relation to other emerging areas. That reinforces the need to push through the structural reforms which, following the boom years first, and the crisis afterwards, were consigned to the background. Turning to multilateral relations, at the forefront of discussions is the role of international financial institutions in crisis-prevention and, in particular, whether or not they can effectively provide instruments that can replace, albeit partially, self-insurance via the build-up of reserves, the attractiveness of which appears to have increased in the wake of the crisis.

Economic and financial developments: external environment

Since mid-2009, the world economy has grown at a higher-than-expected rate, not far off the average growth during the pre-crisis years, of around 4.5% in annualised quarterly terms. Underpinning this growth have been the public support measures, the progressive improvement in confidence and the gradual restoring of trade and financial flows. Nonetheless, the recovery is not spreading evenly across the different countries and regions, and is very biased

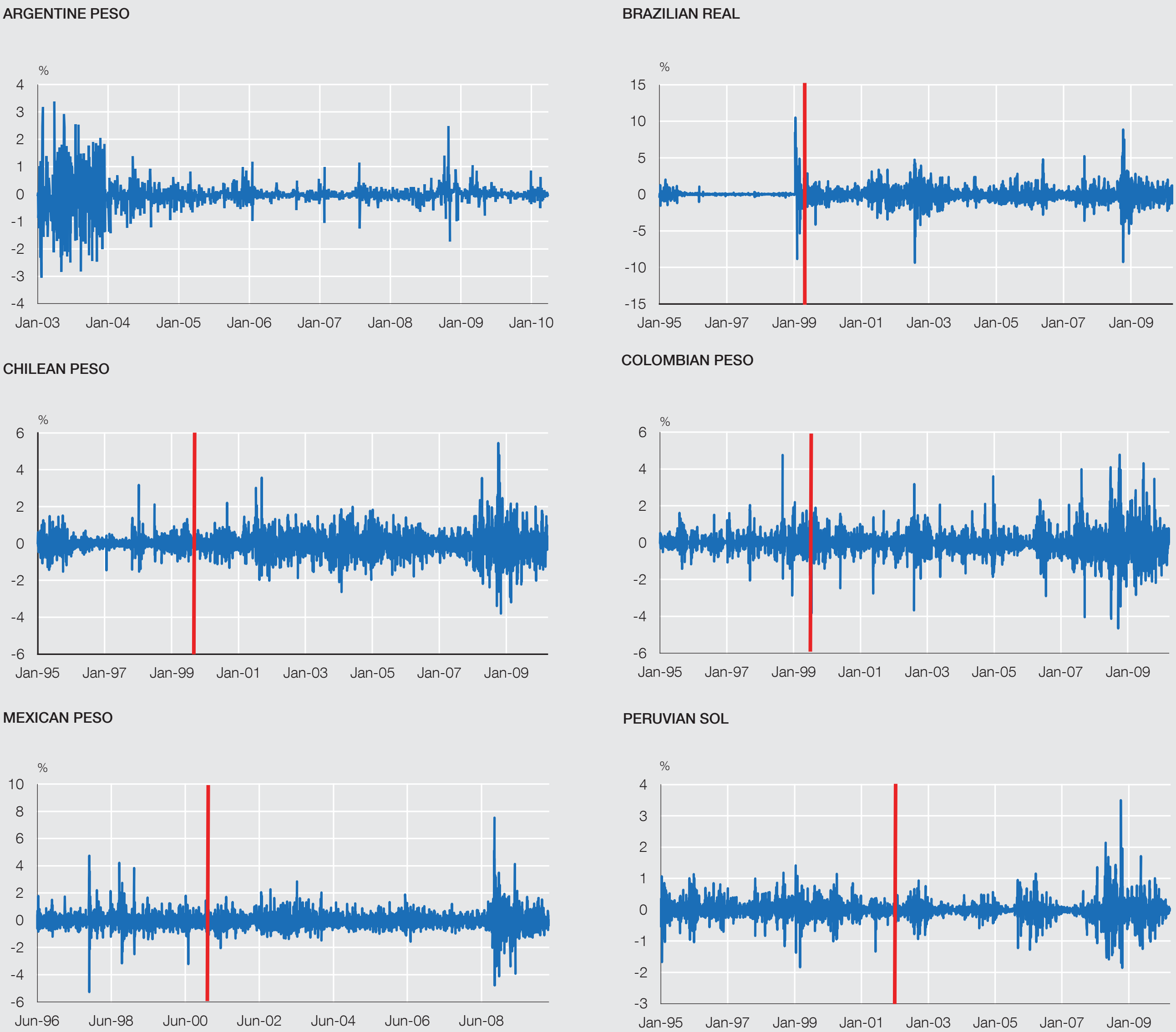
Inflation targeting (IT) is a monetary policy arrangement adopted by an increasing number of countries. The total is 27 at present, 19 of which are emerging economies.[2] In Latin America the main economies, except Argentina and Venezuela, have retained an IT arrangement since 1999.

In these economies the IT regime generally entailed replacing the external anchor provided by the exchange rate with a domestic anchor, based on the credibility and independence of monetary policies. Conceivably, this credibility would help anchor inflation expectations and reduce them. In principle, the free float of the nominal exchange rate is one of the theoretical conditions for the sound functioning of this type of regime since, given unfettered capital movements, an independent monetary policy cannot be combined with a fixed exchange rate or one pegged to another currency by means of foreign exchange interventions (this is habitually known as the "impossible trinity"). Accordingly, some argue that one of the costs of adopting IT is precisely the increase in exchange rate volatility, which may exert adverse effects that are particularly significant for the emerging economies, given their greater real and financial vulnerabilities.

Hence, in the emerging economies, we can observe what Calvo and Reinhardt (2002)[3] coined as "fear of floating". Therefore, de-

1. Based on J.C. Berganza and C. Broto (2010): "Inflation targeting and exchange rate volatility in emerging countries: Credibility vs. flexibility", mimeo.
2. See International Monetary Fund (2005), "Does inflation targeting work in emerging markets?", in IMF, World Economic Outlook, September, Chap. IV, and J.S. Little and T.F. Romano (2009), Inflation targeting – Central Bank Practice Overseas, Public Policy Briefs, no. 08-1, Federal Reserve Bank of Boston.
3. See G. Calvo and C. Reinhart (2002), "Fear of Floating", Quarterly Journal of Economics, 117 (2), pp. 379-408.

DAILY PERCENTAGE CHANGE IN THE EXCHANGE RATE AGAINST THE DOLLAR



SOURCES: Datastream, IMF (2005) and Banco de España.

spite theoretical reservations in this connection, most of the emerging economies with IT usually pursue an active management of the exchange rate, to mitigate its volatility or also its medium-term movements, which translates into interventions on foreign exchange markets. This eclectic means of applying the monetary policy arrangement, which has been called "flexible IT", gave rise to some debate on the validity and viability of this type of arrangement versus so-called "pure IT", where the exchange rate is not in central banks' reaction function.

There is division in the literature on this issue as to whether IT (flexible or not) has proven key to reducing actual inflation in the emerging economies in recent years, although there is a bias towards an affirmative reply [see Mishkin and Schmidt-Hebbel (2006)].[4] However, the relationship between IT and exchange rate volatility in the emerging economies and, more particularly, in Latin America has hardly been studied in the literature, and not in the past two years of crisis. In this context, the economic and financial crisis that began in the summer of 2007 is a very interesting natural experiment for examining this issue which, moreover, may prove useful for drawing some economic policy lessons at a time at which the role of monetary policy in promoting financial stability is under debate.

By way of illustration, the accompanying panel depicts the daily percentage change (return) in the nominal exchange rate against the dollar of the five countries in the region that have IT, along with the date the formal target was adopted. The panel also highlights the change (return) for Argentina, whose currency was highly influenced in the opening months of the sample by the effect of the 2001 crisis. The panel shows that in all the countries of the region with IT, the volatility of their exchange rates against the dollar has increased during the current crisis, which dates back to 2007 Q3, although the rise in exchange rate instability was also recorded in countries without IT, such as Argentina. It can also be seen that, except in Brazil's case, the relationship between the adoption of IT and exchange rate volatility is not evident and, even in Brazil's case, the result is biased by the prior fixed exchange rate regime.

To analyse whether exchange rate volatility was significantly different in countries with an IT arrangement, a more rigorous analysis using an econometric estimation is needed. Here, use has been made of a panel data model that analyses the relationship between exchange rate volatility, the adoption of IT and foreign exchange market interventions for a sample of emerging countries with and without IT, with a particular focus on the crisis period.[5] The role of foreign exchange market interventions is also studied to see whether their effect on exchange rate volatility is different in countries with IT.

Two main conclusions can be drawn from the empirical work for Latin America. First, and in line with other emerging economies, pursuing an IT arrangement appears to entail significantly greater exchange rate volatility than in countries that have not adopted this policy mechanism over the period under analysis. The second conclusion is that although this greater exchange rate volatility for the countries in the region that pursue IT holds after the outbreak of the crisis, foreign exchange market interventions have only proven effective for this group of countries in the region when it comes to moderating exchange rate volatility. In contrast, in those countries without IT, foreign exchange interventions do not appear to have had a significant effect on exchange rate volatility.

These findings appear to support the behaviour of flexible inflation targeting regimes in Latin America. Indeed, they suggest that foreign exchange interventions in periods of particular financial stress may be more effective in lessening exchange rate volatility than other monetary policy arrangements. It remains to be seen whether these episodes of strong foreign exchange market interventions have undermined the credibility of central banks although, as analysed in the main body of the text, no disanchoring of inflation expectations has been observed in these countries.

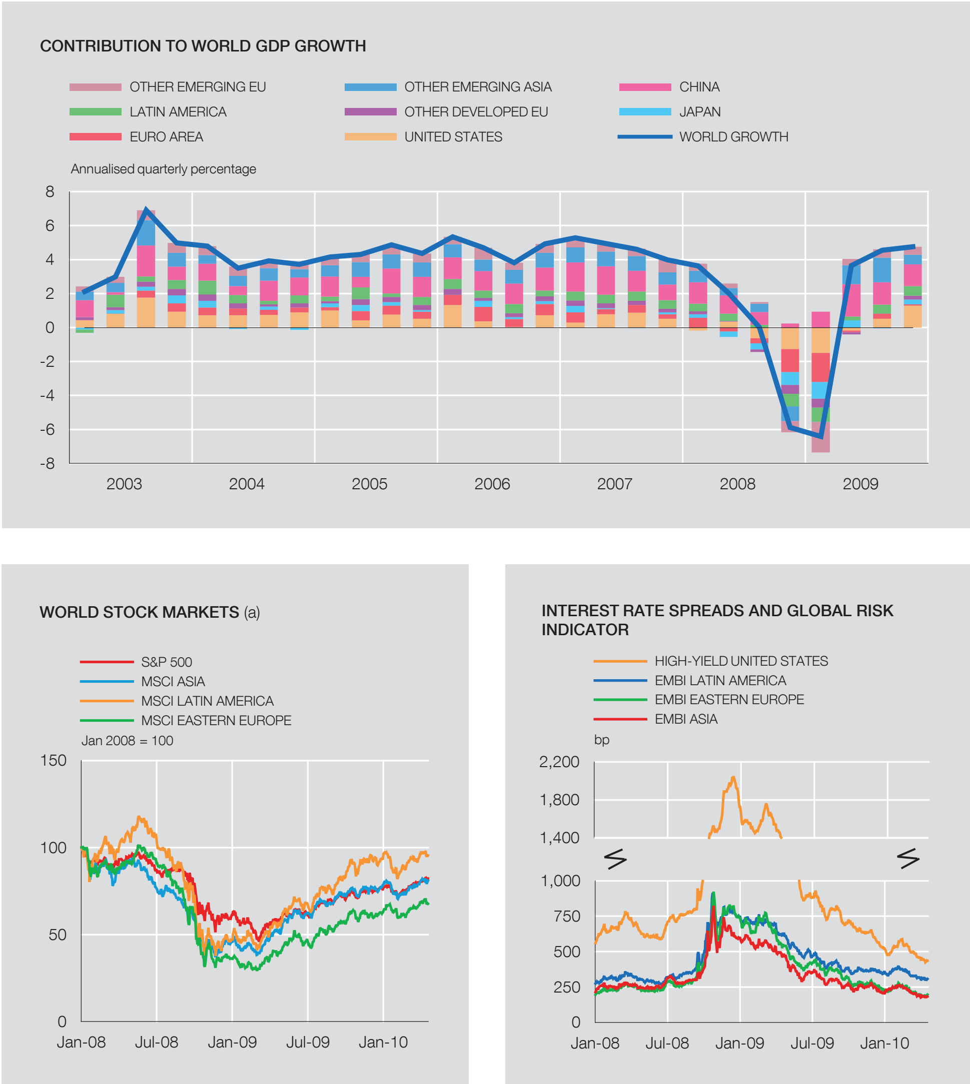
4. Mishkin and K. Schmidt-Hebbel (2006), Does It Make A Difference?, Documento de Trabajo no. 404, Banco Central de Chile.

5. A sample comprising the 18 emerging countries which, according to the IMF, have adopted formal IT and a control group of 15 countries that have not adopted this monetary policy mechanism (excluded from this control group are formally "dollarised" economies or those with a fixed exchange rate) is studied. The following Latin American countries are in this control group: Argentina, Costa Rica, Dominican Republic, Guatemala, Jamaica and Uruguay. The period from 1995 to end-2009 is analysed, as are the sub-samples prior and subsequent to the outbreak of the financial crisis which is dated back to 2007 Q3. The variable that proxies exchange rate volatility is calculated on the basis of the quarterly volatility of the daily returns on the bilateral exchange rate with the dollar. Added in the regressions is a series of control variables such as trade openness, the current-account balance as a proportion of GDP, GDP per capita and certain measures of the volatility of financial variables that proxy global volatility factors.

towards Asia. This region accounted for more than three-quarters of world growth in the second half of 2009, and was the only world region that grew over the course of 2009 (see Chart 2). Among the Latin American economies, this Asian bias in growth tended to favour those South American countries with tighter trade links with Asia. Conversely, it was relatively detrimental to countries such as Mexico, given its closer trade ties with the United States. That said, the US recovery from 2009 Q4 (when it posted an annualised quarterly growth rate of 5.6%) also provided a significant external boost to the Mexican economy. Growth in Europe and Japan was somewhat more moderate than in the United States in late 2009, while Eastern Europe

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Annualised quarterly rate, basis points and indices

CHART 2



SOURCES: National statistics and Datastream.

a. Indices in dollars.

saw a decline in activity greater than that in Latin America, over the year as a whole, weighed down by the adjustment of private-sector overindebtedness.

International financial markets have continued to trend favourably over the past six months, although their behaviour has not been free from bouts of instability, especially in early 2010 when uncertainty over the fiscal position of certain European countries heightened. This episode is indicative of the risks afoot despite the recovery, and highlights the difficulties that may arise in withdrawing the various monetary, financial and fiscal stimuli. Accordingly, regions that are relatively integrated into international markets in trade and financial terms, such as the Latin American economies, may be affected by the pace at and manner in which these exit strategies unfold.

In the second half of 2009 and in early 2010, the main central banks held their official interest rates at levels close to zero, although they progressively withdrew their exceptional liquidity-provision facilities. Long-term interest rates rose to around 3.9% in the United States, a total increase of 40 bp over the past six months. This may be interpreted, first, as a move towards normalisation following investors' heavy flight towards safe-haven assets during the crisis; and further, as a response to the substantial increase in the volume of sovereign issues taking place, in the face of growing levels of public debt. On the foreign exchange markets, the improved US growth outlook and the uncertainty associated with the fiscal position of certain European economies led to an appreciation of the dollar against the euro in recent months, by around 13%.

The emerging markets largely trended in line with global markets, benefiting to January from the renewed appetite for risk, although they were not immune to the bouts of instability. Sovereign spreads, proxied by the EMBI+, fell by some 85 bp to around 255 bp, marking a low for the period since May 2008. Consequently, the rise in US long rates did not entail a direct rise in the cost of financing for the emerging economies, where sovereign spreads most fell, offsetting this rise in full. Across the different regions, the EMBI indices for Latin America, Eastern Europe and Asia fell virtually in parallel, although in Eastern Europe the movement was marginally more favourable (a decline of around 90 bp), following the severe difficulties the previous year. The emerging economies' stock markets, proxied by the MSCI indices in dollars, also posted similar gains to those of the developed economies (around 6% in the last six months). Both the Latin American and the Asian indices are close to their pre-crisis 2008 high, while the Eastern European index remains down on this level. Despite the strengthening of the dollar against the other main currencies (the euro, sterling and the yen), many emerging currencies - with the notable exception of the Chinese renminbi - tended in turn to appreciate against the US currency.

Activity and demand

The incipient signs of recovery in activity observed in Latin America from Q2 onwards were confirmed and spread across the whole region during the second half of 2009, with the exception of Venezuela. In quarterly rates, activity rose by 1.5% in Q3 and by 1.7% in Q4, which sufficed to allow for a resumption of growth in terms of the year-on-year rate at the end of the year (1.3%), following the low of –4% in Q2 (see Chart 3). In 2009 as a whole there was a significant decline of 2.1% in activity, with Mexico accounting for almost 90% of this. In terms of demand components, the fall in GDP in the region was due principally to a 10.5% decline in gross capital formation and, to a lesser extent, to the fall in private consumption (–0.3%). In contrast, external demand contributed positively to growth (owing to the collapse of imports and, to a lesser extent, of exports), while government consumption (4.6%) was the sole domestic demand component that grew in 2009.

As from Q4 the recovery gathered momentum, proving particularly robust in Brazil (4.3% year-on-year) and Peru (2.4%), followed by Chile, Colombia and Argentina (around 2%). Conversely, Mexico and Venezuela are estimated to have run negative year-on-year growth rates at the end of the year, although the quarter-on-quarter rates (shown in Chart 3) show Mexico to be growing at a similar rate to Brazil in the final two quarters of 2009. As regards the composition of growth, though external demand made the main contribution in Q4, in year-on-year terms the negative contribution of domestic demand lessened considerably. This was because both private and government consumption contributed positively to growth, whereas there was a reduction in the sharp contraction of gross capital formation and stockbuilding observed in the previous quarters (see Chart 4). These developments point to a change in the composition of growth towards domestic demand, a change more evident in the associated quarter-on-quarter rates, where the sign of the contributions has already altered.

Private consumption resumed a positive growth rate (2% year-on-year in Q4), and the recovery in this variable was relatively widespread across the different countries (with the exceptions of

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

CHART 3

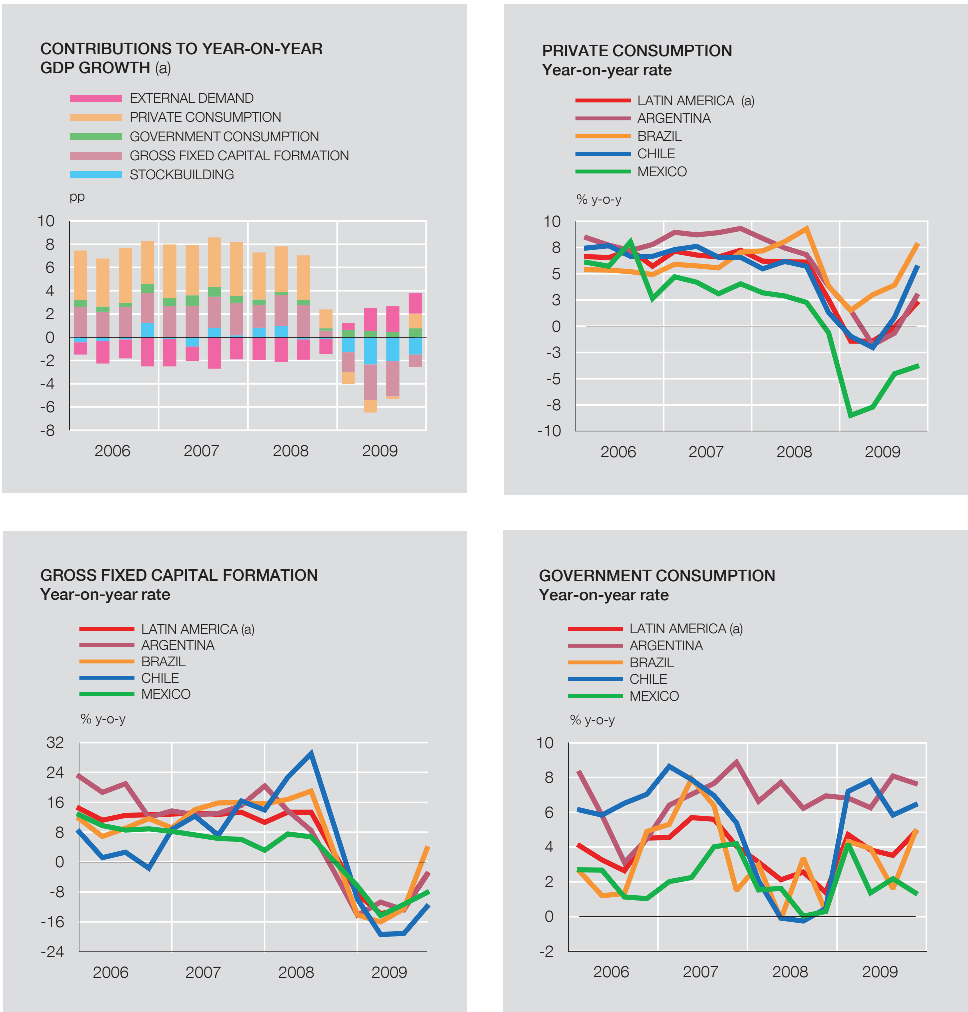
SOURCE: National statistics.

a. Aggregate of the seven main economies.

Mexico, Colombia and Venezuela), although the different conditions in terms of financing and of labour markets explain some of the divergences. In particular, the relative resilience of the labour market in the region as a whole, where the unemployment rate increased relatively little during the crisis (by some 2 pp) and stabilised at around 8% of the labour force, and the contribution of public-sector banks to sustaining credit to the private sector in some countries (especially in Brazil, where the public sector retains a sizeable market share, but also in Chile and Argentina) acted as a prop to private consumption. In this respect, although a clear recovery is not yet discernible in credit, it has tended to stabilise in recent months following the strong slowdown in 2008 and 2009 (see Chart 5); were it not for the role played by public-sector banks, credit to the private sector, measured in real terms, would probably be falling in many countries. The growth of private consumption has been particularly significant in Brazil (7.7% year-on-year in Q4), boosted by the resilience of employment in the face of the crisis (the unemployment rate ended the year at 6.8%, a historical low despite the recession) and by the improvement in financing conditions, supported by public-sector banks and the decline in borrowing costs on markets. At the other extreme, private consumption declined by 6.8% year-on-year in Venezuela. The contributing factors here were companies' limited access to dollar-denominated financing and the depreciation of the parallel exchange rate of the bolivar.

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

CHART 4



SOURCE: National statistics.

a. Seven biggest economies.

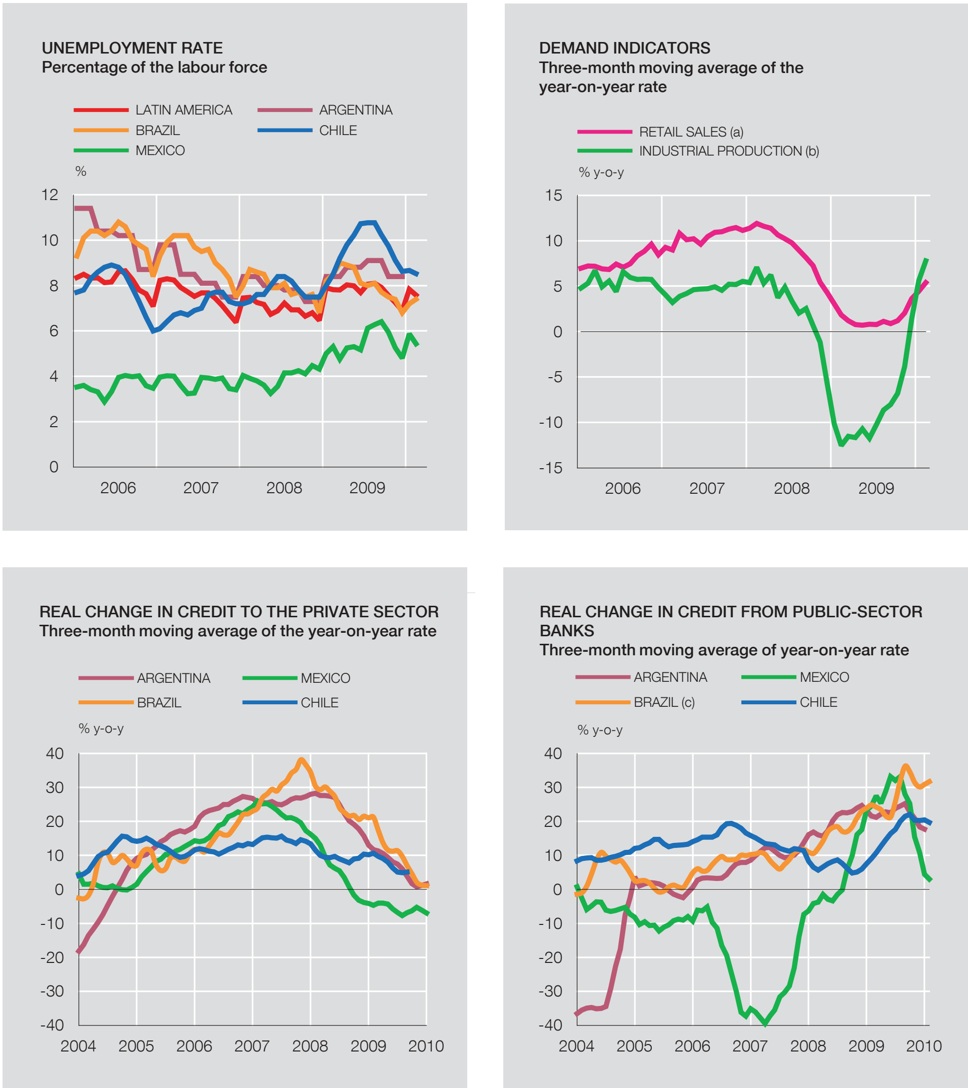
In Mexico, private consumption posted a 3.8% decline in Q4, owing to the weakness of the labour market, the continuing contraction in consumer credit –20% year-on-year) and, most particularly, the fall in remittances (which stand at a six-year low).

However, perhaps the most notable aspect of recent developments in national accounts has been the recovery in investment. After having stabilised at a double-digit negative rate in Q2 and Q3, gross capital formation picked up to some extent, ending the year at a much more moderate negative rate of around –3% year-on-year, although in some countries, such as Brazil, the rate has already turned positive. In this respect, factors such as the recovery in commodities prices (by 35% from their December 2008 low, although they are still 25% below their high), in world trade and in external financing flows have contributed to improving the outlook for investment and even to clearing the way for plans that had been shelved owing to the crisis. Government consumption continued growing in Q4 (4.3% year-on-year), reaching particularly high rates in Argentina and Chile.

From the standpoint of the external sector, the highlight was the return to a trade surplus, to 2% of GDP for the region in 2009 (see Chart 6). The trade surplus was at a record level in 2009

EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Three-month moving average of the year-on-year rate, and percentages

CHART 5



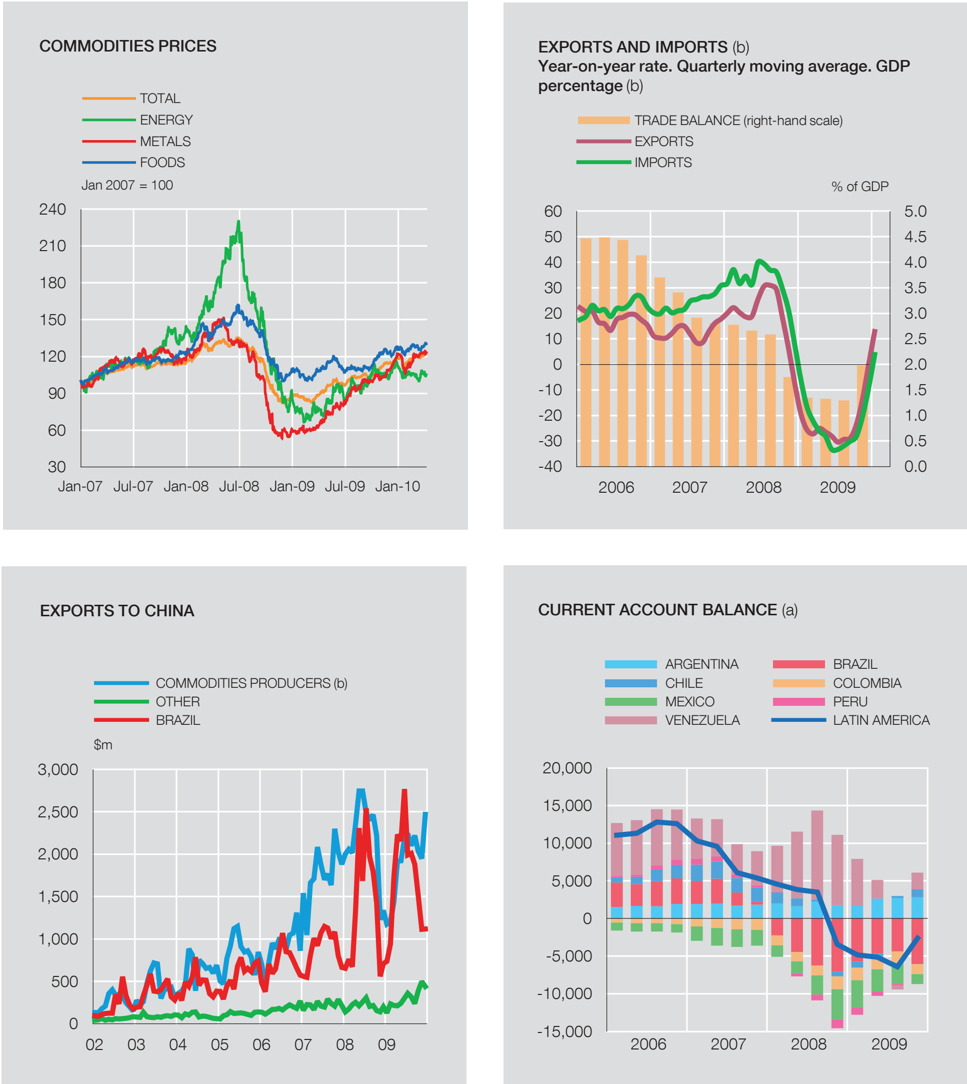
SOURCE: National statistics.

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

in Argentina and Colombia and unchanged in Brazil; in Mexico the deficit lessened. In Venezuela, the trade surplus for the year fell substantially, although the pick-up in oil prices has contributed to some improvement in recent quarters. Both imports and exports fell at a year-on-year rate of close to –30% in mid-2009, and they continued to run negative rates at the end of the year. However, there has been an appreciable recovery in exports across the region in early 2010, towards a growth rate of 10%, higher than that of imports and in line with developments in world demand. The pick-up in exports was particularly dynamic in the South American commodity-exporting countries (Argentina, Chile and Peru), where exports to China (particularly metals and agricultural produce) account for more than 12% of the total. Conversely, in Mexico, although the external sector contributed positively to growth, external demand only began to pick up towards 2009 Q4, further to the recovery in the US economy with which it is highly integrated. Against this backdrop, the current account held virtually in balance (–0.1% of GDP in 2009), albeit showing significant differences from country to country. The current account deficit tended to widen in Brazil in the second half of the year, to –1.5%, in the face of

EXTERNAL ACCOUNTS AND DETERMINANTS CHART 6

Year-on-year rates of change, indices and billions of US dollars



SOURCES: National statistics and Banco de España.

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

the deteriorating balances on income and services. Mexico and Colombia also posted a current account deficit at the close of 2009 (–0.6% and –2.8%, respectively), while Argentina, Chile, Peru and Venezuela continued to run a surplus (which has narrowed significantly in this latter country).

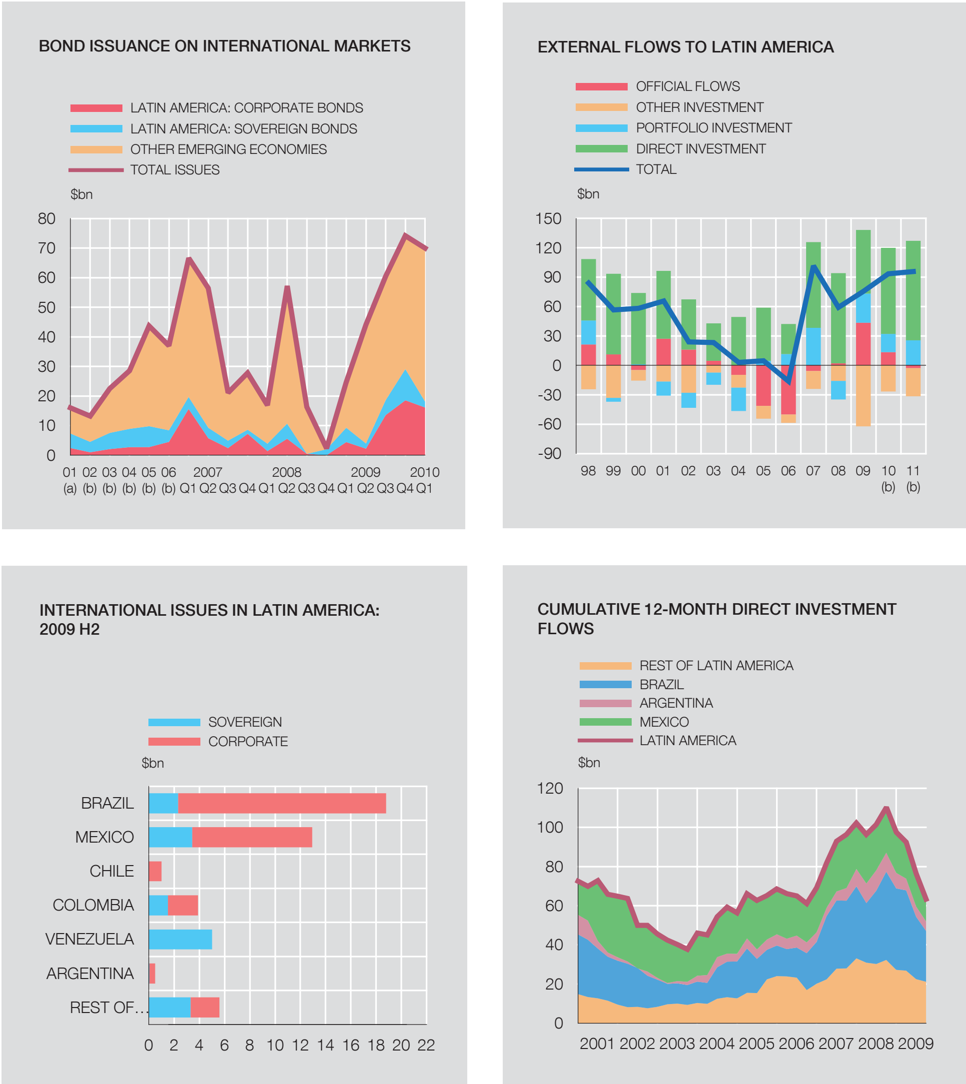
Finally, the higher-frequency indicators suggest that the buoyancy of the economy will have stepped up or, at least, have held unchanged in early 2010. Industrial production has resumed a year-on-year rate of over 5%, similar to that recorded in the 2006-2008 pre-crisis period, and capacity utilisation, confidence indicators and retail sales have increased.

Financial markets and external financing

Over the past six months, the recovery in Latin American financial markets begun in March 2009 firmed, although they were temporarily affected by the bouts of global volatility first, in December, with the rescheduling of the debt of a Dubai fund, and subsequently, in early 2010, with the increased perception of sovereign risk in some European countries, in particular

EXTERNAL CAPITAL FLOWS AND FUNDING
$bn

CHART 7



SOURCE: JP Morgan, IMF and national statistics.

a. Quarterly average.
b. WEO forecasts (April 2010) for 2010-2011.

Greece. There were also episodes of specific instability in some countries in the region (Venezuela and Argentina), which translated into greater asset price volatility on these markets.

Against this background, capital flows recovered forcefully in late 2009, as did private and government issues on international markets ($46 billion, fourfold the amount in the first half of the year). However, over the year as a whole, private capital net flows ($41 billion, according to the IMF) were down on 2008 (see Chart 7), since the rebound in official flows disguised the total figure. Foreign direct investment continued to constitute the main capital flow towards the region (around $70 billion), although it slowed markedly (see Box 2), while portfolio inflows turned positive once again in 2009, following their decline the previous year. Lastly, bank flows (included under "other flows" in Chart 7) posted a fall of close to $60 billion, larger than that of the previous year.

The exchange rates of the main Latin American currencies broadly held on a rising path, although this was much more pronounced than that seen in March to September the previous year (see Chart 8). The Brazilian real, the Chilean peso and the Colombian peso stood during

SPANISH FOREIGN DIRECT INVESTMENT IN LATIN AMERICA DURING THE GLOBAL FINANCIAL CRISIS

BOX 2

This box describes recent developments in Spanish investment flows in Latin America[1], stressing the behaviour of foreign direct investment (FDI) as a main flow of financing to the region. To do this, data are drawn from the Banco de España Balance of Payments and International Investment Position from 1999 to the latest published period.[2] In all cases, the FDI data analysed are net, i.e. they constitute residents' investment abroad minus disinvestment.

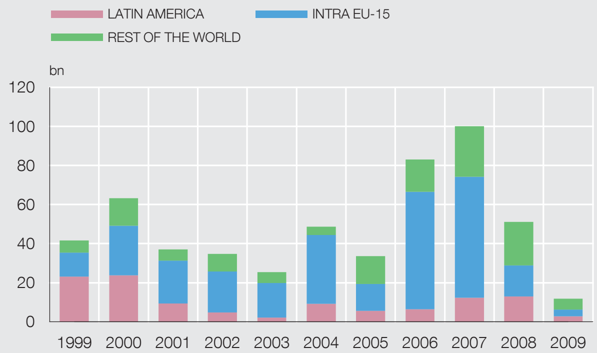
In the past two years there have been significant changes both in terms of the volume and composition of Spanish direct investment flows abroad, in parallel with the reduction seen in global FDI flows, which has also affected Latin America. Spanish FDI peaked in 2007, at over €100 billion. However, in 2008 and 2009, in the context of the international financial crisis, there was a marked decline of practically 70% - taking the average for the two years relative to the 2007 peak - in these flows, down to slightly below the average for the past decade (€31 billion). This fall is essentially a result of a decline in investment within the European Union and, to a lesser extent, in investment to the rest of the world (see Panel 1). The main causes behind this recent behaviour are largely common to most countries: the financing restrictions on international markets evident since the summer of 2007; the high debt of non-financial corporations; the worsening of the financial crisis from September 2008, and the process of adjustment of the Spanish economy.

Conversely, in contrast to the fall in outward Spanish FDI during this period, direct investment in Latin America initially held up somewhat better, since it maintained levels in 2008 similar to those for 2007, at around €13 billion, the highest since 2001. This is in line with the behaviour of global foreign direct investment in Latin America in 2008 (also at record levels that year[3]), which has been partly attributed to the resilience shown by economic growth in these countries during the first year of crisis, to the continuation of high commodities prices for much of 2008, and probably also to the characteristic inertia in foreign investment decisions, which were taken in the pre-crisis boom period.

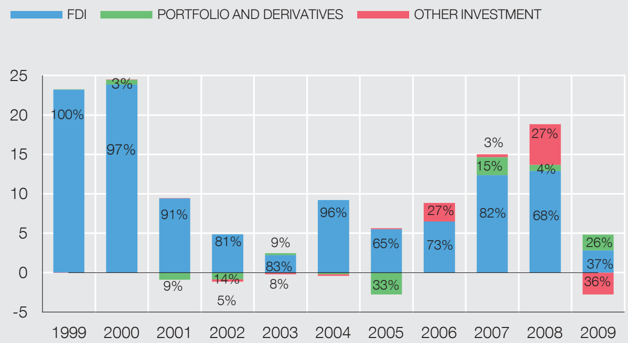
1. Unless otherwise specified, this box will use the aggregate of the seven biggest economies of the region (Argentina, Brazil, Colombia, Chile, Mexico, Peru and Venezuela), which accounted for 88% of Spanish direct investment into Latin America in 2009 **2.** In the case of the Balance of Payments, to December 2009; and for the International Investment Position, to 2009 Q4. The geographical breakdown for the years 2007-2009 is still a preliminary estimate. A revision of the data will be published in The Spanish Balance of Payments and International Investment Position. 2009, later this year.

3. $128 billion according to CEPAL (2009), "La inversión extranjera directa en América Latina y el Caribe, 2008", and $92.2 billion according to the IMF (2010), World Economic Outlook, April 2010.

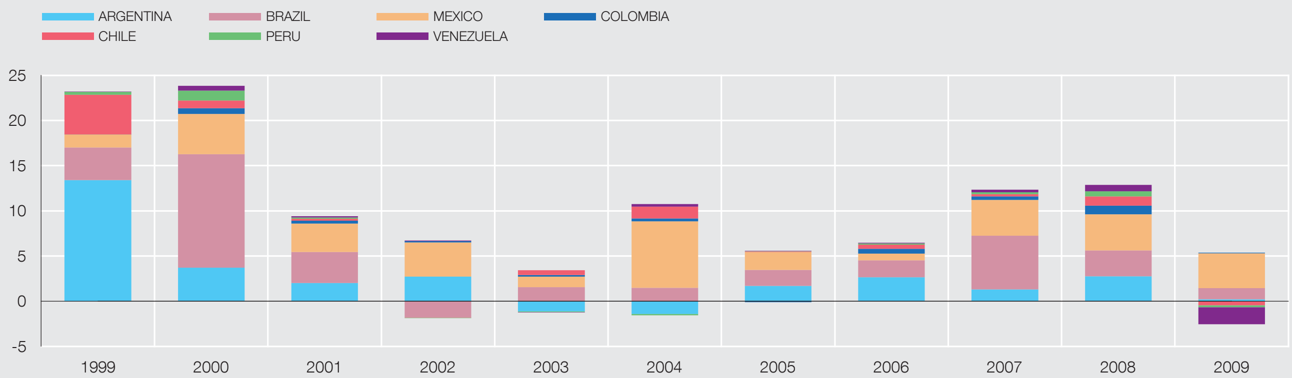
1 NET OUTWARD SPANISH FDI BY REGION



2 SPANISH FINANCIAL FLOWS TO LATIN AMERICA BY COMPONENT (a)



3 SPANISH FDI IN LATIN AMERICA BY COUNTRY



SOURCES: Balance of Payments, UNCTAD, *Bureau of Economic Analysis* and Banco de España.

a. Excluding Banco de España.

In 2009, however, there was a strong decline in Spanish direct investment outflows to Latin America, which stood at €2.8 billion. This decline was in response both to the deterioration in growth and investment in Spain and in Latin America, and to the tightening of borrowing conditions in a setting of greater uncertainty, as well as to some specific factors. The level reached was similar to that of 2003, which marked a low for the decade following the Latin American crisis at the turn of the century. Notwithstanding, direct investment in Latin America has continued to account for a sizeable portion of Spanish FDI (25% on average in the period 2008-2009), and it has remained the most stable component of the financial account (see Panel 2). Moreover, the international investment position in Latin America, where influential factors include not only direct investment flows but also, inter alia, effects relating to exchange rate valuation and asset price changes, increased at end-2009 to 27% (€120 billion) of the total Spanish investment position, with Brazil, Argentina and Mexico respectively ranked second, sixth and seventh in the classification by country, which underscores Spain's continuing sound presence in these countries.

The breakdown of direct investment by country in recent years illustrates differentiated behaviour in this regional overview (see Panel 3). Whereas in 2008 direct investment outflows increased slightly on 2007 in most Latin American countries (with the exception of Brazil, where direct investment grew less than in 2007), in 2009 it slowed in all countries, except Mexico, where it held stable. And in Venezuela, there was notable disinvestment (for a value of €2 billion). This disinvestment is strongly influenced by the sale of Spanish companies' shares in Venezuelan corporations, against the backdrop of the nationalisation programme undertaken by this country since 2008. There was also disinvestment, albeit on a much smaller scale, in Chile and Peru. If the effect of Venezuela were excluded, Spanish direct investment in Latin America in 2009 would stand at around 65% of the average over the past decade. In the remaining countries, both in terms of absolute volume and as a proportion of GDP and of total Spanish FDI, most direct investment in 2009 was targeted on Brazil and Mexico. This is in contrast to the pattern followed to 2005, when the relative weight of Chile and Argentina was greatest.[4]

Finally, the sizeable weight of flows in sectors such as financial services, telecommunications and public services in total Spanish direct investment in Latin America means that this investment is essentially tied to the business cycle and to the growth prospects of domestic demand in the region, although logically it may be influenced by the situation of the Spanish economy. In this respect, the outlook for 2010 is more positive.

4. See Enrique Alberola and Juan Carlos Berganza (2008), "Una evolución cuantitativa y cualitativa de la IED española en América Latina en 1996-2005", in R. Casilda (ed.), Globalización, inversiones y multinacionales españolas en América Latina: huellas y perspectivas, pp. 319-338.

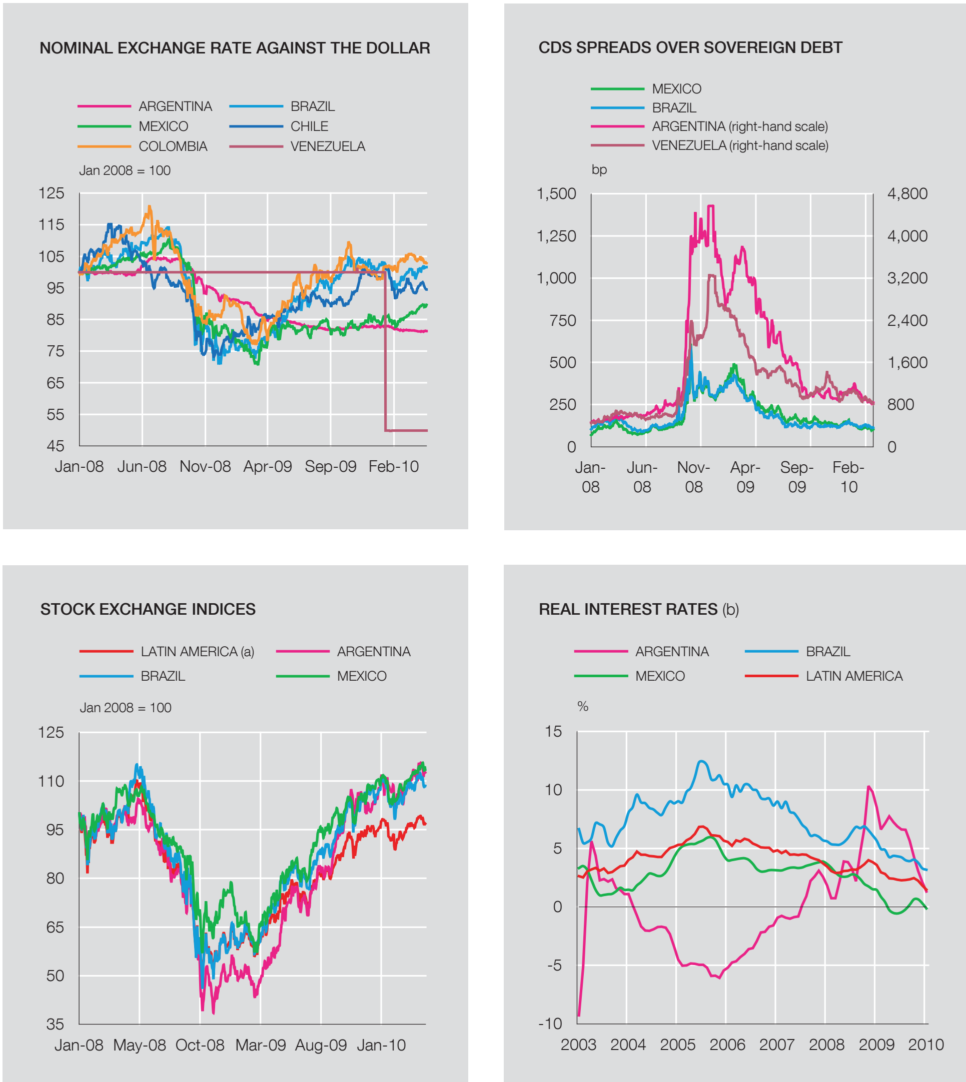
before the end of the year, coinciding with the closure of banks and the emergence of energy problems. But it narrowed to around 800 bp following the devaluation early in the year. Among other factors, this reduction might reflect the fact that the devaluation improves the public sector's bolivar-denominated receipts and, therefore, its solvency. In the remaining countries, CDSs fluctuated while moving on a declining trend, except at the times of greatest tension on international markets. In Mexico, the reduction in the CDS and the narrowing vis-à-vis Brazil was despite the fact that two rating agencies downgraded Mexican debt in November and December, arguing that its fiscal reform was insufficient. Conversely, Moody's upgraded Peru's sovereign debt in December to investment grade. Finally, the earthquake in Chile in late February 2010 prompted a rise in the sovereign CDS which, even so, remains the lowest in the region at around 70 bp.

Turning to the stock markets, the regional index for Latin America ended the period with gains of around 5% in local currency, with a similar result in dollars. That means a similar movement to that of emerging Asia and of the developed countries on the whole, although one far below that recorded in the previous six-month period. Country by country, all the region's stock markets posted gains - of around 10% - except for Peru, which held at a similar level to that of the start of the period. That said, the Peruvian stock market showed the biggest rise in 2009, with its index doubling in value.

Prices and macroeconomic policies

Inflation in the region as a whole began to rise in late 2009 from a rate of slightly over 5%, the downward path initiated a year earlier (see Chart 9) having run its course. The disinflation process in Latin America in 2009 was mostly due to food price developments (in particular to the

CDS SPREADS OVER SOVEREIGN DEBT, STOCK MARKETS AND EXCHANGE RATE AGAINST THE DOLLAR CHART 8
Basis points, indices and level



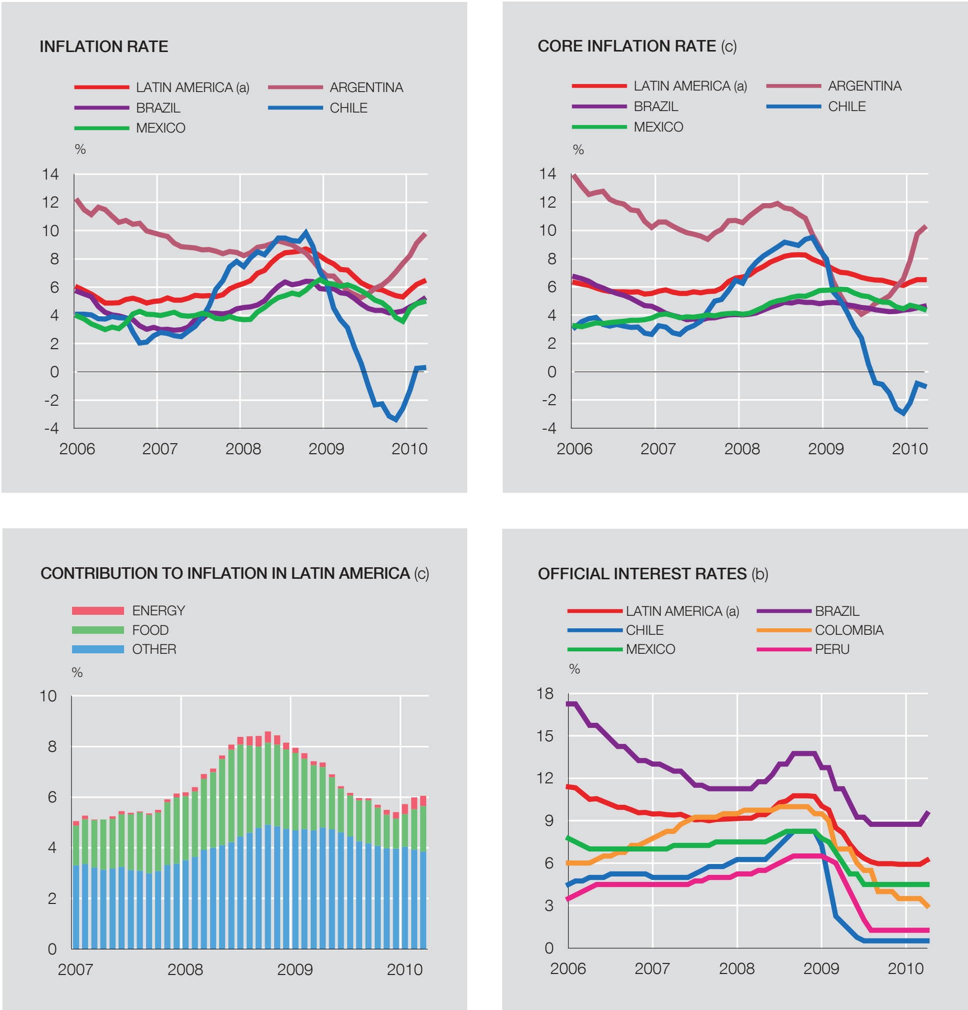
SOURCES: Datastream and JP Morgan.

a. MSCI Latin America Index in local currency.
b. Short-term interest rate minus inflation rate.

this period at relatively appreciated levels, only around 10% down on the highs reached in early 2008, before the crisis spread to the emerging economies. The appreciating trend was particularly sharp towards October, and was countered by central banks' heavy purchases of reserves, along with the application of prudential measures and some capital controls (see Table 2). Particularly notable among these was Brazil's reintroduction of the 2% tax on cross-border financial transactions (OIF by its Portuguese abbreviation), which proved effective, at least in the short run, when it came to moderating capital inflows and stabilising the exchange rate. Certain requirements were also reintroduced in Peru for foreign currency transactions, given the rising trend of the sol. The Mexican peso appreciated by around 10% over the past six months, the biggest appreciation in the region, and one possibly related to the recovery in the dollar and the improved growth outlook in North America; that said, the peso is still relatively depreciated in respect of its pre-crisis levels. The Argentine peso held stable for most of the period, moving on something of a depreciating trend as from the end of the year, against

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

CHART 9



SOURCES: National statistics and Banco de España.

a. Aggregate of the seven main economies.
b. Weighted average of the official rates of the five countries with inflation targets.
c. Banco de España calculations stripping out the food and energy indices from the overall index.

a background of renewed capital outflows related to factors of institutional instability (in particular, those associated with the use of international reserves to repay debt, which led to the resignation of the central bank governor). These factors also affected Argentina's remaining financial variables. Finally, in early January the Venezuelan bolivar was devalued by 50%, and a new system with two official exchange rates was set in place.

Sovereign spreads measured by the EMBI oscillated in a relatively narrow range, between 300 bp and 375 bp throughout the period, following their strong decline in the March-September period. The tendency was one of reduction, with a 75 bp rebound in January (related to Greece's difficulties), which was subsequently reversed in full. In terms of specific factors, mention should be made of the greater volatility of the EMBI and the sovereign CDS in Argentina and Venezuela. In Argentina, the sovereign CDS rose in late January above 1200 bp owing to the heightening of institutional uncertainty. It fell once more towards a low at the end of the period, set against the general improvement in markets and the prospect of the resolution of the debt swap for bond holdouts, whose conditions were made public in mid-April (see the section "Economic developments by country"). In Venezuela, the CDS climbed up to 1400 bp

PRUDENTIAL MEASURES AND CAPITAL CONTROLS TO MITIGATE THE IMPACT OF FINANCIAL FLOWS

TABLE 2

MEASURES	DESCRIPTION	COUNTRY (a) (currently or previously used)
Measures to discourage short-term capital inflows (capital controls)	Reserve requirements on deposits or debt raised abroad	AR, CO*, CL, PE*
	Minimum holding period for foreign investment	AR, CL, CO*
	Taxes on portfolio inflows	BR*
	Taxes on profits arising on derivatives transactions	PE*
Provisions	Dynamic provisions	CO*, PE*
Reserve requirement	Higher requirements during periods of strong capital inflows and lower requirements during periods of outflows	BR*, CO*, PE*
	Higher requirements for foreign-currency deposits than for local-currency deposits	AR (pre-OCT 08), PE*
Currency-based imbalances	Limits on the net foreign-currency position as a percentage of equity	CO, AR, BR, CL, PE
	Limits on the net spot and net derivatives positions in foreign currency as a percentage of equity	CO*

SOURCE: Banco de España.

* Measures taken from 2006 onwards.
a. AR: Argentina , BR: Brazil, CL: Chile, CO: Colombia and PE: Peru.

reversal of the base effect of the 2008 rise), while official core inflation, though it eased, did so to a lesser extent. And this despite the opening of considerable output gaps in several countries. In any event, this moderation in price growth was conducive to an improvement in expectations and allowed inflation to stand below official central bank targets, to the extent that in Chile, Colombia and Peru the rate fell below the target floor (see Table 3). Brazil and Mexico were within target, although inflation stood in the upper range of the target band.

From December 2009 to March 2010, however, consumer prices rose to a year-on-year rate of 6.5% for the region as a whole. At the regional level, this rise is due in equal parts to food and energy (which had fallen to very low year-on-year rates of under 1.5% and 0.5%, respectively), in addition to certain one-off factors such as rises in taxes and administered prices in some countries. Hence, while there are substantial cross-country differences (see the section “Economic developments by country”) and although the underlying component - calculated on the basis of national price indices, uniformly stripping out the food and energy indices - has held relatively stable at a rate of close to 4% (see Chart 9), the recent increase in prices has, according to surveys, been accompanied by a moderate but constant rise in inflation expectations since late 2009.

In this setting, monetary policies remained exceptionally lax throughout last year. However, given the recovery in activity, the progressive closing of output gaps in some economies, the relatively expansionary bias still characterising fiscal policies, the sensitivity of inflation to commodities prices and the rise in inflation, some countries have begun to unwind their expansionary monetary policy measures (some of which were exceptional) applied during the crisis. Thus, for instance, Brazil announced in February that it would progressively reverse most of the reduction in bank reserve requirements applied during the crisis, which accounts for a significant drainage of liquidity, and it raised its official interest rate by 75 bp to 9.5% at the end of April. In contrast, it has once again funded the public bank BNDES, and the interest rate

INFLATION
Year-on-year rates of change

TABLE 3

Country	2009			2010		2011	
	Target	dic-09	Fulfillment	Target	Expectations (a)	Target	Expectations (a)
Brazil	4.5 ± 2	4.3	Yes	4.5 ± 2	4.8	4.5 ± 2	4.7
Mexico	3 ± 1	3.6	Yes	3 ± 1	5.2	3 ± 1	3.9
Chile	3 ± 1	-2.6	No	3 ± 1	3.7	3 ± 1	3.2
Colombia	4.5 a 5.5	2	No	3 ± 1	3.8	3 ± 1	3.8
Peru	2 ± 1	0.3	No	2 ± 1	2.2	2 ± 1	2.5

SOURCES: National statistics and *Consensus Forecasts*.

a. *Consensus Forecasts*, March 2010.

applied by this institution, applicable to the financing of many large corporations, has held unchanged at the historically low level of 6%. Chile announced in November that it would gradually withdraw its exceptional term liquidity facility before May. The Brazilian and Mexican swap lines with the Federal Reserve were not renewed upon their expiry in February, which may also be interpreted along the same lines as the withdrawal of exceptional measures and the normalisation of the functioning of the markets.

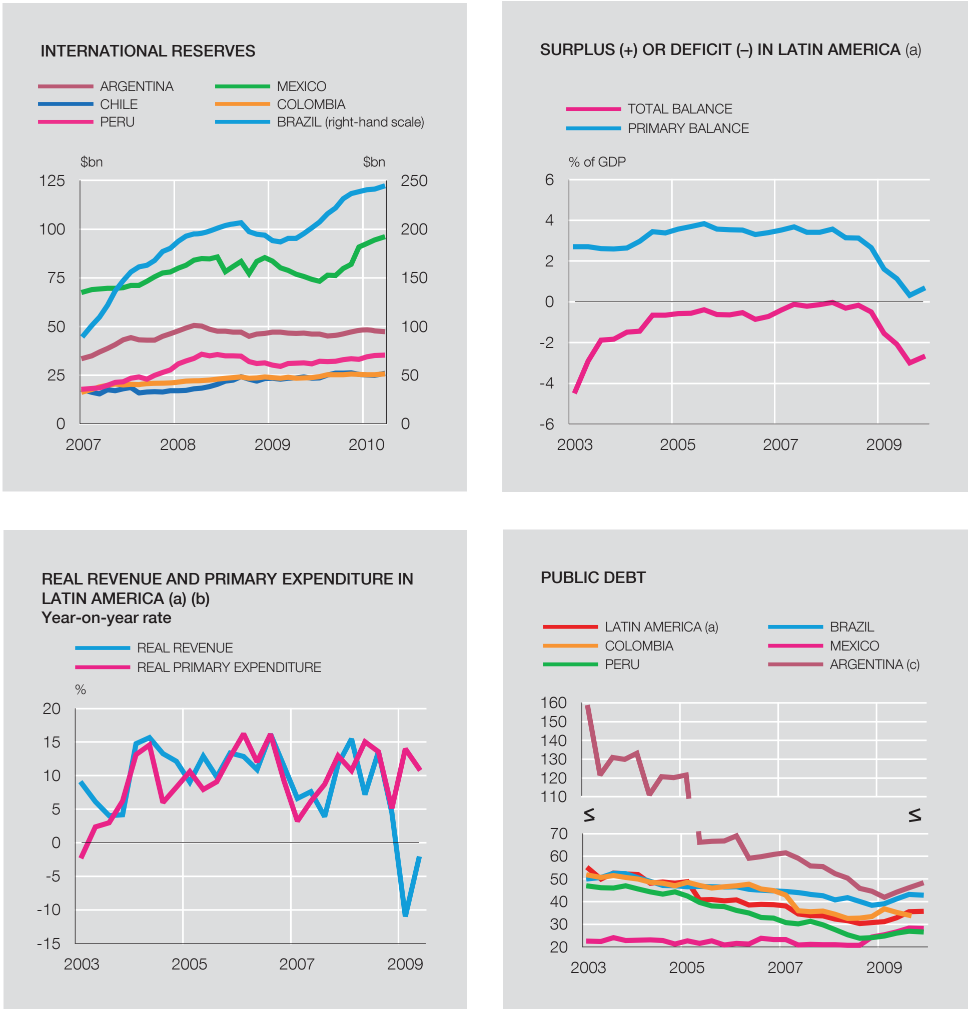
The financial markets expect some central banks in the region (including most notably Brazil's) to progressively reverse the sharp reductions in rates applied during the crisis. This may be complemented by alternative measures, such as reserve requirements. But the situation is not homogenous. Continuing wide output gaps (Mexico), the temporary nature of the shocks received (Chile, Colombia) and other considerations (Venezuela, Argentina) suggest that the cycle of official interest rate rises will not begin simultaneously in all countries, and might be delayed in some of them; in fact, Colombia made a fresh cut to its official interest rate, to 3%, in late April.

A second consideration concerning the possible tightening of monetary policy is whether, in a context of recovering capital flows like the present, the management of interest rates might once again face a dilemma; namely, that the upward pressure on currencies it has been sought to avert is actually accentuated, especially in view of the prospect of high liquidity being maintained in the developed countries. In this respect, although only some countries (Brazil, Peru) have limited inflows with specific capital controls, most have opted to build up reserves to above pre-crisis levels (see Chart 10). Conventional ratios of the appropriateness of reserves (such as reserves/imports, or reserves/short-term external debt), and also more demanding ratios, show that reserves are now generally at very high levels (see Table 4).

The foregoing raises the issue of the IMF's capacity to replace the individual accumulation of reserves as an insurance mechanism against potential crises. While it is generally acknowledged that the build-up of reserves as an insurance mechanism is costly and relatively inefficient, and that it generates growing distortions, the countries that accumulate reserves claim that the main advantages are (i) autonomy in respect of the use of reserves; (ii) that during a crisis the volume of reserves needed to instil confidence and prevent capital flight is much greater than what the conventional ratios indicate; and, therefore, (iii) that there is a need to retain very wide margins (to also replace in full capital outflows for a time). Further, some countries consider that accumulation is also in response to a second objective, namely to temper excessive exchange-rate volatility (and/or appreciation), which cannot be achieved through

INTERNATIONAL RESERVES AND MAIN INDICATORS OF PUBLIC SECTOR PERFORMANCE

CHART 10



SOURCE: National statistics.

a. Seven biggest economies.
b. Deflated by the CPI.
c. Excludes untendered debt in the debt swap offer of 2005.

recourse to the IMF. Set against this assessment, they consider that the characteristics of the alternative multilateral instruments, such as the IMF's FCL (flexible credit line), their short term, the size of the amounts that would be considered necessary in some countries, and their imperfect substitutability for reserves in the eyes of the rating agencies may not be sufficient. Accordingly, lines such as the FCL are viewed as useful, although they are considered to be complementary in nature, and the countries appear to continue showing a preference for self-insurance. In this sense, countries such as Colombia and Mexico have decided to renew in full or in part this line with the IMF, while Mexico announced that it will accumulate reserves, a change on its previous policy.

Finally, given the circumstances, developments in public finances will be a relevant factor in 2010, with the start of an electoral cycle in many countries (Chile, Colombia, Brazil, Venezuela and Peru) that will run into 2011 (Peru and Argentina). In 2009, the fiscal position weakened as a result of the cyclical collapse of revenue and, in some countries, of the momentum of spending. The primary surplus of 3% in 2008 was practically erased and the

RESERVE REQUIREMENTS AS A PERCENTAGE OF DIFFERENT VARIABLES. 2008 TABLE 4

2008	GDP	Exports + Imports	Investment portfolio liabilities	Investment portfolio liabilities + other investment	Short-term external debt	M2	Monetary base
Argentina	13.8	35.0	236.0	56.5	214.6	72.0	128.9
Brazil	12.3	50.7	67.1	48.0	497.0	33.0	239.7
Mexico	8.7	15.4	40.9	31.0	259.9	16.9	183.3
Chile	13.6	18.0	112.6	33.1	153.8	22.5	285.0
Colombia	9.7	30.3	142.4	48.5	416.4	27.5	—
Venezuela	10.4	27.9	244.8	88.5	194.8	—	—
Peru	23.7	49.3	157.5	65.9	482.8	—	396.8
South Korea	21.6	23.5	80.1	40.4	—	15.5	—
China	45.0	76.1	1,209.2	371.3	1,317.1	28.5	—
India	20.5	48.1	264.8	83.3	585.1	—	—
Malaysia	41.1	24.4	141.6	84.4	—	33.7	—
Poland	11.2	15.8	75.5	28.2	90.7	21.6	—
Hungary	21.7	15.8	57.3	22.8	123.4	40.8	159.4
Russia	24.6	52.0	370.2	77.6	563.6	76.0	—

SOURCES: IMF (IFS and WEO) and IIF.

budget moved from a balanced position to a deficit of 2.7% in the region as a whole (see Table 1 and Chart 10). Public debt/GDP ratios rose by around 5 pp of regional GDP (to 35.8% of GDP in the aggregate), breaking the downward trend of recent years, although the increase was much more moderate than that in the industrialised economies (around 17 pp of output).

Exceptions aside, this situation does not appear to pose risks in the short run, but it might influence monetary policy and, more specifically, the balance and timing of exit strategies. Given that expansionary fiscal packages in Latin America (with the exception of Chile and, to some extent, Peru) were much more limited than in the industrialised economies, the need to design an exit or fiscal consolidation strategy would now also be less pressing. However, the dynamism shown by some economies in recent months would probably advise tightening fiscal policy now that the recovery allows it, which in turn would lessen pressure on monetary policy and, indirectly, on the exchange rate. Although there are clear divergences from country to country, the budgets for 2010 are generally of a continuist nature (in Brazil and Colombia priority is not given to expenditure consolidation) or even a procyclical bent (in the case of Argentina and Peru) in a year in which the electoral cycle may make the containment of spending somewhat more difficult. Chile, which had envisaged withdrawing most of its fiscal stimulus measures in 2010 (although it had not yet returned to the 0.5%structural surplus rule), has announced a fund for the reconstruction of earthquake-affected areas comprising more than 5 pp of GDP. Mexico is expected to be the main exception, after having announced a budget that includes a rise in VAT and spending cuts aimed at reducing the State deficit to 0.75% in 2010. Conceivably, and although there may be differences from one country to another, in the region as a whole the monetary impulse will probably be reversed before the fiscal one is.

Trade integration and structural policies

Set against declining global trade in 2009, trade integration processes in Latin America have once again shown the duality present in the region for several years now. Chile, Colombia and

Peru further pursued their strategy of bilateral agreements, particularly with Asian countries. During the period under study, Chile entered into free trade agreements with Turkey and Malaysia, while Peru did so with Singapore, Thailand, China, Canada and the EFTA countries (Switzerland, Iceland, Liechtenstein and Norway). In early March 2010, Peru and Colombia reached a free trade agreement with the European Union which will be ratified at the joint summit in May. Colombia extended the ATPDEA with the United States. Conversely, Mercosur and the Andean Community have continued to face serious obstacles, including the application of trade restrictions among their own members and the lack of agreement on Venezuela finally joining. More positively, Uruguay might shortly follow the Argentine-Brazilian initiative to use local currency in trade, although this initiative currently covers very few transactions (scarcely 1.6% of bilateral trade). Also, the first sucre-denominated transactions between the ALBA (Bolivarian Alternative for the Americas) countries were carried out, the sucre being conceived as a common unit of exchange.

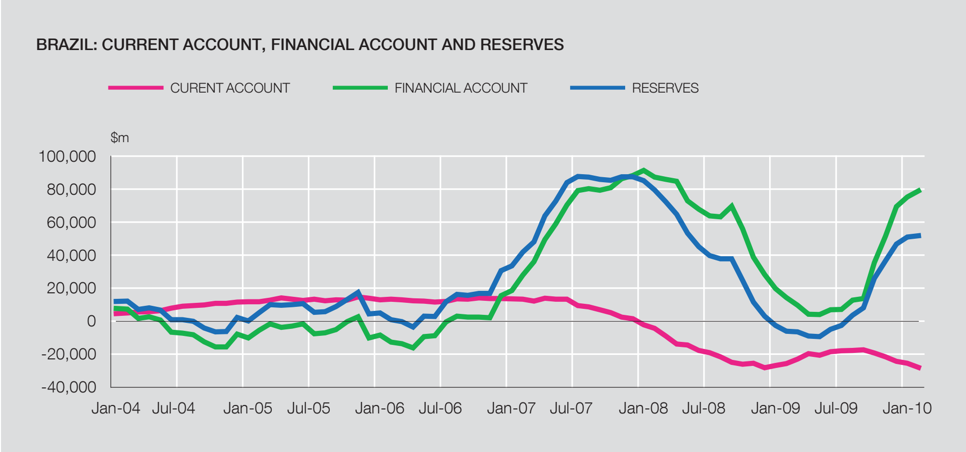
As regards structural reforms, no substantial progress was made. Venezuela put new oil fields out to tender under the new rules for access by the domestic or foreign private sector to this type of business within Venezuela (majority State holding, prior financing of the State oil company and non-use of reserves as collateral for debt), and State control of the financial sector was reinforced with the nationalisation of several of the banks taken over at the end of the year. As to the international measures adopted, both Brazil and Chile and Mexico undertook to increase the financing they grant to the International Monetary Fund. Moreover, Chile became the second Latin American country to join the Organisation for Economic Co-Operation and Development (OECD).

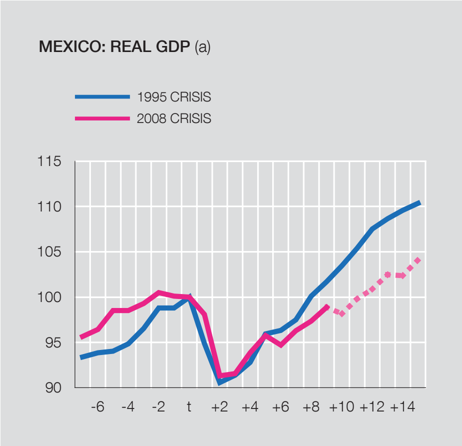
Economic developments by country

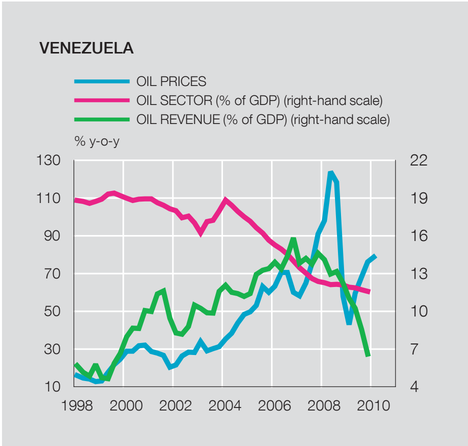
The pick-up in economic growth in Brazil continued during Q3 and Q4 (at respective quarterly rates of 1.3% and 2%). As a result, the year-on-year decline in GDP eased in Q3, and activity rose strongly to 4.3% in Q4. The recovery was boosted by domestic demand (which contributed more than 5 pp to growth), with private consumption expanding strongly and investment resuming a positive growth rate after the sharp adjustment during the three previous quarters. External demand subtracted several tenths of a point from growth in Q4 owing to the pick-up in imports. The indicators for 2010 Q1 point to a further acceleration in activity. In the labour market, the unemployment rate fell, reaching a historical low in late 2009, although it subsequently rose by several tenths of a point, possibly due to seasonal factors. The recovery in the economy came about against a background of moderating inflation to December, within the central bank's target range. However, the incipient rise in prices (5.2% in March, owing largely to food prices, given that the core inflation rate held practically stable) and some increase in inflation expectations raised the issue of whether the economic stimuli should be withdrawn. In this setting, the central bank set out a timetable for the progressive raising of reserve requirements, largely reversing the decrease applied during the crisis, and the cycle of official interest rate rises began with a 75 bp increase to 9.5% at the end of April. Turning to fiscal policy, certain tax exemptions were extended, with others being introduced, and the provision of new funds to the development bank was announced. Public finances continued to worsen, due partly to cyclical factors. As a result, the primary surplus at the close of the year stood at 2.1% of GDP, below the government's target of 2.5%, and the budget deficit duly widened. The primary surplus improved to some extent early in the year, owing to the moderation of spending and the increase in revenue, but the proximity of presidential elections (in October) may hamper the containment of spending this year. In any event, the aim of the draft budget for 2010 is a primary surplus for the consolidated public sector of 3.3% of GDP, up on the 2009 figure. The current account balance posted a moderate deficit in 2009 of 1.6% of GDP. However, in early 2010 it showed a clear deterioration owing to the significant recovery in imports, reflecting the thrust of domestic demand. The second half of 2009 saw a strong rise in

BRAZIL, MEXICO AND VENEZUELA

CHART 11







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

a. 1994 Q4 and 2008 Q3 = 100. The dotted line plots projections based on Bank of Mexico surveys.

financial flows to Brazil, particularly portfolio flows, which generated significant upward pressure on the currency (see Chart 11). Against this background, the authorities introduced a tax (IOF by its Portuguese abbreviation) on financial inflows relating to the purchase of bond and stock market instruments, and the notable build-up of international reserves continued (this has eased in early 2010). Given this propitious external backdrop, Brazil was able to resort to the international markets under favourable conditions, and did not renew its swap facility with the Federal Reserve, which expired in February. Furthermore, Brazil has purchased IMF bonds for a value of $10 billion, and has undertaken to purchase further bonds worth $4 billion.

In Mexico, economic activity picked up markedly in the second half of the year, posting quarterly growth rates of 2.5% and 2%. Even so, year-on-year rates remained strongly negative (–6.1% and –2.3%), and the year closed with the biggest decline in GDP since 1932. The recovery was much more vigorous from November, coinciding with the recovery in industrial activity in the United States, and was underpinned by manufacturing (initially in the car industry, but subsequently in other sectors too), while construction remained weak. The breakdown of GDP confirms, in turn, that the recovery is external demand-led, whereas private consumption and investment, despite improving somewhat, continued to post negative year-on-year rates. The Q1 indicators suggest some acceleration in activity, which is expected to continue to be based on external demand. Hence, whereas exports and industrial production have shown signs of renewed dynamism, the consumer confidence, retail sales and gross investment indicators are holding at very low levels. In this setting, and despite the fact that the growth outlook for 2010 and 2011 has improved significantly in recent months, the decline in activity in 2009 means that Mexico will continue to evidence a negative output gap until late 2011 (see Chart 11). The inflation rate eased from October thanks to positive base effects, standing within the Mexican central bank's target range at the end of 2009. Core inflation was higher. In the opening months of 2010, inflation has increased by more than 1 pp (to 5%) as a result of the rise in indirect taxes, but this should be a one-off effect. The central bank held its official interest rate at the July level of 4.5%, at which rate it is expected to remain in the coming months. Public finances worsened substantially in 2009, moving from balance to a deficit of –2.1%, the worst figure since 1990. In the case of the primary surplus, the deterioration was from 1.8% to –0.1% of GDP. The fall in oil revenue was propitious to fiscal reform and the rise in taxes in 2010. These measures did not prevent the downgrading of Mexico's sovereign rating by Fitch and Standard and Poor's. And, at the end of March, the government unveiled a new, moderately ambitious multi-year saving plan. The current account balance posted a deficit of 0.6% of GDP in 2009, compared with 1.7% in 2008, and this despite the fact there was a strong deterioration in Q3 stemming from the trade balance having moved from surplus into deficit owing to the forceful increase in imports. Incoming foreign direct investment was 75% lower than in the first half of the year, when the figure was already low compared with previous years. Conversely, portfolio investment inflows increased strongly in the period, offsetting in full the outflows in late 2008 and early 2009. The swap line with the Federal Reserve was not renewed, but faced with the return of portfolio flows the Mexican central bank decided to replenish its foreign currency reserves, while the FCL with the IMF (for $47 billion) was renewed.

In Argentina, GDP grew at a quarter-on-quarter rate of 1.9% in 2009 Q4, after posting a figure of 0.2% in Q3 (the respective year-on-year rates were –0.3% and 2.6%). The highlight was the improvement in domestic demand, boosted by the recovery in private and government consumption. Investment held at a negative rate. External demand also made a positive contribution to growth in the final quarter of 2009. Inflation, unlike in the rest of the region, rose during the six-month period, returning to a level of around 9.7% in March on official figures, against a background of unchanged and strongly expansionary fiscal and monetary policies, and of a gradual depreciation of the currency. In a setting of lower capital-account pressures, the Argentine central bank cut its seven-day reverse repo interest rate by 25 bp in October to 9.5%, following the cumulative reduction of 125 bp from July to September. The current account surplus widened by 1 pp of GDP in 2009 (to 3.7%), thanks to the bigger trade surplus. Conversely, foreign direct investment was halved, posting its lowest level since 2004, whereas portfolio investment outflows eased towards the end of the year after having been very intense over several quarters; however, they increased once again in early 2010 further to heightened institutional uncertainty. In 2009, the federal government's primary surplus was 1.5% of GDP (against 3.1% in 2008). This figure was higher than expected, due largely to the recording in December of a portion of special drawing rights as revenue, further to increased IMF resources. Underpinning the growth of government revenue during 2009 were social security contributions (largely because of the nationalisation of the so-called AFJP [retirement and pension fund managers]), and primary spending increased to a greater extent. Developments in provincial public finances were much more adverse, which led the government to relax the fiscal responsibility rule for the provinces for two years. The half-year period under analysis also saw the repeal of the law that prevented the country from reopening the external debt swap carried out in 2005, after which a fresh offer was directed at bond holdouts (bondholders who did not avail themselves of the previous offer) for a total of $20 billion of capital plus $10 billion of accrued interest. The bonds offered are the same as those under the 2005 debt swap, although they do not include the arrears since 2005 on the coupons indexed to Argentine GDP. Minority investors will receive the accrued interest in cash. Finally, the government's initiative to create a fund to cover payment of the external debt with international reserves, which has already been drawn down for an amount of more than $1.1 billion, resulted in the central bank governor being replaced.

In Chile, GDP shrank by 1.4% year-on-year in 2009 Q3, but rose by 2.1% in Q4. The improvement in domestic demand, thanks to the pick-up in private consumption (5.5% year-on-year at the close of 2009) and the persistence of very high government consumption growth rates were the main factors behind the recovery. External demand also contributed positively to growth, but much more moderately. The high-frequency indicators for Q1 pointed to an acceleration in growth, but the earthquake in late February substantially changed the outlook. The central bank estimates that the loss of productive capital is of the order of 3%, which has led the growth projections for 2010 and 2011 to be revised downwards and upwards, respectively, by several tenths of a point. Inflation was more volatile than in other countries in the region, giving rise to a reduction from 9.9% in October 2008 to –2.3% in November 2009, and a subsequent rise to 0.3% in March 2010. In respect of inflation, the earthquake has resulted in the temporary confluence of a supply-side shock due to product shortages and a demand-side shock due to the negative wealth effect, which might cause prices to rise somewhat more in 2010, falling thereafter in 2011. The central bank held official rates at 0.5%, and it began to withdraw the extraordinary liquidity facility that it adopted during the crisis. The current account balance posted a surplus of 2.8% of GDP in 2009, compared with the deficit of 1.5% in 2008, the result both of the increase in the trade surplus (8.5% of GDP) and of the reduction in the income deficit. The budget deficit stood at 4.5% of GDP (0.9% in the case of the structural deficit) as a result of the application of a strongly countercyclical fiscal policy. Public debt accounted for 6.3% of GDP, a little more than 1 pp above the 2008 rate, while the Economic and Social Stabilisation Fund, after having fallen during the year by somewhat more than 5 pp of GDP, totalled $11.29 billion (6.5% of GDP) at end-2009, which financed the fiscal stimulus plan. Prior to the earthquake, the budget for 2010 had withdrawn most of the impulse measures, although there was no return, for the second year running, to the 0.5% structural surplus rule. Nonetheless, after the earthquake priorities shifted towards spending on reconstruction, which is expected to account for around 5 pp of GDP over several years, and will be financed by temporary tax increases, the reassignment of budgetary appropriations, the sovereign fund and local and foreign currency-denominated issues. In these circumstances, the central bank has indicated that the official interest rate will be maintained pending observation of the impact of the earthquake on activity and inflation, but that it might stand at around 5% over a horizon of two years.

Following four quarters of negative year-on-year rates, Colombia showed an appreciable recovery in late 2009, expanding at a quarter-on-quarter rate of 1.1% (compared with 0.4% the previous quarter), the highest rate since end-2007. That placed the year-on-year rate at 2.5%. The strong growth of investment, the rise in private consumption and the strength of government consumption offset in part the sluggishness of exports, weighed down by Venezuela's trade restrictions, which are expected to have subtracted up to 1 pp of growth in 2009. Inflation continued to ease, standing at the end of the year at 2%, below the central bank's target (3.5%–5.5%). The central bank cut its interest rates by 50 bp in November and by a further 50 bp in April, to 3%, after announcing in March that it would intervene on the foreign exchange market with purchases of $20 million a day. Furthermore, it partly renewed (for an amount of $3.5 billion) the FCL with the IMF. Turning to the external sector, the current account deficit widened in the second half of 2009 to 2.2% of GDP, the result of an increase in the deficit on the incomes balance. The public sector posted a deficit of 4.1% of GDP in 2009, compared with 2.3% in 2008, while for 2010 a deficit of up to 4.5% of GDP is projected, owing to the decline in revenue and despite the downward revision of public spending. However, external borrowing needs are expected to be covered by the issue made in early April.

Peru recovered substantially in the second half of the year. In year-on-year terms, a positive rate of change (3.4%) was recorded in Q4, following two consecutive quarters of declines. The improvement stemmed from the favourable behaviour of domestic demand, which was boosted by the lagged impact of the fiscal stimulus package and by a notably expansionary monetary policy. The contribution of the external sector continued to be strongly positive. The signs of recovery in private domestic demand at the onset of 2010 have been confirmed and have meant that the growth projections for 2010 in Peru are among the highest in the region. Inflation reached a low in December and rose to 0.8% in March, although it is still below its target range (1%–3%). In these circumstances, the central bank held its official interest rates unchanged at 1.25%, although the tone of its latest announcements augurs a possible tightening of monetary policy given the renewed buoyancy of the economy. January saw the reintroduction of the foreign currency requirement for loans at less than two years, and a tax on gains in dollars arising on futures was set in place. From February, there was substantial intervention on the foreign exchange market. The current account balance posted a surplus of 0.2% of GDP in 2009, following the deficit of 3.7% in 2008, due to the higher trade surplus stemming from the collapse of imports and the lower deficit on the income balance. In the fiscal realm, the primary deficit stood at 0.7% of GDP (after a surplus of 3.6% in 2009) as a result of the application of a countercyclical fiscal policy.

In 2009 Q4, Venezuela showed a decline in GDP of 5.8% (–4.6% in the previous quarter), and this despite the fact that oil prices held practically throughout the year above their historical average (see Chart 11). The factor behind this contraction is the fall in the oil sector, owing to the cut in OPEC production, the weakness of demand from Venezuela's main trading partner, the United States, and the financial difficulties the State oil company underwent in the first half of the year. Domestic demand subtracted more than 24 pp from growth in Q4, in a setting of collapsing investment and heavily declining private consumption. Moreover, the problems of the banking sector in 2009 Q4 (control was taken over several financial institutions accounting for 12% of the system's assets and over various securities houses), along with the increasing contributions to the deposit guarantee fund, might have prompted an additional decline in credit. The inflation rate is holding at over 25%, driven by the strong depreciation of the parallel exchange rate. The difficulties in checking this depreciation led, in early January, to the official exchange rate being devalued from 2.15 to 4.3 bolivar per dollar, and to a new preferential exchange rate (of 2.6 bolivar per dollar) being created for specific goods imports. Notwithstanding this and the parallel measures implemented to increase the supply of dollars on the market, the parallel-market exchange rate remains strongly depreciated against the new central parity, and reached new all-time highs in mid-April. The effect of the devaluation on activity is uncertain, owing to the new dual system, but the inflationary impact will probably be significant. In any event, State oil revenues measured in local currency will increase. Finally, there was a net outflow of foreign direct investment totalling $3.1 billion (0.9% of GDP) in 2009.

30.4.2010.