Introduction

During the first half of 2010, economic recovery firmed in Latin America with a higher-than-expected growth rate, the result of buoyant domestic demand in most of the countries. In the region as a whole[1], year-on-year growth of 5.6% was posted in Q1, rising to 7.7% in Q2. Although this year-on-year growth is influenced by a favourable base effect, average quarter-on-quarter growth was 1.7%, above what had been seen during the first half of 2008, before the crisis. There were hardly any exceptions to this broad trend and, in fact, only Venezuela remained in recession, while Mexico is lagging somewhat in the current phase of recovery. Domestic demand contributed 10 pp to the aggregate year-on-year growth in the region in Q2, and external demand deducted 2.3 pp, which translated into a widening of the current account deficit to 0.3% of GDP. Nonetheless, this external imbalance was less than might have been expected in view of the strength of the demand for imports, due in part to the high level of commodities prices, which in turn contributed to the robustness of the recovery (see Chart 1 and Table 1).

Prices also trended relatively favourably. The average inflation rate stabilised at just over 6%, after rising in early 2010 to 6.6%. While this development masks sizeable differences across countries, inflation has significantly converged towards target in most of the countries with inflation targeting arrangements, and this despite the closing of output gaps. This relative easing has, moreover, ultimately fed through to expectations, albeit with differing intensity from one country to another.

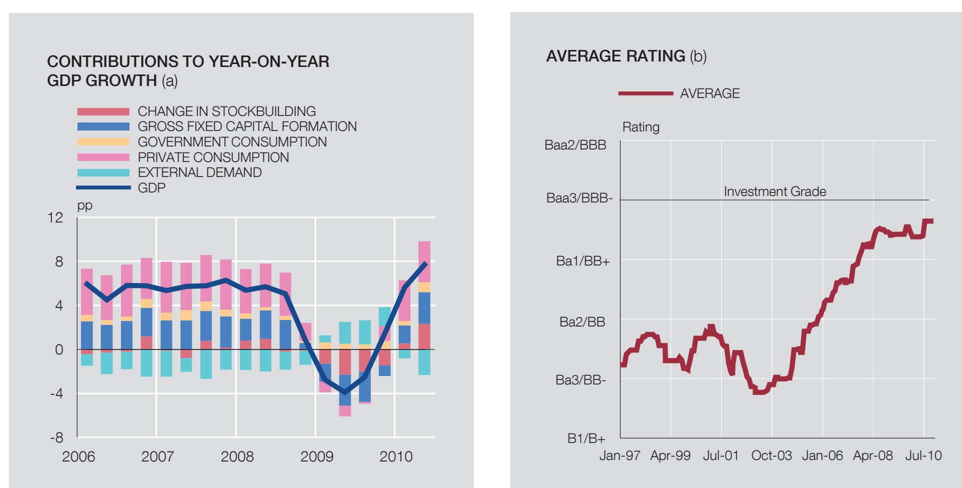
The soundness of these results helps explain why neither the turbulence arising from the fiscal and sovereign crisis in certain euro area countries, between April and June, nor the subsequent fears that a further slowdown would begin in the United States have had a lasting impact on Latin American financial markets, or worsened the growth outlook for 2010 and 2011. The contrary is rather the case. Growth forecasts have continued to be revised upwards, which is indicative of the resilience the region is showing. Among other factors, Latin America has benefited from the re-directing of its trade towards Asia, associated with the strong demand for commodities from this region. In the circumstances, the credit ratings of five countries (Chile, Colombia, Uruguay, Ecuador and Argentina) were revised upwards. Against this clearly favourable backdrop, with positive interest rate spreads over the industrialised economies, and in a setting of extraordinary and potentially growing monetary stimulus in the United States, capital inflows (chiefly portfolio inflows) have picked up in recent weeks and are beginning to pose difficulties for macroeconomic management in several countries, mainly owing to their impact on exchange rates, domestic liquidity and monetary policy. So far, a buffer against these pressures is being provided by a bigger build-up of reserves, and some countries have imposed administrative measures (Brazil and Peru).

From the economic policy standpoint, some countries began in the last six months to partly reverse the monetary stimulus deployed during the crisis. In May and June, respectively, the Peruvian and Chilean central banks initiated the cycle of official interest rate rises on which Brazil had earlier embarked in April. In contrast, Colombia and Mexico held their key interest rates unchanged, and Argentina continued to apply an expansionary monetary policy. Recently, the process of rises has been interrupted in Brazil and Peru, while the rate at which the

1. The average data to which this report refers are calculated using the information on seven countries: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

CONTRIBUTIONS TO GDP AND DEBT CREDIT RATINGS
Percentage

CHART 1



SOURCES: National statistics, Datastream and Banco de España.

a. Seven biggest economies.
b. Average ratings of the three major agencies, weighted by each country's GDP in PPPs.

official interest rate is rising has eased in Chile, a development which may have been influenced by the aforementioned upward pressure on exchange rates. In the fiscal policy realm, the budget balance as a percentage of GDP showed few changes in relation to the previous six months, at the regional level, posting a deficit of around 2.5% of GDP. However, in several countries there was an improvement in primary balances, attributable almost exclusively to the effect of the cycle. From a more structural perspective, mention should be made of the execution of a second debt swap in Argentina, which marks progress in the normalisation of its default situation (pending the resolution of its outstanding debt with the Paris Club), and the presentation by the Colombian government of a fiscal rule designed to manage the revenue expected as a result of the boom in the mineral/energy sector in the coming decade.

The outlook for Latin America is broadly favourable, although some slowing is expected in the second half of 2010 owing, partly, to the moderate tightening of monetary policies. External conditions, marked by a very lax monetary policy that has been pursued for longer than expected in the United States and by strong growth in Asia, are looking very expansionary for the region, in the face of which national policies should adopt a more restrictive stance. Indeed, the main discernible risk is, probably, that economic policies may not respond suitably and may ultimately adopt a procyclical bias. Specifically, the dilemma facing the authorities is to act more resolutely to prevent their economies overheating or, conversely, to adopt a less active position to protect themselves from the risk of a slump in the world economy and to avoid measures, especially in the monetary area, that may stimulate even greater capital flows.

Economic and financial developments: external environment

Following a first quarter in which the world economy showed considerable dynamism, growing at a year-on-year rate of 4.5%, signs of weakness in the developed economies began to emerge as from the end of Q2, more markedly so in the US economy. The signs of fragility were to some extent expected, since the recovery had been largely underpinned by re-stocking and, moreover, sizeable doubts remained over the capacity of private demand to take up the slack once the expansionary effects of the fiscal stimuli that had previously sustained activity progressively tailed off. US growth was checked from an annualised quarter-on-quarter growth rate of 3.7% in Q1 to 1.7% in Q2, while economic activity in Japan also slowed to

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2007	2008	2009	2008		2009				2010		September
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
GDP (year-on-year rate)												
Latin America (a)	5.8	4.2	-2.0	5.0	0.8	-2.9	-4.0	-2.5	1.4	5.6	7.7	
Argentina	8.7	6.8	0.9	6.9	4.1	2.0	-0.8	-0.3	2.6	6.8	11.8	
Brazil	6.1	5.1	-0.2	7.1	0.8	-2.1	-1.6	-1.2	4.3	9.0	8.8	
Mexico	3.3	1.5	-6.5	1.6	-1.1	-7.9	-10.0	-6.1	-2.3	4.3	7.6	
Chile	4.6	3.7	-1.5	5.2	0.7	-2.1	-4.5	-1.4	2.1	1.5	6.5	
Colombia (d)	6.9	2.7	0.8	3.1	-1.5	-0.4	-0.2	0.9	3.0	4.2	4.5	
Venezuela	8.1	4.8	-3.3	3.8	3.5	0.5	-2.6	-4.6	-5.8	-5.2	-1.9	
Peru	8.9	9.8	0.9	10.9	6.5	1.9	-1.2	-0.6	3.4	6.1	10.1	
Uruguay	7.5	8.5	2.9	9.4	7.6	2.6	1.1	2.8	4.7	8.8	10.4	
CPI (year-on-year rate)												
Latin America (a)	5.4	7.8	6.4	8.5	8.5	7.6	6.7	5.9	5.4	6.1	6.6	6.3
Argentina	8.8	8.6	6.3	8.9	7.8	6.6	5.5	5.9	7.1	9.0	10.6	11.1
Brazil	3.6	5.7	4.9	6.3	6.2	5.8	5.2	4.4	4.2	4.9	5.1	4.7
Mexico	4.0	5.1	5.3	5.5	6.2	6.2	6.0	5.1	4.0	4.8	4.0	3.7
Chile	4.4	8.7	0.4	9.3	8.6	4.8	1.8	-1.9	-3.0	-0.3	1.2	1.9
Colombia	5.5	7.0	4.2	7.7	7.8	6.6	4.8	3.2	2.4	2.0	2.1	2.3
Venezuela	18.8	31.4	28.6	34.6	33.4	29.5	28.2	28.7	28.1	27.4	31.9	28.5
Peru	1.8	5.8	2.9	6.1	6.6	5.6	4.0	1.9	0.4	0.7	1.1	2.4
Uruguay	8.1	7.9	7.1	7.6	8.6	8.2	6.7	7.1	6.3	6.7	6.9	6.3
BUDGET BALANCE (% of GDP)												
Latin America (a) (c)	-0.4	-0.5	-2.6	-0.2	-0.5	-1.5	-2.0	-2.8	-2.6	-2.6	-2.5	
Argentina	1.1	1.4	-0.6	1.9	1.4	1.0	0.0	-1.0	-0.6	-0.8	-0.4	
Brazil	-2.7	-1.9	-3.3	-1.8	-2.0	-2.8	-3.1	-4.2	-3.3	-3.4	-3.4	
Mexico	0.0	-0.1	-2.3	0.0	-0.1	-1.4	-1.7	-2.4	-2.3	-1.8	-2.3	
Chile	8.6	5.0	-4.6	6.1	5.0	1.3	-1.5	-3.9	-4.6	-3.8	-1.0	
Colombia	-2.8	-1.8	-4.3	-2.3	-1.8	-2.8	-3.0	-3.3	-3.8	-3.6	-4.3	
Venezuela	3.1	-1.2	-5.4	0.9	-1.2	-2.2	-1.4	-1.3	-0.6	-	-	
Peru	1.8	2.2	-2.0	2.1	2.2	1.4	0.1	-0.7	-1.8	-1.3	-1.0	
Uruguay	0.0	-1.5	-1.7	-1.0	-1.5	-2.1	-2.2	-2.2	-1.7	-2.0	-1.1	
PUBLIC DEBT (% of GDP)												
Latin America (a)	33.8	30.8	35.0	30.4	30.8	31.4	33.1	34.6	34.9	34.6	34.5	
Argentina	52.6	44.7	47.9	45.8	44.7	41.9	44.2	46.1	48.0	48.0	47.1	
Brazil	45.1	38.4	42.8	40.0	38.4	39.1	41.2	43.2	42.8	42.0	41.4	
Mexico	21.0	24.5	28.2	20.8	24.5	25.4	26.7	28.4	28.2	28.5	28.7	
Chile	4.1	5.2	6.1	4.5	5.2	5.0	4.9	5.8	6.1	6.8	7.4	
Colombia	32.9	33.4	35.5	32.8	33.4	36.8	35.2	33.6	35.1	34.6	35.4	
Venezuela	22.8	13.6	22.6	12.6	13.2	13.5	18.1	20.4	22.6	22.6	26.8	
Peru	29.8	24.1	26.7	23.9	24.1	24.8	26.1	26.9	26.7	25.0	23.5	
Uruguay	68.1	52.9	68.9	57.8	52.6	56.7	60.5	67.3	69.1	65.4	58.6	
CURRENT ACCOUNT BALANCE (% of GDP)												
Latin America (a) (b)	0.7	-0.5	-0.3	0.4	-0.5	-0.7	-0.7	-0.7	-0.2	-0.1	-0.3	
Argentina	2.8	2.1	3.7	2.8	2.2	2.0	3.3	3.6	3.7	3.0	2.4	
Brazil	0.1	-1.7	-1.5	-1.5	-1.7	-1.5	-1.2	-1.2	-1.5	-1.8	-2.2	
Mexico	-0.8	-1.5	-0.6	-0.9	-1.4	-1.5	-1.4	-1.4	-0.7	-0.5	-0.5	
Chile	4.5	-1.5	2.6	0.6	-1.4	-2.0	-1.4	0.7	2.6	2.6	1.6	
Colombia	-2.9	-2.8	-2.2	-2.1	-2.8	-2.9	-2.8	-2.7	-2.1	-2.1	-2.3	
Venezuela	7.9	12.0	2.3	15.9	11.7	7.6	2.9	-0.5	2.4	5.0	6.1	
Peru	1.3	-3.7	0.2	-2.4	-3.7	-3.3	-1.9	-0.8	0.2	0.1	-0.2	
Uruguay	-0.9	-4.8	0.7	-4.3	-4.8	-3.6	-1.1	-0.2	0.7	0.6	0.9	
EXTERNAL DEBT (% of GDP)												
Latin America (a) (b)	19.9	17.6	20.5	18.2	17.4	18.7	19.6	21.0	20.6	19.9	19.7	
Argentina	47.8	38.3	38.0	40.6	39.2	37.4	38.2	38.9	38.0	37.4	-	
Brazil	14.1	12.1	12.6	12.3	11.8	12.2	13.3	14.1	12.4	12.1	11.6	
Mexico	12.1	11.5	18.6	11.3	11.4	14.8	15.9	17.8	18.6	18.2	17.7	
Chile	34.0	38.0	44.7	37.5	37.6	40.0	42.1	45.3	45.0	42.2	42.2	
Colombia	21.4	19.1	23.2	18.7	19.1	19.9	19.7	21.9	22.9	18.8	19.4	
Venezuela	24.6	19.4	19.7	20.1	18.9	18.8	18.6	19.3	19.7	21.1	24.5	
Peru	30.6	27.3	28.0	28.2	27.3	27.5	28.0	28.4	28.0	27.2	25.4	
Uruguay	51.0	38.5	44.7	40.5	38.2	39.2	40.9	45.4	44.5	40.7	36.7	

SOURCE: National statistics.

a. Aggregate of eight represented countries, except Uruguay.
b. Four-quarter moving average.
c. Excluding Venezuela.
d. Seasonally adjusted series.

1.5%, after having expanded at a rate of 5% in Q1. In contrast, the pattern was different in the euro area, which grew by 3.9% in Q2, up on 0.8% in Q1, owing to Germany's momentum. However, there were also signs of slowing in the euro area at the start of Q3.

On the whole the emerging economies remained substantially buoyant during this period, China and India most notably so, but also Brazil. In any event, the signs of deceleration were more in response to policy measures aimed at avoiding an excessive rate of expansion (see Chart 2). Some measures aimed at cooling the real estate market in China had an effect, and led economic indicators to resume more sustainable – though still-high – rates. As a result, the pattern of distribution of world economic growth, with Asia to the fore, was conducive to high and relatively stable commodities prices during the last six months, which was in turn a significant boost for Latin America as an exporting region. Crude oil prices moved in a narrow range of $70-80 for most of the last six months, although they rose above these levels towards the end of the period. Metal prices drew close to their highs for the year and agricultural commodity prices also rose after the summer, partly as a result of the trade restrictions imposed by Russia.

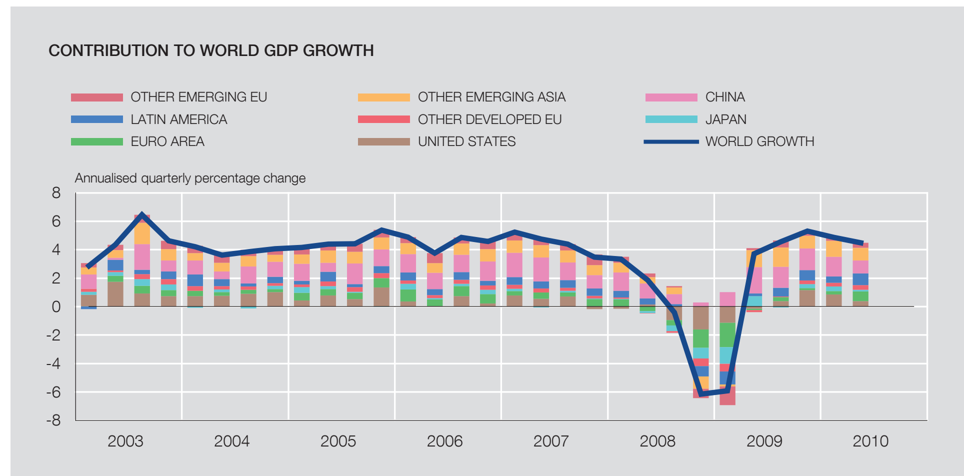
Against this background, the recovery seen on international financial markets in the opening months of the year has been checked in the past six months. From May to June, the predominant factor was the uncertainty over the fiscal situation in the euro area. The publication of the stress tests of European banks in July led to some improvement, but the focus of attention shifted shortly after to doubts over the sustainability of the current recovery in the developed economies. This situation translated into greater volatility and risk-aversion on the markets and flight towards safer assets. And while this movement has eased subsequently, some focal points of fiscal vulnerability in Europe remain active.

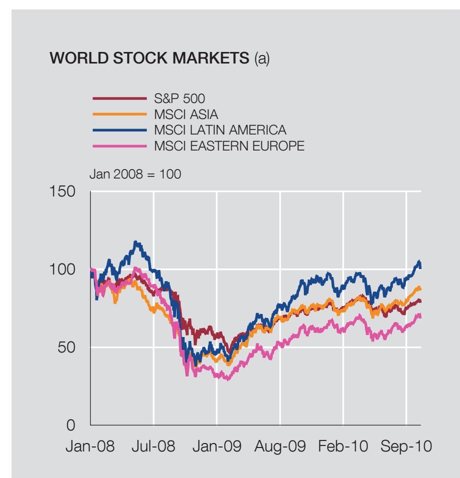
Turning to monetary policy, the main central banks kept their official interest rates close to zero. Nonetheless, set against the expectations prevailing only six months ago about a possible start of an exit strategy from the exceptional measures applied, the weakening of the economies has entailed a delay in expectations that interest rate levels will resume a normal footing. And it has even recently led the Bank of Japan to adopt further exceptional measures, while the possibility of extending quantitative easing is being considered in the United States and the United Kingdom. Against this backdrop, US ten-year interest rates, which had tended to normalise (upwards) in the period to April, declined considerably in the subsequent months (more than 150 bp, to close to 2.50%), despite the heavy volume of sovereign issues. On the foreign exchange markets, the dollar initially acted as a safe haven and strengthened against the euro until July, given the growing uncertainty associated with the sovereign debt of certain European economies. However, part of the rise in the dollar was corrected from August owing to the doubts over US growth and the increasing likelihood of further monetary stimuli. In September, the strength of the yen prompted the first intervention by the Bank of Japan on the foreign exchange markets for more than five years. This intervention highlights the growing sensitivity of many countries, including certain developed economies, to the risk of exchange rate overvaluation. It also shows the greater activism afoot to mitigate such overvaluation, through the build-up in reserves and, increasingly extensively, through the setting of capital controls in the emerging economies.

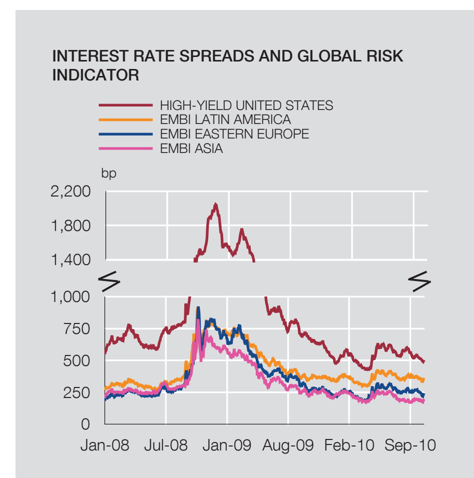
The emerging markets broadly trended in line with global markets and, although they were not insulated from the episodes of volatility and greater risk-aversion during the six-month period, they did show relatively greater resilience. Sovereign spreads, approximated by the EMBI+, widened moderately during the bout of turbulence generated by the fiscal situation in Europe, narrowing subsequently to around 280 bp, very close to the low for the year and at the level at which this spread stood before the global financial crisis.

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

CHART 2







SOURCES: National statistics and Datastream.

a. Indices in dollars.

Across the different regions, the Asian EMBI performed somewhat better than its Latin American and Eastern European counterparts. Stock markets, approximated by the dollar-denominated MSCI indices, tended to stabilise in the period to August, but rose substantially in September and in October. The Eastern European stock market index nonetheless performed worse than the other regions and remains further off the levels prior to the 2008 crisis than those of the other areas. Despite the fact the dollar acted as a safe-haven currency during some bouts of instability during the six-month period, the currencies of the emerging regions tended to pick up and ended the period at levels of appreciation close to the highs for the year. The Chinese renminbi appreciated very gradually (by over 2%) against the dollar, despite the June announcement of greater flexibility for the currency.

Financial markets and external financing

The highlights on Latin American financial markets over the past six months included, initially, their notable resilience in the face of the tensions arising, firstly, due to the doubts over the sustainability of certain European countries' sovereign debt and, subsequently, to the weakening of the US economy. Despite this resilience, Latin American markets were not completely immune and saw some increase in volatility between May and June, accompanied by a moderate depreciation of certain currencies (in particular the Brazilian real, the Colombian peso and the Chilean peso, which had previously been appreciating forcefully), by a widening of

sovereign spreads and by stock market declines. From July, the markets resumed an upward course which has intensified in all segments (stock market, bonds, foreign exchange markets) in recent weeks, in particular following the intervention by the Bank of Japan on the foreign exchange markets, in mid-September, and coinciding with the rising expectations over further monetary easing in the United States.

In fact, in recent months the structure of capital flows has changed to some extent, in two directions. First, towards the emerging markets, in particular those with a favourable growth outlook and positive interest-rate spreads, as is the case in Latin America. And further, in favour of portfolio flows and, with some lag, of foreign direct investment which, though it has picked up since the depth of the crisis, is still far below pre-crisis levels. Significantly, portfolio investment flows over the past 12 months in Latin America stood in Q2 (the latest figure available) at an all-time high (close to $100 billion), concentrated in the main in Brazil. However, direct investment flows in cumulative terms, likewise to Q2, stood at somewhat over $60 billion, with a more proportional distribution between Brazil, Mexico and the rest of Latin America (see Chart 3). There has also been a strong increase in the volume of both public and private international issues, following the temporary closure of the markets during the spring months.

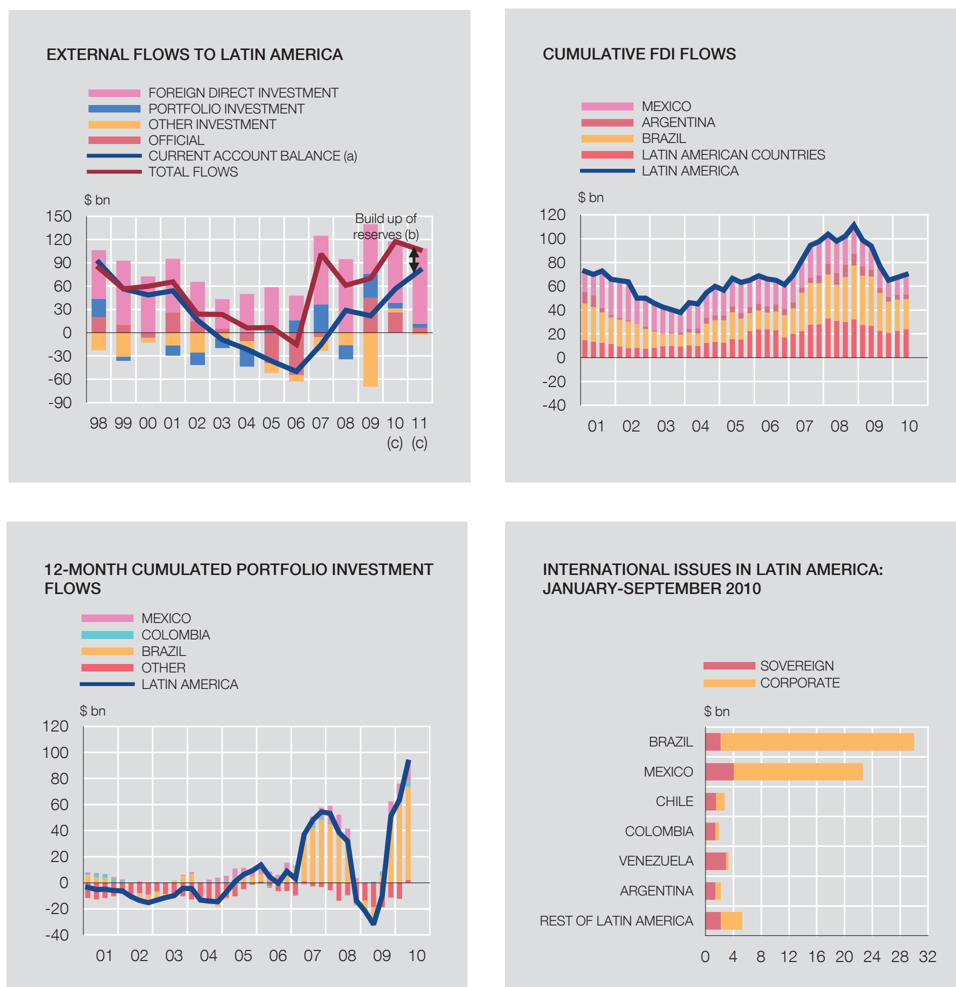
The exchange rates of most of the Latin American currencies (but especially the Brazilian real, the Colombian peso and the Chilean peso), which had tended to strengthen as from the summer, appreciated more sharply, standing in October at levels close to their 2008 highs. Since the start of the year, the Colombian peso has appreciated by more than 15% against the dollar. The appreciation of the Chilean peso, the Brazilian real and the Peruvian sol has been somewhat more moderate but, if calculated from their low in 2008, the figure exceeds 40% in Brazil and 30% in Chile and Colombia (see Chart 4). In contrast, the Mexican peso has held relatively stable throughout the period (except at the time instability was at its height in Europe, when it tended to appreciate) and the Argentine peso has continued on its gradual but constant depreciating course (20% in cumulative terms since mid-2008, 5% in the year to date).

The appreciation of exchange rates, in parallel with the rise on stock markets and the narrowing of sovereign spreads, has once again given rise to discussions in the countries concerned about the risks posed by the strong increase in capital inflows and the excessive appreciation of exchange rates. There are also talks about how to manage them, mainly after the unsuccessful discussions in this connection at the IMF meetings. Against this background, Brazil raised its tax on financial transactions from 2% to 4% in October, subsequently increasing it to 6% for fixed-income investment flows, a measure equivalent to the introduction of capital controls via prices. Peru likewise introduced various capital controls and even countries such as Chile, traditionally inclined not to intervene on the foreign exchange market, left the door open to considering such controls, as a last resort. The build-up of reserves has thus continued, meaning they are at an all-time high, and some countries are easing the pace at which they are raising their official interest rates (Brazil, Peru and Chile).

Key developments in respect of credit default swaps (CDSs) were their stability in Brazil, Mexico and Chile (moving in a narrow range between 100 bp and 150 bp in the two former countries, and below 100 bp in the latter) and, in contrast, the strong widening seen in risk premia in Venezuela and in Argentina (where CDSs widened to 1400 bp in June, strongly affected by the European sovereign crisis). In Argentina, risk premia recently moved back towards their low for the last five years (500 bp), a trend that began following the resolution of the unpaid debt swap in June. However, in Venezuela the economic downturn, elections and the foreign exchange market restrictions led CDSs to hold at levels close to their all-time high until very

EXTERNAL CAPITAL FLOWS AND FINANCING
$ bn and %

CHART 3



SOURCES: JP Morgan, IMF and national statistics.

a. A positive sign denotes a current account deficit.
b. Difference between investment flows and the current account balance (-).
c. WEO forecasts (October 2010) for 2010-2011.

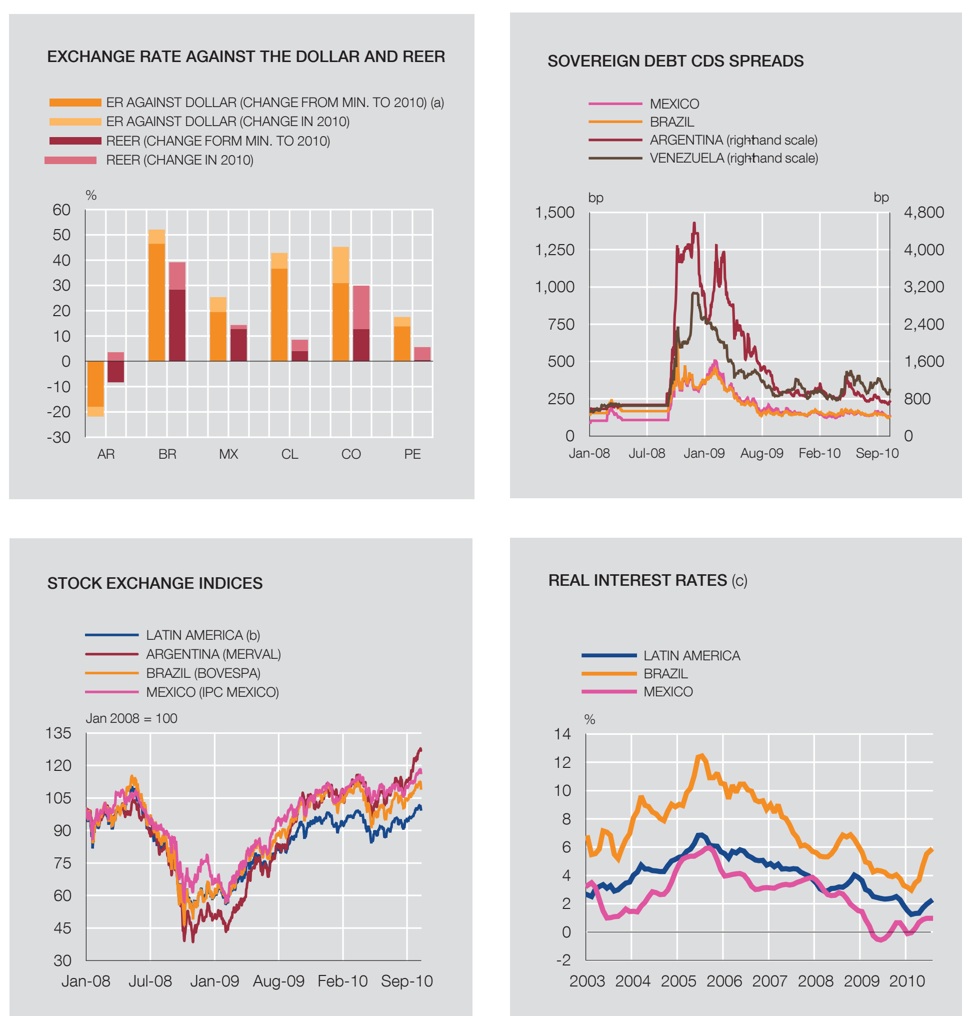
recently. As regards developments on stock markets, the Argentine, Mexican and Brazilian bourses fell by 15% between May and June, but recovered gradually thereafter, to stand once more in September at highs for the year, an all-time high in the case of Argentina. That said, the stock markets that posted the biggest gains were those of Chile and Colombia (more than 30% in the year to date).

Activity and demand

Economic growth was surprisingly high in most of the Latin American economies in the first half of the year. At the same time, the contribution of domestic demand to the region's year-on-year growth progressively increased, exceeding 10 pp (albeit with a sizeable contribution from stocks), while external demand subtracted more than 2 pp in Q2. This mirrored the pattern prior to the crisis, although much more markedly so.

All the economies – with the exceptions of Mexico and, above all, Venezuela, which remains in recession – showed strong dynamism in the first half of the year. In Q1 there was a strong increase in the region's year-on-year growth rate of more than 4 pp to 5.6%, which was to some extent biased upwards owing to a base effect (the quarter-on-quarter rate was 1.1%). However, the acceleration in activity was clearer in Q2, with quarter-on-quarter growth of 2.3%,

CDS OVER SOVEREIGN DEBT, STOCK MARKETS AND DOLLAR EXCHANGE RATE CHART 4
Basis points, indices and level



SOURCES: Datastream and JP Morgan.

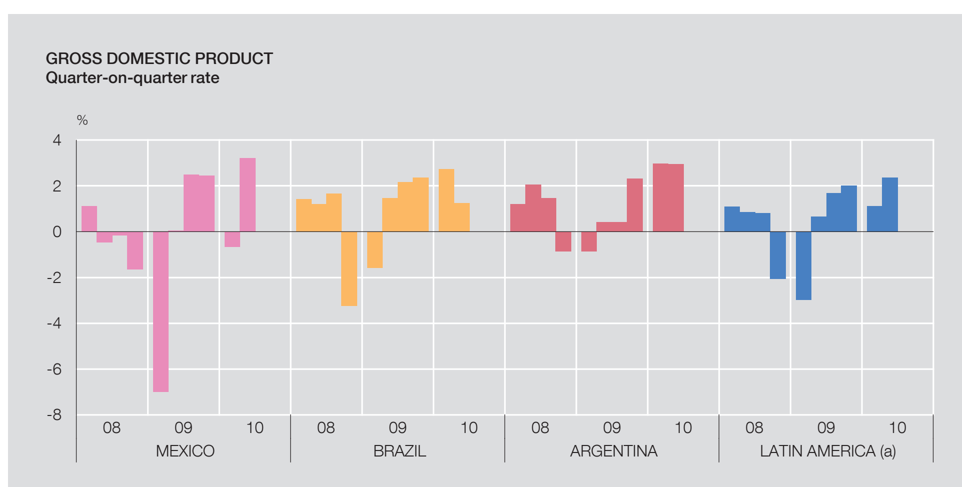
a. Minimum value since the bankruptcy of Lehman Brothers (15.9.2008). The value as at that specific date is taken from Argentina.
b. MSCI Latin America Index in local currency.
c. Short-term interest rate less inflation rate.

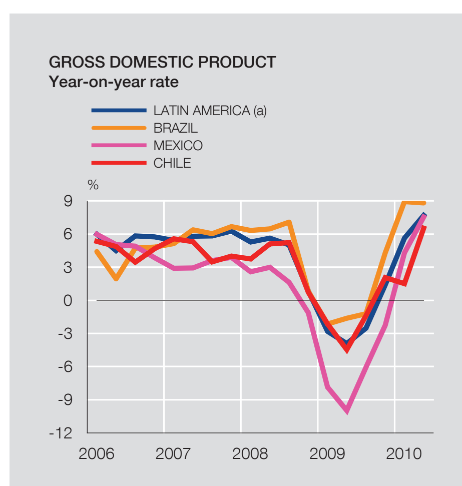
raising the rate on a year earlier to 7.7%. The Brazilian economy was notably dynamic, growing at a year-on-year rate of close to 9% in both quarters, underpinned by the strength of domestic demand (see Chart 5), and providing a boost to its closest trading partners: Argentina (which posted year-on-year growth of 11.8% in Q2) and Uruguay (10.4%), something not habitual in the past (see Box 1). In recent months, however, some easing has been seen in Brazil (mainly in the industrial sector, affected by the discontinuation of certain tax exemptions for investment), though it has sustained high growth rates, given the strong labour market (the unemployment rate stood at a low of 6.7% of the labour force in August), the continuing momentum of lending by public-sector banks (which is growing at a year-on-year rate of 30%) and favourable business and consumer confidence indicators.[2] In Chile (where growth in Q2 stood at 6.5% year-on-year) and Peru (10.1%), economic activity posted very high rates, chiefly as a result of the pick-up in domestic demand and, most specifically, in investment.

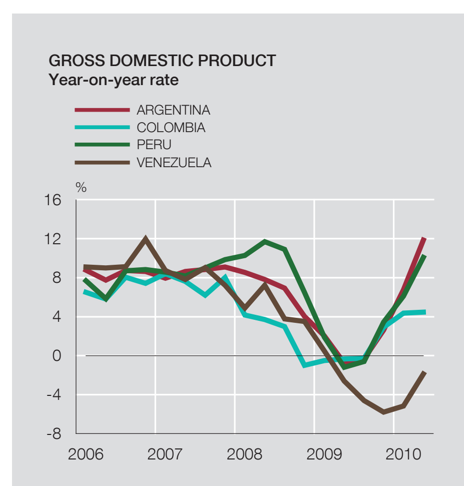
2. However, for the moment the easing has been taken as a factor for justifying the interruption in late August of the cycle of interest-rate rises in Brazil, in addition to other structural reasons.

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

CHART 5







SOURCE: National statistics.

a. Aggregate of the seven main economies.

Conversely, the recovery in Mexico continued to be very sluggish, dependent on the foreign sector and tied to the US business cycle, and with a scant contribution from domestic demand. In this setting, and although activity grew substantially in Q2 (2.3% quarter-on-quarter, and 7.6% year-on-year), part of it can be attributed to a base effect and to a relatively considerable build-up in stocks (see the final section in this report on country-by-country economic developments).

Analysis of the composition of GDP on the demand side identifies the drivers of growth at the regional level: on one hand, the strong recovery in gross capital formation (which posted growth of close to 17% year-on-year in Q2) and, on the other, the expansion of private consumption (5.8% year-on-year) (see Chart 6), the behaviour of whose main determinants remained, with few exceptions, very positive throughout the period. Investment was spurred on by the improved growth outlook (which has given rise to an upward revision of the business confidence indicators), the rise in commodities prices, the decline in real interest rates and the greater availability of financing (external and internal alike, with credit on a gradually recovering trend). These factors broadly allowed the halt in investment decisions between late 2008 and end-2009 to be overcome. Even so, investment as a proportion of GDP remains on average some 3 pp below the highs reached in early 2008, set against the gradual closure of output gaps. In addition,

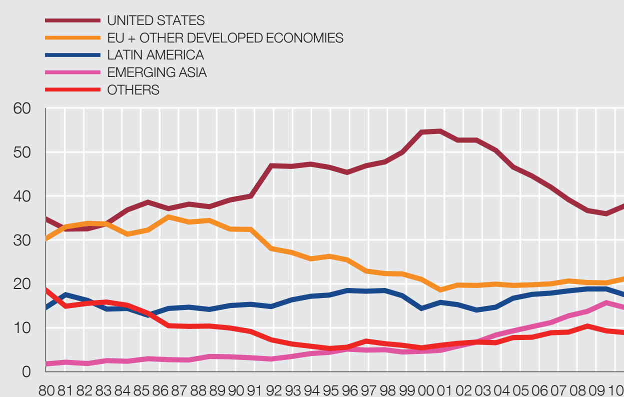
The external integration of the Latin American economies has in recent years undergone a significant reorientation, in particular as regards their trade.[1] Since the end of the 1980s, and especially in the second half of the current decade, the region has recorded an increase in its openness to trade (as measured by the sum of exports and imports divided by GDP), which reached 46% in 2010, accompanied by greater diversification in its export destination countries, as shown by the sharp decline in the Herfindahl indices measuring the concentration of foreign trade.[2]

1. This box refers to trade integration. The region's financial integration, measured by its foreign assets and liabilities, has remained practically unchanged since 2000 (rising from 98% of GDP in 2000 to 102% of GDP in 2009). **2.** These indices are lower than, for example, those calculated for Spain (around 10 for exports and 7.5 for imports).

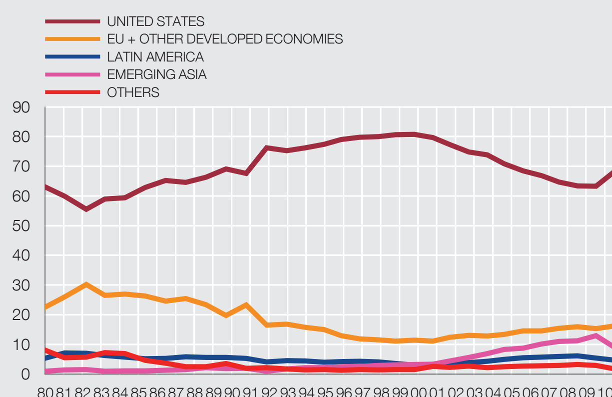
The main trends in the reorientation of the region's foreign trade are presented in Panel 1 and the accompanying table. As can be seen, the United States continues to be Latin America's main trading partner, although its relative importance has substantially diminished over the last decade. In particular, the share of exports and imports corresponding to the United States has fallen from 55% in 2000 to 38% in 2010. This space has largely been occupied by the emerging Asian economies, whose share rose from 4.9% to 14.7% during the same period and, among the latter, by China, whose share increased from 1.3% of the region's foreign trade to 9.3%. Between these dates, intra-regional trade rose from 14.4% to 17.6%. These overall results are influenced, however, by the figures of Mexico, the region's largest exporter and importer, which in the 1980s already had strong ties with the United States (63% of exports and imports) and weak ties with the rest of Latin America

THE REORIENTATION OF LATIN AMERICAN TRADE

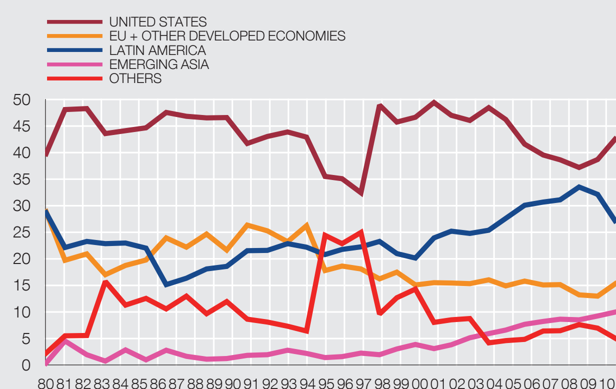
LATIN AMERICA: TRADE INTEGRATION (a)



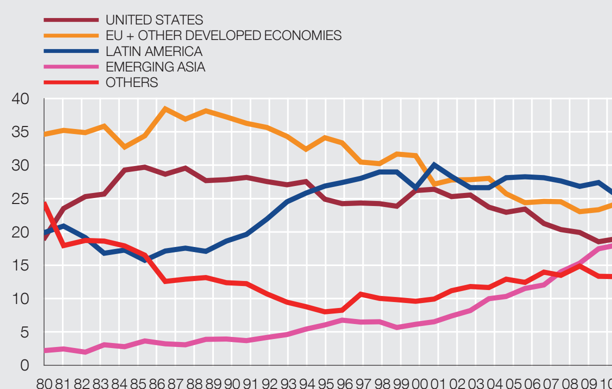
MEXICO: TRADE INTEGRATION (a)



CENTRAL AMERICA AND CARIBBEAN (b)**: TRADE INTEGRATION** (a)



SOUTH AMERICA (c)**: TRADE INTEGRATION** (a)



SOURCES: Datastream and Banco de España.

a. Percentage of all exports and imports corresponding to each country/block depicted.
b. Dominican Republic, Guatemala, Costa Rica, Honduras, El Salvador, Nicaragua, Jamaica, Haiti and Bahamas.
c. Argentina, Brazil, Uruguay, Colombia, Chile, Peru, Venezuela and Ecuador.

TRADE REORIENTATION: MAIN PARTNERS

TABLE 1

	EXPORTS						IMPORTS						HERFINDAHL INDEX (a)		% OF GDP	
													EXP.	IMP.	EXP.	IMP.
Argentina																
1980-1990	US	11.8	Netherlands	10.0	Brazil	8.2	US	20.3	Brazil	13.9	Germany	10.2	4.1	8.9	9.0	6.2
2006-2010	Brazil	19.0	China	8.0	Chile	7.7	Brazil	32.5	US	12.8	China	10.7	6.3	14.0	23.7	19.0
Brazil																
1980-1990	US	25.0	Netherlands	6.6	Japan	6.4	US	18.8	Iraq	10.7	Argentina	9.5	8.2	7.2	10.1	7.9
2006-2010	US	14.3	Argentina	8.7	China	8.6	US	15.6	China	11.3	Argentina	8.4	4.7	5.9	13.2	12.1
Mexico																
1980-1990	US	62.2	Spain	6.7	Japan	6.4	US	64.7	Germany	5.2	Japan	5.0	39.9	42.6	16.6	13.6
2006-2010	US	81.5	Canada	2.9	Germany	1.5	US	50.1	China	10.9	Japan	5.4	66.5	27.1	28.1	29.7
Chile																
1980-1990	US	19.4	Japan	11.8	Germany	10.7	US	21.2	Japan	9.0	Brazil	8.6	7.9	7.5	27.2	26.5
2006-2010	China	15.0	US	12.5	Japan	9.9	US	18.8	China	11.6	Argentina	10.0	6.5	7.7	44.0	33.8
Colombia																
1980-1990	US	35.5	Germany	14.2	Netherlands	5.2	US	35.2	Japan	9.9	Germany	6.7	15.8	15.0	14.9	13.9
2006-2010	US	36.1	Venezuela	15.6	Ecuador	4.2	US	29.1	China	9.6	Mexico	8.4	16.3	11.3	17.3	21.2
Venezuela																
1980-1990	US	40.8	Canada	5.0	Neth. Ant.	4.5	US	46.0	Germany	7.0	Japan	6.4	17.9	23.0	27.5	22.2
2006-2010	US	38.9	Neth. Ant.	8.1	China	3.7	US	26.5	Colombia	13.1	Brazil	9.9	16.2	10.9	29.2	22.3
Peru																
1980-1990	US	30.0	Japan	12.5	UK	5.1	US	31.5	Japan	7.7	Germany	7.1	11.7	12.2	16.7	16.2
2006-2010	US	20.2	China	14.1	Canada	8.7	US	22.1	China	10.6	Brazil	8.5	8.5	8.6	27.2	22.4
Ecuador																
1980-1990	US	51.4	Japan	3.9	Panama	3.8	US	32.5	Japan	11.4	Germany	7.9	27.0	13.6	25.6	24.7
2006-2010	US	43.3	Peru	9.5	Chile	6.0	US	23.2	Colombia	10.6	Venezuela	9.8	21.0	9.2	35.7	36.6
Uruguay																
1980-1990	Brazil	19.4	US	10.8	Germany	8.9	Brazil	20.4	Argentina	12.3	US	9.3	7.4	8.4	21.8	19.6
2006-2010	Brazil	17.4	China	8.2	Argentina	7.5	Argentina	19.7	Brazil	17.8	China	9.9	6.1	10.1	28.4	30.0
Latin America																
1980-1990	US	36.6	Japan	5.9	Germany	4.6	US	36.6	Germany	6.7	Japan	6.3	14.7	15.1	14.5	12.0
2006-2010	US	43.2	China	5.4	Brazil	2.7	US	33.1	China	10.6	Brazil	5.3	19.6	13.3	22.4	21.1
Latin America excluding Mexico																
1980-1990	US	27.6	Japan	5.7	Germany	5.7	US	26.2	Germany	7.3	Japan	6.8	9.3	9.2	13.6	11.3
2006-2010	US	20.8	China	8.1	Brazil	3.8	US	18.9	China	10.3	Brazil	8.3	6.2	6.7	20.1	17.7

SOURCES: IMF and Banco de España.

a. Sum of the square of the shares of each trading partner in each country's or region's total foreign trade. The bounds of the index are therefore between 0 and 100.

(5.8%). Its dependence on the United States increased following the signing of the North American Free Trade Agreement in 1995 (to reach 81.5% in the case of its exports in 2010).[3] The countries of Central America and the Caribbean are in a similar situation. Their trade dependence on the United States rose to 49.2% in 2000, and rose further following the signature of various free trade agreements with the northern neighbour, which supplement the set of treaties contained in CAFTA + DR.[4] Nonetheless, even in these countries the weight of emerging Asia – and specifically China – has grown substantially in recent years, although it is still at relatively low levels (4.6% of the total). By contrast, foreign trade developments in the main South American countries show how intra-regional trade has increased and the extent of the diversification towards Asia, to the point that since 2004 Latin America has been the main source and destination for the exports and imports of South America, and the share of emerging Asia (basically China) rose from 6.5% in 2000 to 18% in 2010.

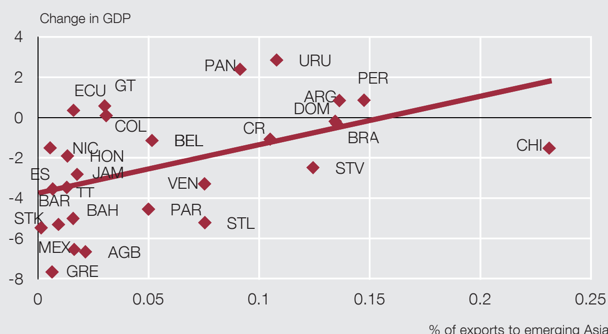
The factors driving this reorientation have been, on one hand, the strengthening, with progress and setbacks, of the most advanced regional trade agreements, such as MERCOSUR[5], along with the new strategy of seeking bilateral trade agreements with the Pacific basin followed by certain Andean countries, such as Chile, Peru and,

3. When Mexico is removed from the analysis the trends described above become even clearer: the United States represents 19% of the foreign trade of the region without Mexico, a similar share to that of emerging Asia (18%), and behind those of intra-regional trade (25.6%) and the EU (24.2%). **4.** Dominican Republic-Central America Free Trade Agreement.

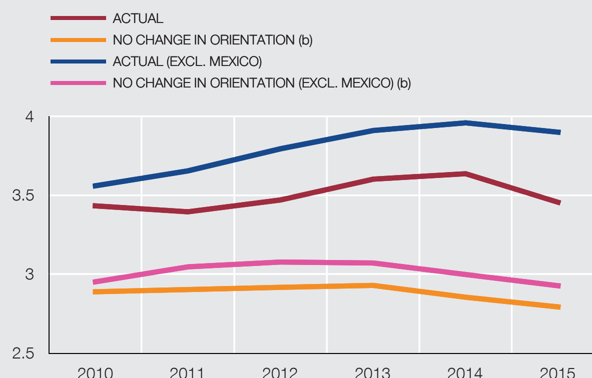
5. The increase in intra-regional trade has been based fundamentally on manufactures (and among the latter, medium-technology consumer goods, such as cars), which may explain the decline in the share of the region since the start of the crisis in 2008.

TRADE REORIENTATION: OUTLOOK AND RISKS

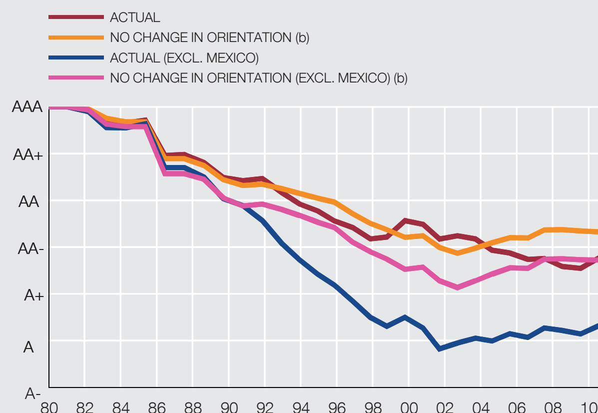
LATIN AMERICA: CHANGE IN GDP AND FOREIGN TRADE



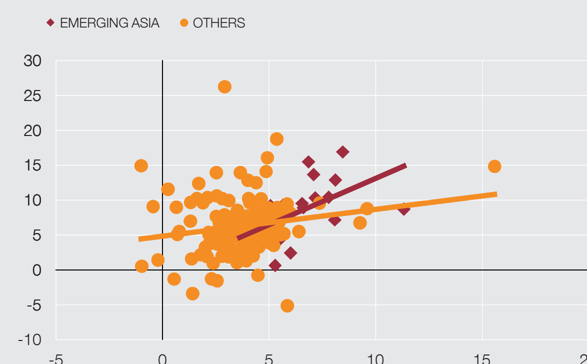
LATIN AMERICA: TRADE PARTNERS' GDP GROWTH (c)



LATIN AMERICA: WEIGHTED RISK OF TRADE PARTNERS (a)



RELATIONSHIP BETWEEN GDP GROWTH AND IMPORT GROWTH



SOURCES: Datastream and Banco de España.

a. Ratings of the region's trade partners weighted by their share in trade.
b. Keeping the trade structure of the 1980s and 1990s for the whole period.
c. Growth of GDP of the region's trade partners weighted by their share in trade.

to a lesser extent, Colombia; and on the other hand, the strong and prolonged increase in the demand for (and prices of) commodities (the main export of a large part of Latin America)[6] worldwide, but especially in Asia and, in particular, China. The entry of the latter into primary product markets has made it the main world importer of agricultural (17.4% of total world imports) and metal commodities (20.7%), and the third largest importer of oil (6.7% of the total, behind only the United States and Japan).[7] The commodities boom since 2003 has also raised the value of commodities in total exports (from 25% to 34.1% or, in the case of the Andean countries, from 55.6% to 64.4%), which therefore explains a large part of the increase in the region's openness.[8]15 In this context, China has significant further potential to develop, despite the sharp increase in its share of Latin American trade, since no country in the region has yet signed an extensive free trade agreement with the Asian giant.[9]

This reorientation of foreign trade has been to the region's advantage during the international financial crisis, since the revival of external demand, once world trade (especially in Asia) had begun to grow again and commodity prices had recovered from their collapse, has contributed to the rapid recovery in activity. The geographical structure of external trade would also partially explain the heterogeneity of the impact of the crisis in the region. On the one hand, Mexico and Central America, the countries most dependent on trade with the United States, have experienced recessions without precedent since the 1930s, while on the other hand, those countries that have increased their trade with Asia have had relatively small declines in GDP in comparison with the past (see Chart 2).

Looking ahead, the new structure of foreign trade may help strengthen the external demand of Latin America, given that the reorientation has been towards more dynamic economies that are predicted to be the engines of world trade in the coming years. Chart 2 presents an estimate of GDP growth in the countries with which the region trades, which may be an indicator of the potential growth of Latin American export markets until the year 2015. According to these estimates, if the Latin American countries had maintained their 1980s structure of trade, the growth in GDP of their trading partners between 2010 and 2015 would on average be 0.6 pp lower than with the current structure. If Mexico is excluded from this calculation, the difference is even greater, at close to 0.8 pp on average. In addition, these new trading partners of Latin America have a higher import elasticity of GDP growth than the rest of the world (see Chart 2), and need almost double the amount of energy that the developed countries need to generate $1,000 of GDP, energy products being one of the areas in which Latin American countries are specialised.

On the other hand, the new structure of foreign trade also entails a somewhat higher risk, as seen in Chart 2. The average sovereign rating (weighted by the countries' shares in foreign trade) of the group of countries with which Latin America trades is lower than it would be if the region had maintained the same geographical structure of exports and imports as in the 1980s. That said, the risk is still low and, in the wake of the crisis, the risk outlook for the Asian countries has improved relative to that of the advanced countries. Another element of weakness that should be highlighted is that all these trends may strengthen a commodities-based export model, which history shows can, in some cases, be detrimental to the development of other more dynamic sectors and, ultimately, limit growth potential. Bucking this trend will be one of the main challenges for this region in the coming years.

6. Brazil is the ninth largest world exporter of agricultural commodities and the fifth largest exporter of food products; Venezuela is the ninth largest exporter of fossil fuels and Chile the fifth largest exporter of metals. **7**. With regard to bilateral trade in primary products, China is Brazil's main trading partner (accounting for 20.9% of its total commodities exports in the last five years, as against 8.9% of all its exports); in Argentina, China is the main destination for exports of soya oil (30.9% of the total), soya beans (79.2%), oil (42.85) and leather (35%); in Peru, more than 87% of trade with China is in commodities, and China is the main trading partner in most metals, such as copper (38% of the total) and lead (60% of the total); in Chile, 43% of all copper exports go to China. **8.** ECLAC (2010), Latin America and the Caribbean in the World Economy 2009-2010. **9.** Chile, in 2005, and Peru and Costa Rica, in 2010, have been the pioneers in seeking such an agreement.

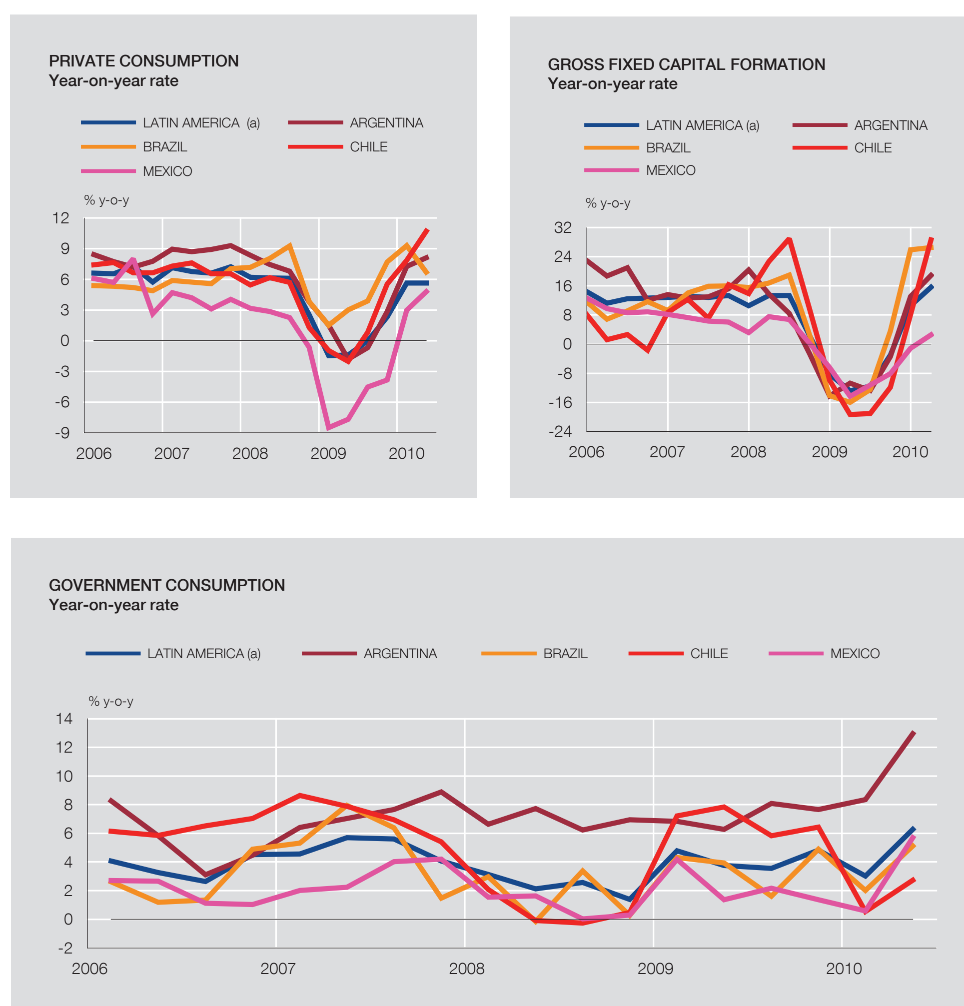
there were specific shocks in some countries (the record harvest and the boost to manufacturing exports to Brazil in Argentina, and the earthquake in Chile and the subsequent rebound in investment) which help explain much of the pattern of investment in these countries.

Turning to developments in private consumption, the significant resilience of this variable in most countries was notable, and may be related to the better behaviour of labour markets compared with previous crises, to the lack of a decline in real wages and probably, too, to the rapid recovery in confidence. In this respect, although significant differences were observed from one country to another, the elasticity of the unemployment rate to the change in GDP was notably less than in previous recessions.[3] Secondly, although there was a reduction in private

3. See World Bank (2010), *From Global Collapse to Recovery*, in the section devoted to labour markets in Latin America.

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

CHART 6



SOURCE: National statistics.

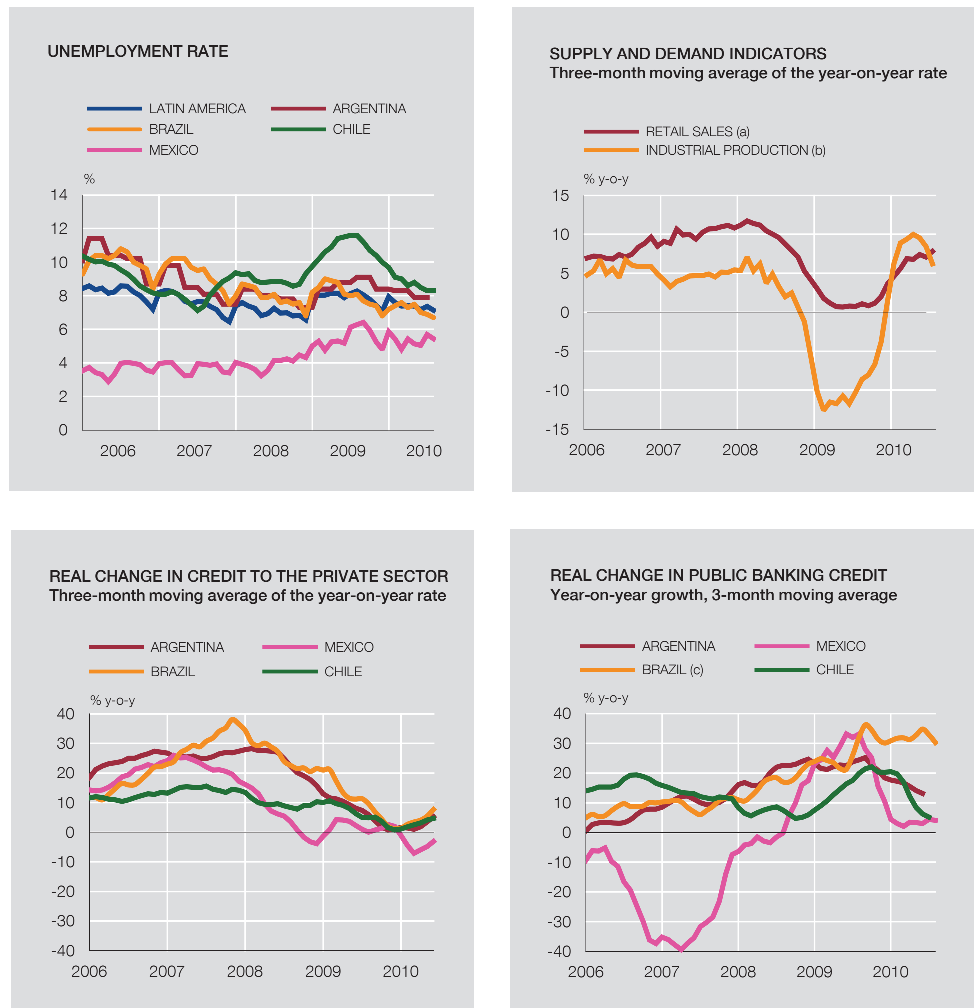
a. Seven biggest economies.

dependent employment and a rise in self-employment and non-remunerated family work (thereby interrupting the ongoing relative reduction in the shadow economy observed in prior years), there was no generalised precariousness in dependent employment[4] (a notable exception will be Mexico). One crucial explanatory factor is that many of the governments in the region were able to implement countercyclical macroeconomic policies, while in previous crises they were obliged to adopt adjustment policies. A part of these policies had a favourable impact on employment, e.g. increases in public investment, emergency employment programmes (temporary job creation for the unemployed in socially useful infrastructure maintenance or construction), job preservation programmes, social protection policies (extension of the duration of unemployment insurance), etc. Further, unlike in previous crises, real wages did not fall, given the low inflation and the downward stickiness of nominal wages. In this respect, and with some delay in relation to the recovery in activity, credit to the private sector is picking up in most of the countries (see Chart 7), despite the withdrawal of public banking (except in Brazil). In Mexico, however, the main determinants of consumption continued to show significant weakness: peso-denominated remittance revenues are below their level one year ago, con-

4. See ILO (2010), Panorama Laboral 2009. América Latina y el Caribe.

EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Year-on-year rate and its three-month moving average, and percentages

CHART 7



SOURCE: National statistics.

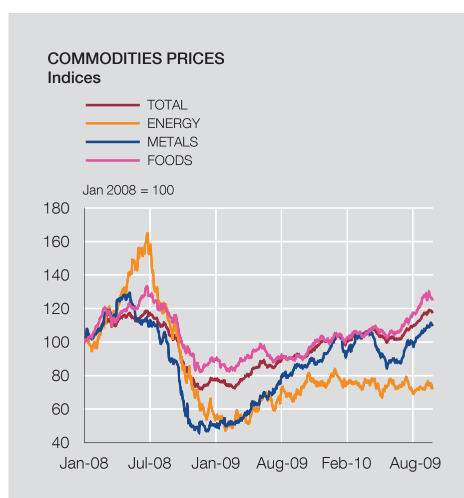
a. Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
b. Eight biggest economies.
c. BNDES.

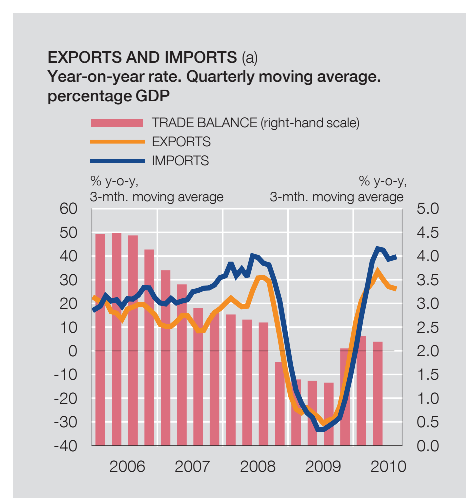
sumer credit continued to decline and formal employment held below its October 2008 level, against a background of continuous growth in shadow-economy employment.

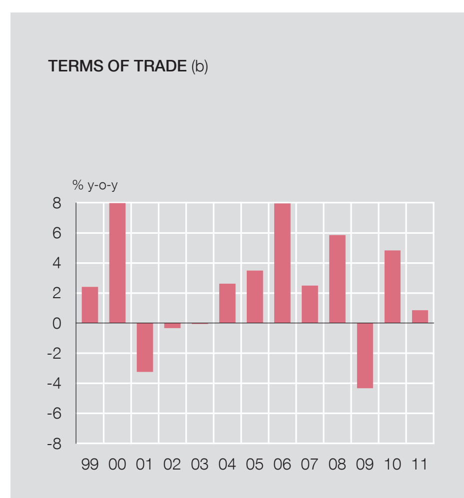
The negative contribution of external demand to growth is another significant feature of the last six-month period. Admittedly, exports increased substantially in value, by close to 30% year-on-year, largely as a result of the rise in commodities prices, linked in turn to the robustness of Asian demand; but the buoyancy of domestic demand tended to translate into a deterioration in the aggregate trade balance, given that the growth of imports exceeded 45% in June, easing off subsequently. The trade balance has thus retained a surplus of slightly more than 2% of regional GDP thanks to the favourable impact of the terms of trade (although the balance is in deficit in Brazil and, to a lesser extent, in Mexico). Despite the poorer performance of the deficit on incomes and services, the current deficit remains very low (0.3% of GDP at the regional level in Q2). Country by country, there is a clear difference between those running a relatively comfortable current surplus (mainly Venezuela and Argentina) and those running a deficit (especially Brazil, whose current deficit of 2.2% of GDP is once again at a level unseen since 2002, following the worsening in recent quarters) (see Chart 8). In any event, in the region as

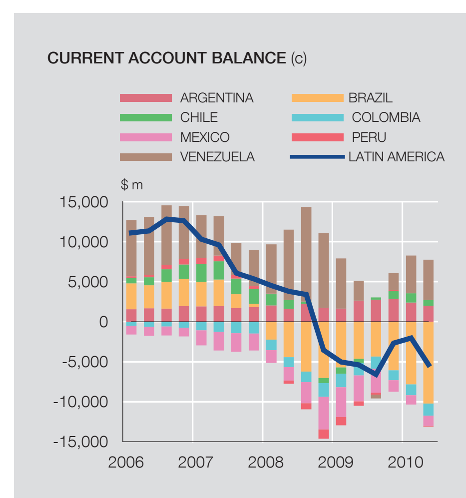
EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rates of change, indices and $bn

CHART 8









SOURCES: National statistics, IIF, central banks and Banco de España.

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

a whole the sharp inflow of capital is allowing the current deficit to be comfortably financed and, moreover, it is accentuating the build-up in reserves.

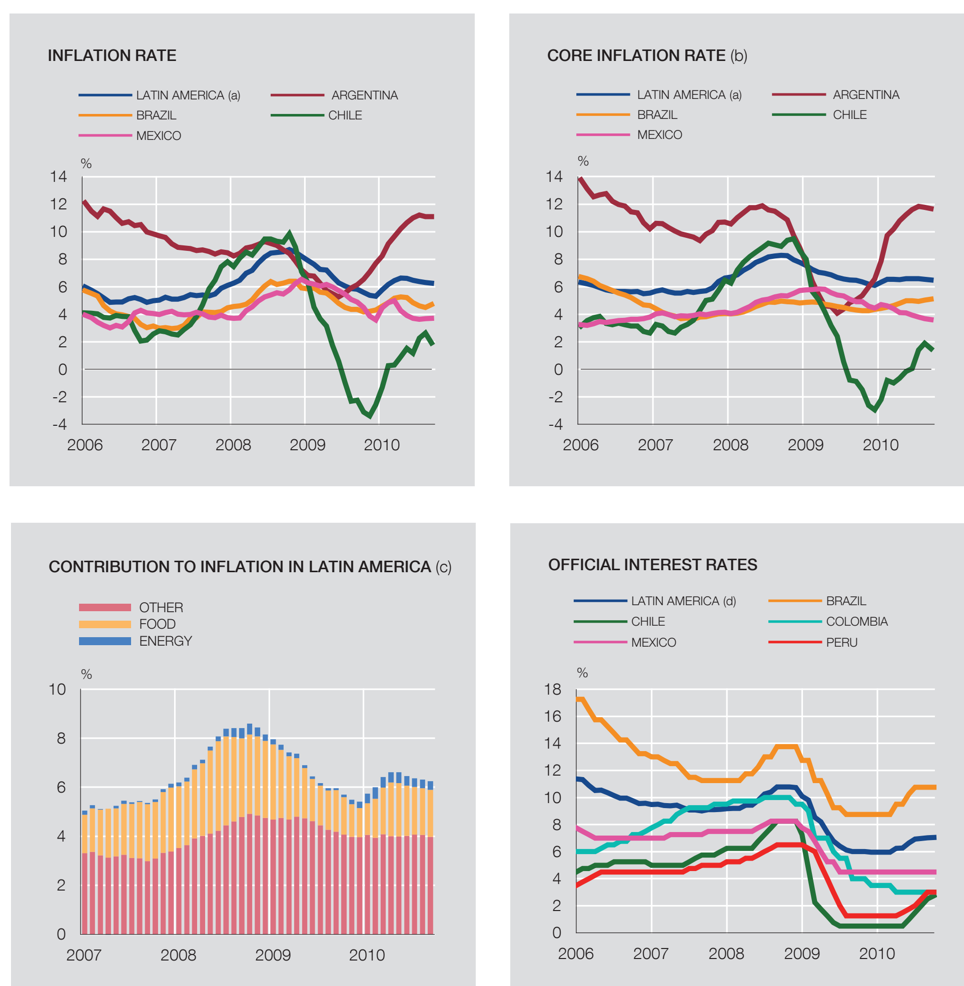
The higher frequency indicators for Q3 point to some slowing in activity at the regional level, partly as a result of a less favourable base effect, but also due to the moderate tightness of monetary policy in certain countries. Accordingly, the cyclical peak in year-on-year growth rates might already have been reached in Q2. Chile (where the impulse of post-earthquake reconstruction has yet to be felt) and Venezuela (where rates could turn positive) would be the main exceptions to this general trend.

Prices and macroeconomic policies

After having risen in the period to Q2, average inflation for the region tended to stabilise at a year-on-year rate of 6.3% in August and September, generally performing better than expected, though with significant differences from one country to another. This stabilisation reflected the easing in the growth of food and, to a lesser extent, of energy prices, and the maintenance of the prices of other components (which would be a proxy for core inflation)

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. Official rates.
c. In-house calculation stripping out the food and energy indices from the overall index.
d. Weighted average of the official rates of the five countries with inflation targets.

(see Chart 9). In the main economies with inflation targets (Brazil and Mexico), consumer prices converged towards the central bank targets; in Brazil inflation stood at 4.7% year-on-year in September, having slipped by 0.5 pp in relation to the start of the year, and in Mexico at 3.7% year-on-year, 1.3 pp down on the level at the start of the year. The main difference between both is that in Mexico core inflation also fell and, by contrast, in Brazil it held stable, although relatively high. In Chile, Peru and Colombia, prices moved on a more uneven path (upwards in the first two countries, and downwards in the latter), but the three countries also held in their target ranges (see Table 2). Only in Argentina was there an appreciable acceleration in the official inflation rate, to over 11% year-on-year (other measures place inflation far above this level), while in Venezuela inflation remained very high at around 30%.

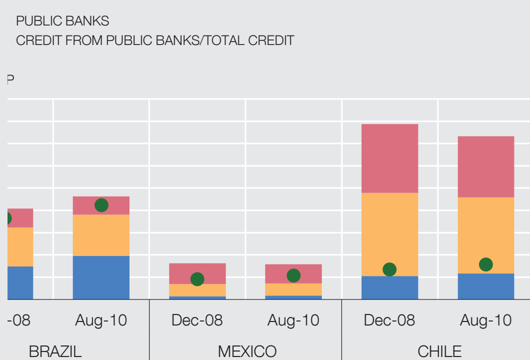
Against this background, three of the region's central banks with inflation targets raised their official interest rates. Brazil initiated the cycle of rises in April, raising rates by 200 bp to August (up to 10.75%). It was followed by Peru in May (which shaved 175 bp off to September, when it initiated a pause) and by Chile in June (225 bp). In Mexico and Colombia, official rates held stable against the backdrop of more accommodating output gaps.

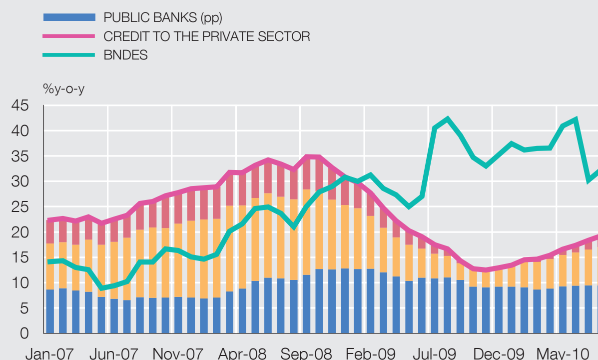
The global economic and financial crisis affected Latin America through various channels, giving rise, inter alia, to a sharp contraction in credit to the private sector during 2008 Q4. This contraction proved, however, relatively limited in time and tended to ease off over the course of 2009 and 2010. One of the factors behind this favourable development was the increased activity of public banks (and, in particular, of development banks), on which most of the credit-stimulus measures adopted by Latin American governments were centred. This box compares the role of public banks in Brazil, Chile and Mexico, the Latin American countries where they were most relevant in terms of the provision of credit to the private sector during the crisis.[1] Following a brief review of the stimulus measures, public banks' activity is compared with that of domestic and foreign private banks during the crisis. Some conclusions are then drawn from the comparison and some of the main risks looking ahead are considered.

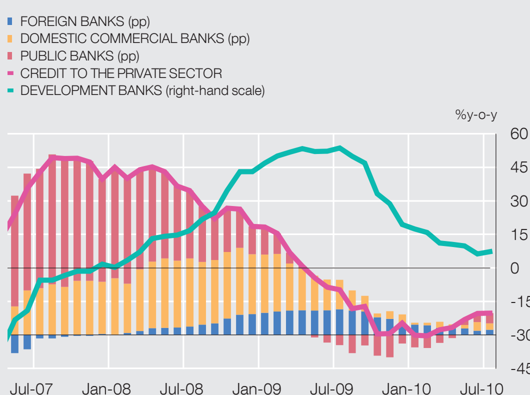
Firstly, it should be stressed that the countercyclical action of public banks in Latin America was possible thanks to their significant presence in the countries under study (see Panel 1). But there are considerable differences across the countries in this respect. The presence of public banking has traditionally been greater in Brazil, where credit to the private sector granted by the development bank BNDES and the two major public commercial banks (Banco do Brasil and Caixa Económica Federal) accounted before the crisis for 36% of the total credit to the private sector (15% of GDP). In Mexico and Chile, the significance of public banking has been relatively more limited, although prior to the crisis public banks accounted for no small part of the total credit to the private sector, 9% and 13% (equivalent to 1.5% and 10.5% of GDP), respectively.

Of the three countries, it is Brazil where public banking was of most importance in sustaining credit to the private sector during the crisis. In the period from late 2008 to early 2009, the resources of the devel-

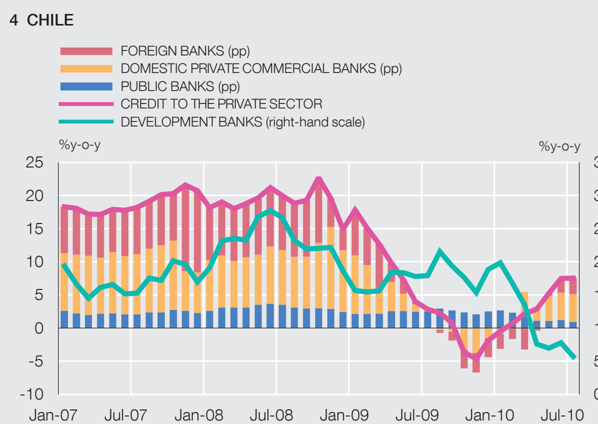
1. Other countries, such as Argentina and Venezuela, also have a significant public banking sector, but their function in providing credit to the private sector was less significant during the crisis.







4 CHILE



Banco Central de Brasil, Comisión Nacional Bancaria y de Valores de México, Superintendencia de Bancos e Instituciones de Chile and Banco de España.

opment bank BNDES were increased by 100 billion reales (3.2% of GDP), followed by an additional equivalent contribution of 2.3% of GDP in the first half of 2010. The increase in resources, in both cases through extraordinary contributions by the Treasury[2], allowed the size of the bank to practically double, thereby reinforcing its habitual activities (the granting of long-term credit, commercial loans to SMEs, and investment in capital goods and exports). Throughout 2008 Q4 and 2009 Q1, measures were also adopted to boost the activity of the public commercial banks. As a result, the growth rate of credit from development banks to the private sector exceeded 30% year-on-year during 2009, with highs in excess of 50% (see Panel 2). As it coincided with a period in which other banks' provision of credit eased off significantly, more than 80% of the credit to the private sector in late 2009 was extended by public banks, while private commercial banks cut their contribution strongly and the contribution of foreign banks fell to zero. As a result, thanks to the contribution of public banks, and although total credit to the private sector slowed (from a very high rate of over 30% year-on-year before the crisis), it did not actually contract and held at a positive growth rate of around 10% year-on-year in early 2009, before picking up again.

The significance of development banks also increased in Mexico during the crisis (see Panel 3). From June to August 2009, credit to the private sector extended by development banks posted a most considerable rate of expansion of close to 60% year-on-year. However, given their lesser importance in the Mexican banking system, development banks' contribution was more limited in sustaining aggregate credit. The increase in activity derived from two stimulus plans: one in October 2008 and the other in January 2009. These included increases in resources (in particular to Nacional Financiera and Bancomext) to support credit and ease credit constraints on specific productive sectors that had faced difficulties in gaining access to funding, such as SMEs, the agricultural sector, housing and infrastructure. The positive growth rates exhibited by public banks are in contrast to the contraction in credit from foreign banks and the stagnation in credit from domestic private banks, but their lesser weight was unable to prevent total credit to the private sector from declining from a year-on-year growth rate of 25% before the crisis to a rate close to 0% during 2009.

Finally, the countercyclical fiscal and monetary policies pursued in Chile exerted greater effects during the crisis, although the role of development banks proved less decisive. Of note, however, was the reinforcement of the role of the CORFO (Chile's Production Development Corporation) and, in particular, the $500 million capital increase at the development bank BancoEstado approved in November 2008, and completed during 2009 (the equivalent to a capital increase of 50%) which, as in Brazil and in Mexico, enabled credit to preferential sectors (SMEs, exporters, housing[3]) to be increased. Further to these measures, credit from development banks to the private sector posted growth of around 20% year-on-year, in clear contrast to developments at private commercial banks (both domestic and foreign), which recorded notable declines. Nonetheless, as in Mexico, this boost translated into a relatively small contribution to credit growth at the height of the crisis, which did not manage to prevent a significant contraction in total credit to the private sector (see Panel 4).

In sum, in the three countries under study, and as a result of the stimulus measures adopted, public banks took on a leading role after the global economic and financial crisis. Their dynamism coincided with a significant easing off of the activity of private commercial banks and, in particular, of foreign banks. One notable difference between Brazil (on one hand) and Mexico and Chile (on the other) regarding the behaviour of development banks concerns their size and, therefore, their capacity to impact credit to the private sector, and this capacity was far greater in Brazil than in the other two countries. The other essential difference lies in the fact that whereas in Mexico and Chile public banks' activity may be considered strictly countercyclical, since it accelerated during the financial crisis and eased as credit from private banks picked up, in Brazil it maintained its pace of activity throughout 2010, despite monetary tightening by the central bank, the strong expansion in the economy and the pick-up in credit from private banks. In this respect, although the role played by public banks during the crisis should be viewed positively, their activity poses risks and questions in a setting in which economic activity resumes a normal footing. One such risk is the potential increase in bad debts arising from a rapid growth in credit. Others will be the risks of competition with private commercial banks, the possibility of credit market segmentation and, in some cases, greater inefficiency. In Brazil's case, where development banks' activity has been more extended over time, potential risks of procyclicality and of conflict with monetary policy conduct arise, in addition to the growing quasi-fiscal cost derived from the subsidised nature of the credit.[4] Lastly, the reaffirmation of the role of public banking after its favourable impact during the crisis once again highlights the problems generally associated with this type of activity.

2. Traditionally, the main source of resources for BNDES has been the unemployment fund (FAT by its Portuguese acronym). However, the extraordinary contribution by the Treasury, by means of public debt issues, has converted it into the main source of funding.

3. Development banking also played a relevant role in the initiative, unveiled in March 2009, to boost bank and non-bank credit. **4.** The injection of resources into the BNDES creates a fiscal cost for the Treasury, which might amount to around 0.3 pp of GDP per annum. Treasury resources are remunerated at a long-term interest rates that stands at 6%, and the average cost of the Treasury's internal debt is around 11% at present.

INFLATION
Year-on-year rates of change

TABLE 2

Country	2010			2011	
	Target	September	Expectations (a)	Target	Expectations (a)
Brazil	4.5 ± 2	4.7	5.3	4.5 ± 2	5.0
Mexico	3 ± 1	3.7	4.6	3 ± 1	3.9
Chile	3 ± 1	1.9	3.7	3 ± 1	3.2
Colombia	3 ± 1	2.3	3.1	3 ± 1	3.8
Peru	2 ± 1	2.4	2.7	2 ± 1	2.5

SOURCES: National statistics and Consensus Forecasts.

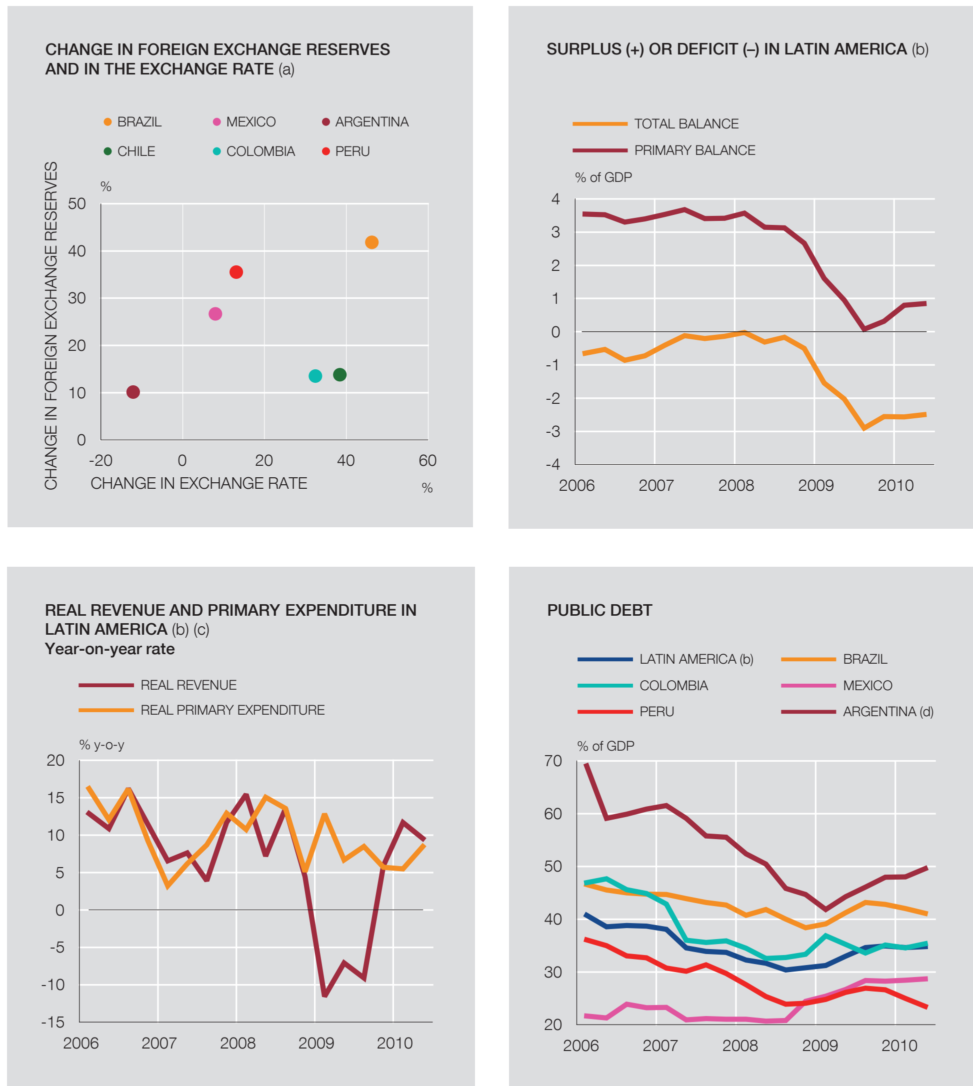
a. Consensus Forecasts September 2010 expectations for the end of the year, as for target.

Both the improvement in the inflation performance as from April in Brazil and the tightening of monetary policy in Brazil, Chile and Peru contributed to improving inflation expectations in these countries, following the deterioration in the first half of the year. However, from a longer-term perspective, recent price developments give rise to several considerations. First, it should be stressed that inflation has generally been moderate, at a time of high growth and progressive closing of output gaps. Further, commodities prices, which are traditionally a major determinant of consumer price pressures in Latin America given its status as an exporting region, have not prompted greater tensions in this period, despite their rising trend (more than 25% since the start of the year in the case of the food price index, and 20% in that of the overall commodities prices index). Admittedly, these increases pass through with some delay to consumer prices and may have been partly contained by the rising trend of the Brazilian, Chilean and Colombian currencies, but perhaps not in their entirety. Moreover, fiscal and quasi-fiscal policies (e.g. public credit) have not adopted, in practically any of the countries, a clearly restrictive stance (see Box 2). Finally, despite the tightening of monetary policy in the three countries, real interest rates have remained extraordinarily low in historical terms, and even lower in Mexico and Colombia. All these factors would suggest that, despite the favourable recent performance, the risks to inflation might be on the upside in most other countries, against the background of pressures on the domestic demand side. Nonetheless, given that expectations have remained relatively well-anchored, consideration has been given in Brazil – as it might also be in other countries in the region, such as Chile and Peru – to the possibility that there has been a structural change that allows inflation-free growth with lower real interest rates than in the past.[5] The concerns over the appreciation of the exchange rate and over the expansionary effects of short-term capital inflows act as a deterrent to any further tightening of monetary policy, all the more so when US real interest rates have remained so low.

In the economies without inflation targets, monetary policies continued to evidence an expansionary bias, which translated into persistently high inflation rates. The Argentine central bank relaxed its monetary targets in August, despite the overheating economy. It raised its growth target for M2 by more than 10 pp, to 29.4% at the end of the year, which in practice entails

5. There is great uncertainty surrounding the neutral real interest rate, given its non-observable nature, but the central bank highlights the reduction in the real interest rates over recent years (currently at around 5%) and various structural changes in the Brazilian economy that would point to a reduction in this variable. These changes include most notably the increase in domestic saving in the economy, through the reduction of debt by means of primary surpluses, and the economy's greater attractiveness to external saving, owing to the reduction in sovereign risk. Also of note is the development of financial markets and the improvement in monetary policy transmission.

FOREIGN EXCHANGE RESERVES AND MAIN PUBLIC SECTOR FIGURES CHART 10
Billions, year-on-year changes and percentage of GDP



SOURCE: National statistics.

a. Change in reserves from December 2008 to September 2010. Change in the exchange rate between the minimum recorded in 2008 Q4 and the average rate for September 2010.
b. Seven biggest economies
c. Deflated by the CPI.
d. Excludes untendered debt in the debt swap offer of 2005

accommodating a higher level of inflation. In Venezuela, the January devaluation translated into a further quickening in inflation, to 32%.

Turning to fiscal policy, probably the key aspect has been the improvement in the primary balance in the region as a whole, reversing the trend of the two previous years. This is the result of the pick-up in public revenue (see Chart 10), since the growth rate of expenditure generally remained very high. This was the case for Argentina, Brazil (despite the pre-election freeze on expenditure amounting to 0.3 pp of GDP), Chile and Peru (which also set spending ceilings). One exception is Mexico, where the budget deficit widened to 2.3% of GDP (the primary deficit was 0.1%), against the background of widespread sluggishness in revenue (except oil-related receipts) as a result of the cycle, and despite the moderation in spending. That said, and unlike the other countries, Mexico's fiscal policy stance remains moderately restrictive in the budget for 2011.

Trade integration and structural policies

The highlight of trade integration processes in Latin America in 2010 to date – in a setting of prolonged stagnation – has been the agreement to finalise the drafting of the common customs code in Mercosur, following more than four years of delay, and a timeframe for the elimination of the double charge under the Common External Tariff. The Andean Community (CAN) continues to face serious obstacles, insofar as one of its members (Venezuela) might join Mercosur; a further two members (Peru and Colombia) have kept up their strategy of re-orienting their foreign trade, especially towards the Pacific basin, using bilateral agreements; and the remaining members (Ecuador and Bolivia) did not join negotiations with the United States and the EU. During the period under study, Peru initiated talks with South Korea, Japan and Panama; and further, on 1 March the agreement entered into with China in late 2009 came into force. Peru and Colombia reached a free trade agreement with the European Union in early March 2010, which was ratified at the joint May summit. Colombia, meantime, initiated negotiations with Korea and ratified an agreement with Canada, pending approval by the US Congress of the free trade treaty between both countries. Chile signed a free trade agreement with Thailand, and Costa Rica reached agreements with Singapore and China. Finally, in mid-August Mexico announced an increase in various tariffs on US imports, in response to the suspension of an agreement for the provision of Mexican transport services in the United States.

As regards structural reforms, a fiscal rule was approved in Colombia whose aim is to reduce debt to levels consistent with an investment grade credit rating (28% of GDP within 10 years), in addition to successfully pursuing a fiscal policy insulated from the business cycle and managing the foreseeable expansion in the oil sector in the coming years, easing its macroeconomic and fiscal effects, and reflecting inter-generational equity considerations. To achieve the first goal a structural primary balance target was set for the public sector at 0.6% of GDP between 2010 and 2020. Further, an implicit target was set for structural saving from oil revenues, which will be geared to reducing debt, and may be the basis for a future saving fund.

Along the same lines, Chile set up an advisory committee to amend the calculation methodology on which the structural fiscal rule is based. The committee's recommendations (basically, not to adjust on the basis of discretionary measures applied by the authorities and not to adjust the valuation of public assets for cyclical changes) will be incorporated into the 2011 budget.

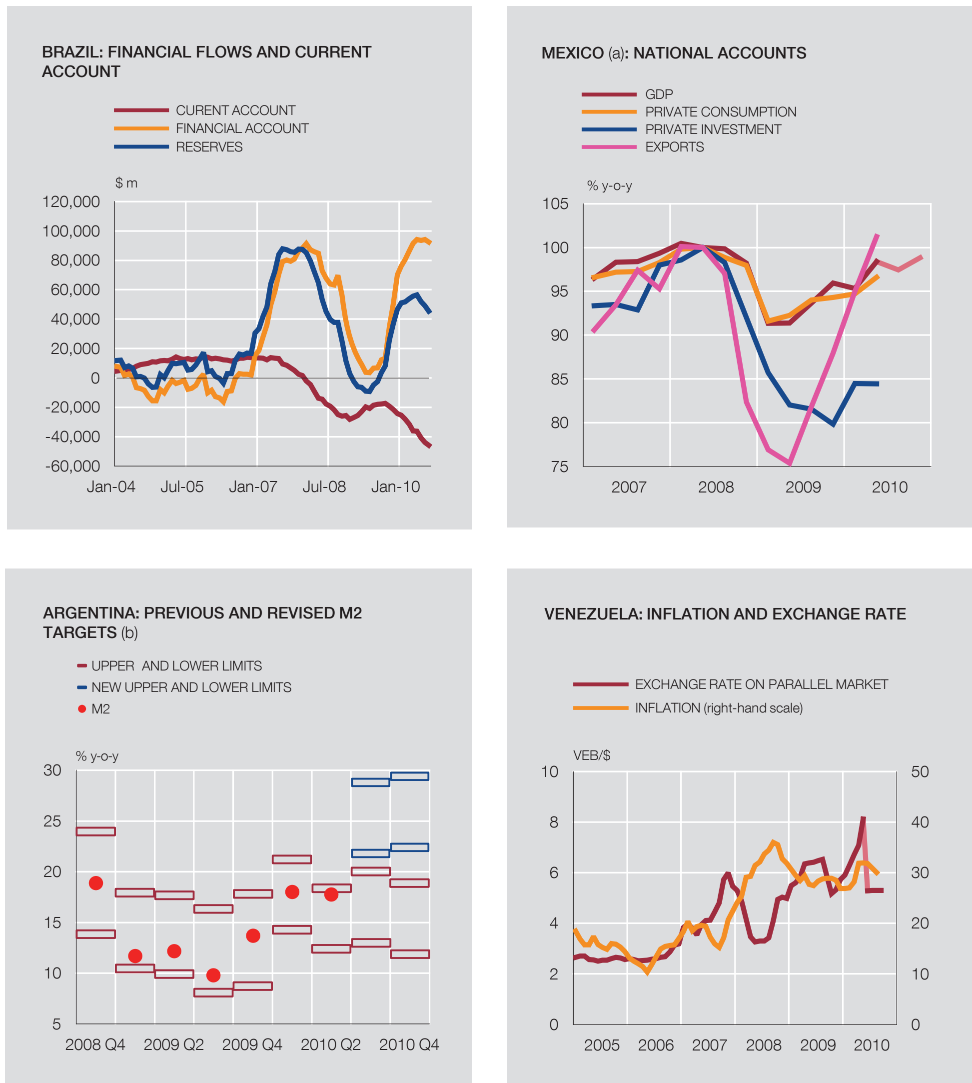
In Venezuela, the government maintained its policy of expropriations and approved, at the tail end of the legislature, several laws changing the modus operandi of the country's financial system, granting greater discretionality to the public sector and providing for the financing of its projects. Finally, Ecuador passed new hydrocarbons legislation entailing the replacement of contracts with private oil corporations, which become service providers, in a similar fashion to what occurred in the Bolivian gas industry.

Economic developments by country

In *Brazil*, the high rate of expansion in the economy in 2010 Q1 stepped up to 2.7% in quarter-on-quarter terms, driven by the strong growth of domestic demand, and in particular of investment. There was a significant slowdown in Q2 but, even so, GDP posted a growth quarter-on-quarter growth rate of 1.2%. Thus, after five quarters of strong expansion, the economy grew at a year-on-year rate of 8.8% in Q2, only 0.2 pp down on Q1. The latest economic indicators point to some moderation in the pace of expansion in the second half of the year, although rates should remain high, in a setting of accommodative fiscal and credit policies and a buoyant labour market. In the light of this dynamism, and of the increase in inflation to May (5.2% compared with the same month a year earlier), the central bank continued with the tightening of monetary policy initiated in April; it raised the official interest rate by 75 bp and 50 bp at its June and July meetings, placing it at 10.75%, a rate that held unchanged at its August and

BRAZIL, MEXICO, ARGENTINA AND VENEZUELA

CHART 11



SOURCES: INEGI MEXICO, Banco Central de Venezuela, and Banco Central de Argentina.

a. 2008Q2 = 100. The dotted line is the forecast of the Banco de México's August 2010 survey.
b. Quarterly targets setting a range for the average levels of total M2 for the last month of each quarter.
c. The market closed on 18 May, to reopen on 9 June.

September meetings, following three months of moderation in price growth. The central bank justified this pause on the basis of the possible reduction in the neutral interest rate (that consistent with target inflation) in recent years and of the recent slowdown in activity, although the appreciation of the country's currency might also partly explain this decision. The financial capacity of the BNDES development bank was further strengthened, and its interest rate was moreover held at 6%. In the fiscal realm, the gradual and slight improvement in the public-sector primary surplus continued, thanks to the higher growth of central government revenue in relation to spending, giving rise to a cumulative 12-month primary surplus of 2% of GDP in July. Nonetheless, this figure remains below the official target of a primary surplus of 3.3% in 2010, despite the economy's dynamism, from which a procyclical stance may be inferred. The primary surplus target for 2011 is 3.2%. The strong dynamism of domestic demand has led to a deterioration in the trade balance which, combined with the widening deficit on incomes and services, has given rise to a bigger current deficit (see Chart 11), placing it at 2.3% of GDP in the 12 months to August. Sizeable capital inflows were also recorded in recent months,

largely in the form of portfolio investment, translating into a notable appreciation by the exchange rate to a high for the year. In this setting the build-up in reserves – the stock of which totalled 261.3 billion in August – continued, the tax on financial transactions was raised from 2% to 4% and subsequently to 6% for fixed-income investment inflows in October, and the Brazilian sovereign wealth fund was authorised to make foreign-currency-denominated asset purchases.[6] The PT candidate (Dilma Rouseff) won the first round of the presidential elections in early October, with a programme that retains the guiding principles of the economic policy of recent years.

In *Mexico*, activity grew at a high rate in year-on-year terms in the first half of 2010, posting rates of 4.3% and 7.6%, respectively, in the first two quarters of the year. Notwithstanding, much of the growth may be attributed chiefly to a statistical effect arising from very low levels of comparison in the first half of 2009, in a setting in which the main national accounts variables remained below pre-crisis levels (see Chart 11). Indeed, in Q1 the quarter-on-quarter change was negative (- 0.6%) and in Q2, although growth was much higher (3.2% quarter-on-quarter), it was largely due to the inventory cycle. Mexico was the only country in which external demand made a positive contribution to growth in the two quarters, although this contribution was small (0.4 pp). This was a consequence of the fact that, although imports posted high growth rates, exports rose even more. The higher frequency data published in 2010 Q3 would suggest a slight slowdown in the economy as a result of the deceleration in the manufacturing sector and in exports to the US market. Set against this persistently high negative output gap, the inflation rate, which had risen to a high of 5% in March 2010 as a result of the rise in VAT, eased substantially and dipped to 3.7% in September. Core inflation had been declining for a few months previously, and posted a rate of 3.6% in September. The central bank held its official interest rates at 4.5% and the yield curve is not discounting movements in the coming quarters. Public finances worsened slightly in the first half of the year compared with the same period a year earlier as a result of the decline in non-tax revenue (owing to the stripping out of the profits transferred in April 2009 by the central bank to the Treasury further to the exchange rate depreciation and the revenue arising on the hedging of oil prices). It was not possible to offset this decline with the increase in tax revenue arising from VAT takings. The budget for 2011 maintains the austerity characterising 2010, with a 2.3% increase in expenditure and a deficit of 0.3%, although no fiscal reform is included. Regarding the external sector, the current account balance in the first half of 2010 posted a deficit equivalent to 0.2% of GDP, lower than in the first half of 2009. The financial account ran a surplus, in which inward foreign direct investment and portfolio investment, mainly in the form of bonds, were prominent. To address the return of portfolio flows, the monthly auctioning of dollar sale options was maintained, for an amount of 600 million, this instrument being reactivated last February. As a result, international reserves reached a high of $108 billion in late September. Finally, fluid access to the international markets was maintained, and in the first week of October Mexico successfully placed $1 billion in a 100-year bond (the first country in the region to do so) at a relatively low cost.

Economic activity in *Argentina* exhibited similar growth rates to those prior to the financial crisis during the first half of 2010, despite the fact that the output gap was already considered to have closed. Quarter-on-quarter growth thus stood at around 3% in both quarters, and the related year-on-year rate rose to 11.8% in Q2. Of note was the growth in domestic demand (13.6% in Q2), the result of strong growth in investment (especially in capital goods) and of buoyant private and government consumption. The contribution of the external sector once again turned negative, especially in 2010 Q1 (2.9 pp). This sound behaviour of

6. Although this is not specified, the sovereign wealth fund will issue local-currency-denominated debt to finance these acquisitions, so as to make its interventions similar to the sterilised central bank interventions involving dollar purchases.

economic activity is the consequence of the pick-up in agricultural yields in 2010, of the growth in Brazil (especially for the automobile industry) and of the expansionary stance of monetary and fiscal policy. The higher frequency indicators suggest that growth will moderate in the second half of the year. The cumulated 12-month primary public surplus rose progressively, up to 1.7% of GDP in Q2, owing to the increase in revenue, since public spending continued to rise at a higher rate (of around 30%). Inflation has remained on an unfavourable course, increasing strongly in recent months. Indeed, although official inflation stands at around 11% in September (a 5-year high), wage settlements are coming in at around 25%, and the government raised the intervals of the different tax brackets by 20%. In addition, the central bank pursued a more expansionary monetary policy, updating the monetary programme targets for the second half of 2010 (see Chart 11), given the higher nominal growth expected for the economy. Further evidence that monetary policy has been more expansionary is the downward trend of real interest rates, since nominal rates have held stable despite the inflationary rebound. In the financial arena, a swap involving a portion of the public debt in default since 2001 was carried out in late June, 66% of it being taken up ($12 billion of the $18.3 million eligible). With this swap and that in 2005, 92.4% of the debt declared in default in 2001 has been covered, which has prompted a notable reduction in the probability of default of public debt (obtained from the prices implicit in Argentine financial assets) and the upgrading of the Argentine government's foreign-currency-denominated sovereign debt rating by two credit rating agencies, although the rating is still far off investment grade. A further notable development was the announcement by the government of the creation of a Federal Disindebtedness Programme, which will entail significant financial relief for the provinces, which will discontinue payment of their debts to the central government until end-2011 and may reschedule them with 20-year maturities. Despite the fact that a portion of the reserves was used to service foreign-currency-denominated debt, low private-sector capital outflows together with the favourable behaviour of the current account allowed international reserves (sterilised with Treasury bill issues by the central bank) to be built up to a historical high, while the exchange rate of the peso against the dollar held on a slightly depreciating trend.

In *Chile*, activity picked up more quickly than foreseen following the earthquake in late February. During Q2, GDP increased by 4.3% in quarter-on-quarter terms (after having declined by 1.5% the previous quarter) and by 6.5% year-on-year (1.5% in Q1). There was an exceptional increase in domestic demand, which expanded in Q2 at a year-on-year rate of 19.4%, from an already-high figure of 11.8% in Q1. This growth was particularly due to investment (specifically in capital goods), although private consumption also expanded forcefully. Investment in construction is expected to rise in the coming quarters, owing to reconstruction work following the earthquake. The contribution of the external sector to growth turned negative in the first half of the year and, moreover, reached a high level (over 10 pp in each quarter). This was a result both of the strong growth in imports and of the adverse trend of exports, although the latter tended to pick up in Q2 following several quarters of decline. This performance also contributed to the virtual elimination of the current account surplus (0.1% in Q2). The higher frequency indicators suggest that the high growth was maintained in Q3. Turning to the fiscal area, revenue increased by 46% year-on-year in real terms during the first half of the year, the result of the buoyancy of domestic demand and of the increase in copper prices, which led to a notable reduction in the budget deficit. The new government reported that the structural fiscal deficit in 2009 was not 1.2% of GDP, but 3.1%, further to certain corrections in the calculation methodology proposed by the Structural Balance Sheet Advisory Committee, set up to improve the functioning of the Chilean fiscal rule. Accordingly, fiscal policy in the coming years will be more restrictive than previously thought, and the new government has renounced attaining a balanced budget in terms of the structural

balance of the end of its mandate. Inflation continued to increase (2.6% in August), albeit at a lower than expected pace and with its underlying components trending favourably. Despite this relatively benign trajectory, the central bank embarked on a process of official interest rate rises (225 bp, to 2.75%, following the September monetary policy meeting), with the aim of lessening the looseness of monetary policy after the 775 bp reduction in 2009. Further, as part of its financing strategy for the reconstruction programme, the Chilean government issued dollar-denominated 10-year bonds on international markets, for the first time since 2004, along with peso-denominated bonds, this being the first issue by the Chilean state in local currency on international financial markets. In recent months the peso has appreciated significantly in nominal terms against the dollar, a development linked to the increase in copper prices, to the rise in official interest rates, to the greater relative surprises in growth, to the funds flowing into the country further to the reconstruction drive, and probably also to global factors. Lastly, in June Moody's raised the rating of Chilean foreign-currency-denominated sovereign debt a notch higher.

Recovery firmed in the *Colombian* economy in the first half of 2010, with year-on-year growth of 4.3%, driven by the acceleration in all domestic demand components except investment, which continued growing at a similar rate to that in the second half of 2009. The favourable trend of stockbuilding was another of the explanatory factors. The notable buoyancy of imports, especially in Q2, accounts for the negative contribution (2.9 pp) of the external sector, despite the fact that exports continued to pick up, as shown by the quarter-on-quarter growth of over 5% during the first two quarters of 2010. This recovery in activity has come about in a benign environment for inflation, which has held at close to 2%, the lower limit of the central bank's target range for this year (2%-4%). In this setting of gradual inflation-free recovery, the central bank held its interest rate constant at 3%, following the last cut in April. In respect of fiscal policy, the government revised its forecast for the non-financial public-sector deficit downwards, to 3.6% of GDP in 2010, and it foresees a further reduction in the deficit in 2011 to 3%, due in part to the higher economic growth expected. A fiscal rule was unveiled to manage oil resources countercyclically, anticipating a boom in the sector in the coming years. On the side of the external sector, there was a notable improvement in the trade balance, against a background of higher nominal growth in exports compared with imports, thanks largely to an improvement in the terms of trade. This improvement will foreseeably continue in light of the resumption of diplomatic relations with Venezuela. Central bank interventions on the foreign exchange market in Q2 totalled $20 million daily, as part of a framework of competitive auctions introduced in April. This mechanism was resumed in September, amid concerns by the authorities about the appreciation of the Colombian peso. Indeed, during the half-year period, the exchange rate continued on a rising trend (10% from late April), standing at around 1,800 pesos per dollar. Lastly, Standard & Poor's upgraded the country's sovereign debt rating a notch to "investment grade".

In 2010 Q2, GDP in *Peru* increased at a quarter-on-quarter rate of 3.1%, following the rise of 1.6% recorded in Q1, extending the sound recovery initiated in the second half of 2009. In year-on-year terms, GDP increased at a rate of 10.1% in Q2, compared with the rise of 6.1% in the previous quarter. Of note was the 11.1% growth of domestic demand during the first half of the year compared with the same period a year earlier. This dynamism is a reflection of the pick-up in private consumption, of the growth in investment and of stockbuilding at similar rates to those recorded prior to the international financial crisis, and of higher growth in consumption and in public investment. The higher frequency indicators continue to show high growth in economic activity in Q3, albeit at somewhat lower rates. The contribution of the external sector to GDP growth turned negative (close to 3 pp) during the half-year period owing to the strength of imports and to the practically zero growth of exports in real terms. Nonethe-

less, the nominal increase in exports was greater than that in imports and close to 40%, year-on-year, thanks to the improved terms of trade. During the first half of the year the current account deficit stood at 1.1% of GDP, since the trade surplus and greater remittances from abroad were more than offset by the deficit on the services and incomes balances, as the profits of foreign-held companies increased. Inflation touched bottom in December 2009 and has continued increasing (2.3% in August), give the greater dynamism of domestic demand, the disappearance of the base effect and supply-side factors, such as the prices of certain foods and, to a lesser extent, of energy products. The central bank increased the official interest rate at all its monetary policy meetings from May to September. This rate was thus raised by 175 bp to 3%. However, at the October monetary policy meeting, a pause was decided on. These increases in the official interest rate were accompanied by a series of measures that raised reserve requirements, both in national and in foreign currency. Meantime, credit continued to pick up, growing by 16.9% in August in real year-on-year terms. The fiscal impulse is holding in 2010 at a similar amount to that in 2009, although the budget deficit is declining in view of higher tax revenue and of the ceilings on public spending set by the government in order to meet its fiscal targets for 2010. in recent months, the central bank has used various instruments to check the pressures pushing the peso up against the dollar: capital controls (raising the requirements imposed on foreign loans at less than two years), dollar purchases since June (reserves increased by more than $9 billion to September) and an increase in the proportion that pension funds may invest abroad.

In the first half of 2010, *Venezuela* was the only country in the region to record an economic contraction, of 3.5% on average compared with the related period in 2009. It picked up in Q2 when GDP grew at a quarter-on-quarter rate of 3.7% (-1.9% year-on-year). On the demand side, government consumption was once again the most dynamic component, and private consumption and investment posted negative year-on-year growth rates, but on a lesser scale than in previous quarters. After having contributed 15.7 pp to GDP growth in 2010 Q1, external demand subtracted 0.7 pp in Q2, owing to the strong contraction in exports. On the positive side, the energy crisis eased, some of the restrictions on electricity consumption were eliminated and the real monthly growth rates of credit turned positive once more in June and July, in particular credit to manufacturing companies. Inflation remained on a very unfavourable course (see Chart 11), and the rate increased substantially from January to May 2010, rising to 32% in the latter month, as a result of the devaluation of the bolivar in early January, given that bigger rises in prices were observed in food, most of which are imported. Subsequently, the inflation rate fell off slightly to 28.5% in September. As regards monetary policy, a key development was the shutdown of the parallel exchange rate market in May, so as to avoid a greater depreciation of the bolivar (which had climbed to 8.6 bolivar per dollar, compared with 5.3 under the new exchange rate system, controlled by the central bank). On the fiscal front, in the face of the proximity of general elections last September, the government raised the growth rates of public spending. Turning to the external sector, there was a reduction in the current account balance in 2010 Q2, further to the strong rise in imports. Meantime, FDI outflows remained negative for the fifth quarter running. In the general elections, the parties supporting the government obtained a majority, but not one sufficient to amend fundamental laws or to grant special powers enabling the president to govern by decree.

1.11.2010