Introduction

The international environment underwent a change during the summer, with a notable downturn in the prospects of recovery in the main economies and a heightening of the crisis in the euro area. This has ultimately affected the Latin American economies, which had to date largely remained on the sidelines of events on international markets.

In addition to the more immediate impact on financial asset prices, the change has been two-pronged. On one hand there has been a turnaround in economic prospects, reflected in the growth projections of several of the main economies in the region, which are beginning to post downward revisions of some size for 2011 and 2012 (see Chart 1). On the other, the economic policy mix has begun to be re-balanced: monetary policy is adapting to a more uncertain environment, despite the fact that inflationary pressures have not so far shown clear signs of abating, while fiscal policy has not adopted a resolutely restrictive stance. In this respect, the upward cycle of official interest rates begun in 2010 has come to a halt, and the Brazilian central bank has eased its monetary policy stance.

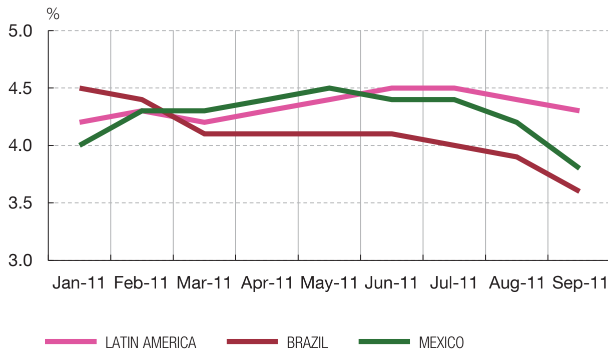
National Accounts figures continued to show robust economic growth in the first half of 2011 in Latin America as a whole, albeit lower than in 2010, when most countries managed to close the negative output gaps that arose during the crisis. The year-on-year growth rate eased from 5.5% in Q1 to 4.3% in Q2 owing to the impact of the slowdown in Brazil and Mexico (partly due to base effects) and an easing in domestic demand practically across the board. Country by country, developments were not fully homogeneous, since while in Brazil and in Mexico the weakness of the industrial sector was a conditioning factor (against the background of an appreciation in the exchange rate, in the first instance, and of the sluggishness of the US economy, in the latter case), in Argentina, Chile, Peru and Colombia growth remained much more robust. Inflation rose to a year-on-year rate of 7% in September for the region on average, somewhat up on the start of the year.

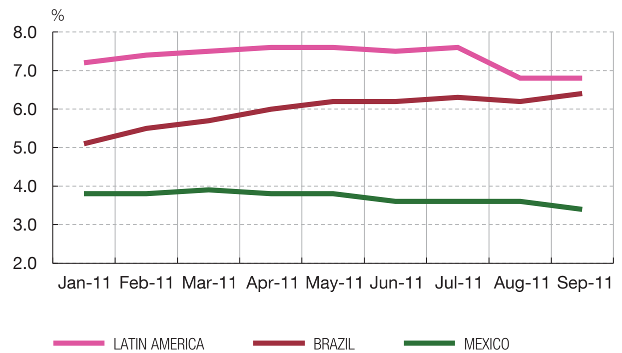
In this setting, the ongoing re-balancing of economic policies can be interpreted in several ways. Most immediately, in the face of the risk of a strong slowdown and even a global recession, concern for the effects on activity in the region has come to the fore, relegating the possibility of an inflationary surge which, moreover, would be mitigated in the context of falling commodities prices. In this respect, monetary policy is conceivably adopting, at least in some countries, a pre-emptive approach (taking as its reference the experience in 2008), though not one exempt from risks to its credibility given the underlying inflationary pressures. A second and not necessarily exclusive interpretation is that the prior economic policy mix – in particular the tightening of monetary policy – was sub-optimal, insofar as it was imposing excessive upward pressure on exchange rates owing to the interest rate spread and, at the same time, it was easing domestic monetary conditions via the massive inflow of short-term capital. A phase of greater risk aversion would thus contribute to mitigating these problems and the monetary policy dilemmas. If the first interpretation is correct, inflation should be contained over the coming months. The risk would lie, however, in the credibility of monetary policy being undermined were this containment not to come about.

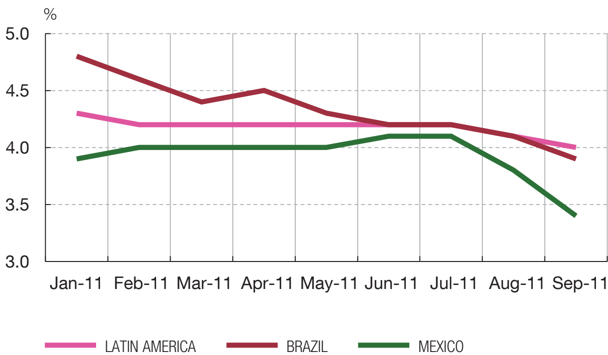
In the short run, the downside risks have increased substantially. The intensification of risk aversion on financial markets in recent weeks, the perceived fragility of the developed countries' banking systems, the fall in commodities prices to which Latin America is sensitive, and the downturn in the world economic growth outlook augur less growth in Latin

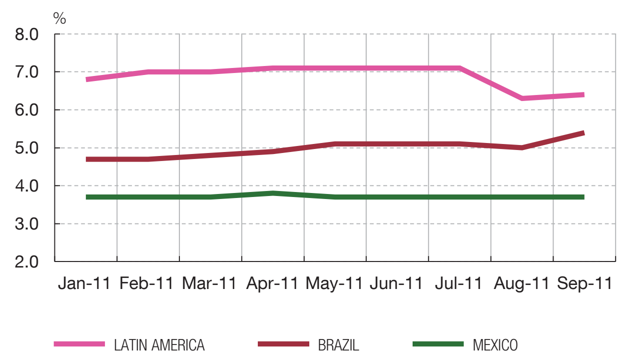
GDP AND INFLATION FORECASTS FOR 2011 AND 2012

CHART 1









America in the second half of 2011, suggesting that domestic demand will only partly offset the effect of the external shock. This would not necessarily be negative in all the countries, in light of overheating. Moreover, external positions have worsened in the present expansionary phase, making the region more vulnerable to the current economic situation. Conversely, the build-up in reserves and the perception of soundness following the 2008 shock would mitigate this potential vulnerability. The countries of South America are today less dependent than in the past on growth in the United States and in the industrialised countries, and more so on Asia, where the slowdown is so far very limited. However, the deceleration could step up if the developed economies were to go into recession, given their high proportion of intermediate trade. Against this backdrop, and bearing in mind that the region's economic policies appear to be adapting swiftly to the changing situation, growth might stand at a rate close to trend in the coming quarters in most of the countries, in the absence of greater instability in the euro area.

Economic and financial developments: external environment

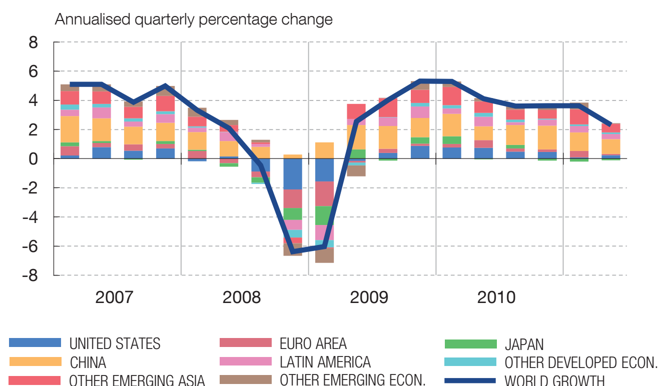
In recent months global economic and financial developments have been marked by the substantial worsening of tensions on international financial markets further to the heightening of the euro area sovereign debt crisis and the bleaker outlook for world – and especially US – economic growth.

In June and July financial tensions mounted in the euro area in the face of the inability to agree on a new aid programme for Greece and the discrepancies surrounding the partici-

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

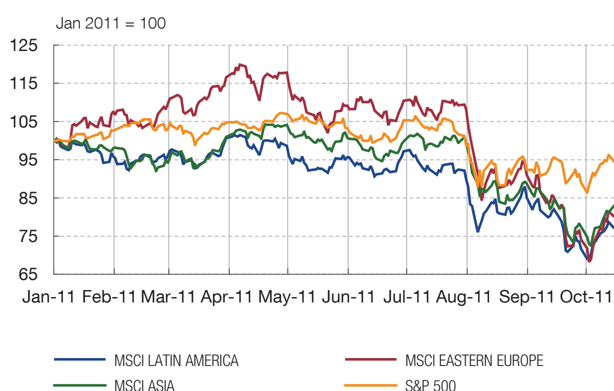
CHART 2

CONTRIBUTION TO WORLD GDP GROWTH

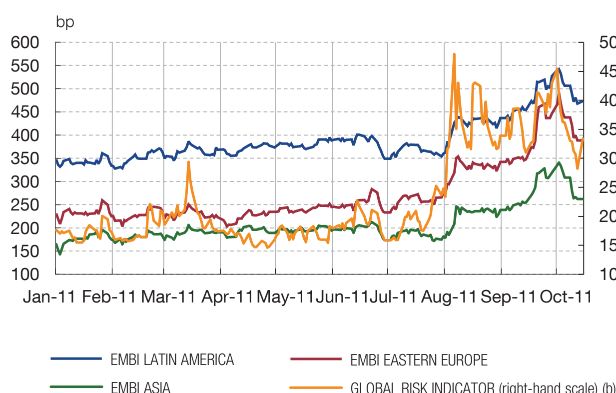


US INTEREST RATES

WORLD STOCK MARKETS (a)



INTEREST RATE SPREADS AND GLOBAL RISK INDICATOR



SOURCES: National statistics and Datastream.

a Indices in dollars.
b VIX.

pation of private investors in the programme. The agreements reached at the European summit of Heads of State or Government on 21 July – which, along with the second bail-out package for Greece, included more ambitious measures for reducing the risk of contagion – did not manage to avoid a prolongation of the instability, which only began to abate from the second week in August, following the ECB Governing Council's decision to reactivate its Securities Market Programme. In any event, this reversal proved transitory, since in September volatility levels once again rose in the face of uncertainty over the disbursement of a fresh aid tranche for Greece and, ultimately, in light of the lack of a conclusive solution to the European sovereign debt problem.

Economic activity slowed appreciably in Q2 (see Chart 2) in the developed economies and, according to the leading indicators, this is expected to have continued in Q3. In principle, this slowdown was associated with temporary factors, such as the interruption of production chains in the wake of the earthquake in Japan or the prevalence of high commodities prices stemming, in part, from supply-side problems. Nonetheless, the notion that the lack of momentum of activity in the developed countries is due to structural fragilities has gradually gained currency. In this respect, the scant leeway available for fresh fiscal and

monetary stimuli and the need for private-sector deleveraging pose serious obstacles to recovery. Compounding these factors is the sharp downturn in agents' confidence, which is bearing down on private consumption and investment. In any event, the central scenario does not envisage another recession, but rather a slower-than-expected recovery and one not free from ups and downs. Along these lines, growth projections for the advanced economies have been revised downwards for 2011 and 2012, to below 2% as opposed to the 3.1% growth posted in 2010, and the balance of risks has shifted significantly onto the downside. In a setting of growing concern over growth, and set against the scenario of the withdrawal of monetary and fiscal stimuli anticipated some months back, the markets are now discounting that official interest rates in the main economies will hold at very low levels for a prolonged period, and in recent weeks several central banks in advanced economies have extended the application of non-conventional measures. In the fiscal arena, despite the major challenges public finances face in the advanced economies (reflected in the downgrading of credit ratings not only in euro area countries but also in the United States and Japan), it has been put forward in recent months that those countries with fiscal headroom should delay the consolidation process, without renouncing the attainment of sustainable public finances in the medium and long run.

In Q2 the emerging economies continued to post rates of expansion that were high, albeit more moderate than in the preceding quarters. The slowdown is expected to advance gradually, aided by the withdrawal of monetary stimuli and by the slowing of the developed economies. The growth rate of the emerging countries is thus expected to stand between 6% and 6.5% in 2011 and 2012, compared with 7.3% in 2010. However, a sharper slowdown cannot be ruled out if the advanced economies go into recession. Of particular concern in this connection is the increasing risk of an abrupt slowdown in the Chinese economy, more for its potential effect on the world economy than for the likelihood of such an acute adjustment taking place.

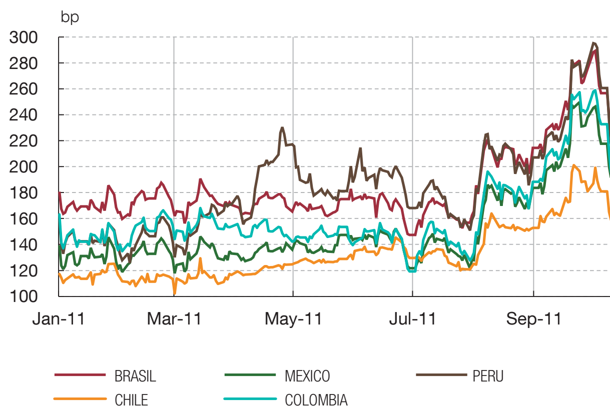
Turning to prices, inflation in the developed economies remains at a moderate level, while inflationary pressures (along with other signs of overheating such as high credit growth or asset price developments) remain in place in some emerging economies. Notwithstanding, these economies have interrupted the cycle of official interest rate rises and certain central banks (such as Brazil and Turkey) have even made cuts in light of the severe weakening of the global environment. Against this background, the international financial markets worsened considerably, as reflected in the widening of sovereign debt yield spreads in the euro area to all-time highs since the creation of the single currency. These tensions spread to other markets, particularly in Europe but also in other developed and emerging economies. Heavy corrections in stock market indices ensued, with a substantial increase in volatility (see Chart 2), higher credit risk premia on securities issued by the private sector and greater difficulties in obtaining funds on interbank markets, especially for European banks in the case of dollars. As a result, the raising of wholesale funding by credit institutions became particularly complex.

The increase in international investors' risk aversion prompted a search for safe-haven assets, which took the form of heavy outflows from emerging stock markets (close to $18 billion between August and September). Along with the downturn in growth prospects, this led to a decline in long-term debt yields in several developed economies, in particular in the United States and Germany, to historically low levels. The Japanese yen and the Swiss franc also acted as safe-haven assets in this period. Indeed, in the face of the strong upward pressures on these currencies, both countries intervened on the foreign exchange markets and approved exceptional measures to check this appreciation. Brent oil prices

SOVEREIGN SPREADS, STOCK MARKETS, EXCHANGE RATE AGAINST THE DOLLAR AND SOVEREIGN RATINGS

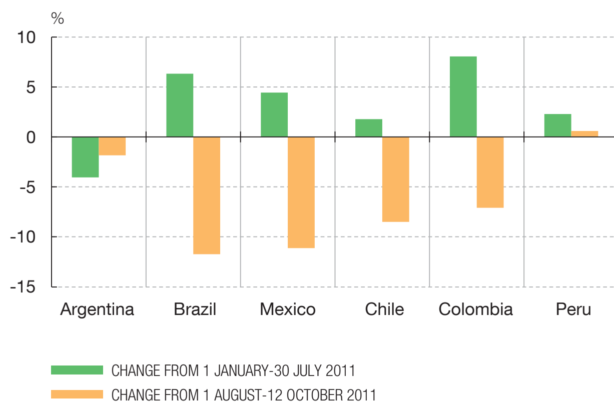
CHART 3

SOVEREIGN SPREADS

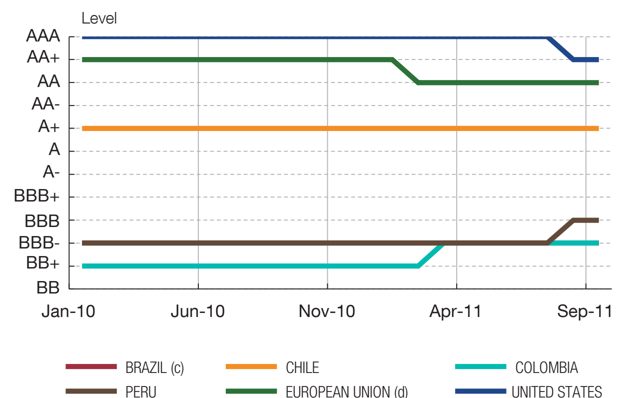


STOCK EXCHANGE INDICES

EXCHANGE RATE AGAINST THE DOLLAR



SOVEREIGN RATINGS (b)



SOURCES: Datastream and JP Morgan.

a MSCI Latin America Index in local currency.
b Standard & Poor's scale.
c Brazil stands throughout the period under study at BBB- and Chile at A+ according to the Standard & Poor's scale. Other agencies raised the rating of these countries during the period.
d Aggregate of 11 countries weighted according to their weight in world GDP: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain.

moved in a relatively narrow range (between $110 and $120 per barrel), even though political tensions in various Middle East countries remained unabated; however, in recent weeks oil prices have fallen below $105, against a backdrop of generalised falls in commodities prices and relatively sluggish demand.

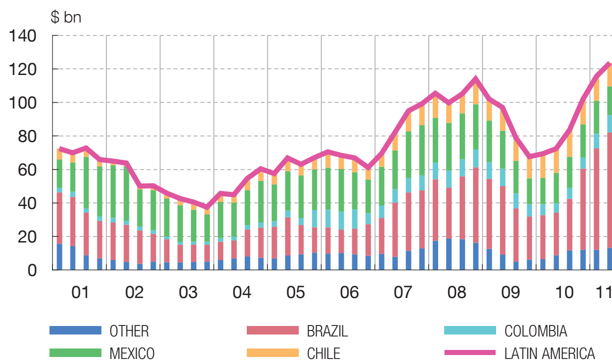
Financial markets and external financing

Developments on Latin-American financial markets over the past six months can be divided into two phases. In the first, from April to end-July, the chain of global events with a potentially adverse impact mentioned in the previous section scarcely affected the region's credit risk indicators. Given the soundness of fundamentals, the markets attributed the emerging economies – Latin American countries among them – with a significant decoupling capacity in respect of the global economy's problems. The sovereign spread, measured by the Latin America Global EMBI, held stable around 360 bp until end-July, in contrast with previous episodes of turbulence. Further, the stability of the aggregate spread was the consequence of the increase in the spreads in two of the countries considered riskiest, mainly Argentina and Venezuela, while in Colombia, Brazil and Peru spreads actually narrowed (by around 20 bp) (see Chart 3).

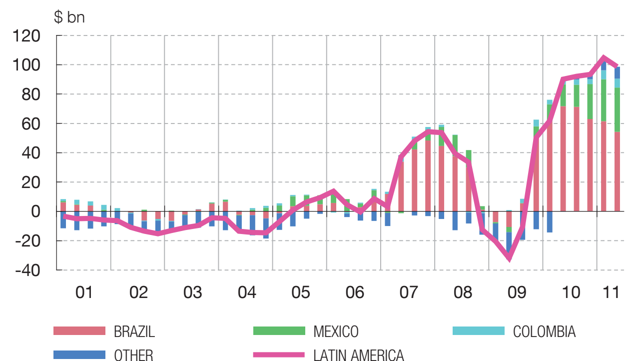
EXTERNAL CAPITAL FLOWS AND FINANCING
$ bn and %

CHART 4

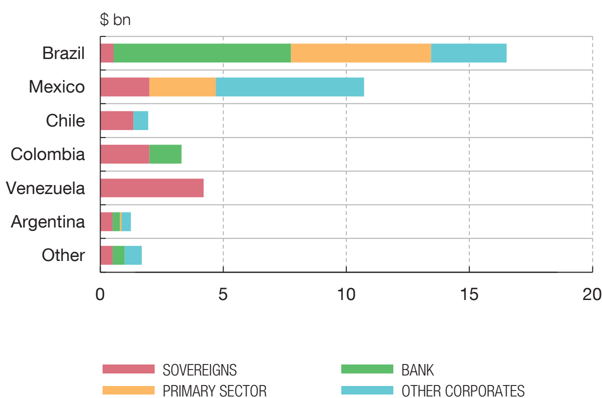
12-MONTH CUMULATED FDI FLOWS



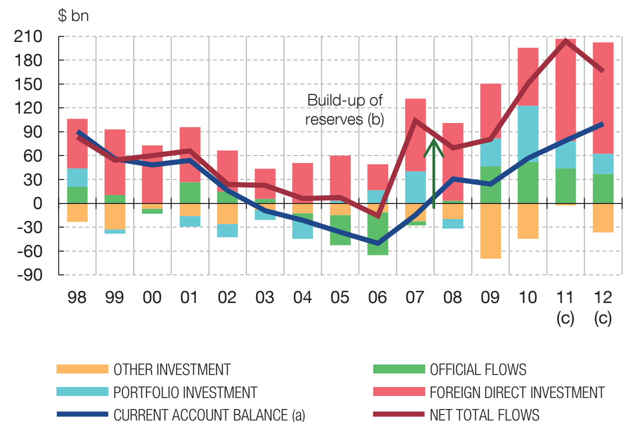
12-MONTH CUMULATED PORTFOLIO INVESTMENT FLOWS



INTERNATIONAL ISSUES IN LATIN AMERICA: FROM APRIL TO OCTOBER 2011



EXTERNAL FLOWS TO LATIN AMERICA



SOURCES: Dealogic, JP Morgan, IMF and national statistics.

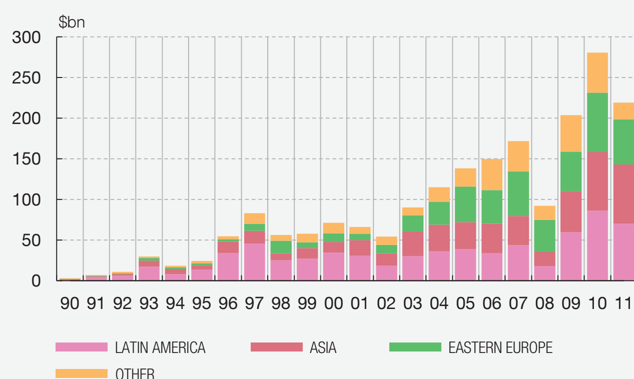
a A positive sign denotes a current account deficit.
b Difference between investment flows and the current account deficit (-).
c WEO forecasts (September 2011) for 2011-2012.

Default risk premia behaved similarly, meaning that in late July those for Brazil, Chile, Colombia and Mexico stood far below the weighted average of the five countries most affected by the euro area crisis. This initial resilience of the Latin American economies was reflected in the upgrading of credit ratings or their outlook in four countries, Brazil, Colombia, Chile and Peru, and there was also a positive feedback effect from this phenomenon (see Chart 3).

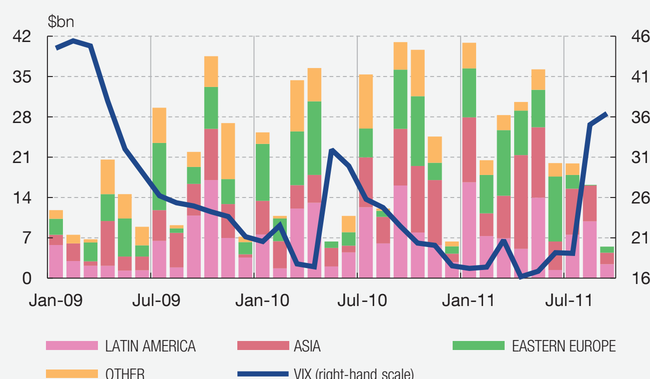
All these developments proved conducive to maintaining capital inflows at close to their highs in the region. Direct investment in the period from July 2010 to June 2011 was $125 billion, while portfolio investment stood at $97 billion, although there was a change in the composition of this latter variable, with inflows into debt and outflows from stock markets, which helps explain why stock market indices have held on a declining trend (see Chart 4). Bond issues on international markets continued apace, led by the Brazilian banking sector (18% of total issues in the region). This placed Brazil and Mexico as the biggest and third-biggest issuers among the emerging economies in this period. Issues by companies in the region on international markets reached monthly highs in January and May 2011, driven by Brazil. Companies that had not previously resorted to these placements did so, although this characteristic is not exclusive to the region (see Box 1).

This box analyses emerging economies' bond issues from a long-term perspective, highlighting some of the benefits and potential risks of the strong increase seen in the past two years. Emerging economies' issues totalled $219 billion in the first nine months of 2011, the second-biggest annual amount recorded. This figure is without the year having ended and despite the fact that, from September, global financial tensions have entailed a virtual freeze on such placements. The biggest issuers at present are the Latin American and Asian countries, with the issues of each of these regions accounting for around one-third of the total bonds issued by the emerging economies in 2011 to date (see Panel 1.1). In the past two years monthly issues were very high, even at times at which global risk was increasing (see Panel 1.2), and in some cases (the corporate sector in Mexico or the banking sector in Brazil) all-time highs were posted in the first half of the current year.

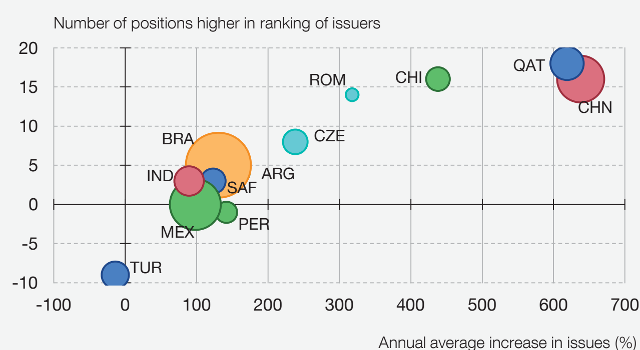
1.1 ISSUES ON INTERNATIONAL MARKETS



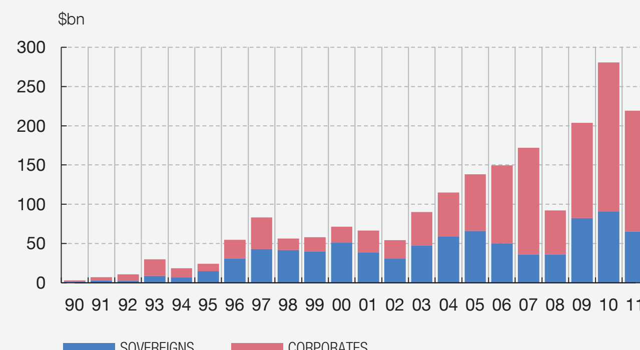
1.2 RECENT DEVELOPMENTS IN ISSUES AND RISK INDICATOR



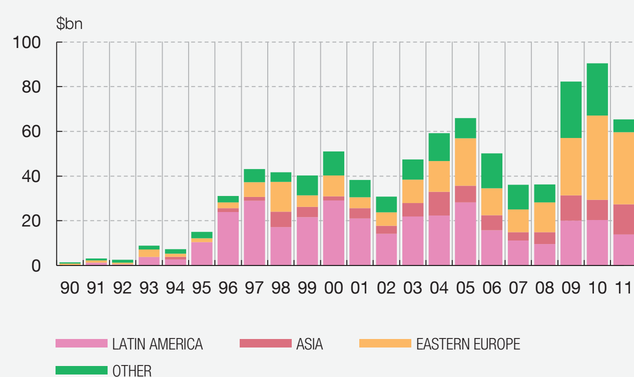
1.3 GROWTH OF ISSUES, VOLUME IN 2009-2011 AND RANKING



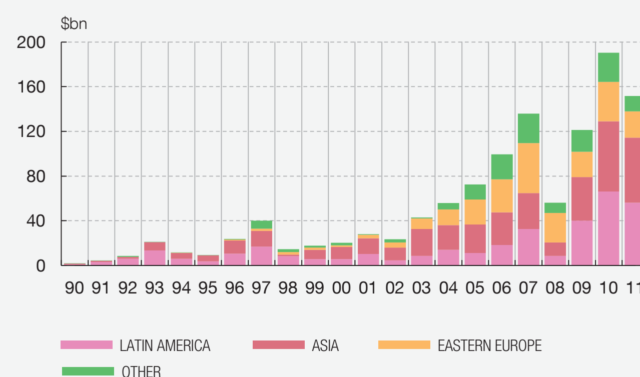
1.4 SOVEREIGN AND CORPORATE ISSUES



1.5 SOVEREIGN ISSUES BY REGION



1.6 CORPORATE ISSUES BY REGION



SOURCES: Dealogic, Datastream and IIF.

In the past three years, the value of emerging countries' issues was somewhat over $690 billion on international markets, which marks an annual average increase of over 73% compared with issues in the period 2003-2007. However, this increase has only been slightly higher than that of the advanced economies' issues, meaning that the weight of emerging countries' placements relative to total world issues has only risen from 9.3% in 2003-2007 to 10.6% in 2009-2011. Panel 1.3 shows the increase in annual average issues between both periods, along with the ranking of the various countries among world issuers in the period 2009-2011, while the size of the bubble represents the volume of issues placed in these three years. Significantly, some emerging economies have already taken on a major role as bond issuers on international markets. Brazil and China, previously ranked 20th and 40th among issuers (emerging and developed alike) in the period 2003-2007, have climbed to 15th and 24th position in the past three years.

Access by the emerging economies to international financial markets has clear advantages, such as the possibility of undertaking projects which, otherwise, would be limited by their thin domestic credit markets. But it also poses risks from the standpoint of financial stability.

An initial risk hinges on the nature of the issuer: if most of the issues have been conducted by the public sector, they might in principle pose fewer risks given their greater capacity to withstand debts or ease shocks affecting their ability to pay. Indeed, corporate bond spreads, measured by the CEMBI, have held above sovereign spreads (by 35 bp on average in 2010 and 2011). Panel 1.4 shows how the corporate sector is responsible for the increase in issues in recent years, accounting for almost 70% of the total, when at the start of the last decade they represented around 45%, which would entail to some extent a greater relative risk for holders of these assets at present compared with the sovereign alternative, although in both cases the spread has narrowed compared with the past. By region, Eastern Europe has taken up the baton from Latin America as the area in which the biggest volume of sovereign issues is concentrated, as a result of the volume issued by Russia and Poland (see Panel 1.5). By contrast, the strong increase in corporate issues on international markets in the past three years has been due, above all, to Latin American companies (see Panel 1.6).

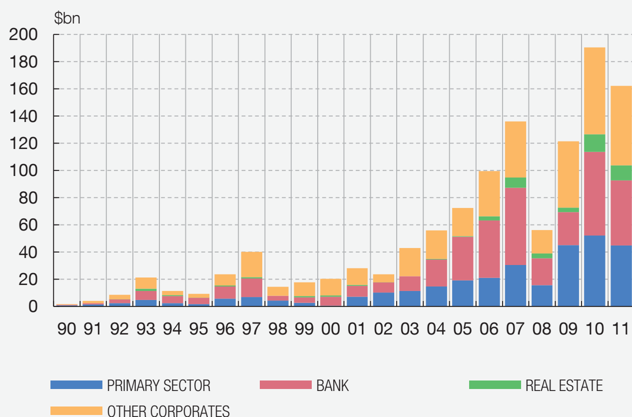
The second risk would be associated with the economic sector undertaking the corporate issues. Given that most of the issues on international markets are denominated in foreign currency, an increase in issues entails balance sheet mismatch risks similar to those experienced in recent emerging economy crises (which amplified the effects of exchange rate devaluations on activity), especially in those companies for which most earnings are in local currency, as is the case of the banking sector. If issues are concentrated in the real estate sector, the risks will be more on the side of the possible formation of bubbles and, if both sectors (real estate and banking alike) are closely connected, the risks will multiply. Conversely, if issues are concentrated in the export sector (e.g. primary-sector companies), exchange rate risk will be lower, as corporate revenue will be mainly in foreign currency. Panels 2.1 to 2.5 offer this breakdown, at aggregate level and by region. It can firstly be seen that the relative weight of the different sectors in total issues has held relatively constant, meaning that it is issues included under the heading "other corporates" (basically public utility industrial and services companies) that continue to account for most of the market, albeit with a growing weight of the banking sector.

In Latin America it is primary-sector companies that have dominated issues since the 2008 crisis, reflecting in part the changes in their productive specialisation and the strong increase in the sector's profitability following the rise in commodities prices as from 2003 (see Panel 2.2). Nonetheless, a notable increase in issues by banks in the region (specifically Brazilian banks) is also perceptible, and in 2011 to date they have already issued more than they raised in 2010 as a whole. The presence of real estate companies is also very limited in respect of issues in Latin America, though not so in Asia - and in particular in China - where these companies have issued around $20 billion in 2010 and 2011, climbing from 0.1% of the region's total issues to 17% in the past two years (see Panel 2.3).

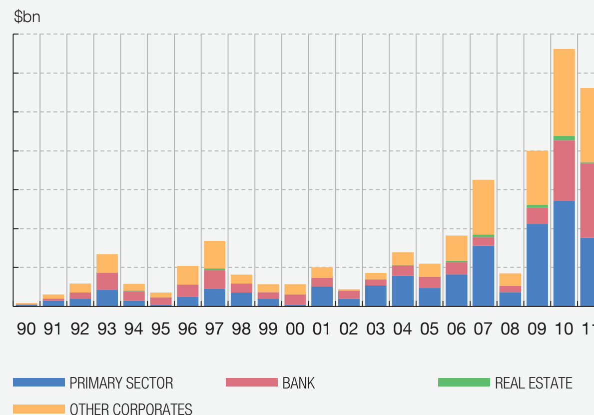
Another significant feature of the emerging economies' bond issues on international markets is the growing use of local currency. If the issue is made in local currency, the risks to holders would arise from exchange-rate changes and from the possible loss of value of the assets due to inflation, while the borrower would be protected in respect of the first factor and would benefit from the second. Traditionally, the emerging economies have been obliged to finance themselves in foreign currency (a consequence of the so-called "original sin"[1]), but in recent years they have increased local-currency-denominated issues. As can be seen in Panel 2.4, local-currency issues peaked in 2010 and 2011, although they continue to account for a minority share. This type of placement has increased mainly in Asia, and, thus, in the real-estate and non-financial corporate sectors, issues in local currency as a proportion of total issues have exceeded 25% in the first nine months of 2011, climbing to more than 42% in the case of sovereign issues (12% and 25% in the years 2009 to 2011). In the banking sector it is Eastern European - and, specifically, Russian - banks that have been most active in this segment, while in Latin America the biggest recent local-currency issues have been in other corporate sectors (more than 10% of the total).

1 The so-called "original sin" of the emerging economies refers to the impossibility of them raising funding on international markets in their own currency, and the only variable that is correlated to this impossibility is the size of the country. Thus, transaction costs, the externalities of using the vehicular currencies of international trade and the imperfections of capital markets would be the determinants of this problem, more so than the individual countries' macroeconomic policies. See B. Eichengreen, R. Hausmann and U. Panizza (2003b), *Currency Mismatches, Debt Intolerance, and Original Sin: Why They Are Not The Same and Why It Matters*, NBER Working Paper, 10036.

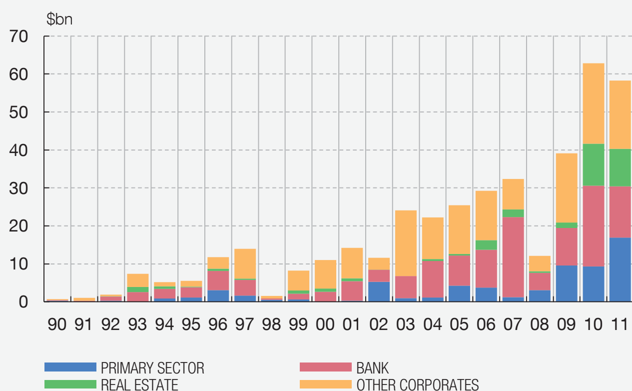
2.1 CORPORATE ISSUES BY TYPE OF COMPANY



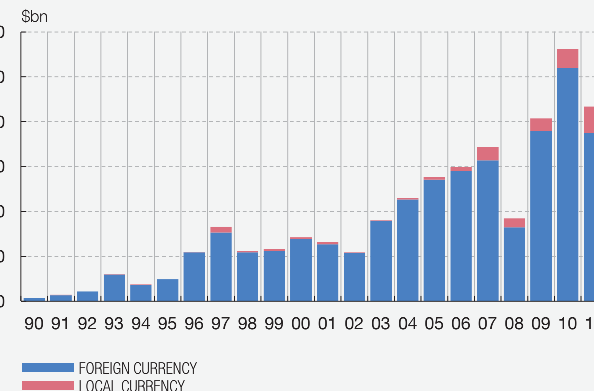
2.2 CORPORATE ISSUES BY TYPE OF COMPANY: LATIN AMERICA



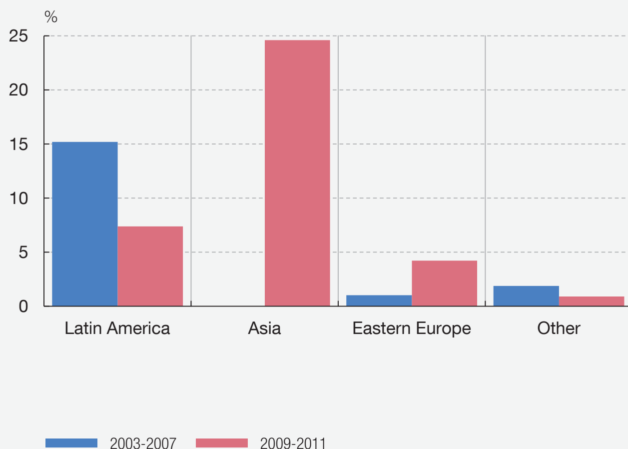
2.3 CORPORATE ISSUES BY TYPE OF COMPANY: ASIA



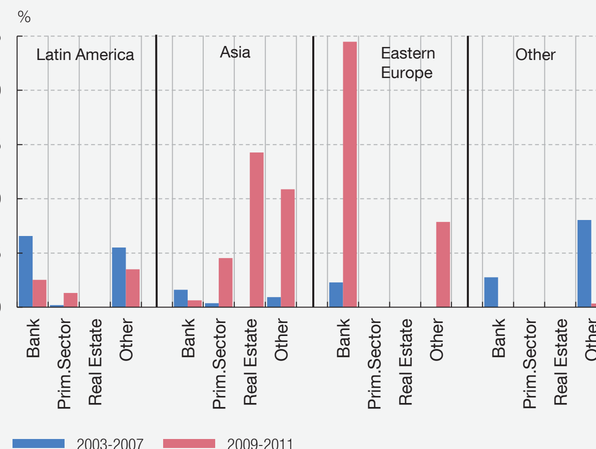
2.4 ISSUES ON INTERNATIONAL MARKETS: BY TYPE OF CURRENCY



2.5 SOVEREIGN ISSUES: PERCENTAGE OF ISSUES IN LOCAL CURRENCY



2.6 CORPORATE ISSUES: PERCENTAGE OF ISSUES IN LOCAL CURRENCY

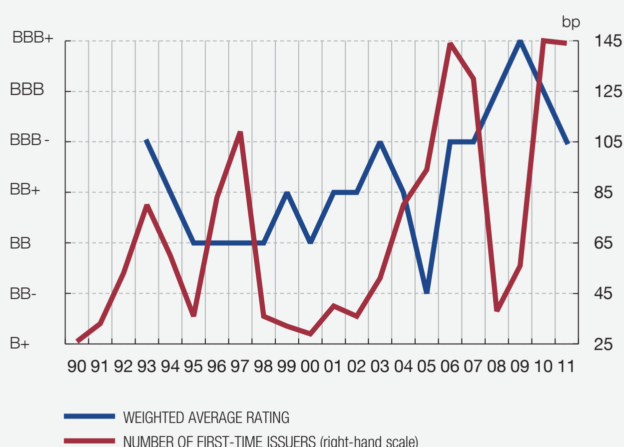


SOURCES: Dealogic, Datastream and IIF.

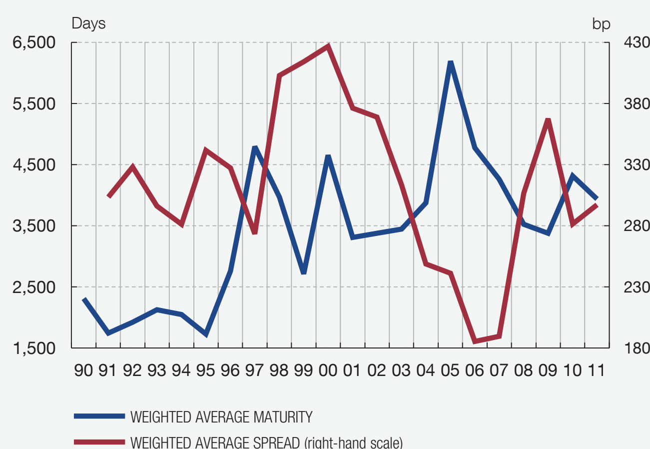
Finally, the increase in placements may be due to new firms entering the market, on which there is less information regarding solvency, or to companies whose presence on international markets is already consolidated. The years 2010 and 2011 have seen a rise in the number of companies in emerging economies - mainly in Asia, and particularly in China - that are gaining access for the first time to international markets. The increase in the number of issuing companies has been accompanied by a decline in the average rating of the issues (see Panel 3.1), which still stands, however, at investment grade. The average maturity of the issues also declined slightly as new firms entered the market, and the average spread charged rose, standing in both cases in a more unfavourable position than the previous high for the entry of new firms, in 2006 (see Panel 3.2).

In sum, there has been a notable increase in emerging economies' issues on international financial markets in the past three years. Undoubtedly, that has proven propitious for the financing of profitable projects which, in the absence of this channel, might not have been undertaken given the thinness of local markets. However, some of the characteristics of this process - the greater weight of corporate issues, of local-currency-denominated issues and of those issued by companies tapping the international markets for the first time - entail some increase in the risks for investors in these markets.

3.1 ISSUES: FIRST-TIME ISSUERS AND AVERAGE RATING



3.2 ISSUES: AVERAGE MATURITIES AND WEIGHTED AVERAGE SPREAD



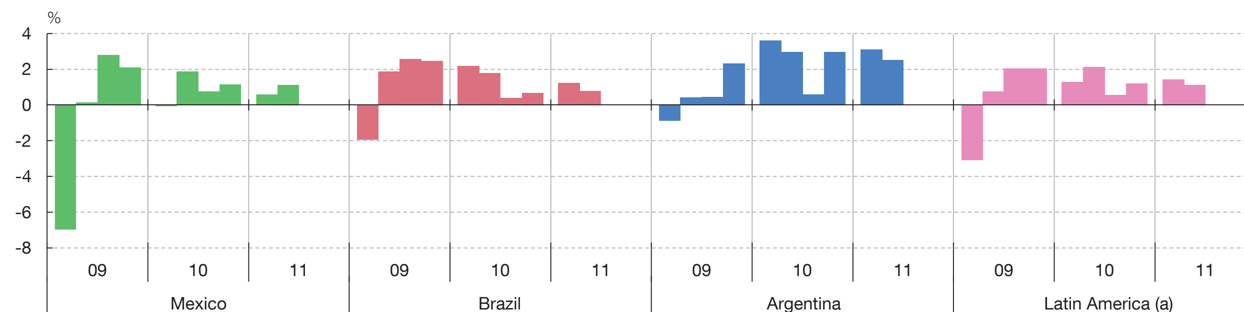
SOURCES: Dealogic, Datastream and IIF.

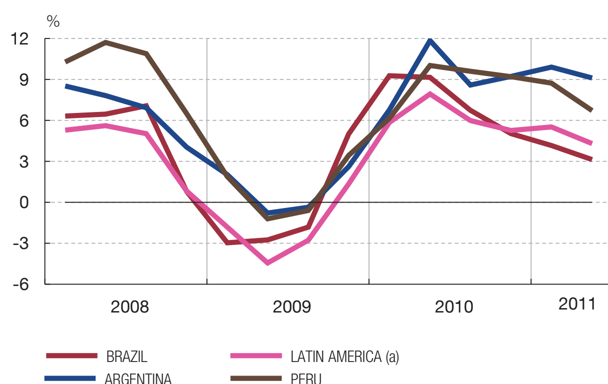
From April to July, capital inflows fuelled exchange-rate rises against the dollar which, along with the increase in inflation, increased the misalignment of real effective exchange rates, which stood in July at historical highs or close to them. To tackle capital inflows, countries had to resort once again to various macroprudential measures, such as foreign currency reserve requirements (Peru), capital controls (Brazil) or central bank intervention in the form of currency purchases.

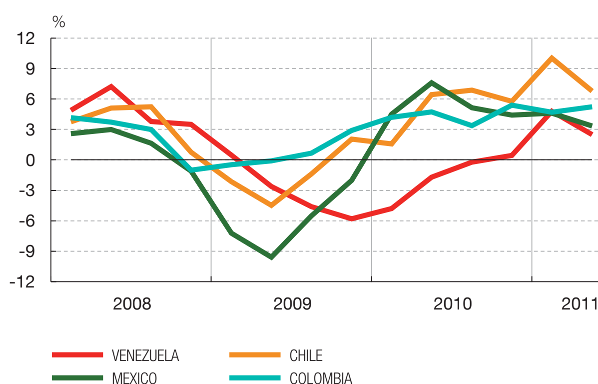
In July, however, the picture changed substantially. As mentioned in the previous section, the heightening of the sovereign debt crisis in the euro area and the weaker growth outlook, chiefly in the United States, triggered a severe worsening on international financial markets, characterised by a substantial increase in risk aversion. Against this backdrop, there was a notable decline in risk-bearing asset prices (among them emerging economies' exchange rates, stock markets and bonds) given the perception that the emerging economies would hardly remain immune to a new global shock. The emerging debt markets – which had until then withstood the downturn in global conditions, with inflows of close to $2 billion and issues in August totalling more than $15 billion, including very long-

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

CHART 5







SOURCE: National statistics.

a Aggregate of the seven main economies.

term operations (a 100-year bond in Mexico) – were finally affected in mid-September by major capital outflows and the grinding to a halt of bond issues.

In this setting, financial indicators deteriorated across the board. From July stock markets fell by 18% in Latin America and sovereign spreads widened (the Latin America Global EMBI increased by 121 bp). The stock markets that most fell were Argentina (-30%), Peru (-17%) and Chile (-12%), while sovereign spreads increased particularly in Mexico (by 86 bp to 245 bp). Finally, there was a strong depreciation in exchange rates towards the end of September (see Chart 4), of more than 10% in Chile and close to 15% in Mexico and Brazil. This was a similar depreciation to that in other major emerging currencies, such as the South African rand (-18%) or the Russian rouble (-14%), and may be largely explained by the cancellation of carry trade at a time of worsening tensions which proved conducive to flows towards safe-haven assets. These developments led the Peruvian and Brazilian central banks to intervene selling reserves, while Colombia altered its foreign exchange intervention arrangements, making purchases of reserves less automatic.

Activity and demand

Growth remained robust in Latin America in the first half of 2011. Quarter-on-quarter rates of 1.4% and 1.1% were respectively posted in Q1 and Q2 (see Chart 5). The main drivers of growth were the commodities-exporting economies. In year-on-year terms, however,

there was an across-the-board slowdown in activity, from 5.5% at the start of the year to 4.3% in Q2, about 2 pp below the related 2010 figures.

The main explanatory factor behind this easing in activity was the diminished dynamism of domestic demand which, even so, remained relatively robust and contributed 5.9 pp to growth (see Chart 6), while the negative contribution of external demand lessened to 1.6 pp in Q2. Set against the tightening of monetary policy virtually across the board in the first half of the year, and with relatively few changes in respect of the external factors affecting growth in the region (capital flows and commodities prices), the slowdown should be attributed to a resumption of growth rates more compatible with potential, following the strong rebound in 2010 after the crisis (see Chart 7). Indeed, a trend-cycle calculation shows that, at the end of 2010, most of the Latin American economies were posting growth rates far higher than trend, with the output gap closing. Also, from early 2011 relatively rapid convergence began towards rates that were more sustainable and even below trend in some cases (Brazil). The only exceptions would be Mexico and, above all, Venezuela, where the recession has been more protracted. Argentina is expected in 2011 to be the economy that is most overheating.

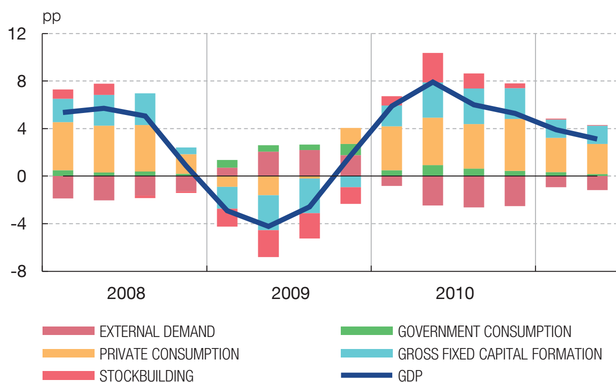
In terms of components, demand is showing a regional pattern very similar to that in 2010, albeit with a lesser contribution of inventories and greater balance between domestic and external demand. Private consumption has continued to be the main engine of growth, posting a year-on-year rate of 6% in Q2, underpinned by the favourable labour market situation, the increase in real wages in most of the countries and the pick-up in credit (see Chart 6). In fact, the unemployment rate across the region continued to fall, down to 6.8% of the labour force at the end of Q2, which was close to the historical lows in several South American countries. In Mexico, the situation is different insofar as the pre-crisis unemployment rate has not been reached, and employment has been resilient partly owing to the increase in informal-economy jobs. Gross capital formation, though it eased from its very high rate in early 2010, has continued growing at a pace of over 9% year-on-year. With perspective, however, it appears that investment measured as a percentage of GDP has not taken off in all the countries, something which might have been expected given the favourable economic outlook and the widespread availability of financing (see Chart 7). The contribution of stockbuilding to growth declined, while government consumption quickened in some countries (Argentina) and tended to moderate in others (markedly so in Mexico). Finally, the slowdown in exports in real terms (6.7% year-on-year) and the continuing strength of imports (14.7% year-on-year) explain why external demand has continued contributing negatively to growth.

Across the various countries, the moderation in growth is also partly due to specific causes. In Brazil it has been concentrated in the industrial sector, a fact linked to the exchange-rate appreciation. Indeed, industrial production in Brazil posted a year-on-year growth rate that was negative in July, and only moderately positive in August, especially in the capital and intermediate goods sectors, while employment in industry showed signs of weakness despite the general momentum of the labour market, with an unemployment rate at a historical low (6%). These trends are also discernible in business confidence indices, which have likewise trended downwards since virtually the beginning of 2011 (see Chart 8). However, the indicators of domestic demand (consumption, imports, retail sales and lending) continue to rise at a dynamic pace, outstripping the supply-side indicators (see Chart 8). Higher growth in domestic demand as opposed to in supply is a trend common to a greater or lesser degree to the other commodities-exporting countries (Chile, Peru and Argentina; see the section “Economic developments by country”). In Mexico, the slowdown

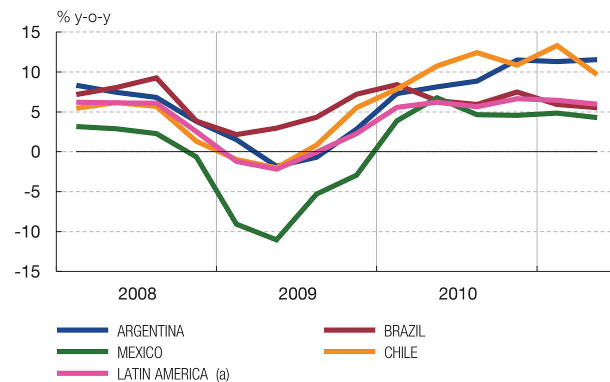
BREAKDOWN OF GDP AND INVESTMENT

CHART 6

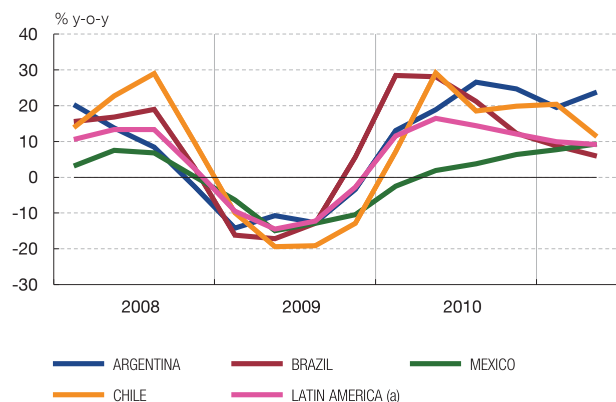
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



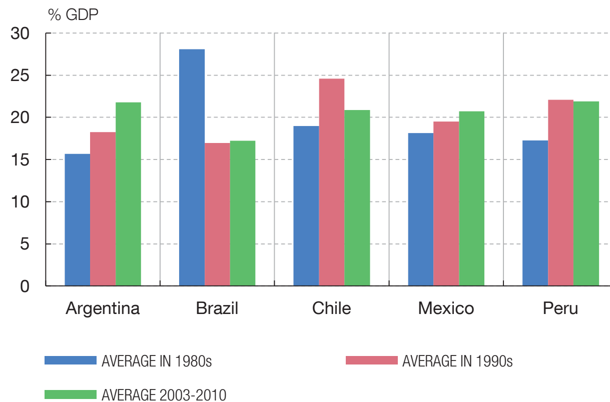
PRIVATE CONSUMPTION
Year-on-year rate



GROSS FIXED CAPITAL FORMATION



PRIVATE INVESTMENT



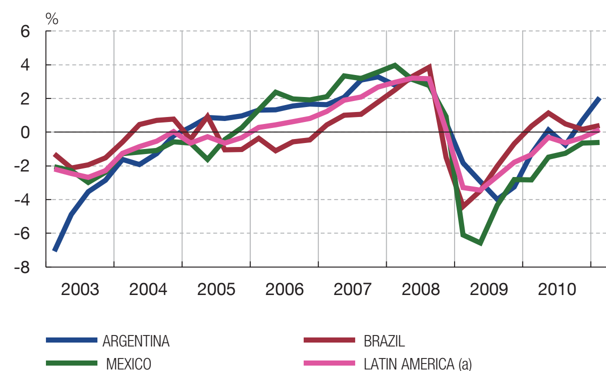
SOURCES: National statistics and IMF.

a Seven biggest economies.

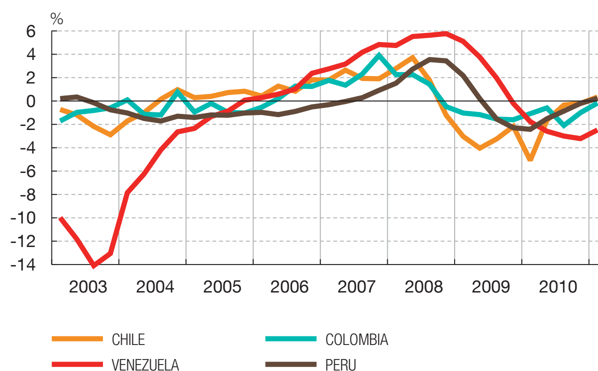
CHANGES IN THE OUTPUT GAP

CHART 7

OUTPUT GAP (b)



OUTPUT GAP (b)



SOURCE: Devised drawing on IMF data.

a Aggregate of the seven main economies.
b Calculated using a HP filter with lambda = 1,600 on quarterly GDP data.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

	2008	2009	2010	2009		2010				2011		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
GDP (year-on-year rate)												
Latin America (a)	4.3	-2.0	6.3	-2.6	1.7	5.8	7.9	5.9	5.3	5.5	4.3	
Argentina (b)	6.8	0.9	9.2	-0.3	2.6	6.8	11.8	8.6	9.2	9.9	9.1	
Brazil	5.2	-0.6	7.5	-1.8	5.0	9.3	9.2	6.7	5.0	4.2	3.1	
Mexico	1.5	-6.1	5.5	-5.5	-2.0	4.5	7.6	5.1	4.4	4.6	3.3	
Chile	3.7	-1.7	5.2	-1.4	2.1	1.7	6.4	6.9	5.8	10.0	6.8	
Colombia (c)	3.5	1.5	4.3	1.1	2.9	3.7	4.7	3.4	5.4	4.7	5.2	
Venezuela	4.8	-3.3	-1.4	-4.6	-5.8	-4.8	-1.7	-0.2	0.5	4.8	2.5	
Peru	9.8	0.9	8.8	-0.6	3.4	6.2	10.0	9.6	9.2	8.7	6.7	
CPI (year-on-year rate)												
Latin America (a)	7.8	6.4	6.4	5.9	5.4	6.1	6.5	6.2	6.6	6.7	6.6	7.0
Argentina (b)	8.6	6.3	10.5	5.9	7.1	9.0	10.6	11.1	11.0	10.1	9.7	9.9
Brazil	5.7	4.9	5.0	4.4	4.2	4.9	5.1	4.6	5.6	6.1	6.6	7.3
Mexico	5.1	5.3	4.2	5.1	4.0	4.8	4.0	3.7	4.2	3.5	3.3	3.1
Chile	8.7	0.4	1.4	-1.9	-3.0	-0.3	1.2	2.2	2.5	2.9	3.3	3.3
Colombia	7.0	4.2	2.3	3.2	2.4	2.0	2.1	2.3	2.7	3.3	3.0	3.7
Venezuela	31.4	28.6	29.0	28.7	28.1	27.4	31.9	29.8	27.3	29.1	24.6	26.7
Peru	5.8	2.9	1.5	1.9	0.4	0.7	1.1	2.2	2.1	2.4	3.1	3.7
BUDGET BALANCE (% of GDP) (d)												
Latin America (a) (e)	-0.5	-2.9	-2.2	-3.1	-2.8	-2.7	-2.5	-2.0	-2.2	-1.8	-1.6	
Argentina	1.4	-0.6	0.2	-1.0	-0.6	-0.8	-0.3	0.2	0.2	0.2	0.0	
Brazil	-2.0	-3.3	-2.6	-4.2	-3.3	-3.4	-3.3	-2.3	-2.6	-2.3	-2.2	
Mexico	-0.1	-2.3	-2.8	-2.3	-2.1	-1.8	-2.2	-2.4	-2.7	-2.8	-2.8	
Chile	5.0	-4.6	-0.3	-3.9	-4.6	-3.9	-1.1	0.0	-0.3	1.0	1.5	
Colombia	-1.8	-3.8	-3.6	-3.2	-3.8	-3.4	-4.0	-3.6	-3.5	-2.9	-1.6	
Venezuela	-1.2	-5.1	—	-3.9	-5.1	-4.8	-3.8	-3.5	—	—	—	
Peru	2.2	-1.8	0.0	-0.7	-1.8	-1.3	-0.9	-0.3	0.0	0.3	0.3	
PUBLIC DEBT (% of GDP)												
Latin America (a)	30.7	34.7	33.7	34.5	34.2	34.1	33.3	33.5	33.1	33.5	—	
Argentina	44.7	47.9	44.6	46.4	45.8	47.9	40.5	43.3	41.3	44.3	—	
Brazil	38.5	42.8	40.4	43.3	42.8	41.9	40.9	40.3	40.2	39.9	39.7	
Mexico	24.3	28.0	27.4	27.5	26.3	27.7	27.7	27.4	26.0	27.1	26.9	
Chile	5.2	6.2	9.2	5.8	6.1	6.9	7.5	8.7	9.2	9.6	10.1	
Colombia	33.2	34.7	34.8	33.6	35.1	34.3	35.0	34.7	34.7	34.8	33.1	
Venezuela	13.6	22.6	28.4	20.4	22.6	19.0	22.4	26.1	28.4	26.9	—	
Peru	24.2	27.3	23.9	27.2	27.3	25.5	23.7	23.2	23.5	22.5	21.8	
CURRENT ACCOUNT BALANCE (% of GDP) (d)												
Latin America (a)	-0.6	-0.3	-0.7	-0.7	-0.2	-0.1	-0.4	-0.6	-0.8	-0.9	-0.8	
Argentina	2.0	3.6	1.0	3.5	3.4	2.9	2.3	1.4	0.8	0.7	0.3	
Brazil	-1.7	-1.5	-2.3	-1.2	-1.5	-1.8	-2.1	-2.4	-2.3	-2.3	-2.1	
Mexico	-1.5	-0.7	-0.5	-1.4	-0.6	-0.4	-0.5	-0.3	-0.5	-0.7	-0.8	
Chile	-1.9	1.6	1.9	0.7	2.6	2.4	1.8	1.6	1.9	0.9	0.6	
Colombia	-2.8	-2.2	-3.1	-2.7	-2.1	-2.1	-2.2	-2.8	-3.1	-3.2	-3.4	
Venezuela	12.0	2.6	6.1	-0.6	2.6	6.0	6.8	6.3	6.0	6.5	8.4	
Peru	-4.2	0.2	-1.5	-1.0	0.2	0.0	-0.2	-0.9	-1.5	-1.5	-2.1	
EXTERNAL DEBT (% of GDP)												
Latin America (a)	17.5	20.6	20.7	20.8	19.8	19.7	19.1	20.4	20.6	20.5	19.8	
Argentina	38.3	37.9	34.9	39.2	36.3	36.9	31.5	34.2	32.3	33.5	27.4	
Brazil	12.0	12.4	12.2	14.0	12.2	11.9	12.0	12.3	12.3	12.6	12.3	
Mexico	11.5	18.5	18.2	17.0	16.8	17.9	17.8	18.4	19.0	18.5	18.4	
Chile	38.0	45.9	42.3	45.3	45.0	42.8	42.2	43.4	42.5	42.6	42.6	
Colombia	19.1	22.7	22.6	21.9	22.9	18.8	19.3	21.5	22.5	20.6	20.9	
Venezuela	19.4	22.6	35.5	21.4	22.6	23.8	25.1	31.1	35.8	34.4	35.0	
Peru	27.3	28.1	26.1	28.6	28.1	27.3	25.4	26.6	26.4	26.1	25.6	

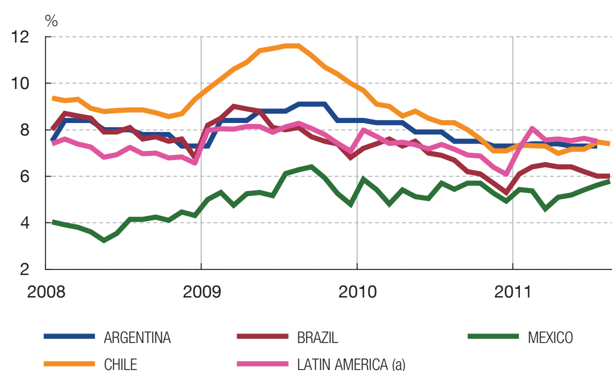
SOURCES: National statistics.

a Aggregate of the 7 countries represented.
b Official figures.
c Seasonally adjusted.
d Four-quarter moving average.
e As from 2010 Q4, the budget balance aggregate does not include Venezuela.

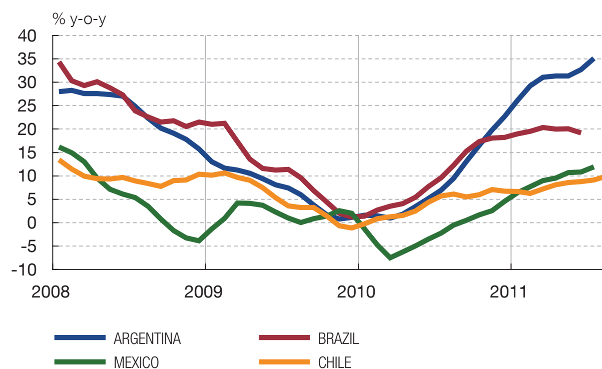
EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Three-month moving average of the year-on-year rate, and percentage

CHART 8

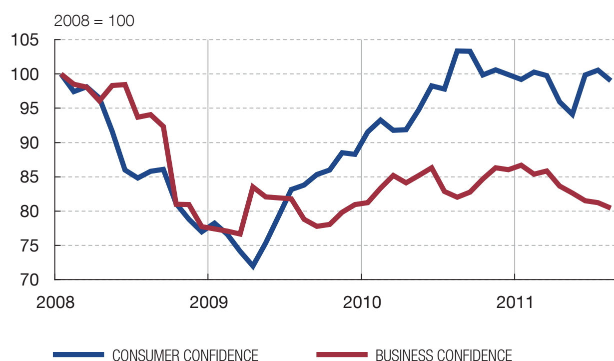
UNEMPLOYMENT RATE



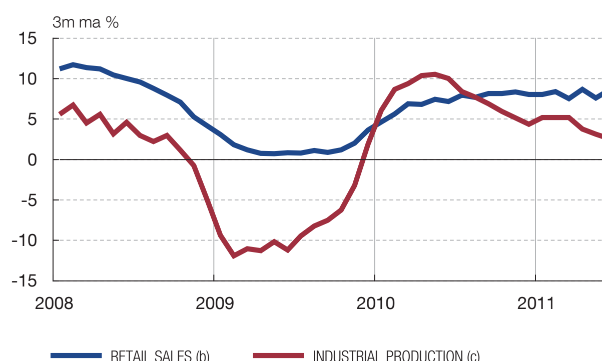
REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR
3-month moving average of the year-on-year rate



CONSUMER AND BUSINESS CONFIDENCE INDICES



DEMAND INDICATORS
3-month moving average of the year-on-year rate



SOURCE: National statistics.

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

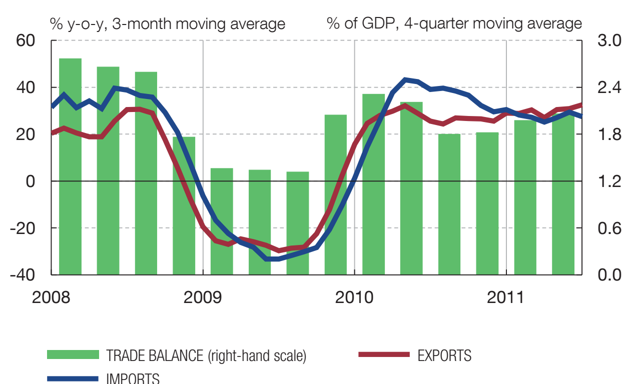
during the first half of the year has coincided with the downturn in the US industrial cycle in recent months. This suggests that, despite the pick-up in recent quarters, Mexican domestic demand is not generating sufficiently self-sustained growth as to mitigate high external dependency.

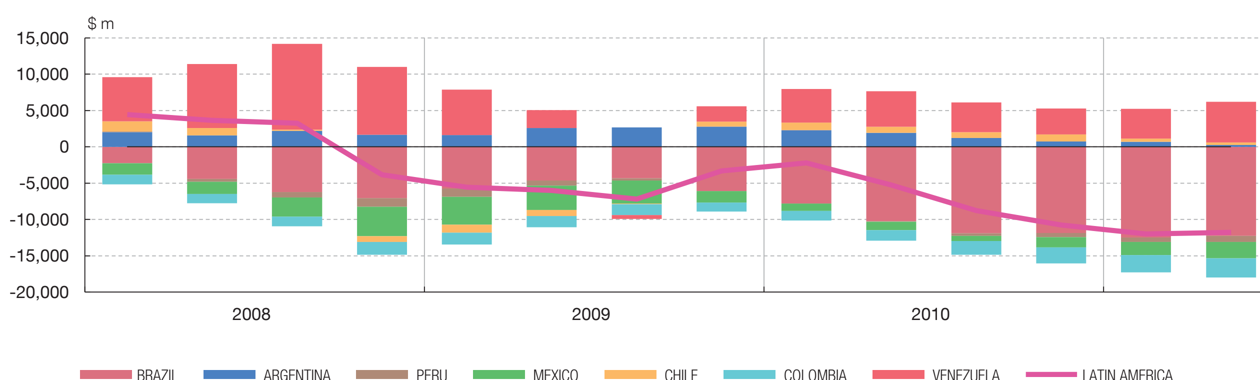
Against this background, credit to the private sector continued to increase at a rate of close to 20% (see Chart 8) in real terms in August in the region as a whole, with some easing observable in certain countries (in Brazil, for example, further to its monetary tightening measures) and an acceleration in others (Argentina, or Chile and Mexico, departing from much more moderate rates). One of the main factors that has pushed such growth upwards in recent quarters has been the increase in net capital flows. In fact, the episodes of increasing capital inflows are one of the main determinants of the excessive expansion in credit.[1] This risk has been perceived as potentially significant in Brazil, given the greater size and liquidity of its financial markets, and the possibility that the availability of financing might provide for an easing of lending standards, or the formation of bubbles in the prices of certain assets. In this respect, although excessive growth in some segments cannot be

1 *WEO*, October 2011, chapter 1, and *BIS Quarterly Report* (2011).

EXTERNAL ACCOUNTS AND DETERMINANTS
Year-on-year rates of change, indices and billions of US dollars

CHART 9





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

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

ruled out, the risk of a bout of generalised overexpansion seems low. Mortgage lending still accounts for only 4.2% of GDP in Brazil, despite its recent dynamism, and it is in the main directed[2], the consequence of the stimulus policies in this sector. Public credit is decelerating, and the recent slowdown in capital inflows should also temper in part this expansion. The acceleration in this variable is also a concern in Argentina, although it is from a very low base, in a setting in which uncertainty over the elections appears to be reflected in deposits, dollarisation and capital outflows.

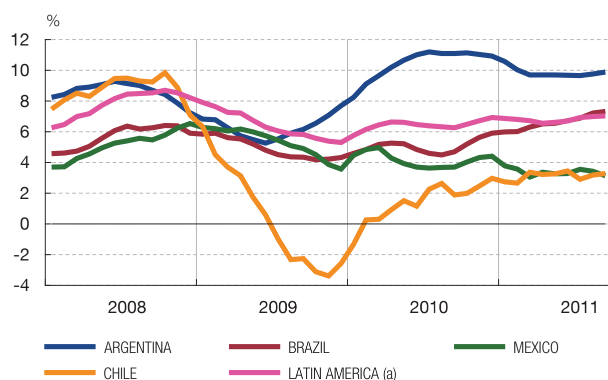
Finally, developments in the external sector in Latin America were determined to August by the prevalence of high commodities prices and of capital flows. Thus, as a result of some easing in the growth of imports in nominal terms and of the continuing robust increase in exports (above all due to the price effect), the trade surplus in the region increased slightly, to 2.2% of GDP (see Chart 9). Meantime, the current account deficit stabilised at somewhat below 1% of regional GDP, largely due to the worsening of the incomes balance (owing to the habitual repatriation of dividends from the commodities-exporting economies). This situation is expected to have changed in September, although the trade balance figures are

2 The stock of mortgage lending is 155.7 billion reales, 146 billion of which relate to directed lending.

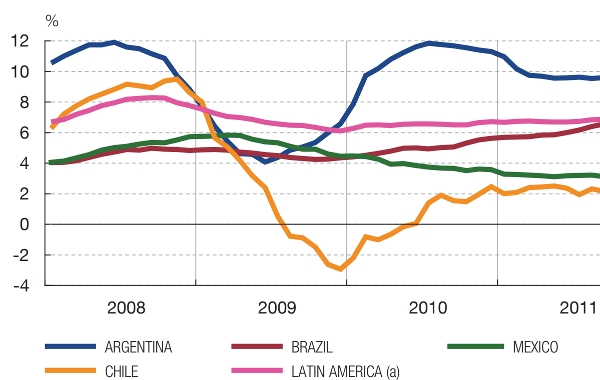
INFLATION AND OFFICIAL INTEREST RATES
Year-on-year rates of change and percentage

CHART 10

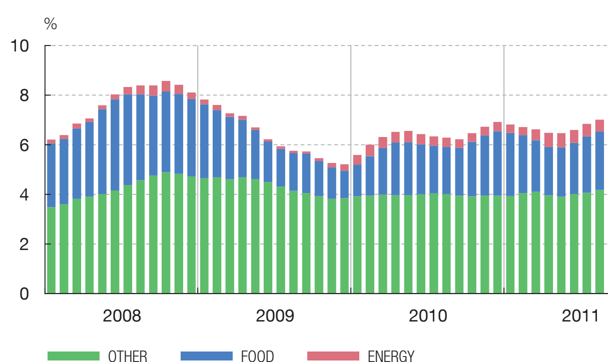
INFLATION RATE



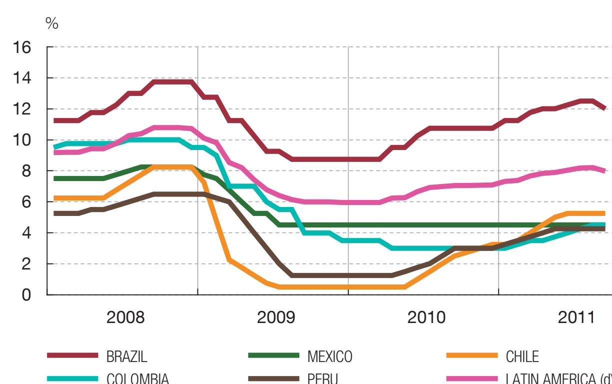
CORE INFLATION RATE (b)



CONTRIBUTION TO INFLATION IN LATIN AMERICA (c)



OFFICIAL INTEREST RATES



SOURCES: National statistics and Banco de España.

a Aggregate of the seven main economies.
b Official rates.
c Banco de España calculations 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.

not yet available, in light of the collapse in the prices (in some cases up to 20%) of the region's main commodities. It should also be stressed that practically all the countries saw their current account deficit widen or their surpluses narrow during the six-month period, this being offset only by the substantial widening of the current surplus in Venezuela to 8.4% of GDP. In respect of the capital account, foreign direct investment continued comfortably to finance the current deficit, although in circumstances such as the present in which there is a change in market sentiment, the external position – which was a strength at the start of the crisis given its surplus situation – might now prove to be a weakness in some countries (chiefly Colombia and Brazil). This vulnerability, however, would be partly compensated for by the increase in central bank foreign exchange reserves, which have reached far higher levels in all the countries than those in place pre-crisis.

Prices and macroeconomic policies

Far from stabilising, inflation in Latin America rebounded in the period of 2011 under study, placing the year-on-year rate of the aggregate for the region at 7% in September, 0.5 pp up on the end-2010 figure. As in the previous six-month period, much of this rise was due to the behaviour of prices in Brazil, where annual inflation rose to 7.3% in September (far above the upper target band). That said, Peru, too, among the countries pursuing inflation targets, posted an above-target rise in prices (see Chart 10). By contrast, in Chile,

INFLATION
Year-on-year rates of change

TABLE 2

Country	2010			2011		2012
	Target	December	Fulfillment	September	Expectations (a)	Expectations (a)
Brazil	4.5 ± 2	5.9	Yes	7.3	6.4	5.4
Mexico	3 ± 1	4.4	No	3.1	3.4	3.7
Chile	3 ± 1	3.0	Yes	3.3	3.4	3.0
Colombia	3 ± 1	3.2	Yes	3.7	3.4	3.4
Peru	2 ± 1	2.1	Yes	3.7	3.4	2.6

SOURCES: National statistics and Consensus Forecast.

a September 2011 Consensus Forecast for the end of the year.

Colombia and Mexico, inflation tended to stand within the central bank target range (see Table 2). The increase in food prices at the start of the year continues to explain part of the rise in the overall indices, although core inflation pressures have been observed in some countries, particularly in Brazil, where it stood at a six-year high of 6.7% year-on-year, owing to the rise in services prices. Yet in the other countries with inflation targets, core inflation performed better. In Mexico, for instance, it held stable against a background of ample output, low growth in labour costs and an appreciating currency to June. In Argentina, inflation stood at around 10% (while wage increases are running at 20%/25%, the range in which the unofficial inflation measures stand), and in Venezuela it climbed to 26.5%.

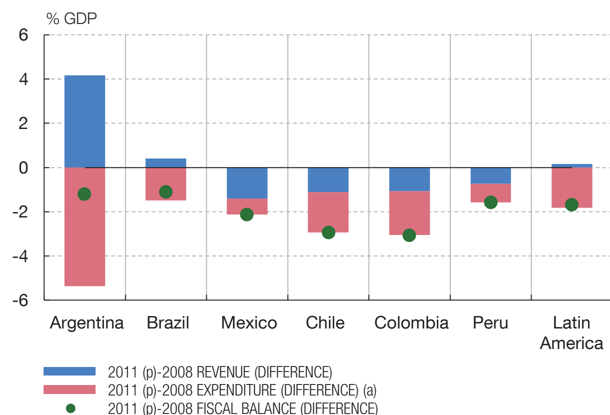
Against this background, the cycle of interest rate rises in which four of the five countries with an inflation target in the region since 2010 were immersed continued during the first seven months of the year. In Brazil, the official rate climbed to 12.5% in July, after three 25 bp rises; in Chile and Colombia there were five consecutive increases totalling 200 bp, also to July; and in Peru the benchmark rate increased by 250 bp to May. The upshot was a considerable tightening of monetary conditions, and at the same time this increased the incentives for carry trade and exchange rate appreciation. Indeed, to contain the pressure on exchange rates, the first eight months of the year saw a build-up of reserves of more than $100 billion in the region (an increase of 18%), mainly in Brazil and Mexico. This trend was reversed in September in the face of downward pressure on the currencies.

In late August, however, the Brazilian central bank unexpectedly cut its official interest rate by 50 bp, highlighting in its communiqué the change in the international scenario, which involved a significant increase in the risks to the Brazilian economy through various channels, such as trade flows, external investment and confidence effects. This shift in the global scenario would in principle entail a more favourable balance of risks in respect of containing inflation, allowing for convergence on the target of 4.5% in 2012, a perception strengthened by the prospect of greater fiscal restriction, announced during the summer. Nonetheless, survey-based inflation expectations for 2011 have tended to rise moderately in recent months, and this trend has continued despite the cut in rates. In the remaining countries in the region, the upward interest rate cycle has been interrupted, and in some cases (Chile, Mexico) there has been some indication of the possibility of a cut in rates. Yield curves, which retained a very positive slope until late July, incorporating expectations of a rise, have become inverted and are currently discounting declines which, in some cases, are very significant (more than 100 bp before the end of the year in Brazil, more than 50 bp in Chile and 25 bp in Mexico). All these developments point to a further change in the interest rate cycle in the region.

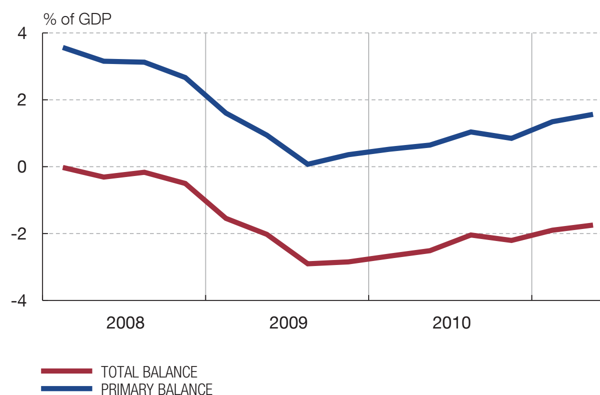
MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and index

CHART 11

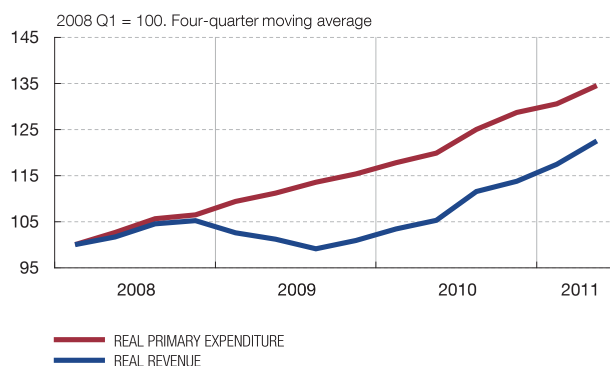
GENERAL GOVERNMENT BALANCE



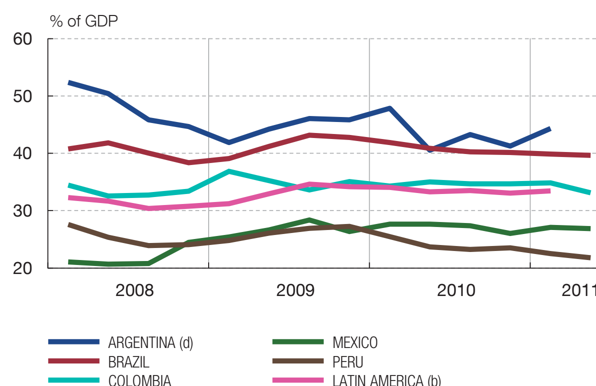
SURPLUS (+) OR DEFICIT (–) IN LATIN AMERICA (b)



REAL PRIMARY REVENUE AND EXPENDITURE IN LATIN AMERICA (b) (c)
Index



PUBLIC DEBT



SOURCES: IMF Fiscal Monitor September 2011 and national statistics.

a A negative sign denotes an increase in general government spending between 2008 and 2011.
b Seven biggest economies.
c Deflated by the CPI.
d Excludes untendered debt in the debt swap offers of 2005 and 2010.

In the fiscal policy realm there were no notable new developments during the six-month period, except perhaps the announcement by Brazil of an increase in its primary surplus for 2011. This was interpreted as a sign of greater fiscal restriction. However, it should be borne in mind that the strength of revenue provided for an improvement in public finances at the regional level (with some exceptions, such as Argentina; see the section "Economic developments by country"), despite the fact that public spending continued to grow at a rate far above that of the economy's nominal growth. Other countries, such as Peru, defined moderately expansionary fiscal policy measures after the elections. One key question worth asking is how fiscal policies in Latin America should react in the event of a significant slowdown in global growth, and if there would be headroom, as in 2008-2009, to apply countercyclical policies. In this respect, although at the regional level the primary public balance has increased to 2% of GDP in 2011 (see Chart 11), this is considerably below the level of 4% reached in 2008. By contrast, developments in structural primary balances – the change in which is habitually taken as an indicator of the fiscal impulse[3] – appeared to show that in several countries fiscal policy has been countercyclical both in 2010, when negative output

3 Increases (reductions) in the structural primary balance entail contractionary (expansionary) fiscal impulses.

gaps were accompanied by an expansionary fiscal impulse, and in 2011, when positive gaps and contractionary fiscal impulses prevailed, though in some countries, given the boom in their domestic demand, it might have been so to a greater extent. This highlights the potential usefulness of fiscal rules (see Box 2), which will help endow fiscal policy with a more markedly countercyclical nature in the long run.

Trade integration processes and structural policies

The main headway made in regional integration processes and the external integration of the Latin American countries was the approval in October of the free trade treaty between the United States and Colombia by the US Congress (along with the free trade treaties with Korea and Panama), which had been signed five years earlier, following Colombia's acceptance of an amendment in the protection to employed nationals, and the Republicans' acceptance of an extension of the subsidies to US employees affected by these agreements. Conversely, there was no significant progress in the negotiation of the agreement between Mercosur and the EU, and the EU proposed amending the tariff preferences granted to developing countries, which would adversely affect Argentina and Brazil.

Protectionist tensions arose once more in Mercosur, warranted in part by a strong appreciation of the attendant currencies that detracts from competitiveness. The Brazilian authorities launched non-automatic import licences for automobiles and their parts, something which affects almost 40% of Argentine exports to Brazil, and also bears on the sector on which the development of the bloc was originally based. Likewise, Brazil proposed that each member should raise its tariffs individually against third countries in the face of sudden increases in imports, which would deactivate, de facto, the Common External Tariff, while Argentina suggested that the aim of the bloc was the replacement of imports at the regional level. Peru furthered its strategy to re-orient its trade through bilateral treaties, and entered into agreements with Costa Rica and Panama, along with an Economic Complementation Agreement with Brazil and Argentina (which will allow the entry of almost 100% of Peruvian products into these two countries from 2012), and with Mexico. Finally, Ecuador, in light of the expiry in February of the ATPDA tariffs granted by the United States, announced a compensation programme for affected exporters in the form of tax rebates.

In terms of structural reforms, progress was scant. In the main, such reforms were aimed at increasing the States' fiscal resources. In Argentina, a project was submitted to amend the central bank's organic charter, which requires the central bank to "co-ordinate its mission with the government", obliging it to finance social activities and programmes, i.e. converting it into something closer to a development bank. In Venezuela, legislation was approved to raise the tax burden for the oil sector, the prohibition on PDVSA having government members as directors was repealed, and the nationalisation of gold mining was approved, which sets a maximum 45% holding for foreign companies in such concerns and prohibits the export of the metal, in addition to raising royalties from 3% to 13% and subjecting contracts to national jurisdiction. In Peru, the new government reached an agreement with mining companies to set in place a new tax regime, which would provide additional revenue for the State equivalent to 0.7% of GDP per annum. In Mexico, the end of the congressional sessions period in the run-up to the July 2012 elections prevented approval of the political and labour reforms proposed in 2010. In Chile, however, the government unveiled 50 so-called Competitive Impulse Agenda measures aimed at improving competitiveness with the goal of growth at a rate of 6% per annum. It should be stressed, lastly, that, following the agreement on the integration of the stock markets of Colombia, Peru and Chile in late April, the volume of transactions has been minimal, and the plans to merge the stock markets of Colombia and Peru have been discontinued.

Since 1994 a growing number of countries around the world (approximately 80 at present) have adopted fiscal rules.[1] The severe fiscal deterioration in the developed countries has provided fresh impetus for adopting or reinforcing fiscal rules (including at the constitutional level, as recently seen in Spain) in order to strengthen fiscal credibility and ensure the sustainability of public debt.[2] The advisability of having fiscal rules stems from the well-documented fact that fiscal policies show a bias towards deficit. This bias may be explained by: i) the common ownership of public resources; ii) typical principal-agent problems (information is asymmetrical and the interests of elected representatives do not always coincide with those of voters), and iii) time-inconsistency problems (the fiscal position reflects not only the business cycle, but also the political cycle).

Adding to these broad considerations in Latin America is the specific feature whereby fiscal policy has always been notably procyclical, partly owing to the exposure of the regions' countries to market economic fluctuations resulting from changes in the terms of trade and in the ability to raise financing abroad. Thus, it has often been difficult for governments in this region to commit themselves credibly to saving extraordinary revenue (arising from the cycle or from the rise in commodities prices) in good times, owing to the pressures to increase public spending in democratic but very unequal societies. Accordingly and traditionally, "sufficient fiscal space" was not created to counter the shortage of financing in bad times, or to prevent the rapid changes in investor sentiment and ease the vulnerability to financial crises. In this respect, instead of offsetting cyclical shocks, discretionary fiscal policy may have contributed to increasing macroeconomic volatility and fiscal vulnerability in the region. Against this background, and to promote greater economic stability and to achieve the sustainability of public debt, the biggest countries in the region have in recent years adopted fiscal rules. The purpose of this Box is to review their characteristics and to show the main differences and similarities. Panel 1 summarises the main characteristics of the fiscal rules in Argentina, Brazil, Chile, Colombia, Mexico and Peru.[3]

Fiscal rules are usually defined as commitments specified as numerical targets for certain key fiscal variables: budget balance, public revenue, public spending and public debt, among others, so as to establish a framework for fiscal policy that is independent of the political cycle. While discretionary fiscal policy may be advisable in some circumstances (for instance, in the presence of unexpected shocks that require a rapid political response), there is growing evidence that such discretionality tends to lead to a sub-

1 New Zealand was the pioneer in setting fiscal rules. See IMF (2009), *Fiscal rules anchoring expectations for sustainable public finances*, Fiscal Affairs Department.

2 For Spain's case see, for example, the article "The reform of the fiscal framework in Spain: constitutional limits and the new public spending growth rule", published in the October 2011 edition of the Banco de España's *Economic Bulletin*.

3 In Venezuela the fiscal ruled has frequently been changed or suspended in recent years.

Country	Original law	Latest amendment	Stabilisation instrument?	Level of government (a)	Numerical target?	Related institution(s)	Golden rule?	**Exceptions to the rule?**
Argentina	Law 25.152 on Fiscal Solvency (1999)	Law 25.917, General Fiscal Responsibility Regime (2004)	No	CG, SNG (agreement with CG)	Yes	FCRF (Federal Council for Fiscal Responsibility)	Yes	**Yes**
Brazil	Law on Fiscal Responsibility and Municipal Public Finances (2000)		No	NFPS (without Petrobras)	In separate legislation	Fonfo Soberano do Brasil (Brazil Sovereign Fund)	Yes	**Yes**
Chile	Law 20.128 on Fiscal Responsibility (2006)		Yes	CG	Yes (set by government)	Economic and Social Stability Fund/Pensions Reserve Fund	No	**No**
Colombia	Law 358 (1997)	Law 1473 (2011)	Yes	CG	Yes	Consultative Committee for the Fiscal Rule, Saving Fund and Fiscal and Macroeconomic Stabilisation	No	**Yes**
Mexico	Federal Budget and Fiscal Responsibility Law (2006)		No	CG	Yes	Stabilisation Fund	No	**Yes**
Peru	Law 27.245 on Prudence and Fiscal Transparency (1999)		No	NFPS	Yes	Stabilisation Fund	Yes	**Yes**

SOURCES: National laws and references cited in the text.

a CG = Central Government; NFPS = Non-Financial Public Sector; SNG = Sub-National Governments.

optimal result, taking the form of the above-mentioned bias towards deficit, or to the application of procyclical and, therefore, destabilising fiscal policies.[4]

Numerical fiscal rules take various forms in the region and pursue different non-exclusive objectives. An initial group of fiscal rules focuses on the attainment of fiscal sustainability. This is the case of Argentina, Brazil, Mexico and Peru, who set limits on various variables such as budget balances (primary or total), total public spending or specific categories thereof, the servicing of public debt or public debt per se (expressed as a percentage of GDP, as a growth rate or as a total volume). In most cases the so-called "golden rule" is applied, whereby spending on public investment is excluded from the ceilings on public spending so as to prevent public investment from being the item subject to adjustment. In all these cases, too, limits on the financing that the central bank may grant to the public sector are included.[5] The advantages of this type of fiscal rule are, chiefly, that they are simple, transparent and easily controllable. Among the possible drawbacks is the lack of flexibility imposed on fiscal policy, although in almost all countries "escape clauses" have been added for extreme circumstances, such as serious economic crises or natural disasters. Another potentially adverse element is that a certain degree of "creative accounting" might be encouraged in order to ensure fulfilment of the targets.

A second group of fiscal rules has as a priority to preserve cyclical stabilisation capacity (by allowing the operation of the automatic stabilisers), though without forgetting the commitment to fiscal sustainability. These types of rules are usually based on: i) a budget balance target over the course of a business cycle, or ii) numerical targets for the structural balance (adjusted by the business cycle and/or commodities prices) for each year. In this connection, these rules seem particularly appropriate for addressing the challenges that uncertain and volatile revenues (depending in many cases on commodities prices) pose to fiscal management in many Latin American countries. Set against the greater flexibility of these types of rules is their greater complexity and the inevitable degree of arbitrariness of the techniques used in estimating output gaps, long-term commodities prices and budgetary elasticities. At present, only the Chilean government follows a rule of this type, which sets a target on the structural budget balance (isolating the effect of the business cycle and of copper and molybdenum prices from public revenue).[6] In the coming years, fiscal policy in Colombia will also follow a similar outline, since regulations are currently being implemented on the basis of the law approved in July.

This second type of fiscal rule is habitually associated with the setting up of stabilisation funds, generated on the basis of the fiscal surpluses in economic boom times, which allow public spending to be funded during recessions. Thus, for instance, Chile maintains its Economic and Social Stabilisation Fund[7] which, in addition to acting as an automatic stabiliser, has allowed the Chilean government to apply countercyclical measures in the recent financial crisis (making withdrawals from the Fund for an amount equal to 5.7% of GDP in 2009). In any event, it should be stressed that all the other countries in the region have these types of stabilisation funds to lessen the impact of recessions or sharp declines in commodities prices, although only in Peru is the fund of a significant size (close to 3.4% of GDP in August 2011).

In all the countries in the region except in Chile, the application of fiscal rules is not confined to central government but also encompasses

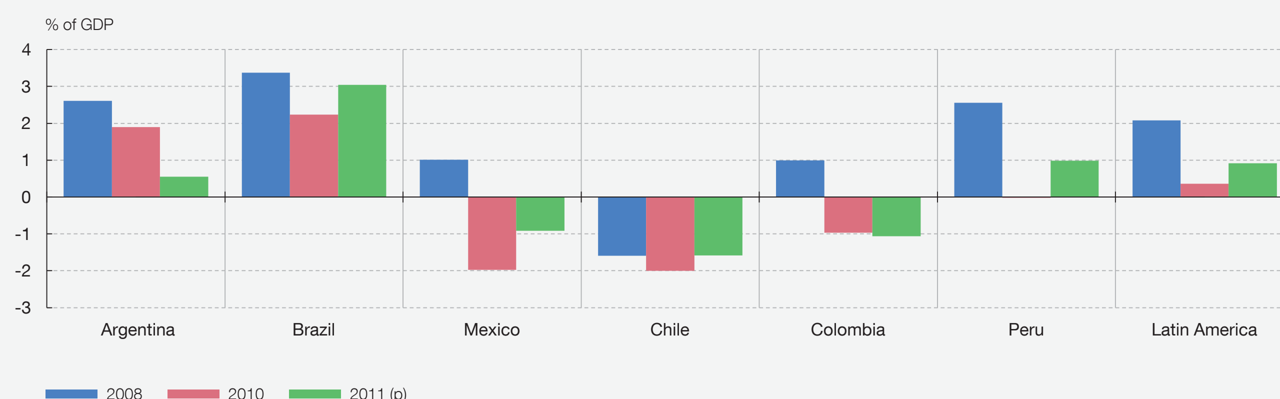
4 G. Kopits (2001), *Fiscal rules: useful policy framework or unnecessary ornament?*, IMF Working Paper 01/145.

5 The legal instruments used may be constitutional provisions or other high-level rules, ordinary legislation or simply a broad policy guideline. The legislation also usually includes sanctions relating to non-compliance (at the institutional or individual level).

6 The rule might be reviewed in the coming months following the guidelines offered by an advisory committee set up to this end.

7 Likewise, the Pension Reserve Fund receives contributions to meet future obligations of the public pension system.

GENERAL GOVERNMENT CYCLICALLY ADJUSTED PRIMARY BALANCE



SOURCE: IMF, Fiscal Monitor.

other tiers of government. When there are several levels of government, the risk of some of these sub-national governments failing to be fiscally accountable multiplies. The provisions governing sub-national fiscal behaviour may be adopted following a top-down or a bottom-up approach. In the first case, the central authority establishes a series of numerical rules for the sub-national governments. This type of approach can be seen in countries with a federal structure, in experiences involving the bail-out of sub-national governments (Brazil), or in fiscally more centralised countries in which the Constitution gives the central government power to legislate in all areas and to decide which fiscal resources it delegates to the sub-national governments (Colombia and Peru). However, it is much more difficult to set consistent fiscal rules through a bottom-up approach, i.e. when sub-national governments voluntarily adopt binding rules (Argentina). In any event, fiscal rules for sub-national governments are particularly useful in cases in which market discipline does not function correctly.

A fiscal rule is better accepted politically and socially if an independent fiscal monitoring agency is entrusted with its application, since it is considered that this significantly reduces the risks of manipulation of the rule for political motives. This is especially the case for rules based on structural budget balances. However, only in Argentina is there a body of these characteristics, although its functions focus more on the monitoring of sub-national governments.[8]

8 The report of the advisory committee for the design of a second-generation structurally balanced fiscal policy for Chile recommends the creation of this type of body.

Assessing the effects of fiscal rules on fiscal performance is not straightforward, partly because in some cases the rules have been in force for very few years, and above all because there are sample-selection and identification problems (since in some countries fiscal rules are part of a broader macroeconomic policy framework) that mean that the econometric analysis is prone to certain limitations.[9] However, numerous fiscal indicators show that the region faced the recent global financial crisis in a more favourable fiscal position than in the past, which is partly a reflection of the efforts made in previous years.[10] Thus, unlike in previous episodes, during the global financial crisis almost all the countries in the region were able to pursue a countercyclical fiscal policy to a greater or lesser extent: as the panel shows, as activity was weakening the structural primary balance declined, suggesting the existence of an expansionary fiscal impulse. Further, fiscal policy retained its countercyclical nature as output gaps closed in 2010 in nearly all the countries and as the fiscal impulse turned contractionary in several of them.

9 The empirical studies available suggest that fiscal consolidation processes were already under way before the introduction of fiscal rules, although these might have served to reaffirm and institutionalise these processes. See, for example, C. Caceres, A. Corbacho and L. Medina (2010), *Structural breaks in fiscal performance: did fiscal responsibility laws have anything to do with them?*, IMF Working Paper 10/248.

10 C. Daude, A. Melguizo and A. Neut (2010), *Fiscal policy in Latin America: countercyclical and sustainable of last?*, OECD Development Centre Working Paper no. 291.

Economic developments by country

The *Brazilian* economy slowed in Q2, posting a quarter-on-quarter growth rate of 0.8%, compared with 1.2% in Q1. As a result, year-on-year growth continued to ease, albeit more markedly so than envisaged (to 3.1% in Q2). And judging by the monthly GDP indicators, this trend appears to be sharper in Q3. Accounting for this lesser dynamism is the slowdown in domestic demand, which contributed 4.3 pp to GDP growth, due above all to the lower growth of investment, since private consumption remained strong (5.5% year-on-year). The slowdown in investment may be attributable to the strength of the exchange rate (and its effect on industry), but also to the closing of the output gap or to structural factors (such as the tax level, or the cost of access to credit). The labour market continues to trend favourably, with a very low unemployment rate (6% in August), and with notable growth in real wages. Inflation has performed poorly, posting year-on-year rates of over 6.5% since April (above the central bank's target range, whose mid-point is at 4.5% with bands of +/-2%), and climbing to 7.3% year-on-year in September, evidencing demand pressures. Nonetheless, the central bank cut its official interest rate by 50 bp at its August meeting and by 50 bp in October, lowering it to 11.5%, after respective 25 bp increases at its April, June and July meetings. The central bank stressed that this change in stance was due to the worsening of the external environment. Domestic lending to the private sector held at a high growth rate, of around 20% year-on-year in real terms in the period under study, despite the numerous measures adopted in the preceding months in an attempt to temper it. Directed lending was more buoyant, although it slowed to a rate of 23% in July.

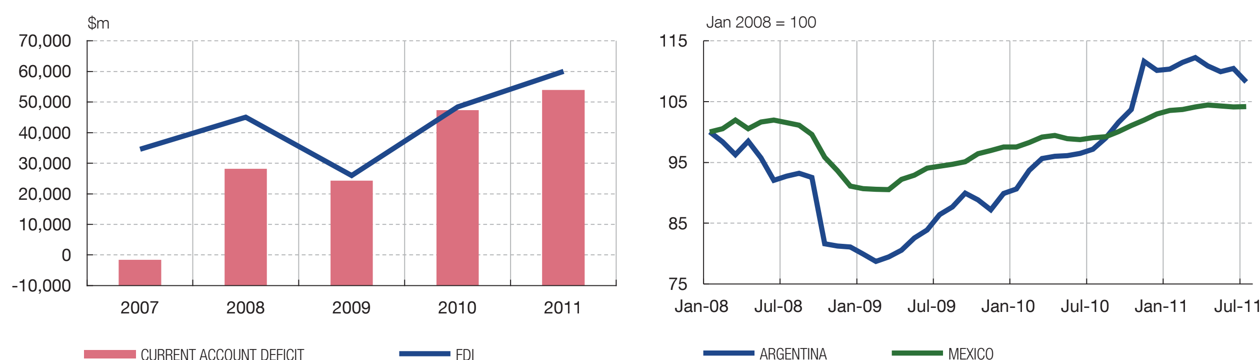
On the fiscal front, the primary surplus accumulated over the 12 months to July increased to 3.8% of GDP (in 2010 as a whole it was 2.8%), and the deficit after interest payments dipped to 1.9% of GDP, from 2.6% at the close of 2010. Net debt fell to 39.4% of GDP, largely owing to the effect of growth. These positive fiscal results are associated with the favourable trend of revenue, which in the case of central government increased at a year-on-year rate of 20% to August, compared with the 11% increase in expenditure. Against this background, the government announced an increase in the consolidated public sector primary surplus target in 2011 of between 0.25% and 0.3% of GDP, raising it to 3.35% of GDP; that said, the increase does not entail any long-term commitment. The first draft budget for 2012 was unveiled, setting a primary surplus target of 3.1% of GDP, on the basis of assumptions as to GDP and inflation which are now considered overly optimistic. Turning to the external sector, the current account deficit widened, since the higher trade balance surplus (driven by the increase in exports) was more than offset by the widening of the incomes deficit. Heavy financial inflows continued, most notably in the case of foreign direct investment. Over the past 12 months to August this year, financial inflows totalled $87 billion, and foreign direct investment inflows $54 billion, with both comfortably financing the current account deficit (see Chart 12). In these circumstances the central bank maintained its reserves accumulation policy for most of the six-month period, although in late September it sold dollars on the futures market to resolve the dollar-liquidity problems and the abrupt depreciation in the real. Moody's upgraded the Brazilian sovereign debt rating, placing it a notch above investment grade.

In the first half of 2011, year-on-year growth continued to fall in *Mexico*, declining to a rate of 3.3% in Q2. GDP thus resumed its maximum pre-crisis level in 2011 Q1, marking a relatively sluggish recovery. Indeed, Mexico, along with Venezuela, would be the only country whose output gap continues to be negative according to the exercise conducted. Notable in the breakdown on the demand side is the positive contribution of the external sector to GDP growth in the first half of the year (0.7 pp), Mexico being the only country in the region where this is seen, owing to a strong slowdown in the growth of imports, probably linked to the deceleration in private consumption. Conversely, private investment, especially in capital goods, quickened somewhat. That may be due to the recovery of the US industrial cycle, although also to the statistical effect following two years of decline. By contrast, public investment posted a negative growth rate, as did government consumption. Accordingly, domestic demand slowed, growing at a rate of 2.9% in 2011 Q2. The data released for 2011 Q3 and the leading indicators (see Chart 12) point to a further slowdown in activity, partly as a result of the lower growth recorded in the United States, which shows the limitations of the Mexican economy in generating domestic demand-led self-sustained growth. In the labour market, formal employment grew at a year-on-year rate of 4.5%, with temporary employment proving more buoyant. In this setting, inflation continued to perform favourably, standing at 3.1% in September, slightly above the mid-point of the target range (3%). Core inflation held at a rate of between 3.1% and 3.3% in the first eight months of the year. Slack output, low growth in labour costs and the appreciation of the currency, at least until July, contributed to maintaining this benign inflation picture. The central bank held its benchmark rate at 4.5%, although its latest communiqué paved the way for possible cuts if global conditions were to continue worsening. Bank lending to the private sector continued to accelerate, to a year-on-year growth rate in real terms of slightly over 10%, with a higher rate for consumer credit. In the fiscal arena, public finances worsened slightly over the six-month period. Excluding investment by the State-held company PEMEX, the deficit stood at 1.1% of GDP in annualised terms, 0.4 pp up on 2010. This was the result of the increase in public revenue to a real year-on-year rate of 4.6%, thanks to the rise in oil-related revenue, and in public spending to 5.3%. One of the

BRAZIL, ARGENTINA AND MEXICO

CHART 12

BRAZIL: FDI AND CURRENT ACCOUNT DEFICIT



SOURCES: National statistics and Bank of Brazil.

incipient risks is that relating to the financing of the federal states, given that their debt has risen by 1 pp of GDP to 2.5%, since 2008, and three of them are in a difficult position with debts exceeding 50% of their revenue. Accordingly, in mid-August the Finance Ministry announced a programme of guarantees for issues by the federal states that need to refinance their liabilities or increase investment in infrastructure. The current account balance posted a deficit of 0.6% of GDP in the first half of the year as a result of the increase in the deficit on the balance of services and on that of incomes, while the financial account ran a surplus of 4.1% of GDP, due both to the higher surplus under the foreign direct investment heading (although that received by Mexico declined, there was a practical freeze on Mexican direct investment abroad) and, especially, to portfolio investment for bond purchases (close to 2.8% of GDP). The central bank retained the mechanism for reducing volatility in the exchange rate appreciation and for building up reserves, which climbed to $138 billion at end-October, i.e. 11.4% of GDP. The government launched several local-currency and foreign-currency issues, including the re-opening of the 100-year bond for a value of $1 billion in the first week of August, amid the turbulence on global financial markets.

Economic activity in *Argentina* remained notably buoyant. GDP grew at a quarter-on-quarter rate of 2.5% in Q2 (3.1% in Q1), and at a year-on-year rate of 9.1% (9.9% the previous quarter). Domestic demand grew by 12% year-on-year in the first half of the year, with all its components quickening somewhat in Q2. The growth of investment (23.8% year-on-year) was particularly notable, owing to the prevalence of very negative real interest rates, and to the thrust of private consumption and also of durable goods imports from Brazil. Imports climbed by almost 25% that quarter leading, along with the notable slowdown in exports, which grew by scarcely 0.5%, to an increase in the negative contribution of the external sector, placing it at 3.1 pp (compared with 1.9 pp in Q1). The indicators for 2011 Q3 suggest some easing in activity, as do the leading indicators (see Chart 12). Unlike in previous years, the trade surplus is narrowing against the background of the firmness of the prices of Argentine commodities exports, the slowdown in the Brazilian economy and the strong increase (38%) in imports in the first eight months of the year, a situation which might be exacerbated if the fall in the price of soya beans since September should persist. Moreover, in 2011 Q2 the current account posted a far lower surplus than that attained four quarters earlier, as a result both of the narrowing of the trade surplus and of the increase in the deficit on the incomes balance. The financial account ran a deficit of $2.32 billion in the first half of 2011, compared with the surplus of 464 million recorded in the same period in 2010, and the formation of net external assets

in the non-financial private sector (an approximate measure of capital outflows) stood at $5.4 billion, a similar figure to that in the same period of the previous year. Foreign direct investment received by Argentina amounted to only $290 million in 2011 Q2. These trends became sharper in Q3, and this, combined with the increase in the volatility of global financial markets, led the central bank to sell dollars (the payment of external debt coupled with interventions saw reserves decline by $4.5 million from the annual peak in January) in order to maintain the peso/dollar rate at a level close to 4.20. As a result of high inflation, the peso has continued to appreciate in real terms. In the fiscal area, government revenue grew by 31.7% in the first eight months of the year (including major transfers arising from central bank profits), and expenditure by 36.3%, whereby the cumulative primary surplus fell by one-third compared with the same period in 2010. Bank lending to the private sector has continued to quicken and, in August, its year-on-year growth rate was over 50%, although its low level measured in terms of GDP should be borne in mind. Also of note is the increase in the dollarisation of deposits that has taken place in the past few weeks and the recent rise in the interest rates on these deposits. In the presidential elections held on 23 October the current incumbent was re-elected, meaning continuity in economic policies is expected.

In *Chile*, the buoyancy of economic activity held up in a setting of benign financial conditions, a labour market with low unemployment and high growth in wages, and favourable terms of trade. The economy thus grew at a year-on-year rate of 6.8% in Q2, with quarter-on-quarter changes of 1.5% in the first two quarters of the year. Growth continued to be led by domestic demand which, however, is showing signs of easing in all its components, especially in government consumption and investment. The negative contribution of external demand fell to 4.3 pp in Q2 (when it had stood at 12.2 pp in 2010), due especially to the slowdown in imports. The data on economic activity in Q3 point to a greater-than-expected slowdown which is due, in part, to mining strikes. Inflation has stood in recent months at around 3%, the central bank target, while medium-term expectations are once again within the central bank's target range, in parallel with the sound performance of core inflation. Against this backdrop, the central bank brought the cycle of rises to an end in July, following five consecutive monthly increases. Notable on the fiscal side is the low level of outturn of public spending in the first half of the year. In June, bank lending to the private sector grew by 10% in real terms, with credit to companies and households moving fairly uniformly.

Activity in *Colombia* quickened notably in 2011 Q2, with quarter-on-quarter growth of 2.1%, following the relative sluggishness in Q1. Domestic demand was notably buoyant, largely driven by investment, which increased by 14.8%. Conversely, external demand detracted 5.5 pp from growth during the quarter, Colombia being the country in the region with the highest negative contribution. The indicators of activity point to continuing buoyancy in the economy in Q3, against a propitious labour market background and favourable conditions of access to credit. Inflation held within the central bank target range (2%-4%). And core inflation stood below 3% in the first half of the year. The central bank kept its official interest rate unchanged in August and September, after raising it to 4.5% in the five previous meetings. On the fiscal front, legislation was approved for the implementation of a structural fiscal rule. Under this rule a structural deficit of 2.5% of GDP is set for 2014, which will fall to 1.8% in 2018 and to 1% in 2022. In light of this fiscal discipline, Moody's and Fitch upgraded the sovereign debt rating by a notch to investment grade, thereby following the lead of Standard & Poor's, who had done likewise in March. The authorities took measures to reduce external vulnerability, including the renewal of the flexible credit line (FCL) with the IMF.

In Peru, GDP grew at a year-on-year rate of 6.7% in 2011 Q2, down on the figure of 8.7% the previous quarter. There was also a modest slowdown in quarter-on-quarter terms, with the respective rates dipping from 1.6% to 1.3%. These developments were marked by the low growth of government consumption and investment, influenced by the legal ceilings on public spending that are set in the run-up period to elections. In the first half of the year the current account ran a deficit of -2.3% of GDP, above that recorded in the same period in 2010, mainly due to the widening of the deficit on the incomes account. Inflation moved throughout the year on a rising trend (up to 3.7% in September), standing from March above the upper limit of the central bank target range (1%-3%). This performance was in response, above all, to the deterioration in the non-core inflation segment, which was exacerbated in June by the reduction in petrol price subsidies. The central bank held its official rate unchanged at 4.25% from May and, to August, it intervened on the foreign exchange market purchasing dollars. However, in late September it made several direct dollar sales to withstand the downward pressure on the currency. For the coming months, the new government has approved a fiscal stimulus package. Further, the Congress has approved the proposed reform of the mining tax regime whereunder royalties will increase and the government expects to boost public revenue by an amount close to 0.7% of GDP. In a setting in which the new government's commitment to adopt orthodox economic policies is palpable, Standard & Poor's upgraded Peru's credit rating from BBB- to BBB, one notch above investment grade.

In the first half of 2011 there was an expansion in economic activity in *Venezuela* of 3.6% on average, compared with the 0.1% increase in the second half of 2010. On the supply side the relative loss of weight of oil activity has continued, dipping from 20% of GDP to close to 12% in the period from 1997 to 2011. In Q2, the re-emergence of the energy crisis bore down on activity, leading in June to the announcement of saving measures to reduce the country's high electricity consumption. Bank lending continued to grow at a rate close to that of inflation, which held at around 25% in the period under study. Monetary policy retained the fixed exchange rate as a nominal anchor. The latest anti-inflationary policy measure announced by the government was new price-control legislation that enables prior control mechanisms to be set in place in the case of companies whose profits are considered excessive relative to their costs. In the first half of the year the current account surplus increased by more than $8 billion compared with the same period in 2010, running a bigger surplus in the first six months of 2011 than the whole of 2010. The improvement stemmed chiefly from the increase in the value of oil exports, which accounted for 94.9% of the total. Standard & Poor's downgraded the country's sovereign debt to B+ from BB- in application of their new methodology, which assigns greater importance to political risk. Lastly, it was announced in August that Venezuela's international monetary and gold reserves ($9 billion and $19 billion, respectively) will be moved from developed countries' institutions to countries such as Brazil, Russia and China.

24.10.2011.