

## Introduction

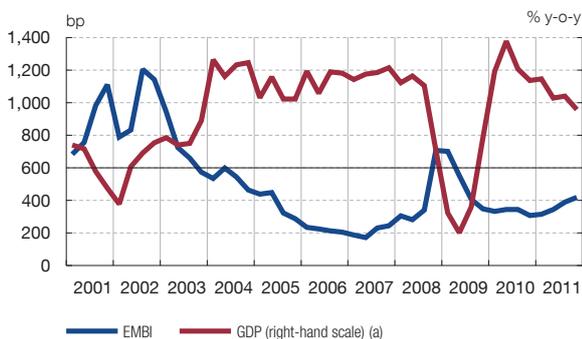
In 2011 as a whole, Latin America posted annual growth of 4.4%. This figure, while marking a moderation of almost 2 pp in relation to 2010 (as was the case with the emerging economies as a whole), can be viewed as a good performance in a year in which the euro area crisis deepened, altering the course of the recovery in the world economy. Following a very dynamic first half to the year, regional growth slowed notably from Q3 to Q4, feeling the impact of the European crisis chiefly through financial-asset and commodities prices (see Chart 1). Moreover, this impact overlapped the lagged effect of the tightening of monetary policies as from 2010 in several Latin American countries. The slowdown was not, however, across the board, at least in terms of intensity. It particularly affected Brazil and, to a lesser extent, Argentina, which both showed signs of overheating in early 2011. In contrast, countries such as Colombia and Venezuela, further behind in the business cycle, and Peru showed notable buoyancy and greater resilience, too, in the second half of the year.

The higher-frequency indicators released in the opening months of 2012 show signs of a pick-up in activity, in line with PMIs and the global industrial cycle following the autumn flatness. But, above all, they reveal the thrust of domestic demand to be holding up in most countries. Along these same lines, Latin American financial markets have trended favourably in recent months. In this respect, the rapid adaptation of economic policies to the new higher-risk environment, after the summer, and the resumption of capital flows since early 2012 – in a setting marked by the adoption of new liquidity-expansion measures in the developed countries – have staved off the risk of a deeper slowdown in activity in the region, although they pose new dilemmas. Notwithstanding, growth in Latin America might ease further in 2012, towards a rate in line with potential, with downside risks arising from the external environment, including most notably a potential deterioration of the European situation.

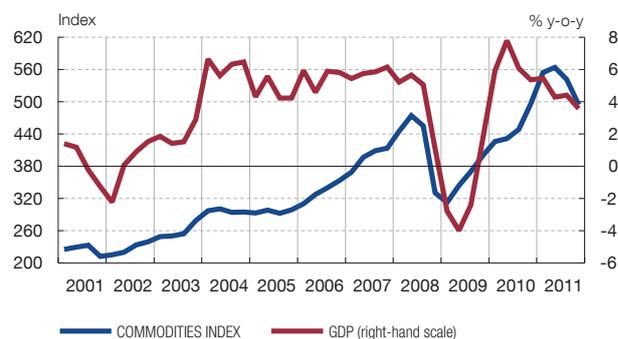
Inflation across the region posted a year-on-year rate of 7.1% at the close of 2011, up on the first half of the year and showing some downward stickiness in a setting of lower growth and the ongoing correction of commodities prices. This stickiness was more marked than that recorded in other emerging areas, such as Asia or Eastern Europe. Prices have only begun to show any correction recently (chiefly in Brazil), meaning that inflation measured as a regional average stood in March at 6.2% year-on-year. Three of the five countries with inflation targets (Brazil, Colombia and Mexico) fulfil them in 2011, although inflation in these three countries stood in the upper interval of the target range. In any event, the Brazilian central bank pursued the cycle of interest-rate reductions it had begun in August, making most significant cuts, and the Chilean central bank lowered its official rate by 25 bp in early 2012. While only Argentina and Venezuela continue to show notable vulnerability owing to their high inflation, there are concerns in several countries – more prominently so than in the past three years – about the risks to inflation stemming from the situation of near-full employment in the formal labour market and from incipient wage pressures, which might underpin a greater expansion in demand, and from dearer oil. Indeed, inflation expectations have been seen to rise somewhat in several countries in recent months.

Finally, vulnerabilities are also beginning to be seen in the external sector – with a growing number of countries in the region posting current-account deficits, despite the high de-

EMBI AND GDP



COMMODITIES INDEX AND GDP



SOURCE: Datastream.

a Aggregate of the seven main economies: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

mand for commodities – and in public finances, which have translated into bouts of financial pressure and the adoption of heterodox and/or protectionist measures in some cases (see the section “Trade integration processes and structural policies”).

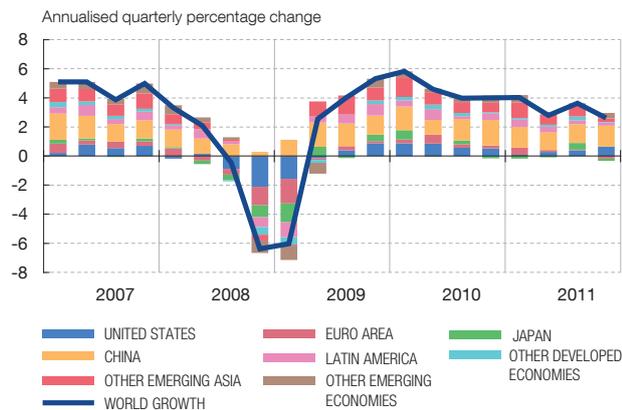
**Economic and financial developments: external environment**

In the closing months of 2011, global economic and financial developments were marked by the sizeable tensions on international financial markets arising from the heightening of the euro area sovereign debt crisis and the potential consequences for the recovery of the world economy. In early 2012, these tensions on European markets eased, and economic indicators in various regions improved. Into April, however, a fresh bout of instability associated with the European crisis was recorded, so far exerting a limited impact on other areas.

In 2011 Q4 there was a notable slowdown in activity in the main advanced economies (Japan, the United Kingdom and the euro area posted quarterly declines in GDP), with the exception of the United States, which saw its growth rate rise (see Chart 2) and signs of improvement in its labour market. Nonetheless, there were signs of stabilisation at the onset of 2012, with rises in the higher-frequency and confidence indicators. Given the lesser leeway available to stimulus policies and the correction under way of the imbalances built up during the expansionary phase, the recovery is expected to remain moderate, meaning that the growth rate of the advanced economies as a whole will be slightly below that of 2011 in 2012 on average.

Inflation rates in the advanced economies reached a high late in 2011 Q3 and, thereafter, fell gradually, against a background of economic sluggishness and an easing in commodities prices from their peak in the spring. These prices have rebounded in early 2012, especially in the case of oil (with Brent exceeding \$125 per barrel), as a result of certain specific supply-side factors, mainly the tensions in Iran, and of the emerging economies’ demand. The central banks of the main advanced economies continued to implement expansionary policies, through quantitative easing and other non-conventional measures, and through changes in their communication strategies. On the fiscal front, the advanced economies continue to face major public finances consolidation challenges, with no room to introduce expansionary measures, although in some countries the decision has been taken to delay fiscal consolidation in the short run.

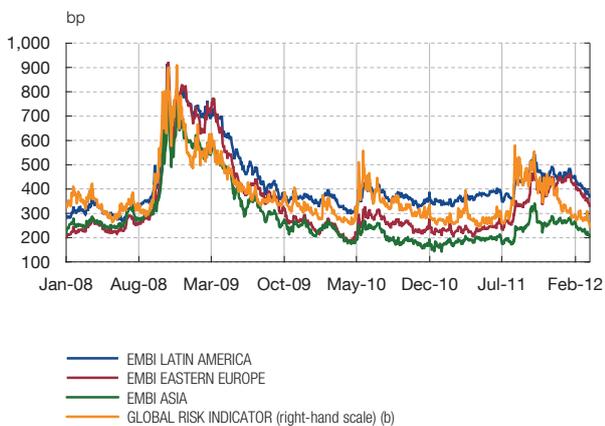
CONTRIBUTION TO WORLD GDP GROWTH



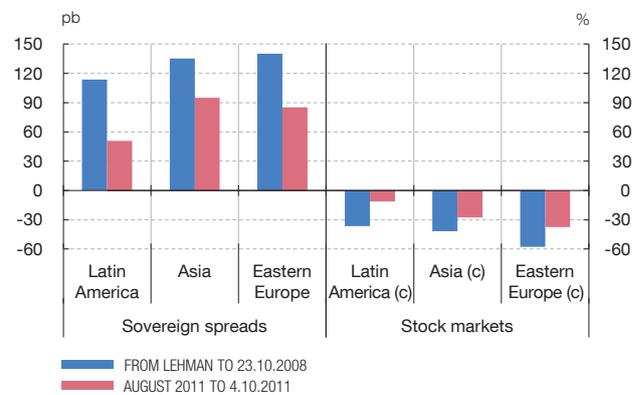
WORLD STOCK MARKETS (a)



INTEREST RATE SPREADS AND GLOBAL RISK INDICATOR



SOVEREIGN SPREADS AND STOCK MARKETS



SOURCES: National statistics and Datastream.

- a Indices in dollars.
- b VIX Index.

The emerging economies continued to show greater resilience, although the rise in global risk aversion in the second half of 2011, along with the weakness of external demand and the lagged effect of their restrictive economic policies, led to a less favourable economic performance. The slowdown was more marked in the emerging European economies, with their tighter trade and financial links with the euro area. At the other extreme was, once again, the notable resilience of the Chinese economy, which has nonetheless not been immune to the global situation and whose activity shows some easing. Inflation also tended to moderate in the second half of 2011 and early 2012, although it held a relatively high levels. In this setting of economic slowdown and lower inflation, several central banks tended to relax their monetary policy stance during the second half of the year and, above all, in early 2012.

Against this backdrop, in the final stretch of 2011 international financial markets remained under the influence of the European sovereign crisis, and in particular of the euro area banking sector's difficulties in funding itself on wholesale markets. These problems fed through to other areas, and were reflected in a flight to quality (which prompted the appreciation of the dollar and the decline in US and UK government debt yields). Early in

## Financial markets and external financing

2012, some headway in the European situation and the dwindling of some of the more extreme risks were conducive to an improvement in confidence. In this context, most stock market values rose significantly and there was an increase in the appetite for risk (see Chart 2). However, in recent weeks there has been a fresh outbreak of tensions on European markets which highlights the fragility of the current situation.

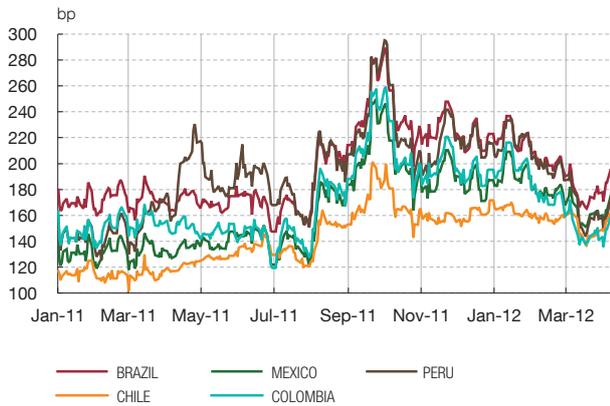
In line with the developments on international financial markets, Latin American markets were affected in the final quarter of 2011 by the heightening of the euro area sovereign debt crisis as from the summer. The situation changed in January 2012, with a clear pick-up on stock markets, a fall in credit risk indicators, the resumption at a forceful pace of capital inflows, and the recovery in exchange rates. This improvement, which held up during the first quarter, went partly into reverse in the final weeks of March and the start of April as a result of the deterioration also observed on international markets.

In any event, contagion from the euro crisis towards Latin America has proved relatively limited in intensity and duration. Contributing to this have been both external factors, which have allowed tensions on financial markets to ease (essentially the medium-term injection of liquidity by the ECB, in December, and the improved US growth outlook), and domestic factors. The latter include most notably the soundness of economic fundamentals, which has allowed countries in the region to navigate the global financial crisis without experiencing a significant deterioration in their financial systems or in their public sustainability or external indicators. Although some of the potential crisis transmission channels – the high European share in foreign direct investment in Latin America, in portfolio flows and in the ownership of some Latin American banking systems – were not unaffected by the tensions, nor did they transmit impacts on the scale of those seen in 2008 with the Lehman Brothers episode, and nor did they give rise to domestic credit restrictions in these economies. Thus, the declines in financial asset prices were of less intensity than those in September 2008 (see Chart 3), whereby the July 2011 levels prior to the tensions had been restored in March 2012.

The rise in the region's sovereign spreads (EMBI Latin America) from October to the end of the year was relatively limited, from 440 bp to 490 bp. The Latin American stock market posted a decline, measured in dollars, of more than 11%, similar to that in Asia and somewhat less than that in Eastern Europe, a region with closer ties to the euro area (Chart 2). Country by country, the biggest deterioration was in Argentina, traditionally one of the more vulnerable countries. The Argentine sovereign spread widened by more than 125 bp and its stock market fell by more than 17%, also influenced by idiosyncratic factors, including most notably those derived from the measures adopted to limit the demand for dollars. In Peru, by contrast, the widening of the spread was restricted to 27 bp, and in Chile and Brazil to somewhat over 10 bp. In this period, the exchange rates of the region's currencies underwent a notable correction, with declines of 9-16% from August to end-2011 (Chart 3), especially those with deeper markets more susceptible to harbouring carry trade operations. The uncertainty was likewise reflected in net capital inflows in Q4 that were substantially lower than those in Q3, in relation both to foreign direct investment (down around \$5 billion for the regional aggregate) and to portfolio investment (down almost \$9 billion), although they held at historically high levels. Further, bond issues on international markets, which had run at a high in 2010 and early 2011, fell in the last two quarters of the year.

The improved conditions on international markets as from January 2012 were reflected in a surge in international issues by the emerging economies, which exceeded \$115 billion in Q1 (Chart 4), a new all-time high for a quarter, of which Latin American issuers accounted

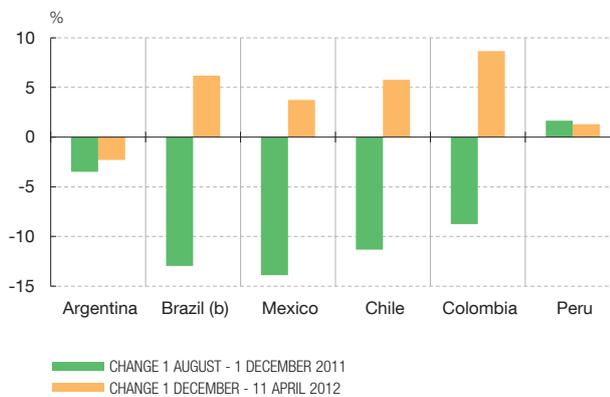
SOVEREIGN SPREADS



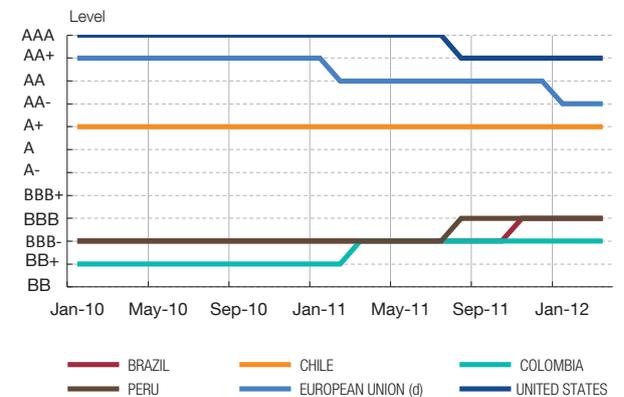
STOCK EXCHANGE INDICES



EXCHANGE RATE AGAINST THE DOLLAR



SOVEREIGN RATINGS (c)

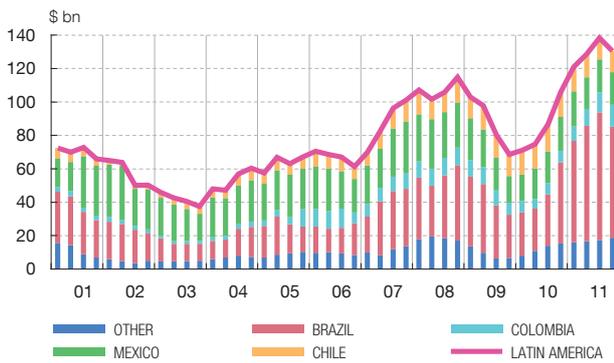


SOURCES: Datastream and JP Morgan.

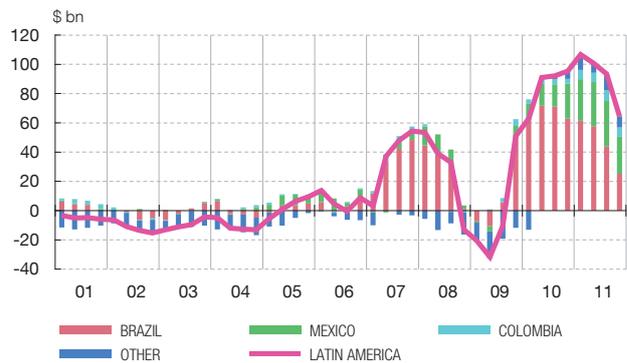
- a MSCI Latin America Index in local currency.
- b For Brazil, change between 1 December and 28 February 2012, floor price.
- c S&P ratings.
- d Aggregate of 11 countries weighted according to their weight in world GDP: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain.

for 33%. There were placements of local-currency-denominated sovereigns (Peru), numerous companies tapped the market for the first time or conducted transactions in new segments (for example in renminbi), and the biggest issue ever by an emerging sovereign or company took place, namely for \$7 billion by the Brazilian state oil corporation. Against this background, the financial indicators recorded a reversal of previous movements, in terms of a narrowing of the region's credit risk spreads by more than 115 bp, between mid-January and mid-March, and a rise in stock market indices, measured in dollars, of 10%; this recovery was somewhat less than that of the other emerging regions, which had also been more affected by the euro area crisis. Investors' favourable view of the region was likewise reflected in the stability of or improvement in sovereign ratings (Brazil, Peru), at a time when the ratings of certain developed countries worsened, and of very low probabilities of default, measured by CDS premia. Thus, the average risk premia for the region, including Argentina and Venezuela, stood below that for the euro area. As earlier mentioned, the improvement on financial markets in Q1 has been checked since mid-March, with the worsening of the European sovereign crisis.

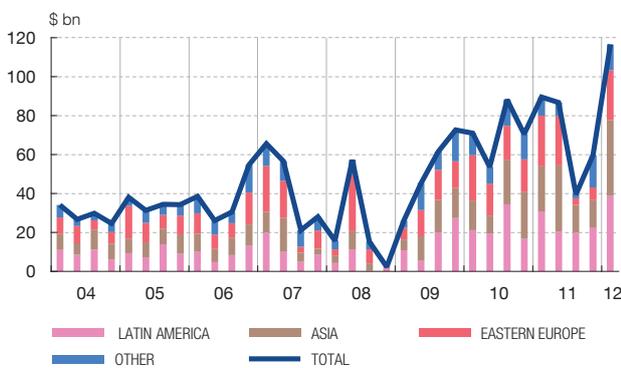
12-MONTH CUMULATED FDI FLOWS



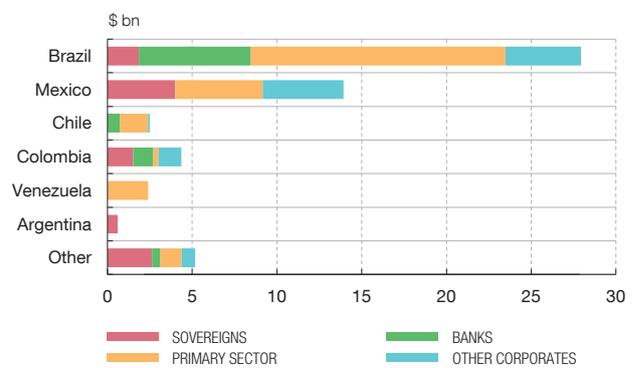
12-MONTH CUMULATED PORTFOLIO INVESTMENT FLOWS



BONDS ISSUED ON INTERNATIONAL MARKETS



INTERNATIONAL ISSUES IN LATIN AMERICA:  
FROM OCTOBER 2011 TO APRIL 2012



SOURCES: Dealogic, JPMorgan, IMF and national statistics.

The rise in capital inflows prompted a strong appreciation in the region's currencies (Chart 3). That partly offset the depreciation recorded from August 2011 and re-ignited the monetary policy dilemmas that Latin American central banks faced in 2010, namely how to free monetary policy from external constraints, and in particular from the appreciation arising from the high interest rate differential with the developed countries. There were various responses: an increase in tax on capital inflows (Brazil); the reversal of prior measures to check the depreciation (Colombia); interest rate cuts (Brazil) and the build-up of international currency reserves (Peru, Colombia and Brazil) (see Box 1). Some of these measures appear to have had an effect. Thus, for instance, the Brazilian real has depreciated against the dollar by more than 7% over the past month.

### Activity and demand

Over the course of 2011, Latin America grew by 4.4% on average. While this figure is down on 2010, it includes base effects and reflects considerable resilience on the part of the region, in a year in which the crisis in the euro area – South America's second trading partner in terms of export volumes – deepened, dampening the prospect of a global economic recovery. After a very buoyant first half of the year, with quarterly GDP growth rates exceeding 1%, activity in the region slowed appreciably in Q3 and Q4 to 0.7% and 0.6%, respectively (see Chart 5). The slowdown was more marked in Brazil, although it also made itself felt to a lesser extent in Argentina and, in Q3, in Chile. As a result, growth across the region moved on a declining path in year-on-year terms, dipping from 5.5% in

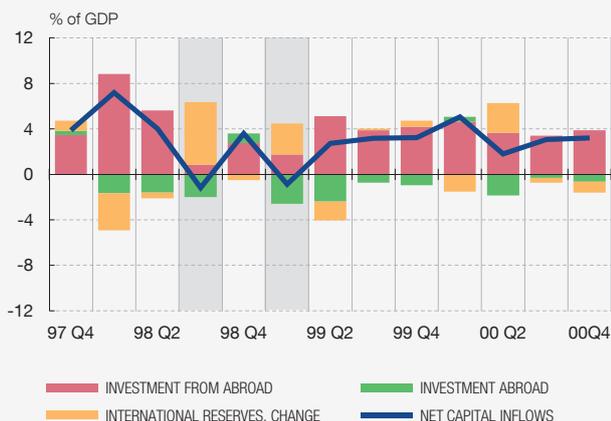
In the last 20 years there has been intense financial integration in the international economy, marked by the notable increase in international financial flows and by their global scope, spreading to most countries across the world, including the emerging economies. However, the process has been very irregular: international flows increase strongly in periods of global financial stability, and decline sharply in phases of instability. Partly for this reason, financial integration poses particularly marked risks in emerging countries where, in periods of strong investment from abroad, there may be an excessive appreciation of the exchange rate and, simultaneously, a sharp expansion in credit. In contrast, a sudden reversal of investment from abroad exposes these countries to exchange-rate depreciations and to funding shortfalls, which may eventually result in declines in GDP or in financial and foreign exchange crises. One factor that may mitigate these developments is the reduction by residents of financial assets abroad at times of financial stress.<sup>1</sup>

This behaviour has been frequent in the advanced economies in such periods. In the emerging economies, the build-up of foreign assets by the private sector has been on a smaller scale and, perhaps for this reason, they have accumulated international reserves (external assets of public-sector institutions) as a mechanism to withstand these bouts of contraction in external funding. This Box reviews the course of financial flows in Latin America around the time of the 1998 and 2008 financial instability episodes, which are particularly interesting as they were exogenous to the region. The evidence confirms that, in the Latin American case, there was a reduction in investment abroad by residents, and in particular by the private sector, in the last episode of financial instability. And, on recent empirical evidence, this suggests the reduction might have been associated with the higher level of international reserves in the region.

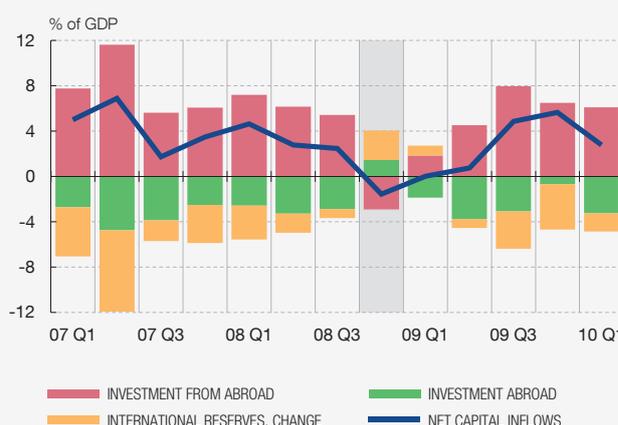
1 See F. Broner, A. Erce, J. Didier and S. Schmuckler, *Gross Capital Flows: Dynamics and Crises*, Documentos de Trabajo, no. 1039, Banco de España.

Panels 1.1 and 1.2 show financial flows around the quarters when net capital inflows were lowest, with the two episodes shaded. In

1.1 AROUND 1998 Q3



1.2 AROUND 2008 Q4

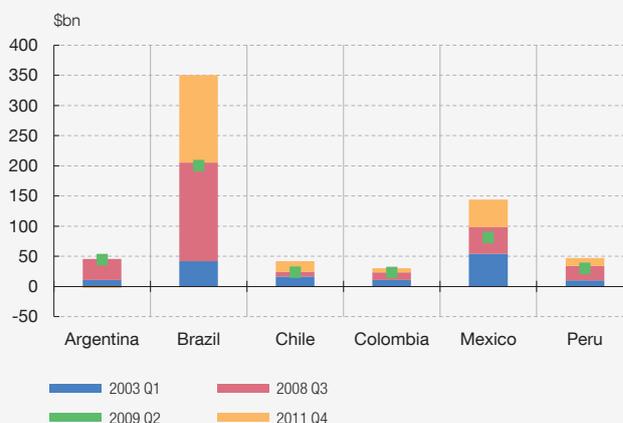


SOURCE: IFS (IMF).

2.1 RESERVES RATIO FOR THE REGION AS A WHOLE



2.2 INTERNATIONAL RESERVES BY COUNTRY



SOURCE: IFS (IMF).

1998 the trigger was debt restructuring in Russia, in the third quarter of the year, the impact of which spread sequentially to much of Latin America, proving particularly severe in Brazil, and worsening in 1999 Q1. In 2008 the Lehman Brothers bankruptcy in Q4 marked the start of an economic and financial crisis which most notably impacted financial flows in the region, continuing into early 2009. In both episodes there was a contraction in net capital inflows. Indeed, as the line in panel 1.1 reflects, in 1998 Q3 there were, in annualised terms, net capital outflows from Latin America of 1.2% of GDP, compared with net inflows of 4% of GDP in the previous quarter; and after stabilising slightly in the following quarter, net capital outflows were once again recorded in early 1999. The course of net capital inflows after the Lehman Brothers bankruptcy in 2008 was similar, with net outflows of 1.6% of GDP, in contrast to net inflows of over 5% in the preceding quarters. This reduction was relatively widespread across the various countries, but stood out for its intensity in Brazil and Chile, where financial integration was greater and bigger inflows had been received in the previous quarters.

As can be seen in panels 1.1 and 1.2, both in 1998 and in 2008 net capital outflows were associated with the reduction in investment from abroad, i.e. with the lower funding received, which is commonly called a “sudden stop” of capitals. In the 1998 episode, flows received from abroad did not turn negative, which was indeed the case in 2008. Residents’ investment abroad shows a differentiated pattern in both episodes. In fact, in 1998 Q3, when external financing was at its most restricted, residents (the green bar in the panels), particularly in Brazil, increased their investment abroad (which is commonly known as “capital flight”) and this accounted for much of the aggregate behaviour in Latin America.<sup>2</sup> Conversely, in 2008 residents reduced their investment abroad, repatriating assets. This change in residents’ conduct in periods in which external financing is contracting is of great significance: when, as was the case in 1998, capital “flees” abroad coinciding with the external financing constraint, the contraction in net financing may be high and exert a very severe impact on credit conditions, the financing of public debt and, through various channels, the real economy. The different conduct by resident investors in 2008 also explains the differing need to use reserves on the part of the central bank (the other – publicly held – component of foreign assets) to mitigate the loss in financing. As a result, there were high sales of reserves in 1998, while in 2008 the need for these sales to offset foreign disinvestment was less, given the repatriation of investment by residents.

The higher repatriation of funds by residents during the bout of instability in 2008 meant similar behaviour to that of the developed countries and can be favourably interpreted: improved economic management and the reduction in vulnerabilities in this period

2 Also in Chile’s case, it has been highlighted how in 1999 as a whole residents’ financial outflows were bigger than usual, which would account for the reduction in financing recorded (R. Caballero, K. Cowan and J. Kearns, *Fear of sudden stops: lessons from Australia and Chile*, 2004).

were conducive to maintaining confidence in the country and in the stability of the exchange rate.

Indeed, the notable increase in international reserves in all countries in the region in absolute terms, as highlighted in panel 2.1, contributed to this reduction in vulnerability. Reserve ratios relative to international financial liabilities or to M2 –two habitual measures of the suitable level of international reserves – also rose. The build-up in reserves is partly driven by the perception as to their benefits in periods of financial instability: on one hand, they might play a mitigating role, allowing potential reductions in net capital inflows to be offset, as earlier indicated; and on the other, they have a pre-emptive role, if they prevent these reductions in net capital inflows or uphold residents’ confidence in each country, thereby lessening the risk of capital flight, as shown in Obsteld et al. (2010)<sup>3</sup>. Jeanne and Rancièrè noted that the level of international reserves, which might be excessively high in many countries when regard is had exclusively to their positive role in net capital inflows or in foreign investment, might be appropriate if it contributed to easing investment abroad by residents in these periods.<sup>4</sup> However, on occasions the accumulation of reserves tends to exacerbate capital inflows in boom periods, by entrenching expectations of an exchange-rate appreciation or by reinforcing the sentiment of confidence in the recipient economy.

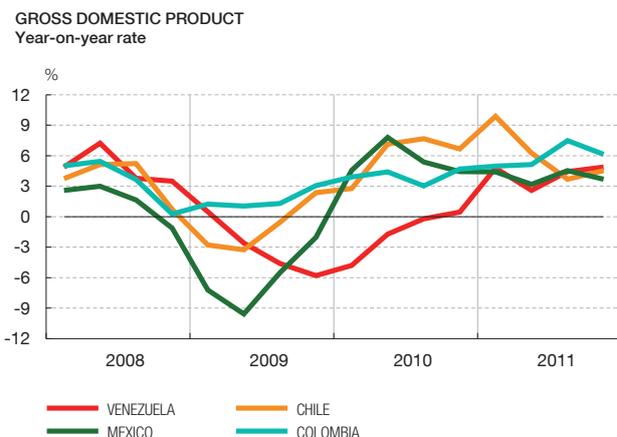
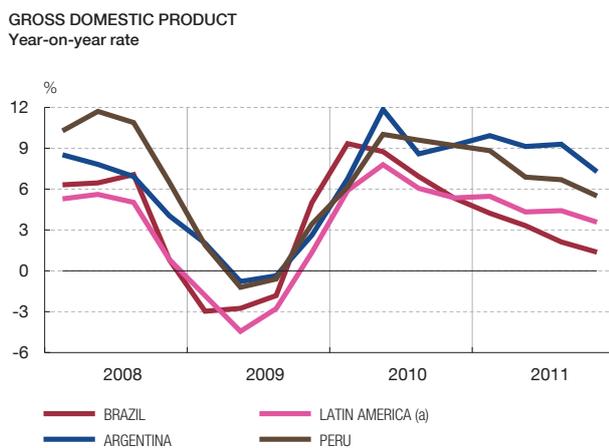
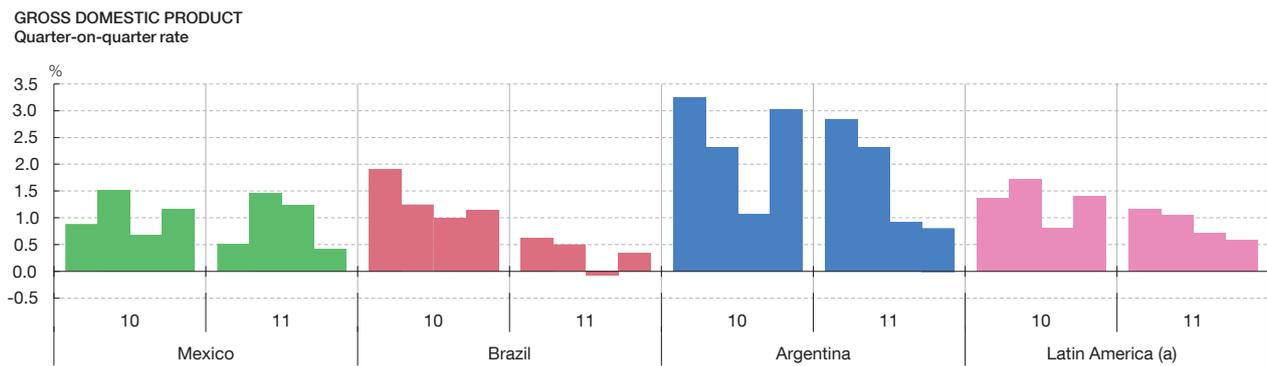
The beneficial effect of international reserves in periods of global financial instability is explored empirically by Alberola, Erce and Serena (2012)<sup>5</sup>. Their findings suggest that capital repatriation during episodes of financial instability (i.e. lowering investment abroad) does in fact depend positively on the level of international reserves, although their effect is a diminishing one. In contrast, the accumulation of reserves does not prevent sudden stops in capital inflows in such periods.

In short, high holdings of reserves might contribute to maintaining confidence in the country’s macroeconomic and financial developments, or in the strength of the exchange rate, thus easing the way for the repatriation of residents’ investment. Accordingly, the increase in reserves recorded in the decade spanning 1998-2008 might be an explanatory factor of the disinvestment abroad by Latin American residents in the last period of financial instability. This perception has perhaps contributed, as panel 2.2 shows, to the forceful resumption of reserves accumulation in all countries, with the exception of Argentina, following the economic and financial crisis of 2008. As a result, holdings of reserves in Latin America are currently notably higher than those in place before the crisis.

3 M. Obsteld, J. Shambaug and A. Taylor (2010), “Financial stability, the trilemma, and international reserves”, *American Economic Journal: Macroeconomics*, vol. 2 (2), pp. 57-94.

4 O. Jeanne and R. Rancièrè (2011), “The Optimal Level of Reserves for Emerging Market Countries: a New Formula and Some Applications”, *Economic Journal*, Royal Economic Society, vol. 121 (555) pp. 905-930.

5 E. Alberola, A. Erce and J. M. Serena (2012), *International reserves and growth capital flows. Dynamics during financial stress*, Documentos de Trabajo, no. 1211, Banco de España.



SOURCE: National statistics.

a Aggregate of the seven main economies.

Q1 to 3.6% in Q4 and marking a notable slowdown on the figure of 6.3% recorded in 2010 (see Table 1).

In terms of components, domestic demand remained the chief underpinning of the expansion in activity (with a contribution of 5.5 pp to GDP growth), compared with a negative contribution of 1.3 pp by external demand (see Chart 6). However, it should be stressed that the slowdown in GDP in 2011 was due in its entirety to the cooling of domestic demand, and in particular of investment (whose growth fell by 5 pp to 8.6%), while net external demand, despite the complex external environment, subtracted somewhat less from growth because the slowdown in imports was greater than that in exports. This indicates that domestic demand, which grew in several countries at very high rates as a result, among other factors, of the countercyclical policies applied after the crisis, ultimately reacted to the tightening of monetary policies in 2010 and early 2011, to the depreciation of exchange rates and, in the second half of the year, to the greater uncertainty arising from the heightening of the euro area crisis. Accordingly, the risk of overheating in countries such as Brazil eased to some extent.

The slowdown in investment was particularly sharp in Brazil and in Peru, plummeting from rates of over 20% in 2010 to around 5% in 2011, in both countries. In Brazil's case, it was influenced by the appreciation of the exchange rate and by specific problems in the car industry; and in Peru, by a fall-off in confidence, and by the very level reached by the in-

## LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

|   | 2009 | 2010 | 2011 | 2010 |      |      |      | 2011 |      |      |      | 2012  |
|---|------|------|------|------|------|------|------|------|------|------|------|-------|
|   |      |      |      | Q1   | Q2   | Q3   | Q4   | Q1   | Q2   | Q3   | Q4   | March |
| <b>GDP (year-on-year rate)</b>                |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a)                             | -1.9 | 6.3  | 4.4  | 5.9  | 7.8  | 6.1  | 5.4  | 5.5  | 4.3  | 4.4  | 3.6  |       |
| Argentina (b)                                 | 0.9  | 9.2  | 8.9  | 6.8  | 11.8 | 8.6  | 9.2  | 9.9  | 9.1  | 9.3  | 7.3  |       |
| Brazil  | -0.3 | 7.5  | 2.7  | 9.3  | 8.8  | 6.9  | 5.3  | 4.2  | 3.3  | 2.1  | 1.4  |       |
| Mexico  | -6.2 | 5.5  | 3.9  | 4.5  | 7.8  | 5.4  | 4.4  | 4.4  | 3.2  | 4.5  | 3.7  |       |
| Chile   | -1.0 | 6.1  | 6.0  | 2.8  | 7.1  | 7.7  | 6.7  | 9.9  | 6.3  | 3.7  | 4.5  |       |
| Colombia (c)                                  | 1.7  | 4.0  | 5.9  | 3.9  | 4.4  | 3.0  | 4.7  | 5.0  | 5.1  | 7.5  | 6.1  |       |
| Venezuela                                     | -3.2 | -1.5 | 4.2  | -4.8 | -1.7 | -0.2 | 0.5  | 4.8  | 2.6  | 4.4  | 4.9  |       |
| Peru  | 0.9  | 8.8  | 6.9  | 6.2  | 10.0 | 9.6  | 9.2  | 8.8  | 6.9  | 6.7  | 5.5  |       |
| <b>CPI (year-on-year rate)</b>                |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a)                             | 6.4  | 6.4  | 6.8  | 6.1  | 6.5  | 6.2  | 6.6  | 6.7  | 6.6  | 6.9  | 7.0  |       |
| Argentina (b)                                 | 6.3  | 10.5 | 9.8  | 9.0  | 10.6 | 11.1 | 11.0 | 10.1 | 9.7  | 9.8  | 9.6  |       |
| Brazil  | 4.9  | 5.0  | 6.6  | 4.9  | 5.1  | 4.6  | 5.6  | 6.1  | 6.6  | 7.1  | 6.7  |       |
| Mexico  | 5.3  | 4.2  | 3.4  | 4.8  | 4.0  | 3.7  | 4.2  | 3.5  | 3.3  | 3.4  | 3.5  |       |
| Chile   | 0.4  | 1.4  | 3.3  | -0.3 | 1.2  | 2.2  | 2.5  | 2.9  | 3.3  | 3.1  | 4.0  |       |
| Colombia                                      | 4.2  | 2.3  | 3.4  | 2.0  | 2.1  | 2.3  | 2.7  | 3.3  | 3.0  | 3.5  | 3.9  |       |
| Venezuela                                     | 28.6 | 29.0 | 27.2 | 27.4 | 31.9 | 29.8 | 27.3 | 29.1 | 24.6 | 26.5 | 28.5 |       |
| Peru  | 2.9  | 1.5  | 3.4  | 0.7  | 1.1  | 2.2  | 2.1  | 2.4  | 3.1  | 3.5  | 4.5  |       |
| <b>BUDGET BALANCE (% of GDP) (d)</b>          |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a) (e)                         | -2.8 | -2.2 | -2.0 | -2.7 | -2.5 | -2.0 | -2.2 | -1.8 | -1.7 | -1.8 | -2.0 |       |
| Argentina                                     | -0.6 | 0.2  | -1.6 | -0.8 | -0.3 | 0.2  | 0.2  | 0.2  | 0.0  | -0.4 | -1.6 |       |
| Brazil  | -3.3 | -2.5 | -2.6 | -3.4 | -3.3 | -2.3 | -2.5 | -2.3 | -2.1 | -2.5 | -2.6 |       |
| Mexico  | -2.3 | -2.9 | -2.5 | -1.8 | -2.2 | -2.4 | -2.7 | -2.8 | -2.8 | -2.6 | -2.4 |       |
| Chile   | -4.3 | -0.3 | 1.5  | -3.9 | -1.1 | 0.0  | -0.3 | 1.0  | 1.4  | 2.0  | 1.5  |       |
| Colombia                                      | -3.8 | -3.6 | -2.1 | -3.4 | -4.0 | -3.6 | -3.5 | -2.9 | -1.4 | -1.4 | -2.1 |       |
| Venezuela                                     | -5.1 | -3.8 | —    | -4.8 | -3.8 | -3.5 | -3.8 | —    | —    | —    | —    |       |
| Peru  | -1.7 | 0.1  | 0.9  | -1.3 | -0.9 | -0.3 | 0.1  | 0.4  | 0.3  | 0.9  | 0.9  |       |
| <b>PUBLIC DEBT (% of GDP)</b>                 |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a)                             | 34.5 | 33.4 |      | 34.1 | 33.3 | 33.5 | 33.1 | 33.1 | 33.0 | 32.4 |      |       |
| Argentina                                     | 47.9 | 44.6 |      | 47.9 | 40.5 | 46.1 | 44.6 | 44.8 | 42.9 | 40.8 |      |       |
| Brazil  | 42.1 | 39.2 | 36.5 | 41.9 | 40.9 | 39.4 | 39.2 | 38.9 | 38.6 | 36.3 | 36.5 |       |
| Mexico  | 28.0 | 27.5 | 26.5 | 27.7 | 27.7 | 27.3 | 26.1 | 27.1 | 26.8 | 27.5 | 26.5 |       |
| Chile   | 5.8  | 8.6  | 11.2 | 6.9  | 7.5  | 8.7  | 9.2  | 9.0  | 9.4  | 10.6 | 11.2 |       |
| Colombia                                      | 35.0 | 35.0 | 33.7 | 34.3 | 35.0 | 34.7 | 34.7 | 35.0 | 33.2 | 34.1 | 33.7 |       |
| Venezuela                                     | 22.6 | 28.1 | 25.1 | 19.0 | 22.4 | 25.9 | 28.1 | 26.9 | 33.8 | 37.2 | 25.1 |       |
| Peru  | 27.3 | 23.4 | 21.7 | 25.5 | 23.7 | 23.2 | 23.4 | 22.4 | 21.7 | 20.9 | 21.7 |       |
| <b>CURRENT ACCOUNT BALANCE (% of GDP) (d)</b> |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a)                             | -0.3 | -0.7 | -0.8 | -0.1 | -0.4 | -0.6 | -0.8 | -0.8 | -0.7 | -0.7 | -0.8 |       |
| Argentina                                     | 3.6  | 0.8  | 0.0  | 2.9  | 2.3  | 1.3  | 0.7  | 0.6  | 0.2  | 0.0  | 0.0  |       |
| Brazil  | -1.5 | -2.2 | -2.1 | -1.8 | -2.1 | -2.3 | -2.2 | -2.2 | -2.1 | -2.0 | -2.1 |       |
| Mexico  | -0.6 | -0.3 | -0.8 | -0.4 | -0.5 | 0.0  | -0.3 | -0.3 | -0.5 | -0.7 | -0.8 |       |
| Chile   | 2.0  | 1.5  | -1.3 | 2.4  | 1.8  | 1.6  | 1.9  | 0.8  | 0.6  | -0.4 | -1.3 |       |
| Colombia                                      | -2.1 | -3.1 | -3.0 | -2.1 | -2.2 | -2.7 | -3.1 | -3.1 | -3.2 | -3.0 | -3.0 |       |
| Venezuela                                     | 1.8  | 5.0  | 9.2  | 6.0  | 6.8  | 5.4  | 5.0  | 5.9  | 7.6  | 9.1  | 9.2  |       |
| Peru  | 0.2  | -1.7 | -1.3 | 0.0  | -0.2 | -1.1 | -1.7 | -1.8 | -2.2 | -1.4 | -1.3 |       |
| <b>EXTERNAL DEBT (% of GDP)</b>               |      |      |      |      |      |      |      |      |      |      |      |       |
| Latin America (a)                             | 20.6 | 20.9 |      | 19.7 | 19.1 | 20.4 | 20.7 | 20.6 | 19.9 | 20.0 |      |       |
| Argentina                                     | 37.6 | 35.0 |      | 36.9 | 31.5 | 34.4 | 32.4 | 33.9 | 27.9 | 30.4 |      |       |
| Brazil  | 12.2 | 12.0 | 12.0 | 11.9 | 12.0 | 12.0 | 12.0 | 12.3 | 12.2 | 12.0 | 12.0 |       |
| Mexico  | 18.9 | 19.0 | 18.2 | 17.9 | 17.8 | 18.4 | 19.0 | 18.5 | 18.4 | 17.9 | 18.2 |       |
| Chile   | 42.1 | 40.1 | 40.3 | 42.8 | 42.2 | 40.8 | 39.9 | 39.8 | 39.8 | 39.3 | 40.3 |       |
| Colombia                                      | 22.7 | 22.4 | 22.8 | 18.8 | 19.3 | 21.5 | 22.5 | 20.6 | 20.9 | 21.7 | 22.8 |       |
| Venezuela                                     | 22.6 | 35.5 | 36.4 | 23.8 | 25.1 | 33.8 | 38.8 | 37.5 | 37.6 | 37.2 | 36.4 |       |
| Peru  | 28.1 | 26.1 | 24.4 | 27.3 | 25.4 | 26.6 | 26.4 | 26.1 | 25.9 | 25.3 | 24.4 |       |

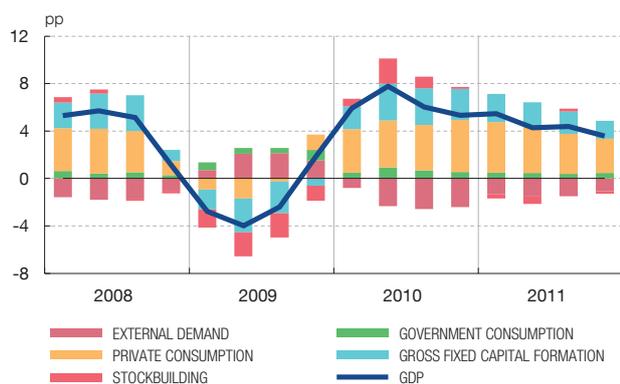
SOURCE: National statistics.

- a Aggregate of the seven 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.

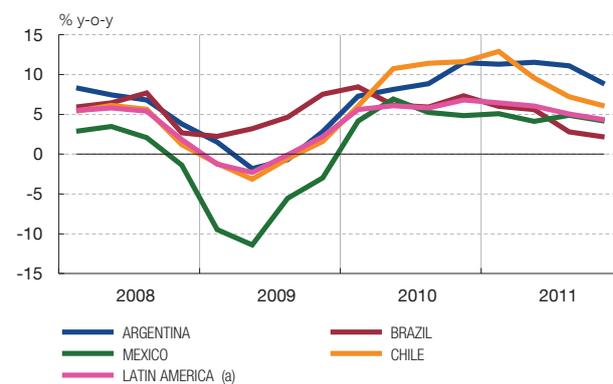
**BREAKDOWN OF GDP AND INVESTMENT**  
Year-on-year rate and percentage points

CHART 6

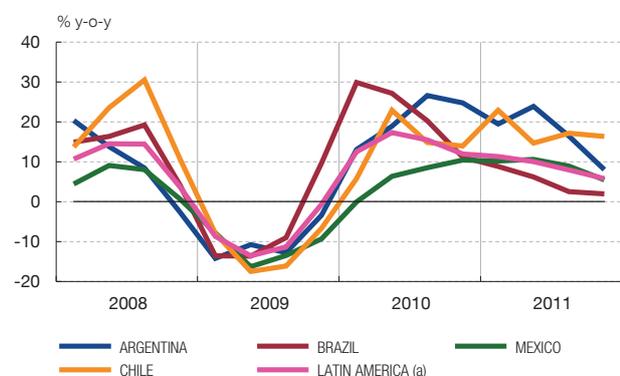
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



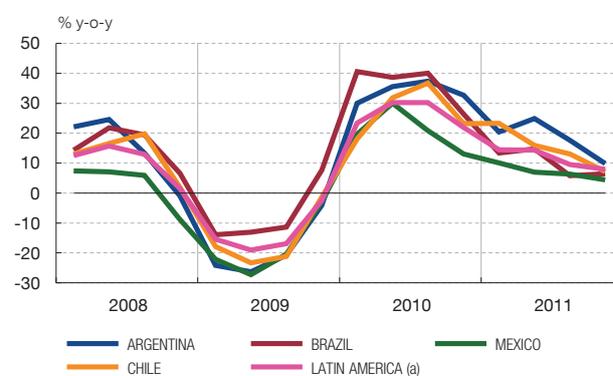
PRIVATE CONSUMPTION  
Year-on-year rate



GROSS FIXED CAPITAL FORMATION



IMPORTS  
Year-on-year rate



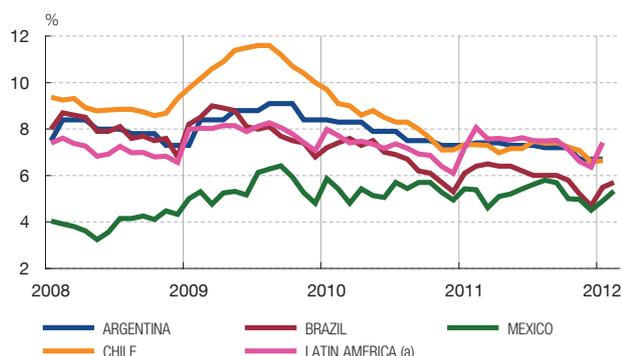
SOURCES: National statistics and IMF.

a Aggregate of the seven main economies.

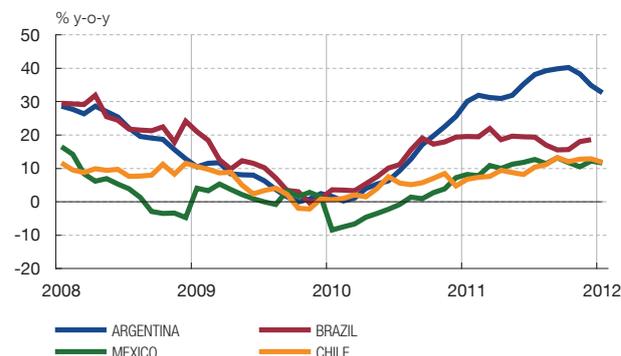
vestment/GDP ratio in recent years (25%) and the slowdown in public investment. In Argentina, investment decelerated owing to the worse economic outlook, the uncertainty on financial markets from August to November, and the subsequent application of import barriers and capital controls. In contrast, investment spending quickened in Colombia (due especially to the strong growth in the oil industry), in Chile (owing to the pick-up in construction), in Venezuela (public-sector stimulus) and also in Mexico (although investment remains below pre-crisis levels).

Private consumption growth remained robust in most of the countries, and the year-on-year rate of increase for the region on average was 5.5% in 2011 (compared with 6.1% in 2010). Indeed, in several countries (Argentina, Colombia, Venezuela and Peru) private consumption growth outpaced that in 2010, and in those countries in which it slowed (Brazil), it may be argued that it did so moving towards more sustainable rates, following strong growth in 2010. This behaviour was against a background of buoyant job creation (running at above an annual rate of 2% for the region on average), a decline in unemployment rates (see Chart 7) to levels not seen since the 1990s, namely 6.6% of the labour force, and growth in real wages. In Chile, where – despite slowing – private consumption grew at a year-on-year rate of 8.8% in 2011, the unemployment rate stood at 6.6%, and the growth of real wages at 2%-3%. In Mexico, where the pick-up in the labour market had been more

UNEMPLOYMENT RATE



REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR  
 Year-on-year rate



CONSUMER AND BUSINESS CONFIDENCE INDICES



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



SOURCE: National statistics.

- a Aggregate of the seven main economies.
- b Argentina, Brazil, Mexico, Chile, Colombia and Venezuela.
- c Aggregate of the eight main economies (the former plus Uruguay).

fragile, employment tended to quicken in the final quarter of the year, the participation rate rose and the unemployment rate dipped by 1 pp to 5%, a figure still 2 pp higher than that recorded before the crisis. Finally, a further supporting factor was domestic credit to the private sector, which grew by 17% year-on-year in real terms in the region as a whole in 2011. This rate of expansion is far higher than that of GDP, although it eased somewhat in the second half of the year (see Box 2).

Turning to the external sector, volume exports eased across the region (posting growth of 5.8% in 2011 compared with 11.3% in 2010), showing a more marked decline in the final quarter of the year that may be associated with the weakness of the global economy. The slowdown in imports was even greater: 11.3% in 2011, against 26% in 2010 (see Chart 6). Given the redirecting of Latin American trade in recent decades towards the United States and the Pacific,<sup>1</sup> the potential for the direct transmission of the recession in the euro area through the trade channel to the region as a whole is relatively limited. Exports to the euro area in the most exposed countries (Chile and Peru) account for 20% of total exports, but less than 6% of GDP; in Mexico they account for less than 5% of exports and 1.5% of

<sup>1</sup> See Box 2 in the "Report on the Latin American economy. Second half of 2010", *Economic Bulletin*, October 2010.

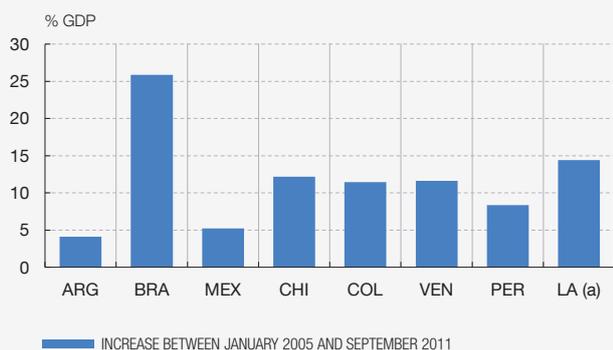
In the current setting of financial instability, concern over the cross-border effects of the measures adopted by European banks in order to strengthen their capital ratios has focused, above all, on certain emerging European countries, given their proximity and their close financial links. However, the notable presence of European banks – and of Spanish banks in particular – in Latin America, their importance in extending credit in the region, and the high correlation between credit and growth in several Latin American countries have given rise to some concern. This Box sets in context the recent changes in Spanish banks’ exposure in Latin America and their possible effects in a setting of very dynamic credit growth.

During 2011, the perception of credit developments in several Latin American countries (chiefly Brazil, but also Colombia, Chile and Peru) shifted from one of concern over the risk of a process of over-indebtedness in the first half of the year to one of fear about the effects of deleveraging in the second half of the year. The first risk was exacerbated by the fact that it coincided, as on previous occasions, with a phase of intense capital inflows, which contributed to easing financing conditions and access to credit, and which were manifest in a reduction in risk premia and in a significant increase both in the vol-

umes issued and in the share of new issuers in the market.<sup>1</sup> Moreover, some of the indicators used in the literature for the purpose of determining whether excessive credit growth or a phase of “genuine” financial deepening in economies in the process of convergence was the case appeared also to indicate some type of warning (see the *Regional Economic Outlook: Western Hemisphere*, IMF, April 2010). Of particular concern was the rapid increase in credit/GDP ratios in countries such as Brazil (25 pp in five years), or to a lesser extent in Chile (12 pp) and Colombia (11 pp) (see panel 1.1). Likewise, growth was seen to be increasing above its long-term trend in Brazil, Chile, Colombia, Peru and Uruguay, and some specific market segments showed notable dynamism, such as the mortgage market (e.g. in Brazil, with growth of around 45% year-on-year, although its size was very limited, at around 4% of GDP, and was associated with specific regulations, such as those promoting directed credit) and the public-sector segment. Finally, the increase in the resort to wholesale markets as a means of financing the expansion in assets was seen as an additional vulnerability. That began to impair one of the traditional

1 See Box 1 of the “Report on the Latin American Economy: second half of 2011”, *Economic Bulletin*, October 2011, Banco de España.

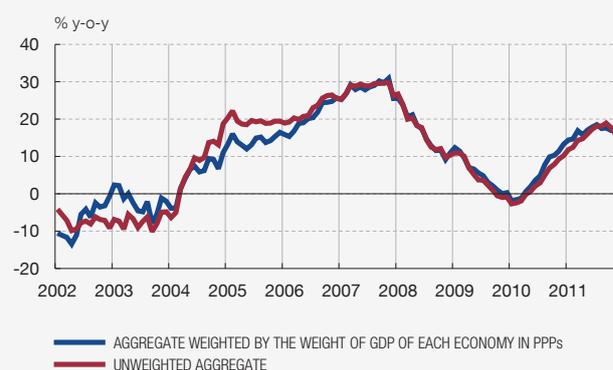
1.1 CHANGE IN CREDIT TO THE PRIVATE SECTOR



SOURCE: Datastream.

a Aggregate of the seven main economies.

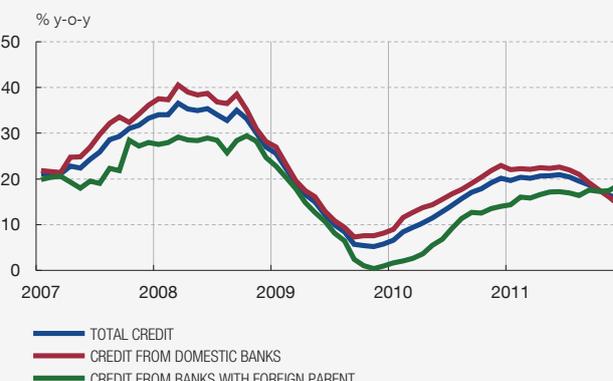
1.2 REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR IN LATIN AMERICA (a)



2.1 COLOMBIA



2.2 BRAZIL



SOURCES: National supervisors.

strengths – the low level of the loan-to-deposit ratios – in some of the region's financial systems, after a relatively prolonged credit cycle by Latin American standards (over seven years, with the brief interruption in 2009). In Brazil's case, for instance, banks' issues in 2010 and 2011 were fourfold those of the previous years, accounting for around 40% of the country's total private fixed-income issues. This led to various warnings by international organisations to monitor and prevent, essentially with monetary and macroprudential policies, excessive credit growth and a potential over-indebtedness process destined for an abrupt ending. Some countries set in train corrective measures which had some effect in the course of 2011.<sup>2</sup>

Throughout the second half of the year, perceptions changed completely. The negative turn in the euro area crisis as from August, the growing difficulties for EU banks (Spain's among them) of raising funding on the wholesale markets and the European Banking Association's (EBA) requirement that capital ratios be strengthened significantly before June 2012 prompted fears that European banks' deleveraging process – understood as a reduction in the assets/equity ratio – might have some impact on Latin America. Nonetheless, domestic credit to the private sector in Latin America posted an end-2011 real year-on-year growth rate of 17% for the region on average, a far higher expansion than that in GDP, albeit moving on a moderating trend in the second half of the year (see panel 1.2). In this respect, although there was extensive disparity, it may generally be affirmed that the buoyancy of credit was generalised, following a swift recovery in 2010 that was surprisingly synchronised across the different countries, given the different impact of the crisis on each of them. In these circumstances, the moderation of their growth might even be beneficial.

There are several mechanisms through which banks may deleverage, with differing impacts on the supply of credit. Faced with the need to restore their capital ratios, banks may tap the markets to raise capital (or receive injections of public funds), sell assets (normally the most profitable ones, or non-essential business lines, almost always with a discount) or reduce them (e.g. by not rolling over short-term credit lines on their maturity, requiring the early cancellation of longer-dated lines or cutting the supply of new loans, among others). Some of these measures may reduce banks' cross-border exposure, but not all of them necessarily restrict the supply of credit. For instance, the sale of a subsidiary to another solvent institution need not entail a fall in the supply of credit. In emerging economies with relatively tight financial markets, as is the case with many of the Latin American countries, fear of the effects of deleveraging may stem also from the potential decline in valuations, which reduces capital and may prompt even greater deleveraging in the economy. This process is exacerbated when many institutions attempt to disinvest at the same time.

Spanish financial institutions have opted for a mix of options in their attempt to re-build capital above the 9% benchmark demanded by the EBA. These options include recapitalisation on the

basis of retained earnings, new issues and selective asset sales (among which some Latin American assets).<sup>3</sup>

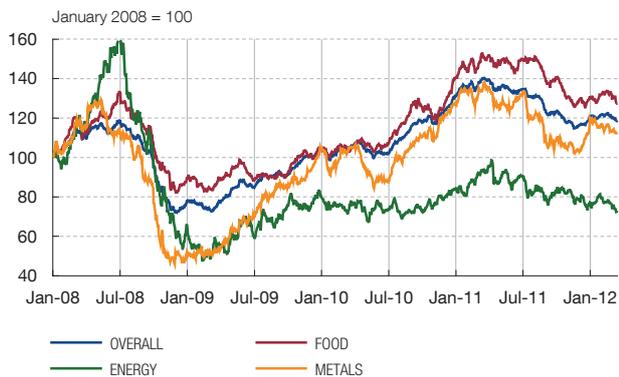
Of the two Spanish banks with a significant presence in Latin America, the exposure of one is concentrated in Mexico, and that of the other in Brazil. The former has not announced any decision involving disinvestment from the region. The latter, on the other hand, put forward a recapitalisation plan between September 2011 and January 2012 which included, in addition to capital-increasing measures (almost 90% of the plan), various sales of assets in Latin America. Its subsidiary in Colombia was sold to the sixth biggest Chilean banking group by volume of assets. Further, the sale of a 7.8% minority holding in the Chilean subsidiary, and of 4.4% in the Brazilian one, was announced. The subsidiary in Colombia had a relatively limited market share of deposits and loans, of around 3%. Its scant size, along with its acquisition by another banking group that may benefit from international diversification in an economy like Colombia with a favourable outlook, has not given rise to concern. On the contrary, at the aggregate level, credit in Colombia is running at a high growth rate (see panel 2.1), and although the credit/GDP ratio is at a low level of around 35%, the central bank is the only one in the region to have raised interest rates since the end of last year in order, *inter alia*, to moderate credit expansion. The disinvestment in Chile initially gave rise to some concern over its effect on the supply of credit, especially given the size of the bank, with a share in the market for credit of 20% (one of the country's two biggest banks). Further, the growth of credit at this subsidiary had outgrown market rates, although it was beginning to ease. However, the bank's high profitability, its majority holding (67%) and the environment of growth and macroeconomic stability in the country should cushion the effect on the supply of credit, in the absence of greater market pressures. Something similar is happening in Brazil, where the subsidiary accounts for only 9.6% of the credit market share and evidences very high profitability. The growth rates of credit to the private sector in the region reached a turning point in July (several months earlier in Brazil) and have moved on to a path of gradual moderation, which is not confined to more restrictive behaviour by foreign banks (see panel 2.2).

In sum, the worsening of the crisis in the euro area along with greater capital requirements have had some impact on the exposure of European banks, and of Spanish banks in particular, in the region. Nonetheless, given the limited volume of disinvestment, the eminently local financing of lending by the subsidiaries and the fact that other institutions can replace them makes it unlikely that they will have notable effects on the supply of credit in these countries. Moreover, high bank profitability in this region reinforces the strategic nature of investments, in a setting of depressed demand in Europe. Lastly, the recent pick-up in capital flows to the region in early 2012, which has once again prompted economic policy responses such as the accumulation of reserves, and the widening of capital controls, appear to reflect the maintenance of an extensive availability of foreign credit to Latin America.

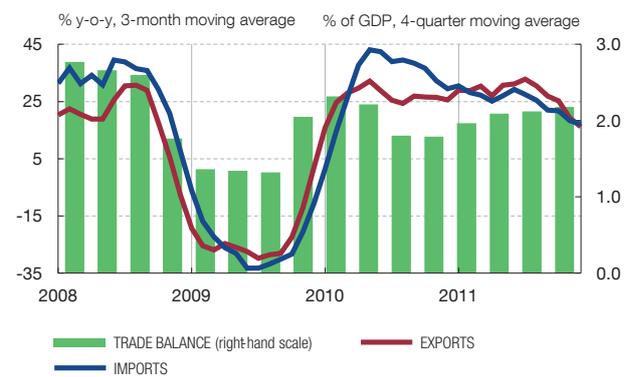
2 The countries, such as Brazil, in which a higher correlation was seen between private consumption growth and credit growth were also those which applied a greater number of measures to check credit growth.

3 Other international banks have also divested their Latin American subsidiaries. The leading British bank sold some of its Central American subsidiaries, and one of the main Dutch banking groups sold its insurance and pension units in Latin America in 2011.

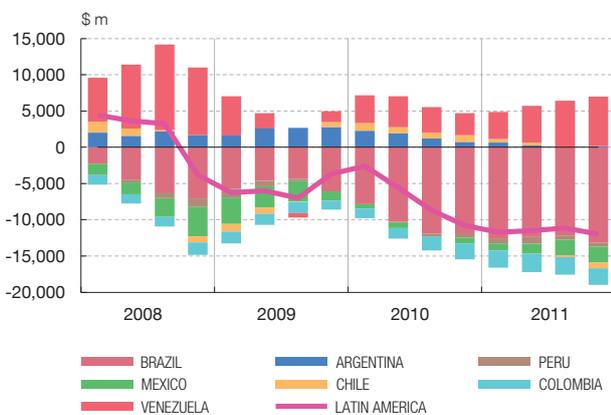
COMMODITIES PRICES  
Indices



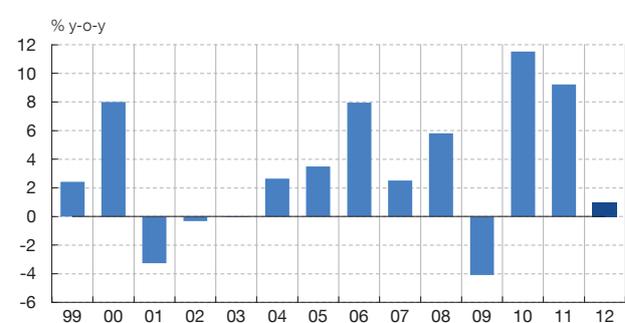
EXPORTS AND IMPORTS (a)  
Year-on-year rate. Quarterly moving average. Percentage of GDP



CURRENT ACCOUNT BALANCE (b)



TERMS OF TRADE (c)



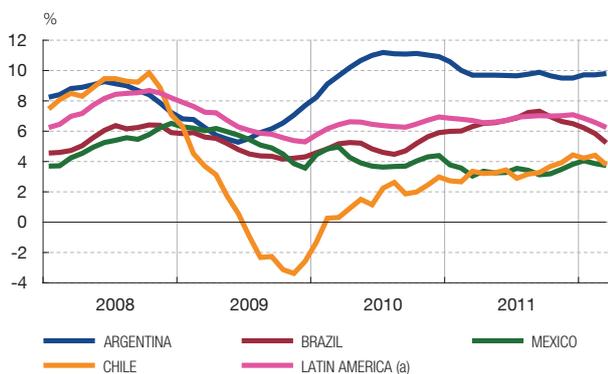
SOURCES: National statistics, central banks and Banco de España.

- a Customs data in dollars, aggregate of the seven main economies.  
b Four-quarter moving average.  
c IIF data and 2012 estimates.

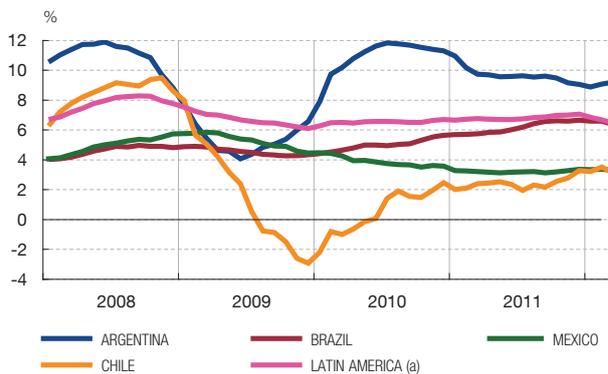
GDP. In any event, the main risk lies in the fact that the euro area recession may ultimately take on a global dimension, affecting China and world growth, and commodities prices. In that case, Chile and Peru, with their small open economies, would be the most vulnerable countries to the trade channel, given that their exposure to the Chinese economy amounts to 3.5% and 1% of their GDP, respectively, which must be added to their exposure to the euro area and to the rest of emerging Asia.

The performance of trade and current-account balances since September also reflects the influence of the downward correction of commodities prices and the decline in external demand. The slowdown in nominal exports was across the board, with average growth falling by half between July and December (from 32% to 16% year-on-year) (see Chart 8). Nonetheless, the trade surplus for the region as a whole increased in 2011 to 2.2% of GDP (due mainly to Venezuela), while the current-account deficit tended to stabilise at around \$45 billion (0.8% of regional GDP), since the widening of Venezuela's current-account surplus (9% of GDP) offset the change in sign in this balance in Argentina and in Chile, and the widening of the deficit in Mexico. In Brazil, meantime, there were few changes in the current-account balance. At a greater level of detail, the widening of the trade surplus (or

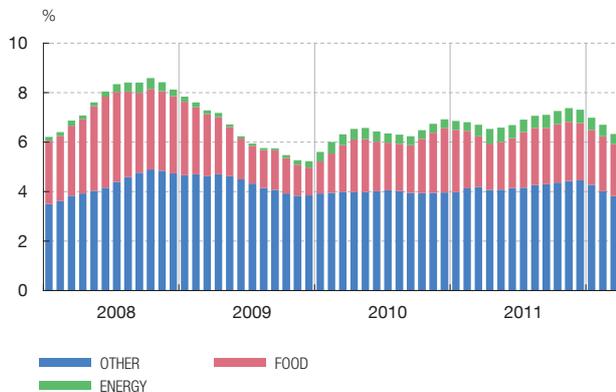
INFLATION RATE



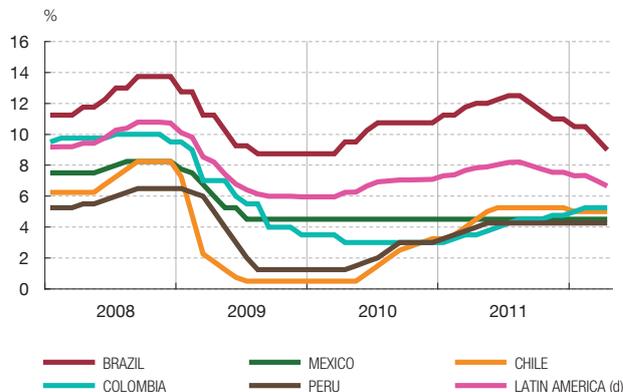
CORE INFLATION RATE (b)



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 (see Table 2).

the reduction in the deficit) in most countries did not manage to offset the deterioration in the transfers and incomes balances (Brazil, Mexico, Chile and Peru), owing to interest payments and the repatriation of dividends.

The higher frequency indicators published since end-2011 offer signs of a gradual recovery in activity, in a setting of resilience of domestic demand and of its determinants, namely employment, consumer confidence and credit (see Chart 7), which appears to suggest some pick-up in GDP at the start of 2012.

### Prices and macroeconomic policies

At the end of 2011, average inflation in the region stood at a year-on-year rate of 7.1%, up on the first half of the year and showing some downward stickiness, in a setting of slowing activity. However, the latest data (March) indicate some easing (to 6.2% year-on-year). The regional average masks cross-country divergences in the past months; while in Brazil prices fell considerably from the high rates posted in the summer, above 7%, to stand at 5.2% year-on-year in March, in the other countries with inflation targets (Chile, Colombia, Peru and Mexico) prices moved on a moderately rising course, albeit from very low rates (see Chart 9).

| Country  | 2011    |          |             | 2012  |                  | 2013             |
|----------|---------|----------|-------------|-------|------------------|------------------|
|          | Target  | December | Fulfillment | March | Expectations (a) | Expectations (a) |
| Brazil   | 4.5 ± 2 | 6.5      | Yes         | 5.2   | 5.4              | 5.3              |
| Mexico   | 3 ± 1   | 3.8      | Yes         | 3.7   | 3.8              | 3.7              |
| Chile    | 3 ± 1   | 4.4      | No          | 3.8   | 3.3              | 3.1              |
| Colombia | 3 ± 1   | 3.7      | Yes         | 3.4   | 3.4              | 3.3              |
| Peru     | 2 ± 1   | 4.7      | No          | 4.2   | 2.7              | 2.7              |

SOURCES: National statistics and Consensus Forecasts.

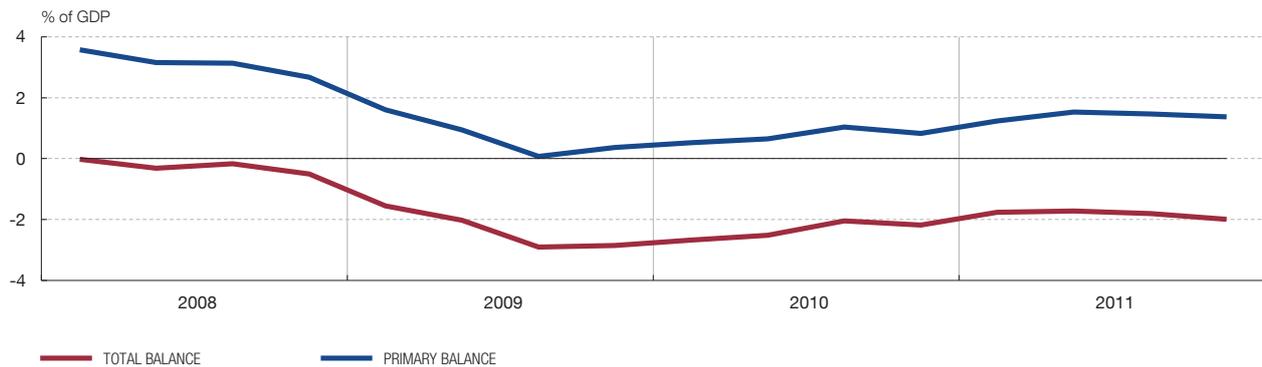
a March 2012 Consensus Forecasts for the end of the year.

Thus, although none of the central banks with inflation targets strictly met their central targets in 2011, in three countries (Brazil, Colombia and Mexico) annual inflation ended the year within the target range, and in two (Chile and Peru) somewhat above the upper limit (see Table 2). Official inflation in Argentina held relatively stable at a rate of 9.5%-10%, although this figure remains far below the estimates made by private consultants, leading to a warning by the IMF that the quality of this statistic should be improved. In Venezuela, inflation fell back in February to a rate of 24.2%, the lowest figure since the start of last year, following the surge seen as from the summer owing to the rise in food prices, against a background of shortages.

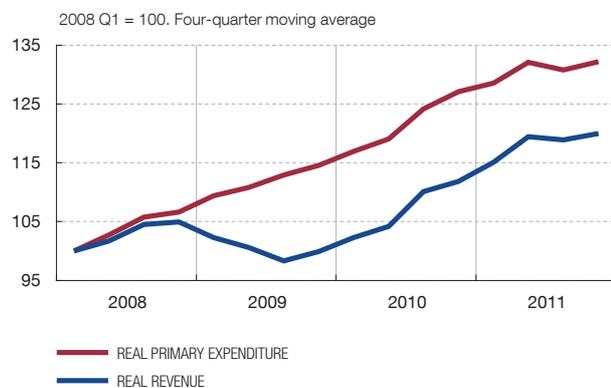
Recent inflation developments across the region are notably heterogeneous, making it difficult to arrive at a common characterisation. On one hand, the easing seen in Brazil is mainly due to the correction of food prices, but also to base effects, the appreciation of the exchange rate and, possibly, to lower economic growth. In Mexico, by contrast, the recent upward trend towards 4% responds to the adjustment of electricity charges and to one-off supply-side factors in the agricultural sector, although the exchange-rate appreciation and the favourable course of unit labour costs, along with the signs of slackness in the labour market, suggests that inflation will continue to hold at moderate levels of around 3.5%. In Chile and in Peru, the rise in inflation has been partly due to the increase in food prices (and, to a lesser extent, in energy), but also to the underlying component, in a setting of forceful domestic demand, and in particular the strength of the labour market. Survey-based forecasts and expectations suggest that inflation will remain on a downtrend or will stabilise during 2012 in the countries with inflation targets, with downside pressures (growth in line with potential and a decline in non-energy commodities prices) prevailing over potentially upside demand-side factors. However, the tightness of the labour market and the recent rise in oil prices pose upside risks which should not be underestimated. Indeed, underlying inflation does not, so far, show clear signs of easing in practically any country (see Chart 9), and inflation expectations in some cases have risen recently.

These divergences are reflected, in turn, in interest rate movements. Over the past six months, two of the central banks with inflation targets cut their official interest rates (Brazil and Chile), two held them unchanged (Peru and Mexico), while the Colombian central bank resumed in November the cycle of rises that had been interrupted since the summer, extending it to mid-March (see Chart 9). The Brazilian central bank, which had initiated the cycle of reductions in August in the face of the risks posed by the international outlook to the Brazilian economy, cut its benchmark rate on four more occasions, placing it at 9% in April, with the perception that the economy's natural interest rate might have fallen in re-

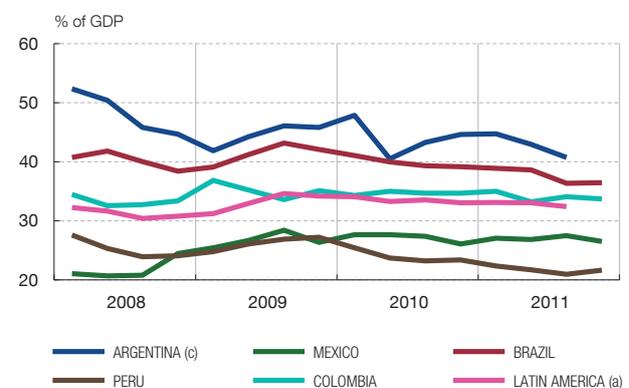
SURPLUS (+) OR DEFICIT (-) IN LATIN AMERICA (a)



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



PUBLIC DEBT



SOURCES: National statistics.

- a Aggregate of the seven biggest economies.
- b Deflated by the CPI.
- c Excludes untendered debt in the debt swap offers of 2005 and 2010.

cent years. Only Argentina and Venezuela continue to show signs of notable vulnerability owing to their high inflation. In Argentina, the official interest rate held unchanged (at 9.5%, where it has stood since October 2009), against a background of high credit growth (running at 45% year-on-year in nominal terms in early 2012).

There were few new developments in the fiscal policy field. In most countries the deficit targets included in the 2011 budgets were met, and what is known of the 2012 budgets broadly points to a line of continuity. Thus, in 2011 the budget deficit averaged 2% across the region as a whole (see Chart 10), somewhat down on 2010, although with major differences from country to country. On one hand, there were notable improvements in Chile (a surplus of 1.5% of GDP) and in Peru (0.9%), and, on the other, the shift from surplus to deficit in Argentina (1.5% of GDP). In Mexico, Colombia and Brazil the deficit narrowed moderately. The cyclically adjusted primary balance that the IMF calculates indicates that fiscal policy and 2011 remained countercyclical in most of the countries, although the fiscal margins consumed during the crisis have not been recovered (except in Brazil), partly due to the high increase in spending, supported in some countries by the revenue arising on commodities. With a view to 2012, Brazil has announced a cut in expenditure in order

**Trade integration  
processes and structural  
policies**

to make up for the envisaged reduction in revenue due to the slowdown in activity. Subsequently, the doubts raised by the weakness of the industrial sector led to the launch of an investment-boosting programme, which includes selective tax cuts. In Mexico, the expected consolidation has been delayed owing to the slowdown in activity. In Peru, however, public investment might be boosted in 2012, given the lower-than-forecast outturn in 2011. Finally, in Argentina the primary surplus fell appreciably to 0.3% of GDP, below the target of 1.5%, set against the sizeable increase in subsidies and the decline in revenues, which has made the dismantling of some such subsidies necessary. The budget deficit also widened considerably, due among other reasons to payment of the GDP-linked coupon corresponding to the performance of the economy in 2010.

During the period under study, protectionist tensions heightened in Mercosur, due ultimately to the strong appreciation of certain currencies – despite the turbulence on international financial markets in August – and to the apparent massive inflow of industrial products that cannot be marketed in the developed countries, as a result of low growth or recession in these economies. The Brazilian authorities raised vehicle import taxes, announced a levy on Chinese steel products and reintroduced a tax on Mexican automobiles, which puts the free trade agreement announced in early 2011 between both countries on a very difficult footing. The Mercosur summit meeting held at the end of the year provided for the possibility of each member individually raising tariffs under the Common External Tariff system, whose scope was widened to improve the strategic management of international trade, according to Mercosur leaders. Along the same lines, Argentina began to demand import licences from 1 February 2012, affecting 80% of Brazilian exports to its southern neighbour. Argentina further required importing companies to equal their purchases abroad with exports. Such measures, even if temporary, limit the scope of the common external tariff and raise barriers to trade among Mercosur members. Ecuador, faced with difficulties in moving forward an agreement with the European Union and the practical paralysis of the Andean Community, announced its intention to join Mercosur. Venezuela, meanwhile, renewed the preferential tariff treatment it enjoyed within the Andean community with Peru and Colombia.

Columbia made progress in talks with South Korea on the signing of a free trade treaty, and initiated negotiations with Japan. Further, the agreements between Peru and Panama, Japan and Mexico were ratified. Finally, on 1 December the CELAC (Community of Latin American and Caribbean States) was launched, an intergovernmental body in which all the countries of the Americas except the United States and Canada are present, and whose first resolutions had a clearly political content, whereas no agreements were reached on resolutions of an economic nature (the creation of a regional reserve fund to address sudden capital outflows).

With regard to structural reforms, those aimed at increasing the State's share in economic policy decisions or in the allocation of resources were once again prevalent. As regards energy policies, the withdrawal of territorial operating concessions from YPF by several Argentine provinces, against the background of the widening deficit on the energy balance, culminated in an announcement of expropriation by the Argentine Government. The announcement poses clear regulatory and legal security-related risks.

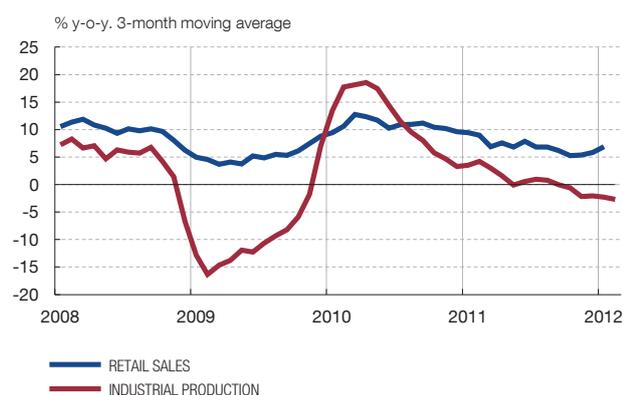
In Venezuela, legislation limiting rental prices and lessor property rights was passed, and a Rent Authority was set up. All owner-lessee relations and issues will come under the jurisdiction of this Authority. The Venezuelan executive is also drafting a new labour law. Bolivia announced the setting up of a public investment fund, financed initially by 10% of international reserves.

In Peru, the Government will allow the state oil company to undertake exploration work and will list 20% of its capital. Moreover, a task force was created to reform the Private Pensions System, with the aim of extending coverage (only 40% of the labour force is affiliated to a pension fund, and only half, approximately, make regular contributions), broadening social protection and raising competition among administrators. In Chile, the Government added 10 measures to its Competitive Impulse Agenda – geared to improving competitiveness with the aim of achieving growth of 6% per annum – and set up an office to monitor its application. To date, only 22% of the measures announced have been set in train. Finally, in Colombia the executive branch made headway in defining its fiscal rule, and in Brazil the Congress approved the reform of the public-sector employee pension system, which has still to be ratified by the Senate, limiting pensions funded by employee contributions and setting in place a complementary system of individual contributions for new employees.

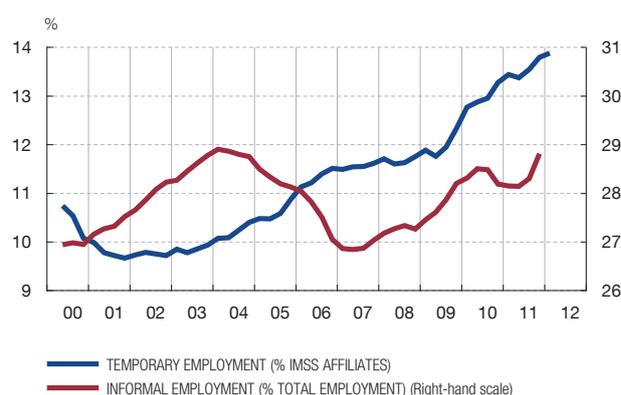
#### Economic developments by country

In *Brazil*, the economy showed signs of picking up in 2011 Q4, expanding at a quarter-on-quarter rate of 0.3% following the strong slowdown in Q3 (when it contracted at a quarterly rate of 0.1%). However, the year-on-year rate eased once more, to 1.4%, from 2.1% the previous quarter, meaning growth for 2011 as a whole stood at 2.7% (7.5% in 2010). The diminished dynamism was due to the slowdown in domestic demand, which contributed 2.4 pp and 1.9 pp in Q3 and Q4, respectively, compared with 5 pp on average in the first half of the year. The negative contribution of external demand dipped to 0.5 pp from 1.2 pp in the first half of the year, principally due to the easing in imports. The indicators for 2012 Q1 point to the continuing favourable situation of the labour market, although the unemployment rate, after reaching an all-time low of 4.7% of the labour force on December 2011, currently stands at 5.7%. The rising trend of real wages is also holding, and will moreover foreseeably be strengthened by the 14% increase in the minimum wage set by the Government for 2012. Industrial production continued to be weak in January, owing to the adverse impact of external competition on the manufacturing sector, related in part to the level of appreciation of the exchange rate. Against this backdrop, and despite a pick-up in industrial production in February, the Government announced the launch of an economic stimulus plan aimed at boosting investment. The programme includes selective tax allowances for specific industrial and exporting sectors, with an estimated impact of 7.2 billion reales. However, the bulk of the programme will be quasi-fiscal in nature, and will comprise the provision of funds by the Treasury to the BNDES for an amount of close to 1% of GDP. These developments are in contrast to retail sales, which have posted greater resilience in recent quarters and whose strength has run into early 2012 (see Chart 11). Inflation, after peaking at 7.3% in September, eased to 5.2% in March, but remains in the upper interval of the central bank's target range (4.5% + 2%), as does core inflation. Inflation expectations for 2012 and 2013 remain in this range. Nonetheless, the central bank cut its official interest rate by 350 bp from August, taking it to 9% in April, and it adopted other macroprudential measures to ease monetary and credit conditions: i) changes to the reserve requirements system in January to lessen small and medium-sized banks' liquidity problems; ii) reduction in the tax on financial transactions (IOF by its Portuguese acronym) on personal loans (from 3% to 2.5%) in December, and iii) amendments to the regulation on capital requirements for certain individual credit transactions in November. The buoyancy of lending to the private sector held up, generally, although it eased somewhat in the opening months of 2012 to a year-on-year rate of 17.3%. There was a more robust expansion in directed credit, at 21.4%, and a greater slowdown in the growth of free credit, to 15%. On the fiscal front, the primary surplus in 2011 was 3.1% of GDP; that matched the target for that year and was up on the preceding years (2% in 2009 and 2.7% in 2010). The budget deficit stood at 2.6% of GDP. For 2012, the Government has a target surplus of

BRAZIL. DEMAND INDICATORS



MEXICO: LABOUR MARKET



SOURCES: National statistics.

3.1% of GDP and, in this connection, it has approved a reduction in spending of 1.2% of GDP, given the expected reduction in revenue, although the growth forecast used (4.7%) still seems ambitious. Turning to the external sector, the current-account deficit stood at \$52 billion in 2011, at 2.1% of GDP. Capital inflows amounted to \$111.9 billion, up on 2010. Foreign direct investment (\$76 billion) contributed notably, while portfolio investment and other investment were lower. In 2011 international reserves exceeded \$350 billion, after increasing by almost \$59 billion during the year, despite the fact that, coinciding with an easing in capital inflows in the final months of the year, the central bank suspended interventions. In 2012, when inflows picked up once more, the central bank resumed dollar purchases. Indeed, to withstand the upward pressures on the real, the Ministry of Economy tightened capital controls via prices, extending the scope of application of the IOF to issues of debt with maturities of more than two and less than five years, which were formerly exempt, and to export prepayment loans in excess of 360 days. Standard and Poor's upgraded the country's sovereign debt rating, placing it a notch above investment-grade.

In Mexico, the economy posted growth of 2.9% in 2011, compared with 5.5% in 2010. The diminished dynamism was notable especially in Q4, when the quarterly rate of increase stood at 0.4%, compared with 1.2% in Q3. The respective year-on-year rates were 4.5% and 3.7% in the last two quarters of the year. On the demand side, investment was the most buoyant component, growing at 8.8%, compared with 6.3% in 2010, although it slowed gradually to 5.5% in Q4. Private consumption progressively lost steam over the course of the year (4.2% in Q4, down from 4.9%), while exports grew at a lower rate than imports, which gave rise to a negative contribution of external demand of 0.8 pp, on average, in the second half of the year. The Mexican economy thus closed in 2011 the negative output gap which opened up at end-2008, confirming a less dynamic recovery than in the rest of the region. The data released for 2012 Q1 point to the continuance of a growth rate similar to that in 2011 Q4, with greater resilience in private consumption and somewhat less strength in industrial production and investment. The labour market performed somewhat more positively in 2011 than in 2010, with job creation standing at 2.2%, but with a higher rate in the informal sector of the economy and, hereunder, in the lowest-quality segment (see Chart 11). Remittances, another of the determinants of private consumption, grew by 9.1% year-on-year during the second half of 2011, but they stood close to 2005 levels both in dollars and in pesos. Inflation held in the upper interval of the central bank's target range (3% + 1%), after having failed to meet the 2010 target. Core inflation (at 3.4%

in February) was below headline inflation during the period under analysis, and medium and long-term inflation expectations remained anchored at around 3.5%. Against this background, the central bank kept its official rate unchanged at 4.5%, where it has held since July 2009, although in the closing months of 2011, following the resurgence of global financial turbulence, the tone of its statements was modified and the possibility of lowering the official interest rate was considered. This bias was corrected in 2012, given the improvement in US economic activity indicators and the reduction in volatility on international financial markets. Bank lending to the private sector continued to show real year-on-year growth rates close to 10%, and these were higher in the consumer segment. In the fiscal realm, public finances improved slightly since, excluding the investment by the State-held company PEMEX, the deficit stood at 0.6% of GDP, down 0.2 pp on 2010 as a result of the fact that public revenue rose slightly above expenditure. The budget approved for 2012 envisages a similar outlook involving a very gradual reduction in the deficit. The current-account balance posted a deficit in 2011 of 0.8% of GDP, against 0.3% in 2010. The financial account showed a surplus of 4.8% of GDP, chiefly reflecting portfolio investment for the purchase of bonds. That entailed an increase in international reserves during the year, a process which was interrupted in the closing months of 2011 (when dollar auctions were announced if the exchange rate depreciated by more than 2% per day, although these were not ultimately resorted to), but which was resumed during the first three months of 2012. As a result, international reserves stood close to \$148 billion, a new all-time high, although in relative terms (12% of GDP) they stood below the other economies in the region. In any event, the credit line (FCL) with the IMF remains in force (up to \$73 billion). The Government continued to maintain fluid access to international fixed-income markets with several global issues in local currency and in foreign currency, and it indicated that as at late February it had met its funding objective for the year on international markets. Lastly, July will see presidential elections in which the opposition candidate, who has been favourable to moving forward some of the structural reforms pending, might win.

Economic activity in *Argentina* lost momentum markedly in the second half of the year. Quarterly growth in Q4 was 0.8% (0.9% in Q3), compared with 2.8% and 2.3% in the first two quarters. In year-on-year terms, growth stood at 7.3% in Q4 (9.3% in Q3, owing to a favourable base effect). The key factor behind the slowdown was the behaviour of domestic demand, which dipped from year-on-year growth of over 11% to 7.7% in Q4. The growth rates of both private consumption (which nevertheless continued to show enormous resilience, at 8.8%) and, especially, investment dipped, while government consumption quickened slightly. In contrast, the negative contribution of the external sector was only 0.6 pp, after having stood at 2.1 pp in the previous quarter, owing both to the acceleration in exports and, above all, to the slowdown in imports (whose year-on-year rate was 9.8%, against 17.7% in Q3, partly due to the import controls set in place by the Government). In 2011 as a whole, GDP growth was 8.9%, compared with 9.2% in 2010. The slowdown in activity continued into the early 2012, according to various indicators. However, mention should be made of the favourable labour market situation, which is holding the unemployment rate at a historical low. The year 2011 was of note as it witnessed a departure from the twin surpluses. Thus, the current-account posted a deficit in the second half of the year as a result of the increase in the negative balance on services and on incomes, since the trade balance improved slightly, despite the increase in the energy deficit. Nonetheless, over the year as a whole the current-account balance still posted a small surplus (\$17 million, compared with \$2.82 billion in 2010). The primary public surplus stood at around 0.3% of GDP in 2011, notably down from 1.7% in 2010. The narrowing of both surpluses, along with the step-up in capital outflows from August (over the year as a whole outflows exceeded \$21 billion), led the Government to adopt a range of measures

ARGENTINA: UNRESTRICTED RESERVES



CHILE: GDP AT CONSTANT PRICES



SOURCES: BCRA and Banco Central de Chile.

following the October presidential elections. As regards the trade balance, import controls were deepened and higher exports of wheat and maize were authorised. In relation to the current and financial balances, controls on residents' investment in foreign assets were increased, exceptions to the obligation affecting foreign currency proceeds on hydrocarbons and mining exports were eliminated, insurance companies were obliged to transfer to Argentina investments abroad, foreign exchange operations entailing significant volumes were monitored more closely, and prior approval was required for the repatriation of profits by foreign companies, among other unorthodox provisions. These measures sought to increase the supply of dollars and reduce the demand for the US currency, given the loss of international reserves (\$5.81 billion in 2011 as a whole). They were successful to some extent, judging by the slowdown in capital outflows, the reduction in the parallel exchange rate premium (a measure of the expected depreciation of the peso) and the reduction in interbank interest rates on operations in pesos, which had increased from 12% in early September to 23% by mid-November. Further, the measures were able to check the withdrawal of local foreign-currency-denominated deposits by the private sector (for some \$2.5 billion) which took place in November and which led the dollarisation of deposits to fall by about 4 pp, to stand slightly above 16%, by means of the approval of a central bank regulation which added flexibility to the minimum requirement governing the amount of dollars commercial banks have to have deposited at the central bank. Before the deterioration in public finances, the Government announced a series of measures to progressively reduce the high level of transport and energy consumption subsidies (4.2% of GDP in 2011). Official inflation held in the range of 9.5%-10%, several points below private estimates and official inflation in the provinces. Finally, both chambers approved draft legislation amending several articles of the Convertibility Law and reforming the central bank's charter. Among other aspects, the level of "unrestricted reserves" (those used during 2010 and 2011 for servicing foreign-currency-denominated debt) was amended, meaning that these reserves will cease to be based on an objective figure (those that exceeded the monetary base) and will now be set by the central bank board (see Chart 12). Moreover, the temporary advances that the central bank may grant to the Treasury have been increased, which will probably translate into a further reduction in tradeable debt on the market and to an increase in gross debt held by the central bank, in Social Security funds and by other public corporations. Finally, the Argentine Government moved draft legislation before Congress to expropriate 51% of the capital of YPF from REPSOL (the latter's holding was 57.43%). The draft legislation also considers that the 51% expropriated shall be divided between the State (51%) and the Federal Organisation of Hydrocarbons-Pro-

ducing States (49%), which encompasses the Argentine producer provinces. The amount of the payment for the expropriation shall be determined by the Argentine valuation authorities, it not being known from where the funds to compensate REPSOL will be found. The Argentine president signed an emergency decree providing for the temporary placing of YPF under State control for 30 days, appointing two members of her Government as administrators in this connection.

Economic activity in Chile quickened notably in Q4, posting a quarter-one-quarter growth rate of 2%, against the meagre figure of 0.3% in Q3. In 2011 as a whole, growth stood at 6% (6.1% in 2010). The new National Accounts series for the period 2003-2011 were published (re-based in 2008), with a significant methodological change: the prices base for estimating variables in terms of volume is now a moving base (chained indices) (see Chart 12). On the supply side, the revisions entailed an increase in the weighting of mining activity for the calculation of GDP (5.6 pp), and a decline in that of industry (5.2 pp); and, on the demand side, an appreciable reduction in the weighting of domestic demand. Domestic demand slowed in Q4 (5.5%, against 8.6% the previous quarter), chiefly as a result of the lower contribution of stockbuilding, but the negative contribution of external demand to growth also fell notably (from 5.9 pp in Q3 to 1.2 pp), owing both to the acceleration in exports and to the slowdown in imports. However, the surplus on the trade balance narrowed owing to the decline in the terms of trade, which led the current account deficit to widen and to account for 1.3% of GDP in 2011 as a whole, with the surplus on the balance of transfers also a contributing factor here. Inflation rose above 4% (the upper limit of the target range) in December, as a result of energy and, especially, food. It held at this level until March (when it stood at 3.8%), although core inflation and inflation expectations remain anchored close to the central bank target (3%). The increase in overall inflation, along with concern over the tightness of the labour market and the buoyancy of domestic demand, contributed to the official interest rate holding at 5% at the February and March meetings, following the 25 bp reduction in January. The yield curve has discounted rises in the coming months. The central bank finalised its reserves accumulation programme in December (\$12 billion in 2012) and implemented a temporary programme of variable-yield repos with a maturity of up to 28 days (from end-December to early February), aimed at smoothing peso-liquidity management in the financial system, against the background of the greater tensions observed on the money market. Bank lending quickened during 2011, ending the year with annual growth of close to 13% in real terms. On the fiscal front, there was a central government surplus of 1.4% of GDP in 2011 (against a deficit of 0.4% in 2010), with capital expenditure notably buoyant. That entails a structural deficit of 1.5% (2% in 2010), in line with the Government target of 1% in 2014.

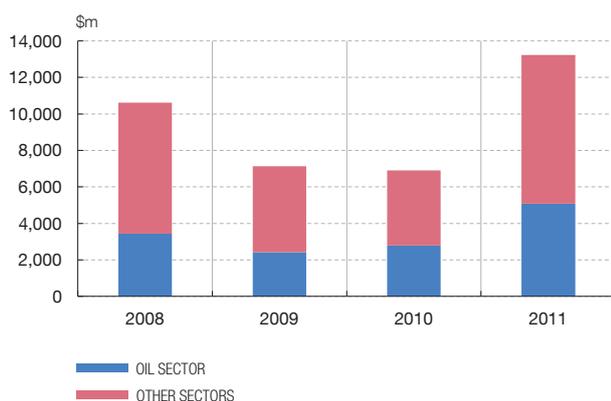
In *Colombia*, activity remained exceptionally buoyant in the second half of the year, registering year-on-year growth rates of 7.5% and 6.1% in Q3 and Q4, respectively. In 2011 as a whole, growth was 5.9% as a result of the strength of private consumption, which grew by 6.5%, compared with 5% in 2010, and of gross capital formation, which climbed 166%, compared with 4.6% in 2010. Accordingly, private investment came to account for almost 28% of GDP. The mining sector led growth in 2011, with a rate of 14.3%. The negative contribution of external demand increased as a consequence of the acceleration in imports outpacing that in exports. Nonetheless, the surplus on the trade balance widened, due mainly to higher exports of oil and oil derivatives, which posted an increase of 61.9% in value terms and 28.1% in volume terms during the year. The current account deficit as a percentage of GDP held at - 3%. Inflation has stood since March 2010 in the upper part of the central bank's target range, hitting the ceiling of 4% in October and November, although it eased subsequently to 3.4% in March thanks to the behaviour of the non-core

items. In the period under analysis, the central bank raised interest rates on three occasions (25 bp each time), taking them up to 5.25%. It did so in light of the strength of demand, the developments in inflation and the dynamism of credit which, though it eased during 2011, posted real year-on-year growth of over 15%. Also, to combat the upward pressure on the Colombian peso, the central bank set in place various foreign exchange intervention mechanisms, and the Treasury announced that the funds obtained from the issue of global bonds would not be converted into pesos. The central government deficit narrowed in 2011 to 2.9% of GDP (compared with 3.8% in 2010) as a result of the 25.4% increase in tax revenue and the 16.8% rise in expenditure (with investment spending particularly buoyant).

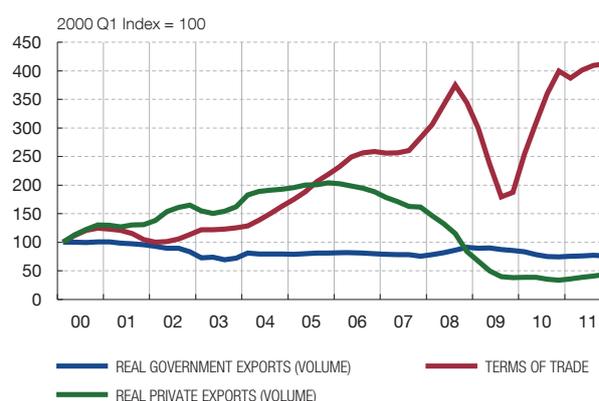
In *Peru*, GDP maintained a very robust pace of growth during 2011, with quarterly growth rates between 1.3% and 1.5% in the last two quarters of the year. That took growth to 6.9% for the year (8.8% in 2010). The contribution of external demand turned from negative in the first half of the year to positive in the second, given the extraordinary easing in imports in the latter period, which was due mainly to the slowdown in investment. By contrast, private consumption remained strong (6.4% year-on-year) and government consumption rose. The current account deficit narrowed in 2011 to 1.3% of GDP (-1.7% in 2010), owing to the improved trade surplus, underpinned in turn by a notable improvement in the terms of trade. However, the incomes balance remained strongly in deficit. The financial account posted a surplus of 4.8% of GDP, down from 8.3% in 2010, owing to lower direct investment and net short-term capital outflows. Inflation increased, especially during the second half of the year. It stood at 4.2% in March, above the central bank's target range ceiling (1%-3%), mainly as a result of the rise in food and energy prices, against the backdrop of strong domestic demand and an increase in real wages. The central bank held its official rate unchanged at 4.25% from May. In the period under analysis, the central bank intervened on the foreign exchange market purchasing large amounts of dollars in order to combat the upward pressures on the new sol. As a result, Peru continued to be the country with the highest proportion of international reserves relative to GDP (over 30%). In the fiscal sphere, the non-financial public sector posted a surplus equivalent to 1.8% of GDP in 2011, reversing the deficits of the two previous years (-1.3% in 2009 and -0.3% in 2010). Revenue increased by 13.9% in real terms and expenditure by only 2%, due in part to the legal limitations imposed in election years and to the non-application by certain local and regional governments of all their budget. The amounts not applied, along with certain additional packages, constitute a fiscal stimulus plan of close to 2% of GDP for 2012. Fitch upgraded the Peruvian credit rating from BBB- to BBB, a notch above investment grade.

*Venezuela's* economy picked up strongly in 2011, with GDP growth of 4.2%, following the decline of 1.5% in 2010. That said, there was a halt in Q4 with zero quarterly growth recorded. Domestic demand grew by 9.1% in the second half of the year (5.9% in the first half), thanks to the acceleration in government and private consumption and in investment, but also because of greater stockbuilding. The second half of the year saw the negative contribution of external demand increase (to above 6.5 pp), due both to the greater buoyancy of imports and to the diminished momentum of exports, which actually posted a year-on-year decline in the final quarter of the year. For the first time since 2007, private-sector growth outpaced that of the public sector, albeit only slightly. In the closing months of 2011 there was a fresh rise in inflation, which ended the year at 29% (27.4% in December 2010), prompted by the rise in food prices, although the inflation rate eased once more between January and March to 24.2%. Monetary policy did not undergo relevant changes in the period under study. In the official SITME parallel market, the bolívar

COLOMBIA: FDI FLOWS BY SECTOR



VENEZUELA: EXTERNAL SECTOR INDICATORS



SOURCES: National statistics.

traded at 19% below the official exchange rate (4.3 bolívars per dollar). According to central bank figures, public revenue is estimated to have increased in 2011 by 3.2 pp of GDP as a result of an increase in oil royalties and of higher revenue from oil companies, while expenditure accounted for 3.1% of GDP, essentially because debt service payments doubled in relation to 2010. The deficit stood at 3.4% of GDP, 0.1 pp less than in 2010. The Government continued to fund itself through dollar-denominated issues on the domestic market payable in bolívars. The current account surplus exceeded \$27 billion in 2011 (\$12 billion in 2010), while the trade surplus posted a historical high thanks to the increase in the terms of trade (see Chart 13). The financial account showed a deficit in absolute terms that was similar to the current surplus. Foreign direct investment inflows were notably far higher than in previous years, and linked chiefly to the public oil sector. The Government continued increasing its degree of intervention in the economy during the period under analysis: gold mining was nationalised, the central bank's international reserves were repatriated, and a new law on price control and another on the control of house rentals were drawn up. In October presidential elections were held, set against the uncertainty of the president's health and with a somewhat more favourable outlook for the opposition candidate than in previous elections.

18.4.2012.