Introduction

Latin America posted growth of 2.9% in 2012, as a whole, 1.6 pp down on 2011, against a backdrop of slower world growth and terms of trade that have stabilised after increasing notably for two years. Following a relatively buoyant first quarter, the aggregate GDP of the region's seven main economies showed a moderating profile to Q3 and, subsequently, in tandem with the easing of strains in the euro area, activity rebounded. Conceivably, the moderation in the region's average growth means that it is returning to long-term trend growth rates, after the post-crisis years when the rapid exit from the recession closed output gaps and signs of overheating even appeared. However, this interpretation is not applicable to all the countries since, as shown in Chart 1, in 2012 the cyclical performance of the economies analysed diverged markedly. In particular, while Argentina and Brazil (which represent practically half of the region's GDP) grew considerably below their trend growth rate (Brazil for the second consecutive year), Peru, Chile, Venezuela and Mexico expanded at rates which were higher than or close to long-term trend. Thus, the loss of momentum in Latin America in 2012 was mainly due to factors specific to those two economies. In fact, in the other countries the pace of growth of activity and demand was buoyant, at more than 4%, and without any inflationary pressures in most of them.

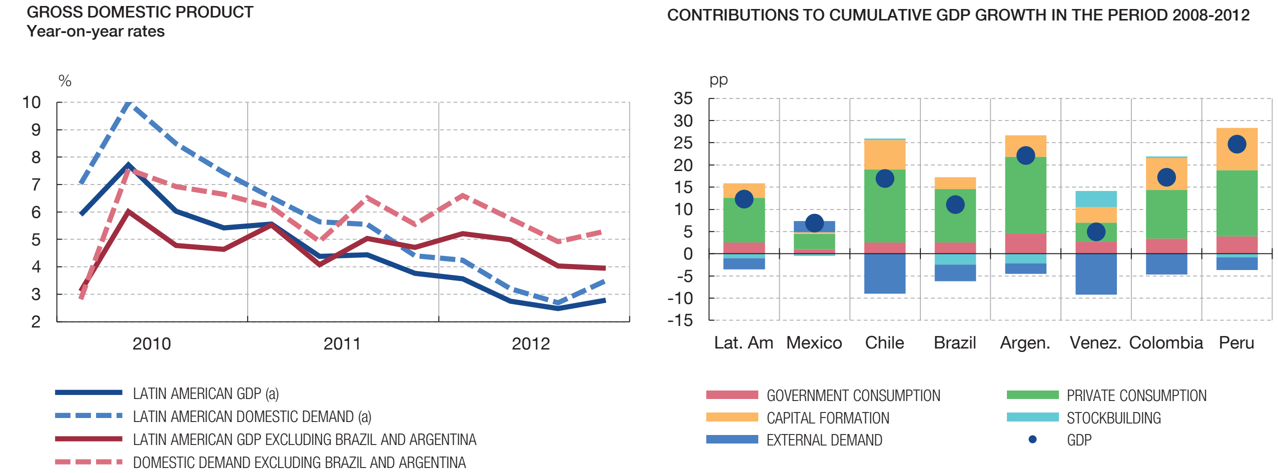
The main support for activity in the region in 2012 continued to be domestic demand, which contributed 3.7 pp to growth, and, essentially, private consumption. The negative contribution of external demand declined to 0.8 pp owing to the significant containment of imports, as opposed to their strong increase in previous years. Exports grew little in line with the smaller increase in world trade mid-year. The most recent indicators seem to point to the recovery in Q4 continuing, firmly and dynamically so in countries like Chile and Peru, and more gradually in countries which have shown less vigour. The main exception is Venezuela, where the contractionary effects of devaluation and the necessary fiscal adjustment point to a considerable slowdown in activity.

Inflation developments were also notably heterogeneous. Although the average inflation rate of the region's seven main economies tended to rise moderately from the beginning of 2013 (reaching 6.7% year-on-year in March), this was due to price behaviour in Venezuela and Argentina and, among the countries with inflation targets, to the sustained upward trend in Brazil (6.6% in March, 1.5 pp up on June 2012), despite the economic slowdown. However, in the other four countries with inflation targets (Chile, Colombia, Mexico and Peru) the pace of increase in consumer prices eased significantly against a backdrop of strong or close to potential growth, which gives evidence of the credibility of their economic policies. At end-2012, the five countries with inflation targets met their targets comfortably; Brazil did so, but only narrowly. In Brazil, the downward stickiness of inflation, in a context of economic weakness, and the rise in long-term expectations pose a considerable challenge to monetary policy following the sharp downward cycle in interest rates until October 2012.

The outlook for 2013 indicates similar growth to that in 2012 (although distributed differently by country), with some elements of risk. On one hand, the weakness of the industrialised economies continues to drag down growth and is only partly offset by demand from Asia (see Box 1). On the other, the perception that interest rates in the advanced economies will remain at low levels and that unconventional monetary policy measures will be maintained raises the need to remain vigilant about developments in capital flows on

GROSS DOMESTIC PRODUCT
Year-on-year rates and percentage points

CHART 1



SOURCES: Datastream and IMF.

a Aggregate of the seven main economies.

account of their implications for credit, exchange rates and financial conditions. Furthermore, there is the risk that administrative measures, which are used increasingly profusely, will ultimately distort the efficient allocation of resources. At the same time, nevertheless, a normalisation in the level of the federal funds interest rate in the US would also pose risks for the emerging economies, where there is a considerable increase in dollar-denominated issues and very narrow spreads.

Finally, following the achievement of a decade-long growth in Latin America (an extraordinarily protracted phase by the region's standards), imbalances may be building up which entail risks in the medium term. The GDP of these countries already stands at between 7% and 25% above the pre-crisis high (see Chart 1), with very robust growth in private consumption. This upswing has been driven by a very favourable commodities cycle and, consequently, the main risk would be that of a substantial fall in commodities prices. This would have a considerable impact on fiscal and external accounts, which are highly favoured in turn by the boom. There has been an increasingly widespread deterioration in external positions and, although they continue to be comfortably financed with direct investment, a downward trend can be seen in several countries. Also, within the region, the imbalances built up by Argentina and Venezuela continue to be important factors of vulnerability.

External environment

The last quarter of 2012 and the early months of this year were characterised by the favourable performance of international financial markets (see Chart 2), against a backdrop of the easing of certain extreme risks – associated with the European sovereign crisis and the possibility of an abrupt fiscal contraction in the US – and further expansionary monetary policy measures in the main advanced countries. However, despite this improvement in investor sentiment, global activity was lacklustre in 2012 Q4 without any substantial changes in the economic outlook.

The main developed economies recorded a strong slowdown in 2012 Q4, with virtually zero growth in the US and Japan and fresh declines in GDP in the euro area and in the United Kingdom. In 2013 Q1 there was a slight rise in activity, which was sharper in the US, although a modest recovery is expected to continue. In this setting, and with inflation rates

ANALYSIS OF THE CYCLICAL CORRELATIONS BETWEEN LATIN AMERICAN ECONOMIES AND OTHER LARGE BLOCKS IN THE WORLD ECONOMY

BOX 1

After leaving behind the latest series of regional crises, since 2003 the external environment of the Latin American economies has been relatively favourable, characterised by rising demand for commodities, which are among their main exports, and the attendant increase in the terms of trade. As a result of the foregoing therefore, and unlike previous decades, growth has not been accompanied by external imbalances. The 2008-2009 global economic crisis has interrupted this trend slightly since the slow emergence of developed economies from the crisis has dragged down world growth (Panel 1, Chart 1), leading to lower external demand for the countries in the region[1] (Panel 2, Chart 1) and, more recently, to a stabilisation – or a decline – in commodity prices.

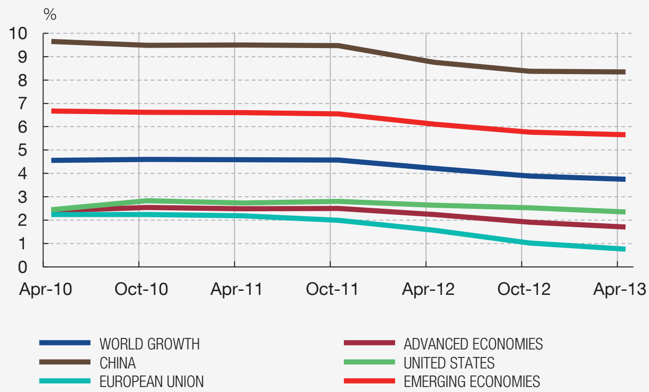
Latin America is a very heterogeneous region in respect of its degree of openness to foreign trade, the geographical direction of trade (with some countries more focused on Asia, others more on the United States or Latin America itself, and others that are more diversified[2]) and in respect of the main type of products exported (commodities or manufactured goods). For this reason, the geographical distribution of world growth is important when determining the effects of the external environment on these economies' activity.

This box presents an estimation of the cyclical correlations between the region – considering both the regional aggregate and the main countries individually – and other large blocks in the world economy: the United States – which has traditionally had the largest weight in the region's foreign trade and financial inflows –, the European Union – an area on which certain countries in the region have tried to refocus themselves by signing free trade agreements – and China – the most buoyant country in world trade, which essentially demands commodities from the region and with which

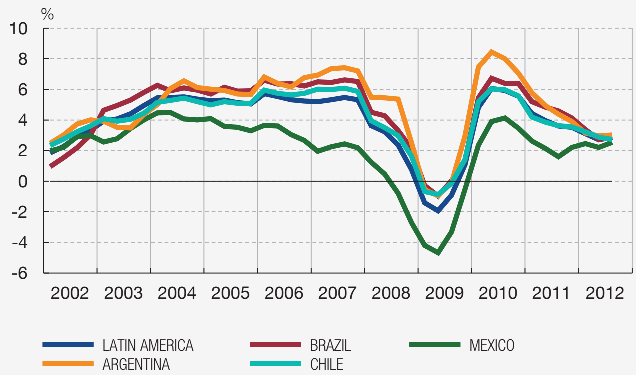
1 External demand is estimated on the basis of the rates of change in the domestic demand of the region's main trading partners, which is weighted by the share of each partner in the foreign trade of each Latin American country.

2 This external focus has changed over time as can be seen in Box 1 of the half-yearly report on the Latin American economy of October 2010.

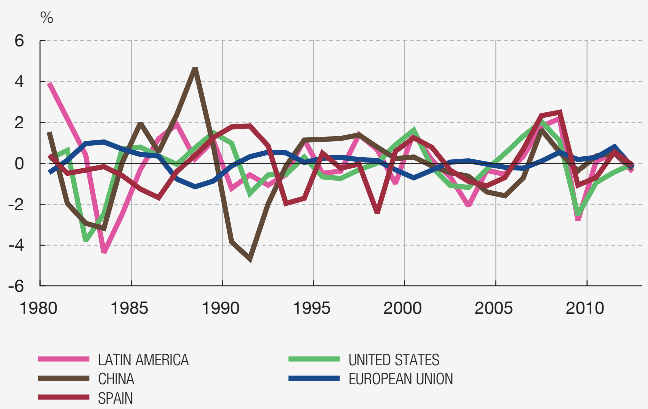
1 GROWTH PROJECTIONS FOR 2013-2014 (a)



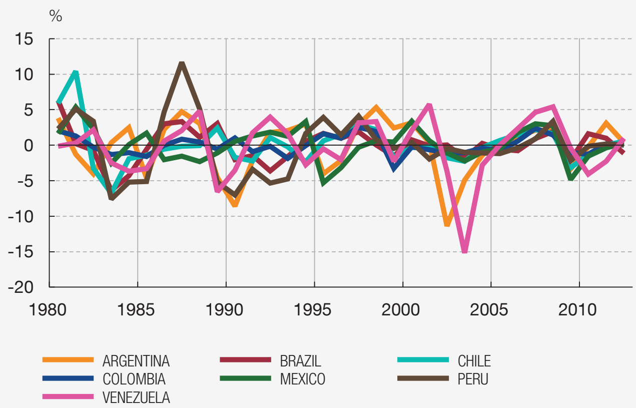
2 EXTERNAL DEMAND (ESTIMATED)



3 ESTIMATED CYCLICAL COMPONENT OF GDP (b)



4 ESTIMATED CYCLICAL COMPONENT OF GDP (b)



SOURCES: IMF and Banco de España.

a Average of GDP growth projections for 2013-2014 from the IMF's WEO published at the date indicated on the axis.
b Using a Hodrick-Prescott filter with a lambda of 6.7.

certain Latin American countries have signed free trade agreements. Similarly, the correlation of the cycles between Latin America and Spain has been analysed, as the latter has a large share in direct investment in the region.

The correlations are calculated by extracting the cycle from the various countries' and regions' annual GDP series for the period 1960-2012 through the Hodrick-Prescott filter; namely, it is a statistical breakdown, different to the usual one, derived from the estimation of potential growth.[3] Chart 1 presents the estimation of the cycles for the regional aggregate and the areas of comparison, as well as for the more important countries in the region. Noteworthy is the higher volatility of the cycle seen for the Latin American countries, especially those whose external integration is more reliant on commodities. In countries with a more diversified productive structure like Mexico and Brazil, the cycles are smoother and more protracted; consequently, they are more similar to those of the United States and the European Union.

The contemporary cyclical correlations are shown in Table 1.[4] For the period 1960-2012, the regional aggregate only has a statistically significant correlation (in bold and italics) with the United States (32%), as a result of a positive correlation with all the countries in the region except for Peru; this correlation is particularly high and significant with Colombia (32%) and Chile (41%), countries traditionally closely tied to the US economy. Conversely, the cyclical correlations of Latin America with China and Spain are very low (lower than 10% at aggregate level), which is logical, taking into account that the increase in exposure to the two areas is a more recent phenomenon. The correlation with the cycle of the European Union is negative and not statistically significant. Finally, noteworthy are the positive significant correlations between the cycles of the countries in the region, which are the highest of all those estimated in Table 1. This seems to indicate that as the region became increasingly integrated into the external environment, regional economic ties deepened.

In order to detect a possible structural change in the correlations following the beginning of the most intensive phase of the recent globalisation process and to estimate at which point in time the bilateral correlations become significant, the correlations were calculated in ten-year moving windows. As can be seen in Chart 2, from 2000 onwards (which includes the average correlation from 1991 to 2000), the correlations of the cycle of the regional aggregate with the United States and Spain turn positive, and become significant in the boom years immediately before the last international financial crisis. For China, the correlation has been high throughout the period examined and became significant in 2008, albeit at lower levels than those of other countries analysed. Fi-

3 Specifically, a Hodrick-Prescott filter with a lambda parameter of 6.7 is used, extending the GDP sample both backwards (to 1950) and forwards (to 2020, with long-term projections of *Consensus Forecasts*).

4 It should be pointed out that correlations, not causal relationships, are presented in the box. The exercise has, furthermore, other limitations: (i) the data used for certain economies (particularly China, which shows a GDP trend with very high and practically constant rates of change almost throughout the sample, making the cycles explosive at the beginning of the sample and smoother afterwards); (ii) the same method for trend estimation is used with the same parameter for all the countries and all the time periods instead of a fundamentals-based model, which may bias the results, if as occurred in 2008, there is a simultaneous shock in all the economies; and (iii) the cyclical correlations do not mean a direct effect on activity since this will depend on the weight of the country in the external positioning and degree of openness of the economy.

1 CONTEMPORARY CYCLICAL CORRELATIONS (1960-2012) (a)

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	Latin America (b)
Argentina	1.000							
Brazil	0.209	1.000						
Chile	0.161	***0.338***	1.000					
Colombia	0.235	***0.482***	***0.557***	1.000				
Mexico	0.241	0.020	0.257	0.202	1.000			
Peru	***0.319***	***0.563***	0.226	***0.386***	0.036	1.000		
Venezuela	***0.447***	0.079	0.146	***0.310***	0.231	0.258	1.000	
Spain	-0.185	0.186	0.121	0.117	-0.068	-0.034	0.057	0.059
United States	0.192	0.206	***0.410***	***0.320***	0.259	-0.069	0.129	***0.317***
China	0.199	-0.138	0.036	0.063	0.110	0.136	0.120	0.045
EU	-0.107	-0.141	-0.273	-0.240	-0.078	-0.061	-0.061	-0.200

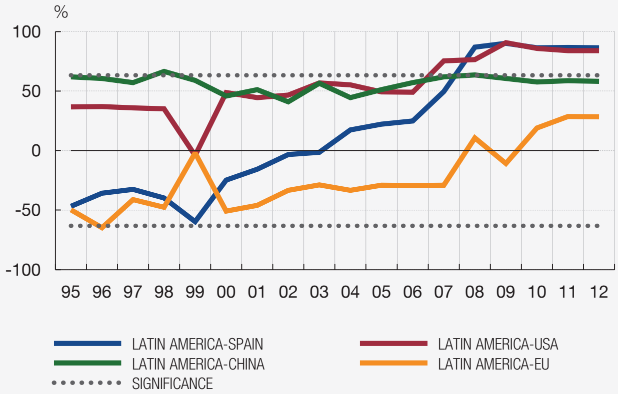
SOURCE: Banco de España.

a Estimated from the cyclical component of GDP extracted with a Hodrick-Prescott filter with a lambda of 6.7. The significant correlations are shown in bold and italics (calculated as ±2 / (t^0.5), t = the number of correlations).
b Aggregate of the seven main economies.

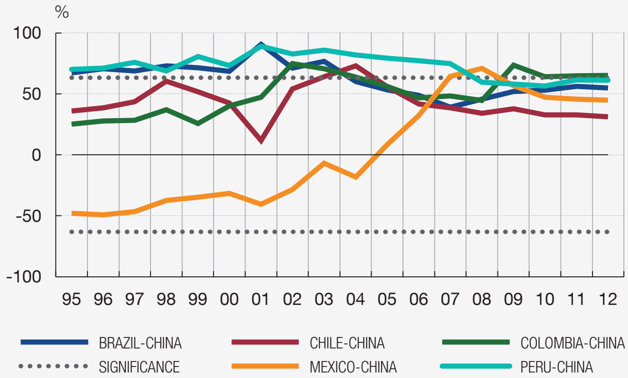
nally, the stabilisation (or slight decline) of the region's cyclical correlations with the three countries mentioned in the years following the crisis should be noted, which underlines the strong cyclical divergence recorded in the last years of the sample. The correlations with the European Union's cycle are not significant throughout the period examined.

The lower regional correlation of Latin America with China, and its non-significance, is a result of the bilateral correlation with Mexico, which until 2004 was even negative – this is logical taking into account that they compete in the same markets and in similar product ranges. By contrast, the correlation of China and Brazil's cycles is high from 2000 (50%), although it does not become sig-

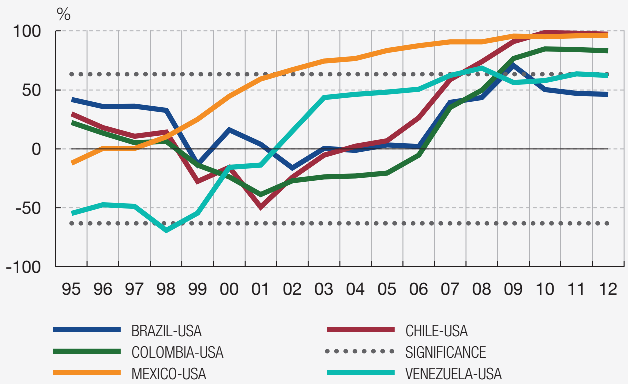
1 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



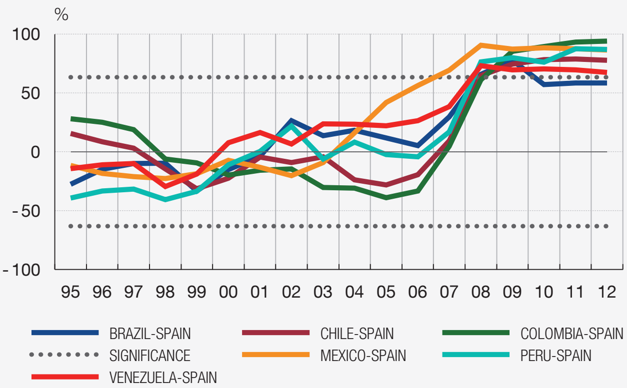
2 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



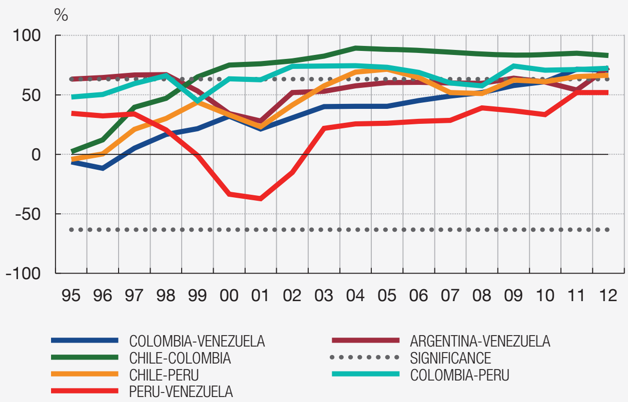
3 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



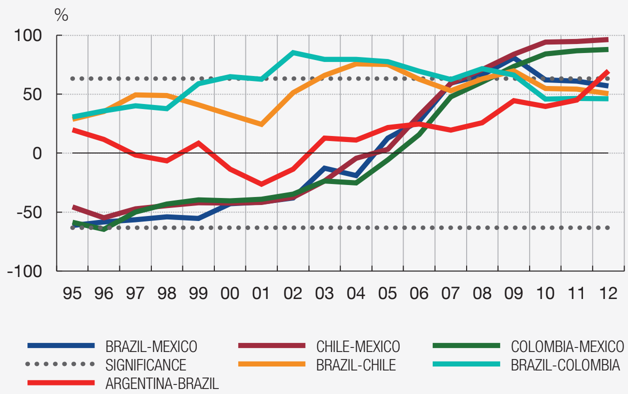
4 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



5 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



6 AVERAGE CORRELATIONS OF GDP CYCLICAL COMPONENT (TEN-YEAR WINDOW)



SOURCE: Banco de España.

nificant, which underlines the growing importance of China – already Brazil's main trading partner – even for those economies in the region which are more closed and have a more diversified commercial and productive structure. The United States shows significant positive correlations with almost all the countries in the region from 2006, which are particularly high (above 90%) in Chile and Mexico. This increase has tended to reverse partially in recent years on account of the cyclical divergences. Spain is a similar case: the cycle shows a growing correlation, albeit non-significant until 2008 with that of all the countries in the region (2006 in the case of México); from that year onwards, the correlations stabilise or decline slightly. Lastly, in the lower panels the cyclical correlations between the most representative countries in the region are presented. For the Andean countries, most of the correlations increase over time, reaching a significant level from 1995, which is higher towards the end of the period examined. This reflects how they have redirected their trade to the most dynamic area of growth in the world, the Pacific basin. As for the two largest economies in the region, Mexico and Brazil, the opposite trend is noteworthy in the correlations. There is an increase in Mexico's correlations to the point of being significant with the Andean countries more oriented towards Asia, and Brazil's correlations fall to the point of losing significance from the crisis onwards, which may have been affected by its different degree of productive specialisation. Finally, it is also worth pointing out the gradual increase in the cyclical correlation between the two big MERCOSUR economies (Argentina and Brazil), which in any event only becomes significant at the end of the sample.

In short, the processes of openness to foreign trade and strengthening intra-regional trade have given rise to greater synchrony both between Latin American countries themselves and with other major players in world trade, and in many cases, outperforming the traditional relationship with the United States. The cyclical synchrony with Spain has also risen as a result of the large presence of Spanish firms in the region, although from the crisis onwards it has stabilised or tended to decline. An increase in cyclical synchrony implies a higher impact of both positive and negative external events on the region's activity, either directly (high bilateral correlations with the United States, the EU or Spain) and indirectly (countries with a low correlation with the above-mentioned blocks but a high correlation with Brazil, for example, which is indeed highly interrelated with China and the United States).

tending to ease, there was a further expansionary turn in the monetary policies of these countries. In the US, at its December meeting the Federal Open Market Committee decided to continue to purchase treasury securities and agency mortgage-backed securities. More recently, the Bank of Japan introduced a substantial change into its expansionary strategy, with the adoption of the monetary base as its operating target, which is projected to double within a two-year horizon.

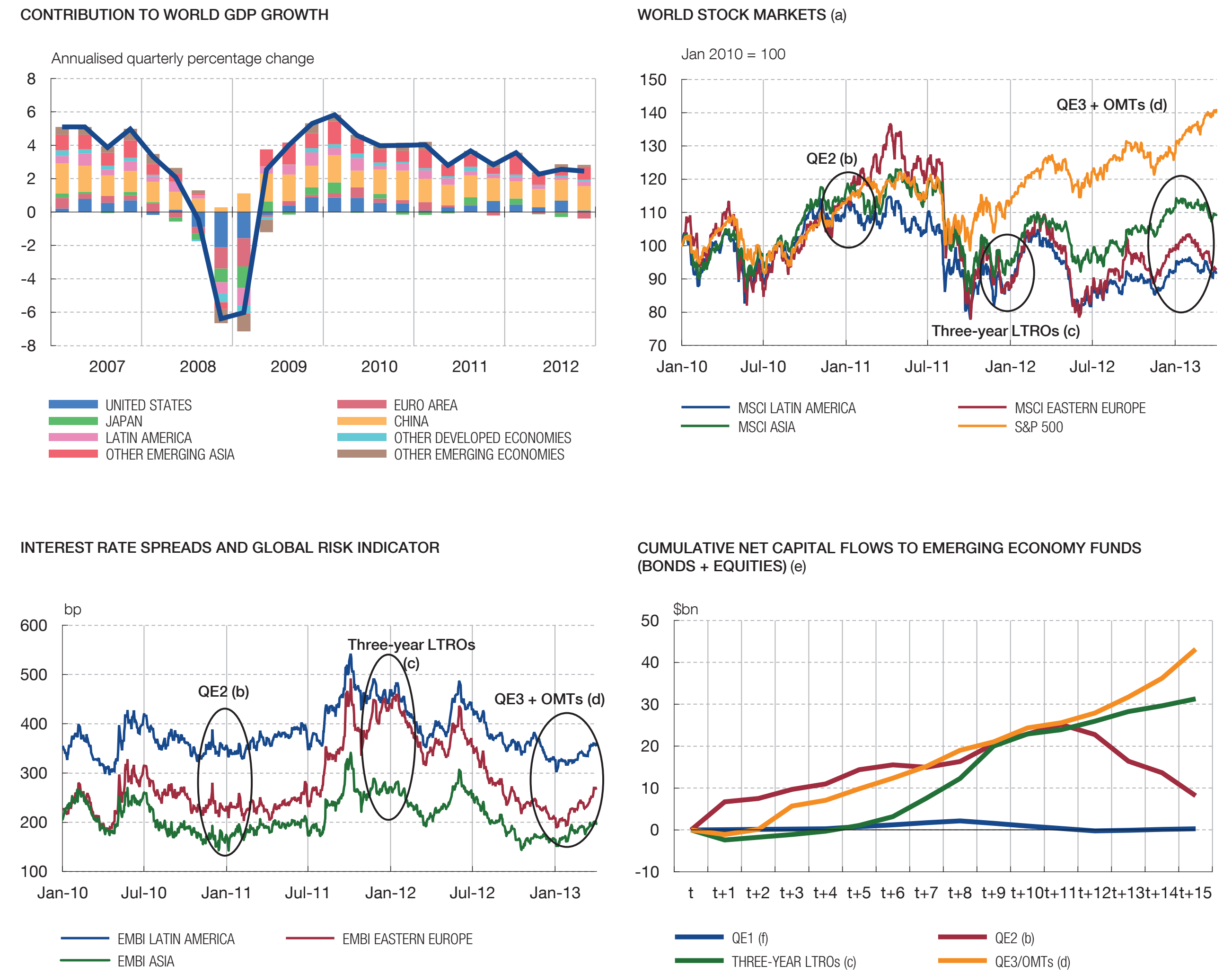
Against this background, the emerging economies recovered moderately in 2012 Q4, following the sluggishness experienced mid-2012 which was linked to weakening world demand. In particular, doubts were dispelled about the strength of the slowdown in China where the recovery seems to have taken root.

The latest economic indicators point to a continuation of the gradual strengthening of activity, albeit with considerable cross-regional differences: the notable buoyancy in emerging Asia and the marked weakness in emerging Europe should be underlined. Inflation remained stable or even tended to ease in some countries in Asia, and some declines in rates were recorded to a greater extent in emerging Europe.

The favourable performance on international financial markets improved further in 2012 Q4, in a setting of greater risk appetite, which was reflected in rises in stock markets, declines in credit risk premia and a strong increase in debt issuance in higher-risk segments. This improvement moderated from mid-February 2013, with the rising uncertainty about the election results in Italy and the difficulties involved in bailing out the Cypriot economy, which negatively impacted stock markets and European credit risk indicators while the US stock market reached a historical high. In the foreign exchange markets the yen depreciated strongly,

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Annualised quarterly rate, indices, basis points and billions of US dollars

CHART 2



SOURCES: National statistics, Dealogic, EPFR and Datastream.

a Indices in dollars.
b Second phase of Federal Reserve quantitative easing (3 November 2010).
c ECB longer-term refinancing operations (8 December 2011).
d Third phase of Federal Reserve quantitative easing (13 September 2012) and announcement of ECB outright monetary transactions (second week of September 2012).
e Weeks since the measure was announced.
f First phase of Federal Reserve quantitative easing (25 November 2008).

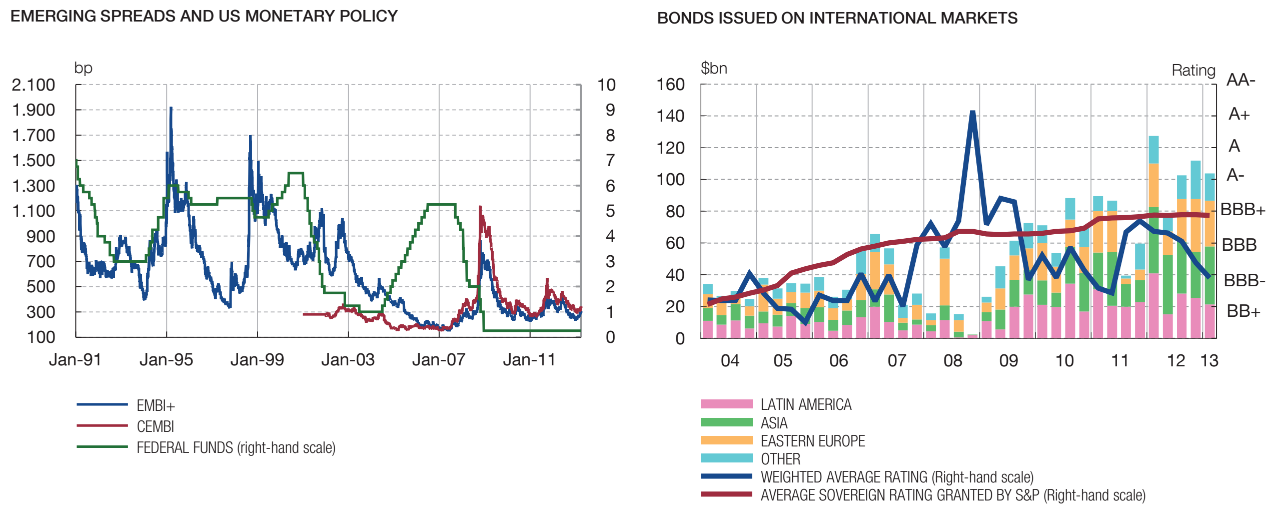
boosted by the expansionary economic policy stance after the new Government took office. As for commodities, the price of Brent oil fluctuated around $110/barrel in the second half of the year, whereas metal and food prices generally trended downwards.

Emerging markets improved substantially over the course of the last six months, although from the beginning of 2013 they have performed comparatively worse than industrialised ones. Bond issues on international markets increased rapidly from September (Chart 3) and reached their peak for 2012, as a whole. This robust rate of issuance continued in 2013 Q1, especially in January, when countries with very limited access returned to the markets or tapped them for the first time, although this has come to a significant halt in recent weeks.

The narrowing of spreads, the strong rise in issuance and the tapping of the market by sporadic issuers pose the risk that excessively optimistic valuations may be being reached

SOVEREIGN SPREADS AND BOND ISSUES
Basis points and billions of US dollars

CHART 3



SOURCES: Datastream, IMF, Dealogic and JP Morgan.

in these markets. As an attenuating factor, it should be pointed out that fundamentals, in general, are sound in emerging economies and the conditions of issuance have not been relaxed as much as in previous growth cycles. Thus, the average weighted rating of recent issues continued to range from BBB to BBB+, between one and two notches above those seen in 2010 and at the beginning of 2011, close to the average sovereign rating of emerging economies (see Chart 3). The exchange rates of emerging economies with deeper markets have appreciated more moderately than in previous times, while the sovereign and corporate spreads held above the lows recorded in 2007 (see Chart 2).

Financial markets and external financing

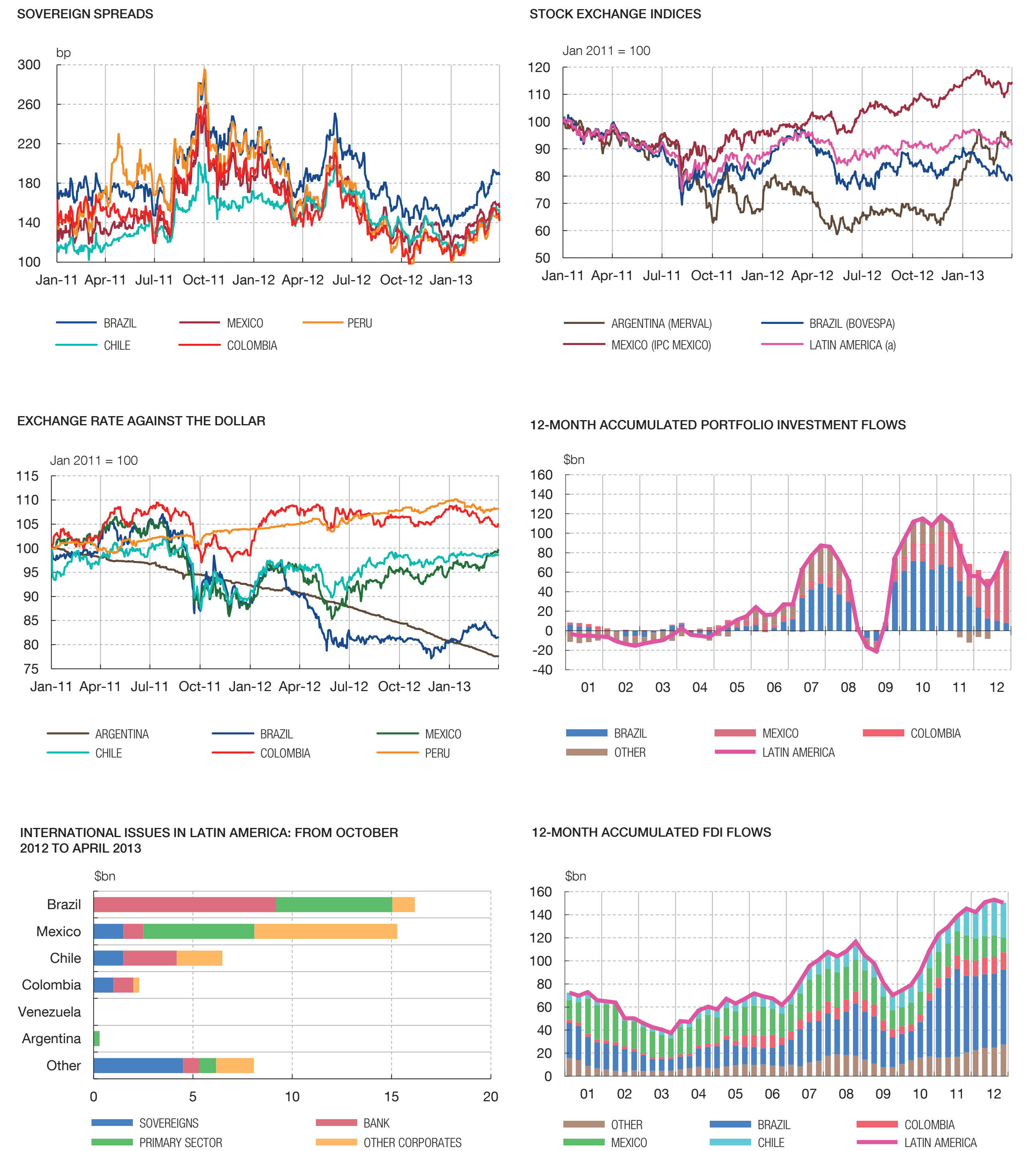
The markets of the Latin American economies have performed similarly to other emerging markets, with some exceptions. Thus, sovereign spreads narrowed slightly between November and the beginning of January, but subsequently widened, influenced by global developments and idiosyncratic factors.

Initially, the narrowing of the aggregate spread was almost solely attributable to the performance of the higher risk countries – Argentina, Venezuela and Ecuador –, since the other countries posted a slight widening (see Chart 4). However, the three aforementioned countries continued to show very high risk indicators. In the case of Argentina, this was above 900 bp, and at the end of the period, above 1,200 bp, as a result of the increased probability of default due to the decision of the courts in New York about debt restructured in 2005. In Venezuela fluctuations in the sovereign spread were linked to political events there: the elections held in October 2012, the subsequent death of the president and the elections called and resolved in April this year. The widening of spreads from mid-February 2013 was across the board, more so in Brazil, possibly owing to the sluggishness of the economy and worse-than-expected inflation developments.

The Latin American stock markets generally rose to end-January 2013: by 12.4% in Mexico, partly due to expectations of reform generated by the new Government; by 5.2% in Brazil and by 6.2% in Chile. They subsequently posted declines (of around 5%-6%), in line with the performance of other emerging markets, albeit lower than those in eastern Europe. Brazil's stock market recorded the highest fall while Mexico's remained stable,

EXTERNAL CAPITAL FLOWS AND FINANCING
Basis points, indices and billions of US dollars

CHART 4



SOURCES: Datastream, Dealogic, JPMorgan, IMF and national statistics.

a Latin American MSCI index in local currency.

although with some volatility, influenced by the measures adopted by the Government in the real estate sector and by the expectations about the telecommunications reform.

Finally, the region’s exchange rates performed unevenly, with a strong appreciation in Mexico (6.6% between November 2012 and March 2013) and greater volatility in the case of Brazil, whose currency, following a sharp depreciation before the end of the year and a subsequent recovery, held in real effective terms at similar levels to those in mid-2009, and 15% lower than its level at the beginning of 2011 (see Chart 4). In other less deep markets which have attracted capital in recent months such as those in Peru or Colombia, the currency appreciated (by 2.5% and 3.5%, respectively), which was later reversed after the central banks stepped up their interventions (see Chart 4).

The Latin American economies have continued to record strong foreign direct investment inflows, close to historical highs ($150 billion per year) (see Chart 4). Noteworthy are the inflows into Brazil and Chile – with historical highs in Chile due to the mining sector – which offset the reduction of inflows in Mexico. Portfolio inflows were lower than in previous years (40% down on the highs of 2010 and 2011), and the breakdown by destination changed, increasing to highs in Mexico and moderating very significantly in Brazil (see Box 2). In 2012, bond issues in the region peaked in the corporate segment in some countries, in a market dominated by issuance by Brazilian banks and companies in the primary sector (see Chart 4). Particularly of note are the smaller countries (grouped in the chart under the heading "other"), on account of the sovereign placements of central American countries (El Salvador, Guatemala and Costa Rica) and others with very limited access to these markets to date (Honduras and Paraguay).

Activity and demand

After bottoming out at a year-on-year growth rate of 2.4% in 2012 Q3, the aggregate GDP for the seven main economies in the region recovered moderately in Q4 to 2.8% (see Table 1). In quarter-on-quarter terms, the increase was 0.9% compared with 0.4% recorded in Q2 and Q3 (see Chart 5). The average annual growth rate in 2012 stood at 2.9%, the lowest since 2009, although this average is not very representative of developments in the various Latin American countries due to growing polarisation. Thus, Argentina and Brazil recorded very low growth rates in the year as a whole (1.9% and 0.9%, respectively), with a timid recovery in Q4, while at the opposite end of the scale, Peru grew by 6.3%, and Chile and Venezuela by 5.6%, ending the year with equally sound rates of increase. Mexico and Colombia were in an intermediate position with annual growth of 3.9% and 4%, respectively, which moderated somewhat in Q2.

Of the demand components, private consumption continued to post robust growth rates across the board (averaging 3.9% per year for the seven main economies), while investment, – which was expected to have recovered in 2012 – ended the year with average growth of 2.7% year-on-year, compared with 8.5% in 2011 (see Chart 6). This growth rate masks falls of 4% in Brazil and of 4.9% in Argentina, two of the economies with the largest weight in the regional aggregate, compared with growth rates of 23% in Venezuela, of more than 12% in Chile and Peru, and of around 6% in Colombia and Mexico. Given the low investment to GDP ratio in Brazil (18%), the weakness of this component against a favourable global backdrop is striking (see the section on Brazil below). In Argentina, the fall in investment was linked to the import restrictions and capital controls imposed. By contrast, in Chile and Peru gross capital formation in relation to investment in the mining sector increased considerably in a context of solvent macroeconomic management and in Peru it was perceived that structural reforms had received a greater boost.

The negative contribution of external demand to regional growth was halved in the year as a whole (-0.8%) (see Chart 6). Exports slowed (by 1.5% year-on-year in 2012, compared with 6.3% in 2011), in line with world trade grinding to a halt mid-year, and with the decrease in the terms of trade in several countries, which affected commodities exporters more, particularly Argentina. Mexico, by contrast, the region's main exporter, performed

In the years that have elapsed since the global financial crisis, most Latin American economies have attracted a large amount of international financial flows which have tended to put upward pressure on exchange rates. In mid-2012, in Brazil, Mexico, Chile, Colombia and Peru, as a whole, gross non-residents' investment amounted to $250 billion, equivalent to 5.7% of the five countries' aggregate GDP and in net terms (minus residents' investment abroad), to $160 billion, 3.6% of GDP.[1] The capital inflows are associated with external factors and idiosyncratic structural ones. High international liquidity has triggered sizeable flows as a result, among other reasons, of greater risk appetite and carry trade operations targeting economies with high interest rate spreads like the Latin American ones. Furthermore, this situation has coincided with the favourable outlook for growth in the region's economies – especially compared with that in the advanced economies – which is linked, among other causes, to the high price of commodities and the improvement in institutional frameworks and in economic policy.

As a result of the large inflow of capital and the emergence of certain macroeconomic imbalances, the authorities have responded with a combination of monetary and macroprudential policies and, in some cases, even with capital controls in an attempt to manage capital inflows and to contain their potential adverse effects, particularly those related to more volatile short-term flows. This box analyses recent developments in capital flows and the strategies for managing them in the five Latin American countries with inflation-targeting regimes. Also, the recent behaviour of exchange rates, the rotation of flows between countries and changes in the process of accumulating reserves are discussed.

The most significant case in the region is Brazil. Since mid-2009, Brazil's economy recorded a notable net capital inflow, which peaked in mid-2011 at $125 billion (5% of GDP), exceeding pre-crisis levels (see Panel). Despite growing foreign direct investment, this boom mainly took the shape of an increase in portfolio investment flows which reached $72 billion (2% of GDP) in 2010 Q2 and held at equally high levels for more than a year. From 2009 to mid-2011, the Brazilian real appreciated by 40%, reaching a historical high of around 1.55 reales per dollar. This appreciation prompted the authorities to implement a series of countercyclical measures in a setting in which the upward trend in inflation imposed a considerable dilemma for monetary policy. Thus, the purchase of foreign reserves quickened – with a cumulative increase in one year of $91 billion in August 2011, 2.2% of GDP – and a series of macroprudential measures were adopted such as bank reserves and capital requirements, and capital controls, which included most notably the increase and extension of the tax on cross-border financial operations. From mid-2011, net capital inflows gradually declined to $74.6 billion (3.5% of GDP) at the end of 2012. Particularly noteworthy was the decrease in inflows of portfolio investment which fell back to less than $20 billion from 2012 Q1. At the same time, domestic credit began to slow down. In mid-2011, the central bank began a process of official interest rate cuts faced with the early signs that the expansionary cycle of activity was waning, and subsequently began to reduce the tax on cross-border financial transactions and several of the macroprudential measures imposed previously against a backdrop of lower upward pressure on the exchange rate. Since that date, the exchange rate has corrected by around 30%, the pace of accumulation of reserves has moderated very significantly ($19.2 billion, 0.9% of GDP, at end-2012) and the monetary policy dilemmas which had conditioned macroeconomic management in 2010 and 2011 have disappeared.

In Chile, Peru and Colombia, the appreciation of the exchange rate from 2009 was essentially linked to the improvement in the current account balance due to the increase in the terms of trade. These developments were accompanied by a sharp increase in net capital inflows throughout 2011, which began to be concentrated in portfolio investments and foreign loans reaching high levels in Chile (8.2% of GDP), Colombia (4.5% of GDP) and Peru (9.1% of GDP), a trend which continued in 2012 (see Panel). As a result of the foregoing, until 2011 the Chilean peso appreciated by 27%, the Colombian peso by 20% and the Peruvian sol by 13%.

The central banks have reacted differently to this appreciation. Specifically, in Chile measures to restrict flows from abroad have not been used to manage the capital inflows. The central bank has intervened very occasionally on the foreign exchange market and capital outflows were liberalised notably, which affect resident pension funds' investments abroad. Nor have capital control measures been adopted recently in Colombia, although the build-up of foreign reserves has stepped up. In Peru, by contrast, several macroprudential measures were adopted and some dissuasive measures on foreign-currency investments, such as the increase in bank reserves, restrictions on net foreign currency positions and the easing of the limits on capital outflows as well as the accumulation of reserves. Since then, Colombia and Chile's exchange rates have stabilised, albeit at relatively strong levels, while in Peru the appreciating trend has continued against a backdrop of a robust increase in foreign direct investment.

Mexico has faced a slightly different situation in the management of capital flows since the end of the crisis, given that its post-crisis economic outlook was weakened by its neighbour in the north. The exchange rate of the Mexican peso appreciated much less than the other currencies until the beginning of 2010 (by around 8%), against a backdrop of a reduction in the current account deficit and moderate net capital inflows, essentially in the form of direct investment (0.2% of GDP at end-2009). However, from 2010 net portfolio investment has increased considerably to reach $70 billion at end-2012 – 1.5% of GDP – a historical high (see Panel). The foregoing has resulted in a notable increase in foreign reserves.

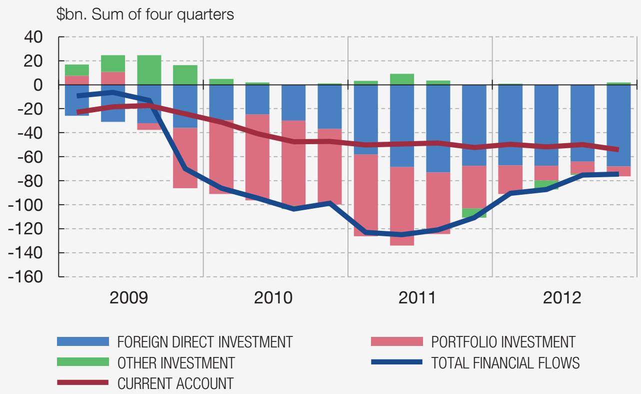
This is the case too for Chile, Colombia and, to a lesser degree, Peru, and the process seems to have intensified in 2012, coincid-

1 These figures are slightly lower than the peak in mid-2011, when gross inflows reached $343 billion (8% of the five countries' GDP) and net flows were $220 billion (5.2% of GDP), but they are higher than the previous cycle's peak at end-2007, when gross inflows stood at $225 billion (7.7% of GDP) and net inflows at $120 billion (4.1% of GDP).

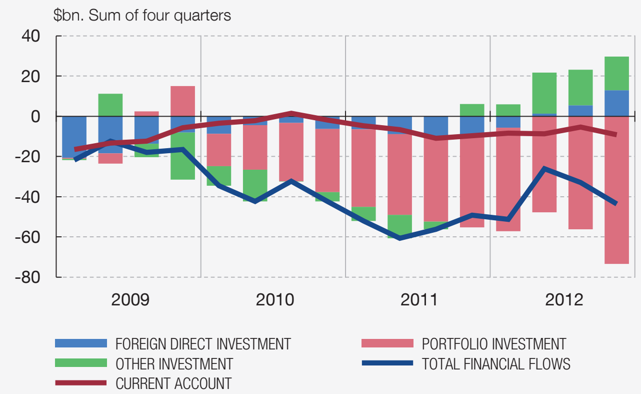
ing with the fall in net portfolio investment inflows in Brazil. Furthermore, in 2012, together with the above-mentioned increase in portfolio investment, in Mexico there was also a considerable rise in residents' investment abroad in the form of other investment which surely accounts for the exchange rate not having appreciated by as much as the high net inflows of portfolio investment would indicate.

It is difficult to assess whether or not the combination of measures adopted to contain the appreciation of the exchange rate in some

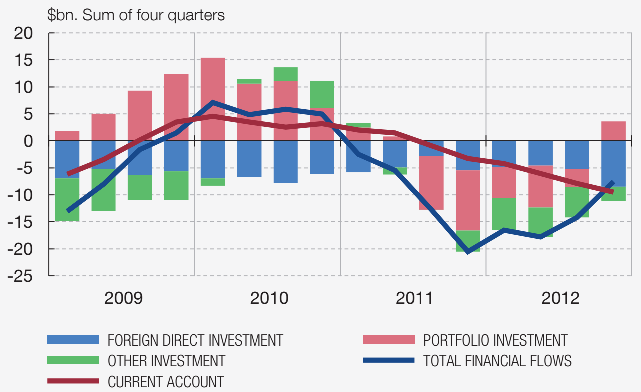
1 **BRAZIL** (a)



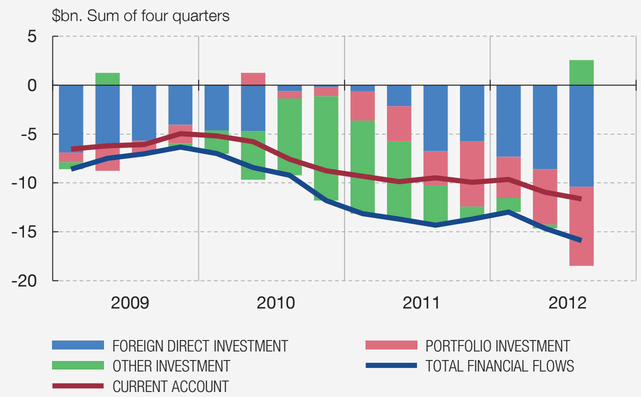
2 **MEXICO** (a)



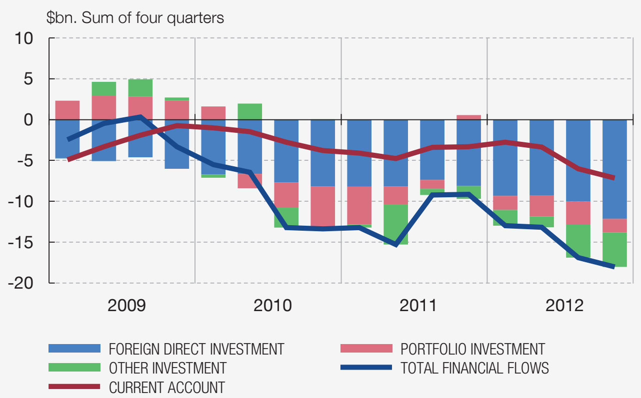
3 **CHILE** (a)



4 **COLOMBIA** (a)



5 **PERU** (a)



6 **EXCHANGE RATES AGAINST THE DOLLAR**

SOURCES: Datastream and IMF.

a The financial flows are calculated as the net change in assets minus the net change in liabilities, thus a negative sign indicates net inflows of capital. The current account balance is calculated as receipts minus payments and, consequently, a negative sign indicates a current account deficit.

countries, including capital controls, has been effective. Brazil has managed to reverse the post-crisis appreciation of the real – which may also have been in response to the interest rate cut, in turn facilitated by the dynamics of the slowdown in domestic activity – and also moderate credit growth. Furthermore, it has avoided the emergence of dilemmas which conditioned monetary policy in the years of greatest pressure brought to bear by capital flows. Baumann and Gallagher (2012)[2] support this argument and also show how the controls in Brazil contributed to shifting capital flows to longer-term investments; however, for Chile they do not find evidence of a change in the level and breakdown of foreign flows, although the interventions reduced the level of the exchange rate. Nevertheless, the introduction and withdrawal of capital controls could have had spillover effects in other countries. Forbes *et al.* (2011)[3] find that the controls imposed in Brazil triggered a reduction in the weight in investors' portfolios both for Brazil and for other countries which, although they had not established controls, they are considered liable to do so. This result is telling, since it seems to demonstrate that investors do not only react to the cost *per se* imposed by capital controls on their investments but it is rather the signalling of policy stance which takes precedence in their decisions. Lambert *et al.* (2011)[4] find the same type of effect and argue that the rise in the transaction tax in Brazil accounts for a large portion of the increase in portfolio inflows into Mexico in the subsequent period which suggests the existence of financial shift and spillover effects within the region.

2 B. A. Baumann and K. P. Gallagher (2012), *Navigating Capital Flows in Brazil and Chile,* Boston University Working Paper, June.

3 K. Forbes, M. Fratzschwer, T. Kostka and R. Starub (2011), "Bubble Thy Neighbor: Direct and Spillover Effects of Capital Controls", 12th Jacques Polak Annual Research Conference, IMF, Washington DC, 10-11 November.

4 F. Lambert, J. Ramos-Tallada and C. Rebillard (2011), *Capital Controls and Spillover Effects: Evidence from Latin-American Countries,* Bank of France Working Paper No. 357, Paris, France.

better with growth in the year of 4.6%. Nevertheless, there was an even larger and relatively widespread slowdown in imports with respect to the previous year (3.5% year-on-year in 2012, as against 11.4% in 2011), which may be partly attributable to the moderation of domestic demand in some countries, but also to an adjustment towards more sustainable growth rates following the extraordinary rise in imports in the last three years; for instance, in Colombia and in Brazil imports in 2012 were between 40% and 45% above their peak in 2008. The main exceptions in this regard were Venezuela and Peru.

The labour market situation remained highly favourable with generally sound job creation and unemployment rates close to their lows in most countries (see Chart 7). In certain cases there was some pressure on the side of wage costs. Credit, which had caused some concern due to its rapid growth in 2010 and 2011, tended to ease, while the higher frequency indicators (retail sales and consumer and business confidence) continue to indicate (with some exceptions) considerably sound domestic demand at the beginning of 2013 and, conversely, few signs of a recovery in industrial production, the regional average for which has held stable since the beginning of 2012.

Finally, against a backdrop marked by the stabilisation or even slightly downward trend in the prices of some commodities (metals, food), the regional trade surplus narrowed considerably to 1.4% of GDP at year-end (see Chart 8), compared with 2.1% in 2011. In nominal terms both exports and imports, which had slowed sharply since mid-2011, bottomed out and growth stabilised at very low rates. Except for Argentina, where the trade surplus widened as a result of the administrative measures adopted, the trade balance fell in all the countries and particularly notably in Chile (1.2% of GDP), in Peru (2.2%) and, to a lesser degree, in Brazil (0.9%). The average current account deficit for the region continued to widen to 1.5% of regional GDP, and, accordingly, all the countries analysed, except for Venezuela, posted negative balances in 2012. In Colombia, Chile and Peru the current account deficit stood at around 3.5% of GDP, and at 2.5% in Brazil. This deterioration can be explained essentially by the trade and services balances since although there is a deficit on the income balance, in practically all the countries, it has stabilised in the last year.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

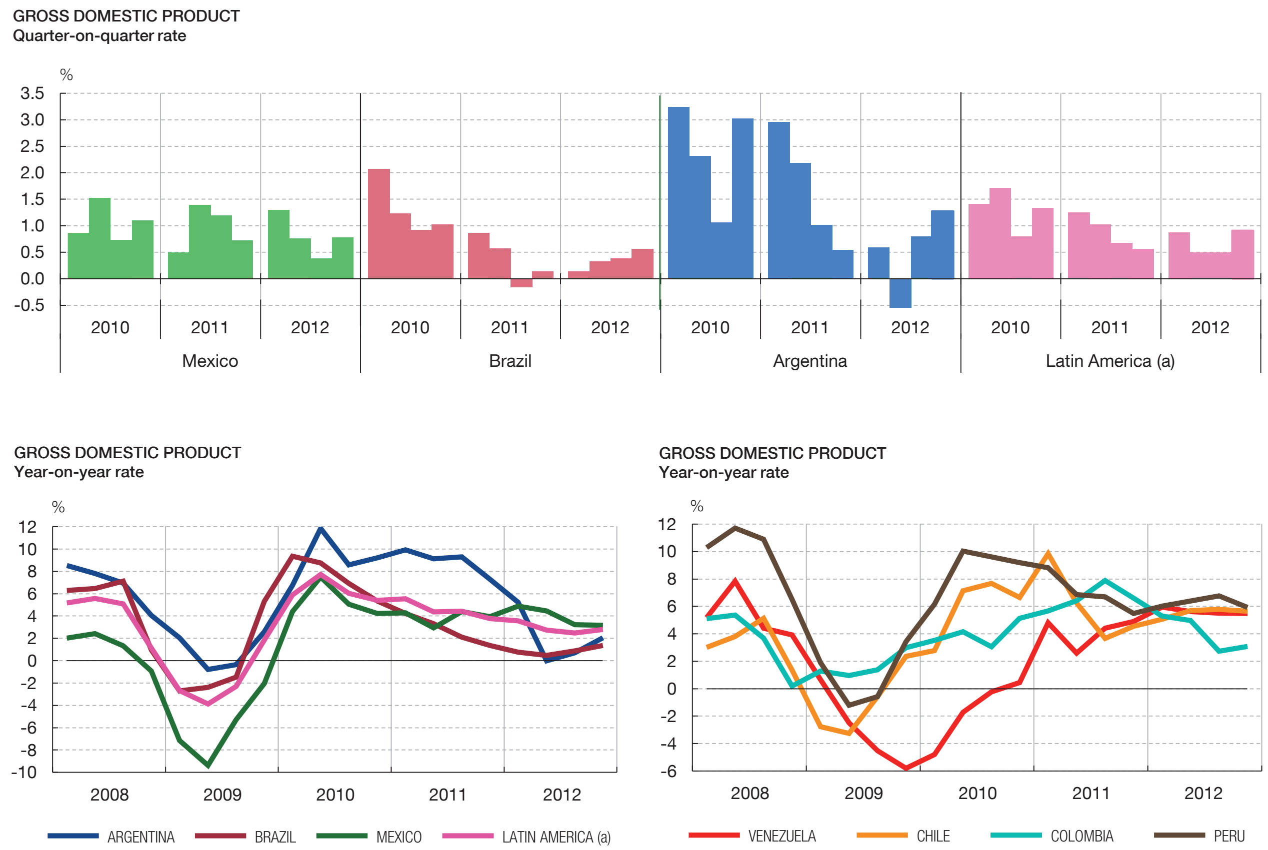
	2010	2011	2012	2011				2012				2013
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	March
GDP (year-on-year rate)												
Latin America (a)	6.3	4.5	2.9	5.6	4.4	4.4	3.8	3.6	2.7	2.5	2.8	
Argentina (b)	9.2	8.9	1.9	9.9	9.1	9.3	7.3	5.2	0.0	0.7	2.1	
Brazil	7.5	2.7	0.9	4.2	3.3	2.1	1.4	0.8	0.5	0.9	1.4	
Mexico	5.3	3.9	3.9	4.3	2.9	4.4	3.9	4.9	4.5	3.2	3.2	
Chile	5.8	5.9	5.6	9.9	6.3	3.7	4.5	5.1	5.7	5.8	5.7	
Colombia (c)	4.0	6.6	4.0	5.7	6.4	7.9	6.6	5.3	5.0	2.7	3.1	
Venezuela	-1.5	4.2	5.6	4.8	2.6	4.4	4.9	5.9	5.6	5.5	5.5	
Peru	8.8	6.9	6.3	8.8	6.9	6.7	5.5	6.0	6.4	6.8	5.9	
CPI (year-on-year rate)												
Latin America (a)	6.3	6.8	6.2	6.7	6.6	6.9	7.0	6.6	6.1	6.1	6.1	6.7
Argentina (b)	10.5	9.8	10.0	10.1	9.7	9.8	9.6	9.7	9.9	10.0	10.6	10.6
Brazil	5.0	6.6	5.4	6.1	6.6	7.1	6.7	5.8	5.0	5.2	5.6	6.6
Mexico	4.2	3.4	4.1	3.5	3.3	3.4	3.5	3.9	3.9	4.6	4.1	4.3
Chile	1.4	3.3	3.0	2.9	3.3	3.1	4.0	4.1	3.1	2.6	2.2	1.5
Colombia	2.3	3.4	3.2	3.3	3.0	3.5	3.9	3.5	3.4	3.1	2.8	1.9
Venezuela	29.0	27.2	21.1	29.1	24.6	26.5	28.5	25.1	22.3	19.0	18.8	24.2
Peru	1.5	3.4	3.7	2.4	3.1	3.5	4.5	4.2	4.1	3.5	2.8	2.6
Budget balance (% of GDP) (d)												
Latin America (a) (e)	-2.2	-2.1	-2.3	-1.8	-1.6	-1.7	-2.1	-2.0	-1.8	-1.9	-2.1	
Argentina	0.2	-1.7	-2.6	0.2	0.0	-0.4	-1.6	-1.9	-1.7	-1.9	-2.4	
Brazil	-2.5	-2.6	-2.5	-2.3	-2.1	-2.5	-2.6	-2.4	-2.6	-2.8	-2.5	
Mexico	-2.9	-2.5	-2.6	-2.8	-2.8	-2.6	-2.4	-2.7	-2.4	-2.2	-2.5	
Chile	-0.3	1.5	0.6	1.0	1.4	2.0	1.5	1.6	1.2	0.4	0.6	
Colombia	-3.6	-2.0	-1.9	-2.9	-1.5	-1.4	-2.1	-2.5	-1.0	-1.2	-1.9	
Venezuela	-3.8	-4.0	-4.9	—	—	—	—	—	—	—	—	
Peru	0.1	0.9	1.3	0.4	0.3	0.9	0.9	1.3	2.4	1.6	1.3	
Public debt (% of GDP)												
Latin America (a)	33.4	32.1	—	33.0	32.9	32.3	32.1	32.2	31.3	—	—	
Argentina	39.9	36.8	—	44.8	42.9	40.8	40.2	39.7	39.5	—	—	
Brazil	39.2	36.4	35.1	38.9	38.6	36.3	36.4	36.5	35.2	35.5	35.1	
Mexico	27.5	26.5	27.8	27.1	26.9	27.6	26.5	28.1	28.0	28.3	27.8	
Chile	8.6	11.2	16.5	9.0	9.4	10.6	11.2	11.2	11.6	11.5	16.5	
Colombia	35.0	33.8	32.2	35.0	33.2	34.1	33.8	32.9	32.4	32.4	32.2	
Venezuela	28.1	25.1	—	25.1	31.5	34.7	36.6	35.1	—	—	—	
Peru	23.4	21.7	20.2	22.4	21.7	20.9	21.7	20.7	20.0	19.7	20.2	
Current account balance (% of GDP) (d)												
Latin America (a)	-0.9	-1.0	-1.5	-0.9	-0.9	-0.8	-1.0	-0.9	-1.1	-1.2	-1.5	
Argentina	0.8	-0.4	0.1	0.5	0.0	-0.2	-0.3	-0.2	-0.1	0.1	0.1	
Brazil	-2.2	-2.1	-2.4	-2.2	-2.1	-2.0	-2.1	-2.0	-2.2	-2.2	-2.4	
Mexico	-0.2	-0.8	-0.8	-0.4	-0.6	-0.9	-0.8	-0.7	-0.8	-0.5	-0.8	
Chile	1.5	-1.3	-3.5	0.8	0.6	-0.4	-1.3	-1.7	-2.4	-3.0	-3.5	
Colombia	-3.1	-2.9	-3.2	-3.0	-3.0	-2.8	-2.9	-2.6	-2.9	-3.1	-3.2	
Venezuela	3.7	7.7	2.7	5.0	6.8	8.3	8.3	7.8	6.8	5.2	3.7	
Peru	-2.5	-1.9	-3.6	-2.6	-2.9	-2.0	-1.9	-1.5	-1.8	-3.1	-3.6	
External debt (% of GDP)												
Latin America (a)	20.9	20.2	—	20.6	19.9	19.9	19.9	20.5	19.4	20.2	—	
Argentina	35.1	31.5	—	34.1	28.4	31.1	30.6	33.2	28.1	29.8	—	
Brazil	12.0	12.1	14.1	12.3	12.2	12.0	12.0	12.1	12.7	13.5	14.0	
Mexico	19.0	18.2	19.4	17.8	18.6	18.0	18.2	18.5	19.1	19.3	19.4	
Chile	38.9	39.5	43.9	39.8	39.8	38.6	39.5	39.4	40.0	42.0	43.9	
Colombia	22.4	22.9	21.6	20.6	20.9	21.7	22.9	21.1	20.9	21.9	21.6	
Venezuela	38.6	35.1	29.0	36.5	36.0	35.2	35.1	32.7	30.7	30.1	29.0	
Peru	26.4	24.4	29.3	28.1	27.9	27.6	26.9	28.6	28.7	29.7	29.3	

SOURCE: National statistics.

a Aggregate of the seven countries represented.
b Official figures.
c Seasonally adjusted.
d Four quarter moving average.
e The quarterly figures for the Latin American aggregate do not include Venezuela.

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

CHART 5



SOURCE: National statistics.

a Aggregate of the seven main economies.

In all the countries foreign direct investment continues to comfortably finance the current account deficit.

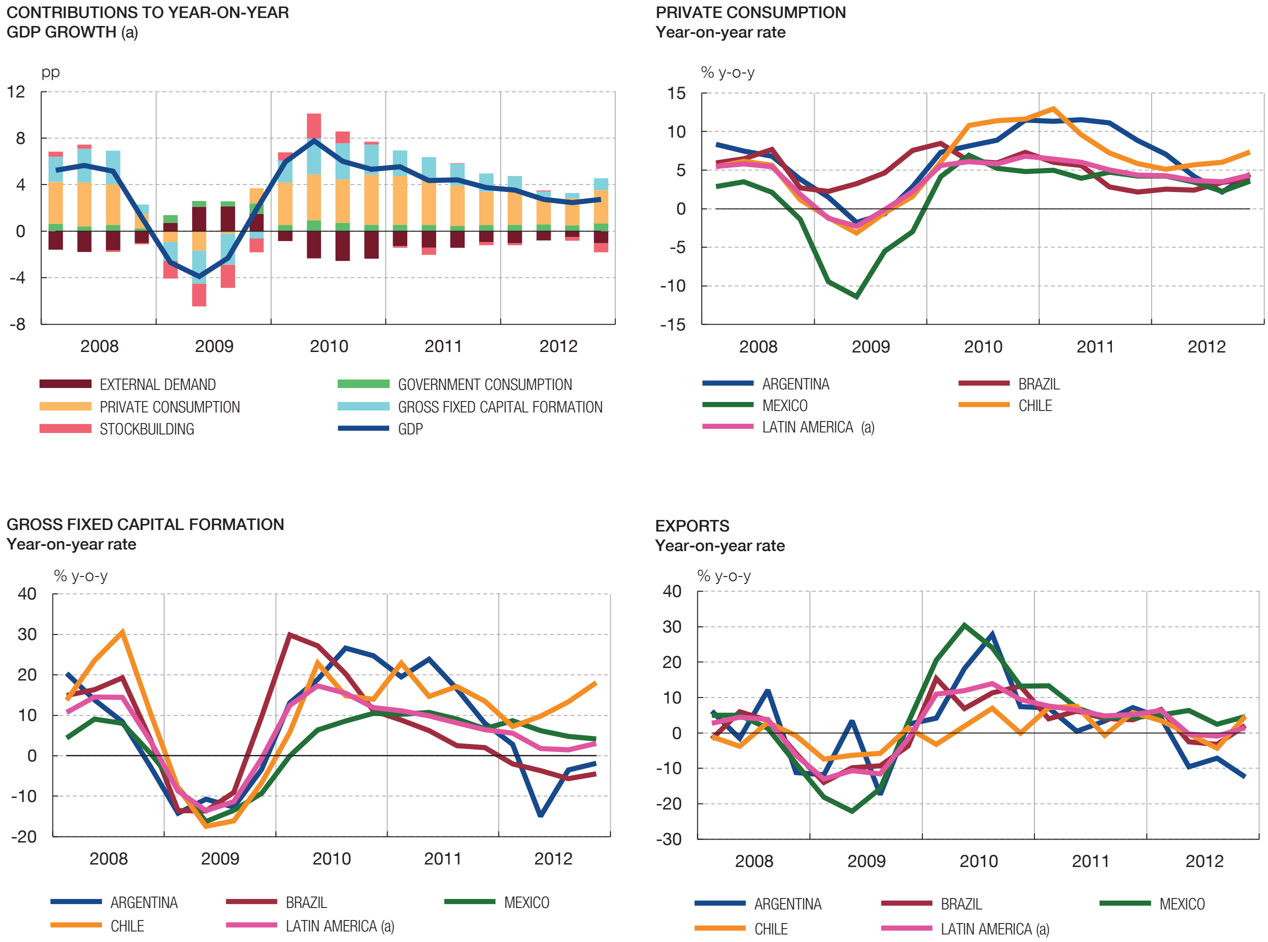
Prices and economic policies

The five countries with inflation targets achieved their objectives in 2012 (see Table 2). However, consumer price developments differed. In Mexico, Colombia, Peru and Chile, inflation tended to moderate particularly notably in the last quarter of the year (see Chart 9), and potential risks arising from vigorous domestic demand and a tight labour market did not materialise. The contrary is rather the case; the sound performance of inflation in a context of high growth vouches for the credibility of their macroeconomic policies, although the recent strong exchange rates may also have influenced developments, together with certain temporary factors which could prompt a slight rise in the coming months. By contrast, in Brazil inflation has tended to climb gradually but without interruption since summer as a result of the increase in food and services prices and despite the economic slackness. Thus, following a low of 5% in June, inflation stood at 5.8% in December and at 6.6% in March, slightly higher than the upper limit of the central bank's target band (6.5%).

In Argentina and Venezuela price dynamics followed a different course. In Argentina inflation reached 11.1% year-on-year in January, on official figures, and more than 26%, according to private estimates, moderating slightly to March. In Venezuela, the relative moderation seen at the end of last year to rates of 18.2% year-on-year, as a result of the

BREAKDOWN OF GDP AND INVESTMENT CHART 6

Year-on-year rates and percentage points



SOURCES: National statistics and IMF.

a Aggregate of the seven main economies.

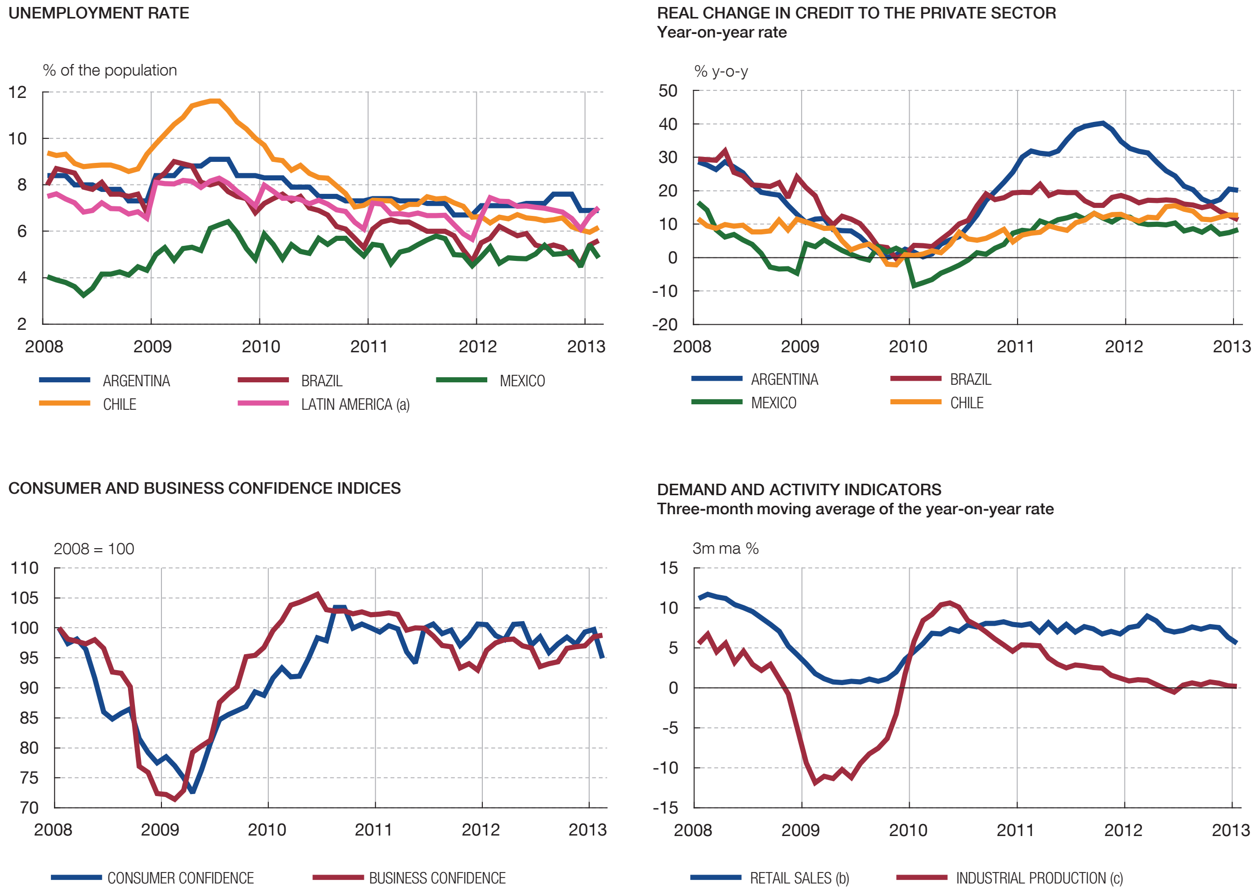
containment of subsidised and regulated prices, was interrupted at the beginning of 2013 due to the devaluation of the bolivar, which prompted inflation to rise to 24.2% in March.

In the countries with inflation targets monetary policy stance differed. In Chile and in Peru official interest rates held stable at 5% and 4.25%, respectively. In Colombia, by contrast, the deceleration of activity in the second half of the year allowed the cycle of official rate cuts to be stepped up, to 3.25% – a cumulative reduction of 200 bp from the high at the beginning of 2012 — against a backdrop of an appreciating exchange rate. Mexico also reduced the official rate in March by 50 bp to 4%, which had remained unaltered since July 2009. The Bank of Mexico justified this move as a response to a structural change in inflation developments (3.6% in December) and not as the beginning of a cycle of reductions. It is possible that the recent appreciation of the Mexican peso, in a setting of growing pressure on the portfolio flow side, has also contributed to explaining this decision, against a backdrop of wage cost restraint and anchoring of inflation expectations.

Lastly, the Central Bank of Brazil cut the official rate for the last time in October to 7.25%, ending a cycle of reductions of 525 bp in just over a year. Between November and December, a series of measures was also adopted aimed at releasing liquidity from the reserve requirements. However, inflation developments in recent months led markets to anticipate

EMPLOYMENT, DEMAND AND CREDIT INDICATORS
Percentages, indices and three-month moving average of the year-on-year rate

CHART 7



SOURCE: National statistics.

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

a change in cycle, in order to avoid long-term inflation expectations (which have risen to 5.6%, one point higher than the central target) from becoming disanchored. Accordingly, as this report went to press, the central bank raised the official interest rate by 25 bp to 7.50%.

Worth noting is that official interest rates in Brazil, Mexico and Colombia stood in March 2013 at levels very close to or even below the post-crisis lows of 2009, whereas in Peru and in Chile they are considerably higher. In fact, taking the ex-post real official interest rate as an indicator of monetary policy stance, Brazil is the country which maintained a comparatively looser stance, much more so than in 2009, whereas the stance is relatively tighter in Chile and Peru. Furthermore, in the case of Peru, the considerable rise in reserve requirements should also be considered.

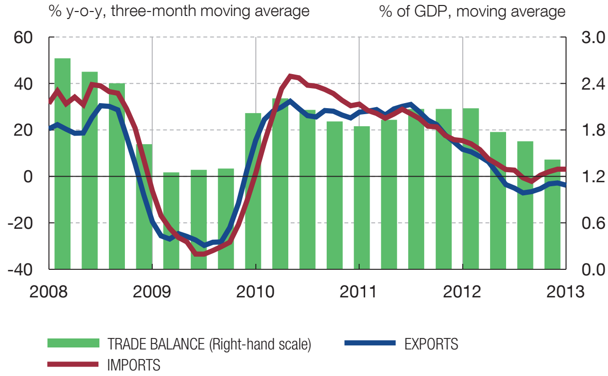
In the area of fiscal policy, there were also substantial cross-country divergences. The region's primary surplus continued to average 1% of GDP, but the total deficit increased to 2.3%, as a result of its performance in Argentina and Venezuela (see Chart 10). In Mexico, Chile, Peru and Colombia, fiscal policy adopted a neutral stance in 2012 and the deficit targets were met in all of these countries. In Brazil, the primary surplus stood at 3.1%, as projected, but only when certain investments are excluded. In Argentina the slowdown of

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

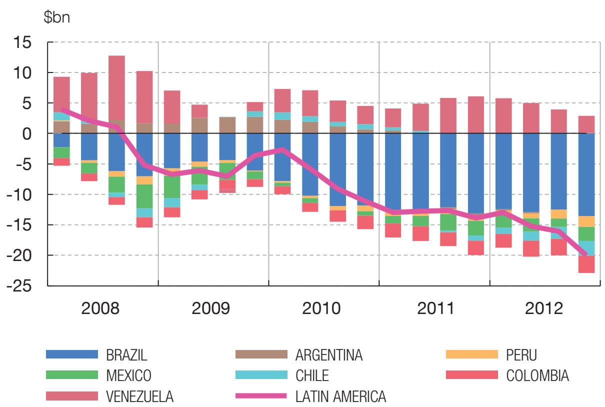
CHART 8

COMMODITIES PRICES
Indices

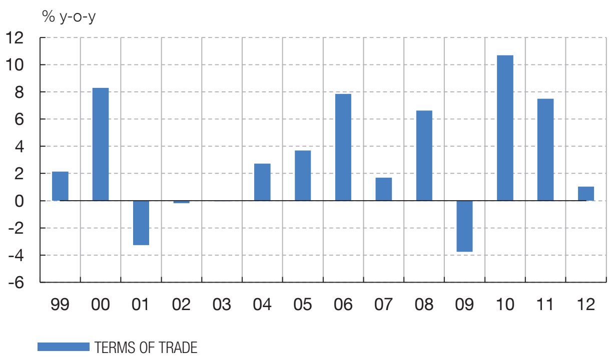
EXPORTS AND IMPORTS (a)
Year-on-year rate. Quarterly moving average. Percentage of GDP



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 estimates.

INFLATION
Year-on-year rates of change

TABLE 2

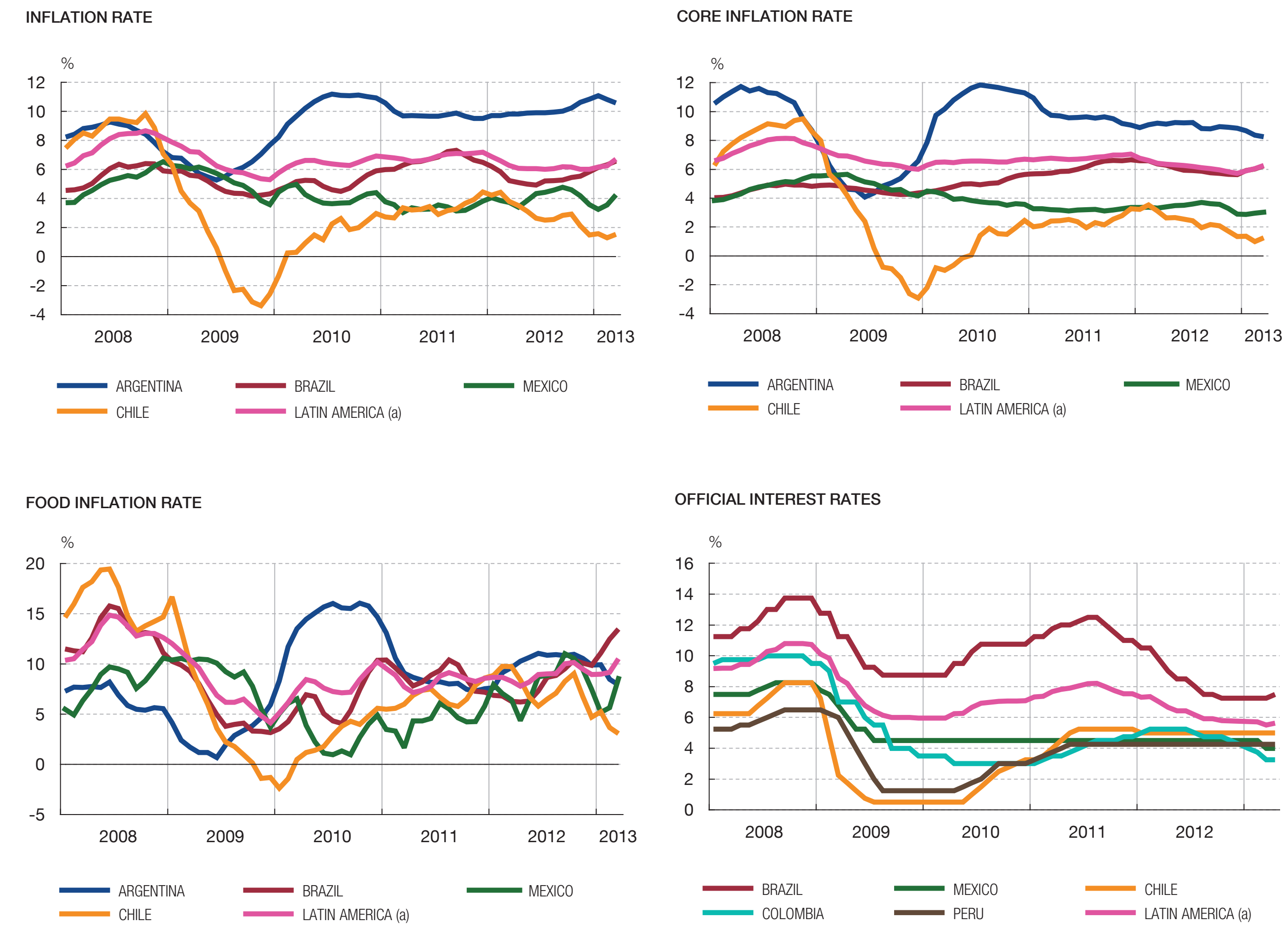
Country	2012 Target	2012 December	2012 Fulfillment	2013 March	2013 Expectations (a)	2014 Expectations (a)
Brazil	4.5 ± 2	5.8	Yes	6.6	5.6	5.5
Mexico	3 ± 1	3.6	Yes	4.3	3.7	3.8
Chile	3 ± 1	1.5	Yes	1.5	3.1	3.1
Colombia	3 ± 1	2.4	Yes	1.9	2.8	3.2
Peru	2 ± 1	2.6	Yes	2.6	2.7	2.6

SOURCES: National statistics and Consensus Forecasts.

a March 2013 Consensus Forecasts for the end of the year.

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

CHART 9



SOURCES: National statistics and Banco de España.

a Aggregate of the seven main economies.

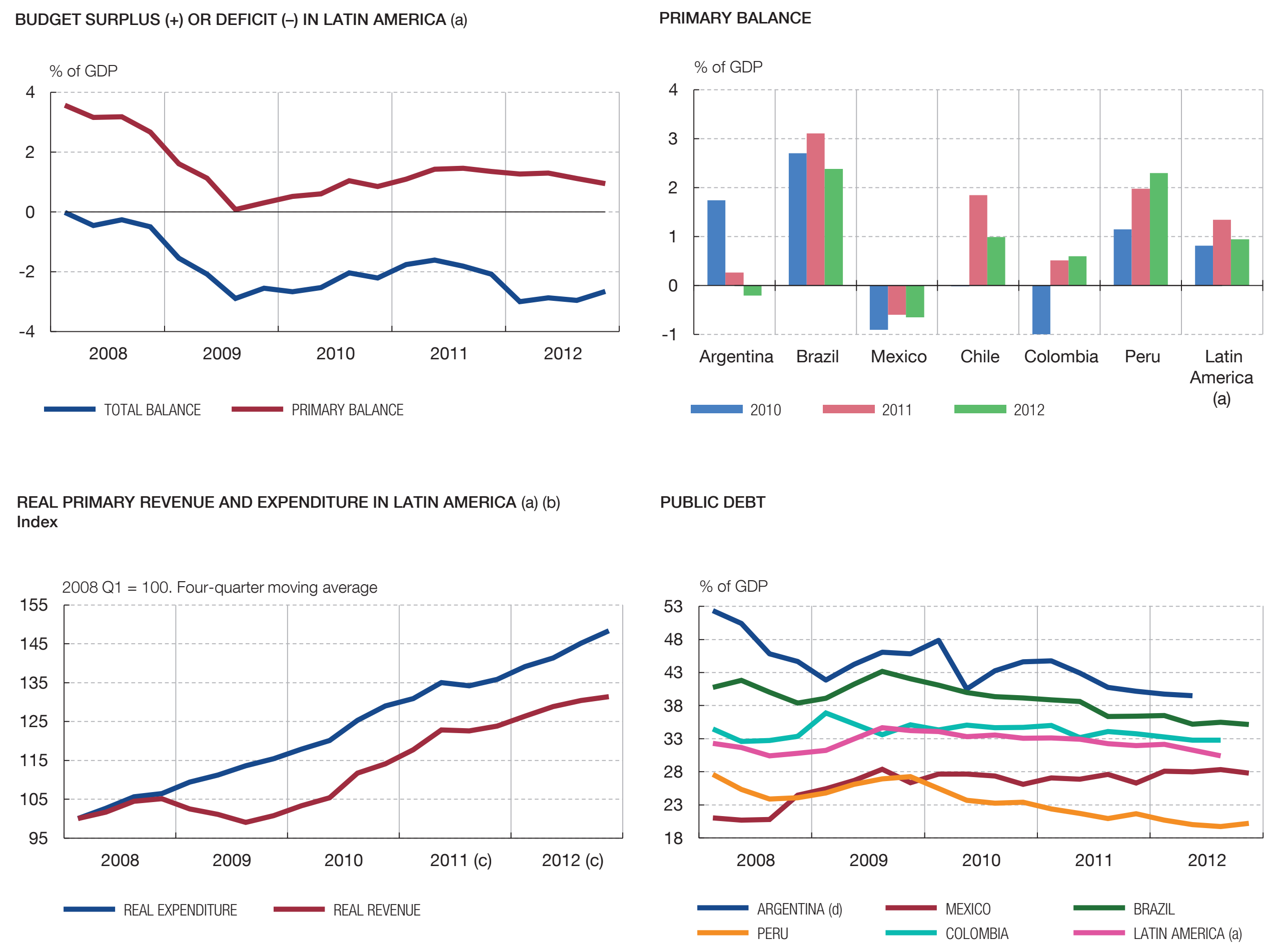
activity and the failure to adjust expenditure after the elections resulted in a primary deficit of 0.4%, the first since 1996, which would have been larger without the transfers of the central bank and the pension fund administrator, while in Venezuela, with the elections held at the end of last year, the government deficit reached very high levels. At regional level, revenue continued to increase at higher rates than expenditure and the debt-to-GDP ratios continued to decline, although there is some concern about the direct or indirect dependence of this revenue on commodities prices.

Trade and structural reforms

In the area of trade integration processes, Chile, Colombia, Peru and Mexico formed the Pacific Alliance, a new trade association which aims to phase out tariffs for more than 90% of the products exchanged between them from 31 March 2013. The US and Canadian free trade agreements with Panama, the EU free trade agreement with Peru and Colombia, and also the free trade agreements with Asian countries integrated into global production chains (Chile with Thailand, Costa Rica with Singapore and Colombia with South Korea) were ratified or came into operation. By contrast, within MERCOSUR, the protectionist trends seen earlier grew stronger. Argentina raised tariffs for more than 100 products from outside the bloc – a measure that Brazil had taken in preceding months; although it simultaneously reduced the obstacles for imports which had had a greater effect on foreign trade at the beginning of 2012, such as the non-automatic import licenses. The opening

MAIN PUBLIC SECTOR FIGURES
Percentage of GDP and index

CHART 10



SOURCES: IMF and national statistics.

a Seven largest economies.
b Deflated by the CPI.
c Aggregate excluding Venezuela.
d Excludes untendered debt in the debt swap offers of 2005 and 2010.

up of the bloc and its participation in global trade could be seriously compromised when the preferential tariffs granted by the European Union to Argentina, Brazil, Uruguay and Venezuela end at the beginning of 2014, and due to the lack of progress in negotiations with the European Union which have been gridlocked since 2011, especially if it confirmed that a free trade agreement has been signed by the United States and the European Union.

Mexico made most progress in the field of structural reforms. Thus, following the approval of a labour reform which includes new types of employment contracts to reduce the shadow labour market – and could raise potential GDP, according to some estimates, by between 0.25 pp and 0.5 pp over the horizon of the next five years – the new Government signed with the three large parties with parliamentary representation the “Pact for Mexico”, a broad raft of measures that will seemingly boost legislative changes in line with the recommendations of multilateral organisations to increase potential GDP. These measures are detailed in the section on Mexico.

In Colombia, a tax reform was approved with the aim of reducing the shadow labour market and, accordingly, business taxes on hiring were cut, low wages were exempted from paying income tax, VAT was simplified and the tax on foreign portfolio investment was reduced. Conversely, in Argentina laws were approved which increased public-sector interventionism in capital markets and insurance companies, and the Bolivian Government issued a decree for the expropriation of the airport concession holder, a subsidiary of the Spanish group Albertis, and of two electricity transmission companies belonging to Iberdrola.

Economic developments by country

BRAZIL

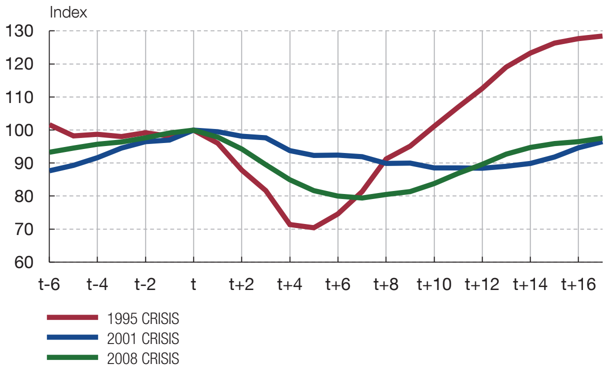
Growth continued to be lower than expected in the second half of 2012 (0.4% and 0.6%, in quarterly terms in Q3 and Q4), showing a very slow recovery, despite ongoing economic policy stimulus. In year-on-year terms growth in Q4 rose to 1.4%, but for 2012 as a whole it stood at 0.9%. By demand component, the recovery is somewhat unbalanced since it is based on growth of consumption with very weak investment. In fact, private consumption quickened over the year (to a year-on-year rate of 3.9% in Q4), underpinned by the strong labour market where the rate of unemployment stood at around 5.5% (0.5 pp down on 2011) and real wages grew once again by more than 3%. By contrast, the growth of consumer credit eased and consumer confidence indicators stood at their lowest level of the last five months. The growth rate of government consumption also increased. However, gross capital formation continued to act as a drag on the recovery since it showed no signs of improvement (-4.5% year-on-year in Q4 and -4.0% in 2012). Among the possible explanations (whose relative weight is difficult to assess) for this behaviour, mention was made of: the effect of the appreciation of the Brazilian real's exchange rate on the manufacturing sector in previous years; the post-crisis boom in investment (with growth of more than 22% in 2010); the tightening of monetary policy between 2010 and 2011; structural problems of various kinds (including substantial bottlenecks in infrastructures) and the perception of greater intervention in the economy, with a cost in terms of business expectations. As a result of the foregoing, growth remained unexpectedly low in Brazil, despite the monetary and fiscal stimulus. External demand contributed positively to growth in the second half of the year, mainly due to the moderation of imports, although its contribution over the year as a whole was practically zero. Inflation surprised on the upside in the second half of 2012 and the early months of 2013, and stood in March at 6.6% year-on-year, above the upper limit of the central bank's target band. The pressure on consumer prices has been linked to the higher cost of food, which could be temporary, as could be that of services (see Chart 11). In this context, monetary policy faces a complicated situation due to high inflation and low growth, with the result that tightening it could weaken even further the most fragile demand component (investment) or, alternatively loosening it could increase inflationary risks. Consequently, the official interest rate held stable from October at 7.25% (a historical low), following the intense monetary stimulus introduced from mid-2011 to mid-April, when it rose by 25 bp. The exchange rate tended to depreciate until end-2012, although it subsequently appreciated, influenced by the central bank's interventions and expectations of an increase in official interest rates. The lower pressure on the exchange rate in recent months permitted the loosening of the capital controls introduced previously and the reduction in the accumulation of reserves. The growth of internal lending to the private sector tended to slow, yet the "directed" credit remained at very high rates of increase and already represents 41% of total credit. The current account deficit climbed to $54 billion in 2012 (2.4% of GDP), faced with a lower goods surplus and a rising services deficit, although net direct investment flows (2.9% of GDP en 2012) are financing the external deficit. In the fiscal arena, the primary surplus target was met (3.1% of GDP), however, if the public investment projects removed from this target were included, the surplus would be 2.4%. The budget deficit stood at 2.5% of GDP, 0.1 pp down on 2011, due to the decline in the public sector's interest payments. The budget for 2013 maintains a primary surplus target of 3.1%, however, it allows up to 0.4% of GDP of tax relief in

BRAZIL AND MEXICO

CHART 11

BRAZIL. INFLATION AND UNIT LABOUR COSTS

MEXICO. PRIVATE INVESTMENT



SOURCE: Datastream.

addition to the investment projects to be excluded from this target. Accordingly, the protracted sluggishness of the economy has induced more proactive fiscal policy and some supply-side measures in recent months which include tax cuts for companies, aid for the automobile sector, a reduction in the financing costs of BNDES and the promotion of directed credit, and aid for exports. Other measures – considered more interventionist – were also introduced, including most notably a cut in electricity tariffs in order to ease pressure on consumer prices, tax breaks for some sectors and in March 2013 there was a reduction in the tax on the main items in the consumption basket. Recent activity indicators point to a slight recovery of the economy. However, since there is no precise diagnosis of the ultimate causes of weak investment, the effectiveness of the macroeconomic policies applied is uncertain.

MEXICO

The economy posted growth of 3.9% in 2012, similar to that in 2011, despite a slight slowdown during the second half of the year as a result of manufacturing and construction. In any event, on the demand side, investment was the most buoyant component in the year as a whole and grew by 5.9%, somewhat less than in 2011. Private consumption recorded annual growth of 3.3% and was held back in the second half of the year by: lower consumer credit growth (14% in real terms, compared with 17% in the early months of the year); a reduction in remittances measured both in pesos and dollars; and a labour market which, although it has shown an improvement, still has vulnerabilities stemming from the crisis (unemployment rate of around 5%, 1.5 pp up on 2008). Exports grew at an annual rate of 4.6%, among the highest in the region, but they weakened in Q3 as a result of the deterioration of the external environment. Imports grew at higher rates in Q4, turning the contribution from external demand moderately negative at year-end (0.2 pp). The higher frequency data point to the continuation of similar growth rates to those in Q4, with more buoyant consumption and slightly less dynamic investment. After inflation reached 4.8% year-on-year in September, on account of a supply-side shock in food prices, it began to moderate and stood at 3.6% in December, within the central bank's target band, where it remained until February and rose again to 4.3% in March owing to food prices. The core rate also fell to a historical low of 2.9% in January 2013, and inflation expectations remained anchored around 3.5%. In this setting, for the first time since 2009, the central bank cut the official interest rate in March by 50 bp to 4%, signalling that it is not the beginning of a downward cycle but a one-off movement to facilitate the adjustment of the economy to the structural change in the behaviour of inflation. Furthermore, public finances remained relatively healthy (a deficit of 0.5% of GDP, excluding PEMEX's investment, similar to that of the previous year, arising from a slightly higher increase in expenditure than in revenue, on account of the cost of debt) and the budget approved for 2013 envisages a reduction of the deficit (a balanced budget and a deficit of 2%, including the PEMEX investment), which shapes a restrictive fiscal policy for this year. Finally, the strong appreciation of the peso (8% in 2012), owing to capital inflows at historical highs, which are estimated to have triggered an increase in international reserves of more than $20 billion in 2012, may also contribute to explaining this move. Accordingly, the new Government signed a far-reaching agreement with the main parliamentary forces, which is driving progress in structural reforms in the first part of its term of office. This could improve expectations about the country's potential growth capacity (see Chart 11), and indirectly contribute to increase pressure on the appreciation of the exchange rate. The planned reforms include most notably universal access to health services, extending pension coverage, creating unemployment insurance and improving the quality of education. In the energy sector, the objective is to increase PEMEX's production capacity and efficiency, although how this is to be achieved has not yet been determined. However, PEMEX will remain under state control, yet it will be able to compete in the industry by changing its corporate management rules and attempts will be made to maximise the dollar revenue received by the State. In the area of tax reform, the intention is to enlarge the taxpayer base, revise the design of taxes (and not only VAT) and eliminate fiscal privileges thus avoiding the subsidies that benefit higher earners. In fact, in its short period in office, the Government has approved or sent to Parliament a reform of the education system, a reform of the telecommunications sector (which would increase competition in the sector by establishing tougher sanctions for monopolistic practices and opening it up to foreign investment), a law to limit the indebtedness of the States (which forbids them to borrow other than for financing investment projects), a plan to promote housing (whereby Sociedad Hipotecaria Federal will guarantee up to 30% of loans extended for housing construction, compared with 6% which was covered previously) and enlarging credit to SMEs using state guarantees. Furthermore, the governing party's congress removed the restrictions imposed on its parliamentarians for voting on changes to VAT and the structure of PEMEX, which together with the Government's desire to speed up the reforms in the first part of the legislature contrasts with previous transition periods.

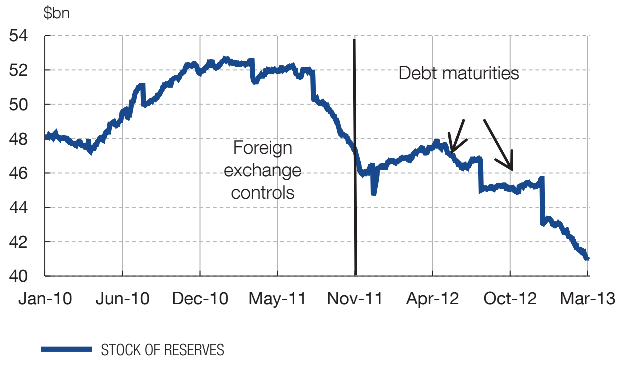
ARGENTINA

Activity moderated sharply in 2012, despite a slight rebound in the second half of the year. Thus, quarter-on-quarter growth was 1.3% in Q4 and 0.6% in Q3, following a fall of 0.9% in Q2. In 2012 growth scarcely averaged 1.9%, a stark contrast with 8.9% in 2011, since a series of import restrictions and capital controls were imposed, in addition to some exogenous factors (poor crops and weak external demand, particularly from Brazil). These measures, created with the aim of reducing demand for dollars and increasing their supply against a backdrop of capital flight, were effective but particularly pernicious for growth, especially import restrictions which prompted an abrupt fall in gross investment (-4.9% year-on-year over the year as a whole). In fact, part of the recovery in economic momentum at year-end – particularly in investment – is due to the easing of import restrictions. At the same time, the Government increased credit directed at productive investment. In any event, private consumption remained the main driver of the economy, supported by the labour market (the unemployment rate in Q4 stood at 6.9%, 0.2 pp higher than a year earlier), although it grew more slowly than in previous years affected by high inflation and slight wage moderation. As a result of the forced adjustment of imports, the contribution of external demand was no longer negative, despite the sharp fall in exports of 6.6% in the year as a whole. Similarly, following the measures, the current account moved back into surplus (0.1% of GDP), as the trade surplus rose by 26.7%. However, the

ARGENTINA AND CHILE

CHART 12

ARGENTINA. INTERNATIONAL RESERVES



CHILE. INFLATION OF TRADABLE AND NON-TRADABLE GOODS

SOURCES: Banco Central de Argentina, Banco Central de Chile and Reuters.

deterioration of the fiscal accounts worsened and a primary deficit of around 0.2% of GDP was recorded compared with a surplus of 0.3% in 2011. This deficit, which would have been notably higher without the funds from the central bank and the pension fund administrator, has been financed by a bigger monetary base (an increase of 40%), which contributes to explaining the quickening of inflation despite the decelereation of activity. Thus, after inflation reached 11.1% in January 2013 (according to private estimates, close to 27%), the Government agreed to freeze prices at the main retail outlets until June. The exchange rate policy, which stepped up the pace of devaluation of the official rate (by around 18% in annualised terms), and the growing importance of parallel markets (on which the premium over official exchange rates is around 70%) also contributed to greater inflationary pressures. The pace of growth at the beginning of 2013 seems to have stabilised, albeit without recovering high rates. Among the factors which should support a slight recovery are a better harvest and fewer debt maturities, less sluggishness in Brazil and a foreseeably expansionary fiscal policy until the legislative elections in October. However, unorthodox measures continue to increase the distortions of the economy, which not only take shape in the strong deterioration of the parallel exchange rate (see Chart 12), but also in the strong outflow of dollar-denominated deposits and an increase in the State's net borrowing. Also, the compulsory "pesification" of debt issued in dollars by the provinces due to capital controls and the "declaration of censure" issued by the IMF against Argentina due to the lack of progress in refining its statistics show some of the effects of the current model. However, the greatest uncertainty concerns the current legal proceedings in New York, which could eventually lead to a suspension of payments, should the judgment requiring Argentina to also pay the holdout creditors, who refused to accept the 2005 and 2010 debt swaps, be upheld. Faced with this eventuality, the main agencies downgraded Argentina's foreign-law bonds.

CHILE

Activity remained highly buoyant throughout 2012, surpassing expectations. Thus, in Q4 a growth rate was recorded of 1.5% in quarterly terms and 5.7% in year-on-year terms, which put annual growth at 5.6%, as against 5.9% in 2011. Despite the external slowdown, both consumer and business confidence held at very high levels, performing differently to 2009, when they were considerably affected by the global crisis. In this setting, domestic demand continued to expand at a much higher pace than GDP growth, and would even have quickened in Q4 were it not for the performance of stockbuilding. Thus, private consumption grew 7.3% year-on-year in Q4 (6.1% in the year as a whole), driven by the sound performance of the labour market; government consumption increased by 7.2%, and investment grew by 18.1% (12.3% in the year) – the machinery and equipment and construction components were highly buoyant. External demand's negative contribution to growth fell with respect to the previous year (-1.7 pp in 2012, compared with -3.8 pp in 2011), although it tended to increase throughout the year faced with a greater recovery of imports than exports. Sluggish external demand and a fall in the terms of trade of 10% resulted in a trade surplus which was 61% lower in 2012 than a year earlier, causing the current account deficit to widen to 3.5% of GDP. This deficit is amply financed with foreign direct investment which reached a record rate of 10.6% of GDP. The higher frequency indicators for 2013 Q1 show a dichotomy between still-robust demand and weaker supply. Inflation also surprised favourably since it showed a marked downward trend and stood in March at 1.5% (core inflation was around 1%), below the lower limit of its target range, although there was an element of some temporariness in this decline. Additionally, inflation expectations remain anchored at 3%. In any event, the sharp contrast between the inflation of tradable and non-tradable goods (the latter grew by around 4%) (see Chart 12) shows that some pressure continues due to the tight labour market (unemployment rate of approximately 6% and real wage growth of above 3%) and that the moderation seen was partly influenced by the appreciation of the peso (8.4% against the US dollar in 2012, as a whole, and slightly less in recent months). Against this backdrop, the central bank has left the official interest rate unchanged at 5% since January last year but it could, if appropriate, apply some macro-prudential measure. Bank lending continued to expand by 11% in real terms. In the fiscal arena, the surplus narrowed from 1.5% of GDP in 2011 to 0.6% of GDP in 2012 (with a better-than-targeted structural deficit standing at 0.6%), which enabled the Government to inject $2 billion into the Economic and Social Stabilisation Fund and to the Pension Reserve Fund (which has built up $22.9 billion), a higher amount than the funds prior to the financial crisis of 2008. One agency put Chile's sovereign debt rating up one notch to AA–.

COLOMBIA

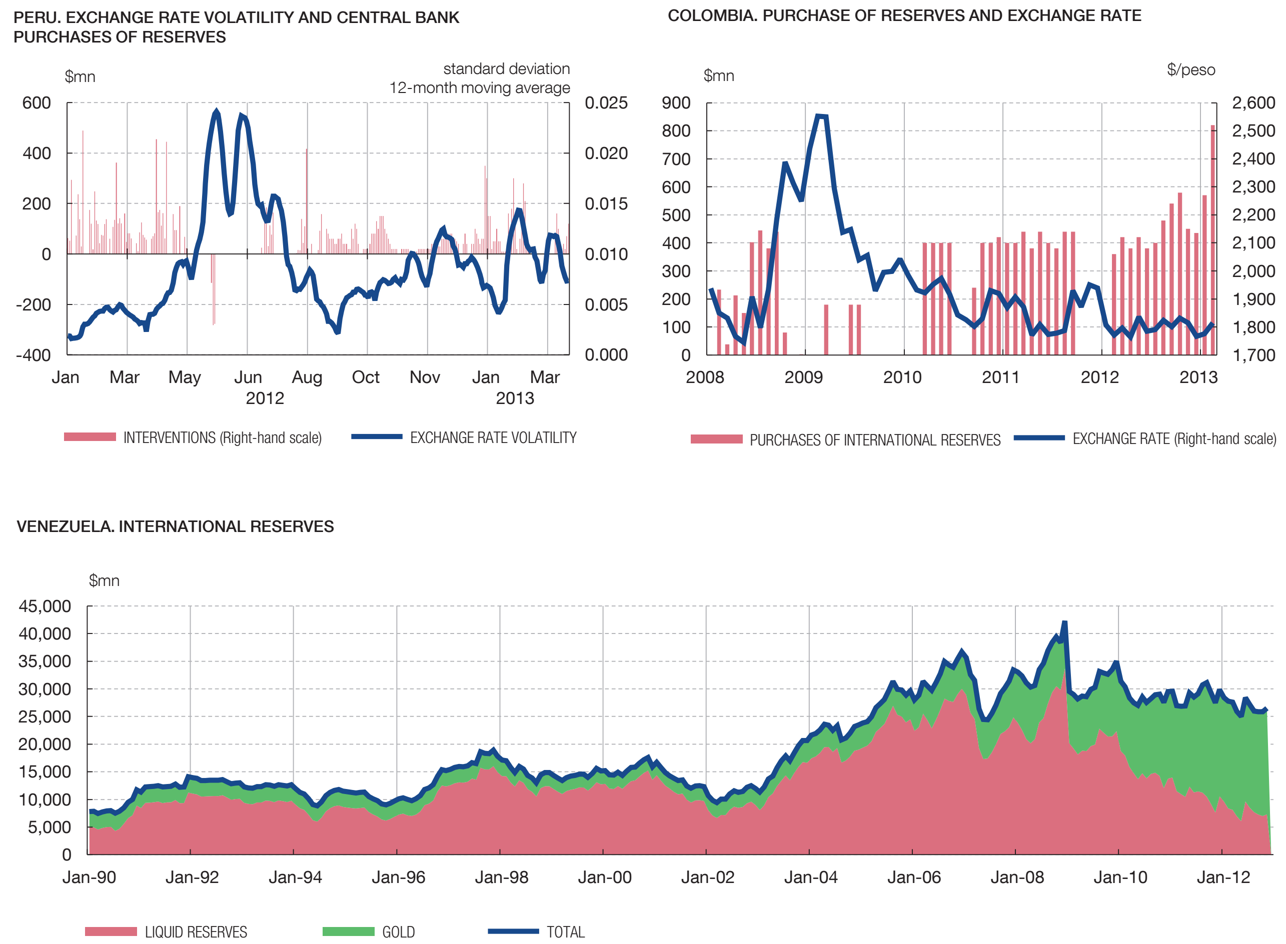
GDP grew 4% in 2012, a sizable moderation with respect to 2011, which in turn was revised upwards by 0.7 pp to 6.6%, owing to a better performance of gross capital formation and exports. The slowdown in growth, which was sharper in the second half of the year, was due largely to investment that was troubled by certain problems specific to the area of construction and due to lower growth in the mining sector. These developments, together with the strong exchange rate, explain the downward cycle in official rates begun by the central bank in July (200 bp in total, the latest reduction was 50 bp in March), against a backdrop of moderating inflation which stood at 1.9% in March, below the central bank's inflation target. The fiscal accounts continued along a path of gradual consolidation. Thus, the central government deficit declined in 2012 to 1.9% of GDP (compared with 2% in 2011). In the external accounts, in addition to the fall in the volume of exports, there is a continuing robust inflow of direct investment. In order to combat upward pressures on the peso, the central bank enlarged the reserve accumulation programme to $30 million per day (see Chart 13), and announced that it will likely be extended until May. Consequently, international currency reserves stood at $38.5 billion ($5 billion up on 2011). The Government adopted various measures to reduce pressure on the exchange rate (holding in dollars of State funds such as the dividends of the public company Ecopetrol and dollar-denominated debt issues). Lastly, the Government approved a tax reform in January, mainly in order to increase the fairness of the tax system and to reduce the shadow labour market.

PERU

Growth remained robust with GDP expanding by 5.9% year-on-year in Q4 and by 6.3% in the year as a whole (6.9% in 2011), although it slowed down somewhat over the year. Growth was underpinned by investment (14.9% in the year as a whole) and by government consumption (10.6%). Private consumption continued to grow by 5.8% in the year as a

PERU, COLOMBIA AND VENEZUELA

CHART 13



SOURCE: National sources.

whole, the same figure as in Q4. Conversely, the contribution of external demand turned more negative as a result of the increase in imports and the moderation of exports, particularly mining ones (affected by supply problems). The higher frequency indicators point to the buoyancy of activity continuing in the early months of 2013, with strong private consumption supported by consumer confidence, the favourable circumstances of the labour market and the positive financing conditions in conjunction with the projected quickening of public spending. The current account deficit rose in 2012 to 3.6% of GDP (1.9% in 2011), due to the sharp reduction of the trade surplus. This deficit continued to be financed comfortably by long-term capital flows which in turn tended to strengthen the local currency. The new sol appreciated by around 4% in 2012 and continued this trend in 2013 Q1. Inflation tended to moderate in recent months and stood at 2.6% in March, on account of the reversal of previous supply shocks. However, core inflation held above the target range (3.3% in February, compared with the target of 2% +/– 1%), showing some pressure on demand, especially due to the slacker labour market (the unemployment rate was 6.1%, a historical low). In this setting, the central bank has maintained the official rate at 4.25% since May 2011. The pace of the currency's appreciation continued to be modulated by the central bank's foreign exchange interventions (see Chart 13), complemented by measures such as raising the reserve requirements in domestic and foreign currency, in order to moderate short-term foreign capital inflows and credit growth, particularly in dollars. Similarly, the limit on fund administrators' investment in foreign assets was increased to 34%. Additionally, in February the Government undertook two bond issues in the domestic market in order to repay debt owed to multilateral agencies. On the fiscal side, the non-financial public sector posted a primary surplus equivalent to 3.2% of GDP, representing a slight improvement due to the higher increase in current revenue compared with expenditure.

VENEZUELA

The economy recorded a notable expansion in 2012 with an increase in GDP of 5.6% (4.2% in 2011), although it slowed in the second half of the year. The two main characteristics of the expansion were the increase in investment (23.3% in annual terms, mainly in housing, related to the rise in pre-election spending) and in private consumption. This growth of domestic demand was coupled with a sharp increase in imports (23.3% in the year). Exports recovered positive growth rates in the second half of the year. Inflation tended to moderate to November and stood at 18.2% year-on-year, as a result of developments in food, regulated prices and a greater distribution of currency to pay for imports, although the depletion indicator reached its highest level since 2008. However, consumer prices began to rise again at end-2012, and the devaluation of the bolivar in January (by 31.7%, from 4.3 to 6.3 bolivars per dollar), after two years with an anchored exchange rate, put inflation at above 24% in March. Conversely, the devaluation is expected to ease the imbalance in public finances, which seem to have deteriorated sharply during 2012 further to the increase in public spending (the latest official data shows a central government deficit of 4.9% of GDP in 2012, excluding the public oil company PDVSA and the various funds). However, the imbalance is not expected to be corrected solely with that measure and, consequently, there will foreseeably be some type of adjustment after the April elections. For the moment, the tax on oil exports has been raised and a new parallel market has been created for the allocation of currency, with auctions of $200 million open to importing firms, with settlement occurring once the entry of the imported good has been checked. Furthermore, the central bank indicated that the difference between the official exchange rate and the cut-off exchange rate of the auctions will be allocated to public funds to promote productive sectors which will seemingly improve the public sector's financial position. The first auction was held at the end of March but the official results of the average exchange rate and the cut-off exchange rate have not been published. On the external front, the current account surplus was 4.7% of GDP in 2012, notably lower than 7.7% in 2011, owing to the smaller trade surplus. The use of international reserves to undertake certain investments and the sharp increase in imports in the last six months have caused liquid reserves to fall to a level at which they cover only two months of imports (see Chart 13). In this setting, the Government relaxed capital controls to a certain degree, allowing exporters to retain a greater share of their dollar revenue and even to open dollar accounts at national banks.

17.4.2013.