

## Introduction

During the first half of 2014, the slowing trend in activity in Latin America observable since 2011 became more marked. The average year-on-year growth rate in the six main economies<sup>1</sup> eased to 0.7% in Q2, from 2.3% in Q1, signifying growth 2 pp down on that recorded on average over the course of 2012 and 2013.

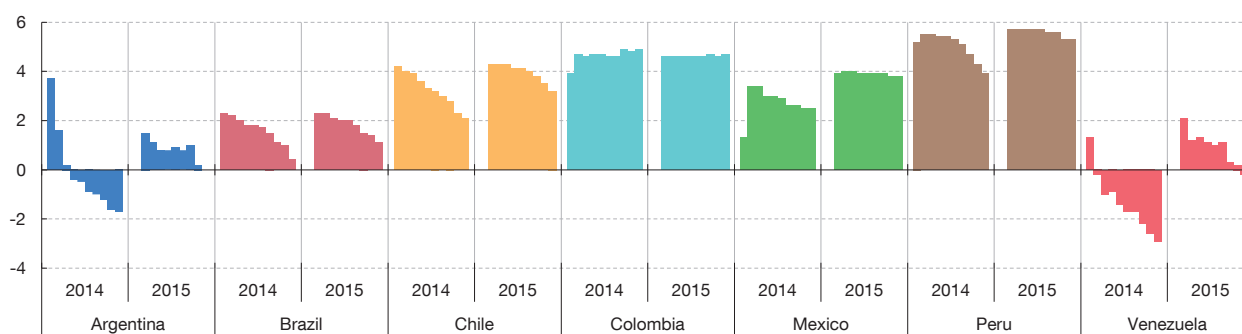
Admittedly, the global economy performed worse than expected in the first half of the year and the commodity price boom continued to show signs of having run its course; but the unfavourable performance of the external environment does not appear to suffice to explain the intensity of the slowdown experienced by the Latin American economy, which was much more marked than that in other emerging regions (including eastern Europe, which may have been more affected by the sluggishness of the euro area and the crisis in Ukraine). Weak economic growth in Q1 in the United States – which had a temporary impact on economies with close trade links, such as Mexico – was partly offset in Q2; moreover, the fears in early 2014 of a sharp slowdown in the Chinese economy tended to evaporate following the stimulus measures adopted there. Lastly, and as the main external factor of support, international financial conditions opened the way for a new period of stability, which was of benefit to risk assets, including those in the emerging markets and, in particular, in Latin America. Hence, from Q2 to early September exchange rates stabilised, with the odd exception, stock markets surged (running counter to the cyclical phase) and sovereign spreads narrowed considerably in most Latin American countries, with worsening geopolitical risks failing to have a lasting impact on the markets. However, these positive trends have reversed in recent weeks.

At the end of the first half of the year, among the biggest economies in the region, the cyclical position of Brazil and Argentina (and possibly Venezuela) was recessionary, while Chile and Peru had undergone a most significant slowdown. Colombia and Mexico were alone in posting more buoyant activity, which is reflected in the stability of their growth forecasts for 2015, amid a generalised downward revision (see Chart 1). Overall, Latin America might record its lowest growth rate since the crisis in 2014.

Inflation has continued to show some stickiness, more so in the economies with more heterodox macroeconomic management arrangements, in which upward-trending, double-digit year-on-year growth rates have been recorded. In several countries with inflation targeting regimes, namely Brazil, along with Mexico and Chile, the year-on-year rates of the CPI have risen. Against this background, although there has been some divergence between the monetary policies of the various countries, the broad trend has been towards easing. Mexico, Chile and Peru used the leeway provided by their economic fundamentals and the credibility gained by their policies to cut their interest rates. Brazil called an end to the monetary tightening cycle last April, following a cumulative increase of 375 basis points (bp) in one year, and it has held its official interest rate at 11% since, but has recently relaxed its reserve requirement ratio so as to increase liquidity. Colombia is the only country to have raised its official interest rate (by 125 bp), against a background of strong domestic demand.

<sup>1</sup> The Latin American aggregate includes six countries: Argentina, Brazil, Chile, Colombia, Mexico and Peru. Venezuela has been excluded as it has not published National Accounts figures since end-2013.

GDP GROWTH FORECASTS FOR 2014-2015 (a)



SOURCE: Latin American Consensus Forecasts.

a Projections published between December 2013 and September 2014.

Some of the vulnerabilities present in several Latin American countries, which in May 2013 – when debate arose over the start of the withdrawal of monetary stimuli by the US Federal Reserve – prompted a strong rise in volatility on the region’s financial markets, have started to be corrected, but this process is still only at an early stage. Thus, the current account deficit in the six main economies as a whole still stands at 2.9% of GDP, despite the easing in domestic demand and the adjustment in exchange rates, although it has ceased to widen. On the fiscal front, stimuli have been introduced in several countries to a greater or lesser extent, despite the fact that the budget deficit has widened to 3% of GDP in the region as a whole.

Following the weakness shown by Latin American activity in the first half of 2014, it is possible in the coming quarters that growth rates may run at a pace more aligned with potential (this could be the case in Mexico), which in any event is estimated as lower than prior to the crisis for most countries. However, there are substantial risk factors. Chief among these is that arising from a potential tightening of global financial conditions (whose impact would be offset in part by more dynamic global growth), although there are also domestic risks. These include the prolonged weakness of investment, which appears to evidence a regional component associated, among other factors, with the end of the commodities cycle and which might exert a more lasting effect on growth, and the major imbalances in certain countries (Argentina and Venezuela, in particular), which may well accentuate economic divergences in the coming months. Against this backdrop, it is essential that economic policies should retain a stance compatible with the progressive correction of the vulnerabilities still present in the region.

### External environment

The world economy advanced less than expected in the first half of 2014. The negative surprises in growth figures were discernible both in the advanced and in the emerging economies. Of note among the former was the contraction in the US economy in Q1 as a result of temporary factors, namely particularly harsh weather and a marked decline in inventories, although it rebounded appreciably in Q2 and is expected to resume a growth rate of around 3% in the second half of the year. Moreover, in Q2, activity slowed significantly in the euro area, while in Japan the impact of tax rises on consumption was somewhat greater than anticipated. Inflation in the advanced economies has held at low levels, with the exception of Japan, where it stood above 3% as a result of the aforementioned tax rise.

On the whole the emerging economies also slowed to some degree in the first half of 2014. In China, in particular, there were signs of a loss of momentum in Q1, although the support brought to bear by economic policy reversed this trend in Q2. As well as in Latin America, the reduction in growth was particularly sharp in Russia and its neighbouring countries owing to the geopolitical conflict in Ukraine. Inflation in these economies has been relatively stable in recent months, with some divergences from region to region.

Once the temporary factors contributing to the disappointing growth in the first half of the year have been overcome, the world economy may be expected to move towards a path of recovery which, however, will foreseeably be fragile and increasingly uneven from region to region. In any event, the balance of risks has veered progressively to the downside in recent months. Notable among the chief risks is that of a deterioration in the various geopolitical “hotspots”, the reversal of the boom on financial markets, the prolongation of excessively low inflation in certain advanced economies and, over a longer horizon, the trend towards lower growth potential in both advanced and emerging economies.

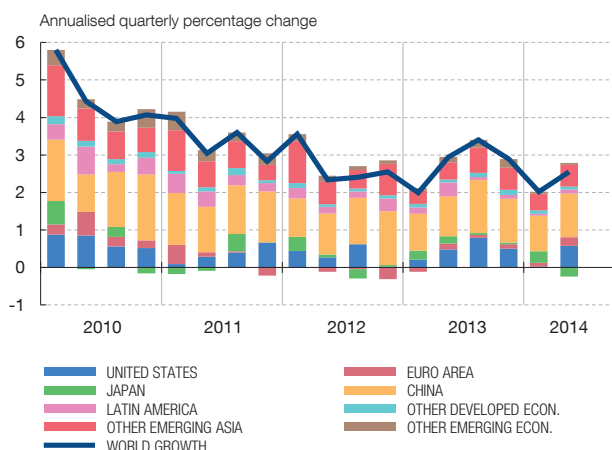
### Financial markets and external financing

In contrast to the slowdown in activity in the first half of 2014 and the progressive downward revision of growth forecasts, the behaviour of the financial markets was predominantly positive from April to September. This was reflected in the search for yield by investors, against a backdrop of extensive global liquidity. As a result, the dichotomy observed in previous years remained in place, with a real economy not managing to map out a firm path of recovery and financial markets continuing to perform favourably. Nonetheless, in light of the growing divergences in monetary policy stance across the main advanced economies, there was a generalised appreciation of the dollar, in parallel with an increase in its volatility. Furthermore, a correction on the markets has been seen in recent weeks, impacting particularly sharply those segments where higher levels of overpricing seemed to be building up.

Along these same lines, the financial indicators of the emerging economies were generally positive until late August. There was thus a pick-up on stock markets and a downtrend in sovereign yields, in a setting of low global volatility; rises to all-time highs on the main international stock exchanges; and a downward trend in long-term interest rates in the United States and other developed economies (see Chart 2). The decline in long-term interest rates partly reflected a compression of term premia, and also the decline in the interest rate expected at the end of the US upward cycle, in addition to further easing through the ECB’s non-conventional policies. The perception of lower risks in China and the progressive abatement of geopolitical tension in Ukraine also contributed to maintaining the aforementioned positive trend. In parallel, there was a marked recovery in retail investors’ capital inflows into these economies, especially onto the stock market, and the pace of bond issues on international markets was brisk. By mid-September, these issues outstripped the cumulative issues in the same period in 2013, which had set a historical high.

This trend was interrupted by certain short-lived bouts of intense global turmoil, arising mainly from escalating tensions in Ukraine and Syria. Subsequently, there has been a heavy fall on stock markets and a rise in sovereign yields since September, the result of emerging expectations that interest rate rises may possibly be brought forward in the United States and the re-emergence of certain doubts over the economic situation in China. This change has been reflected in an upward adjustment in US long-term interest rates and a generalised appreciation of the dollar, which lessened the profitability of carry trade with the more liquid emerging markets.

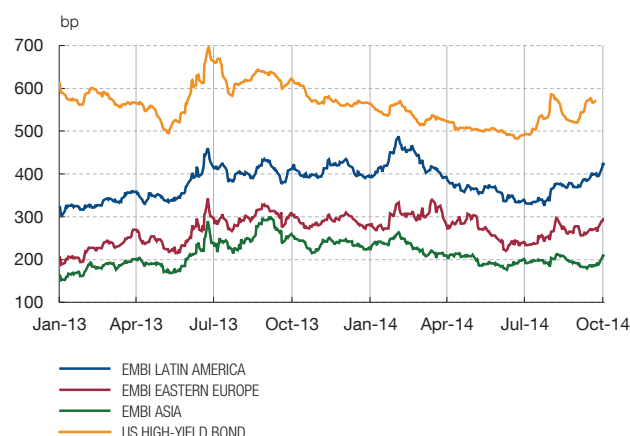
CONTRIBUTION TO WORLD GDP GROWTH



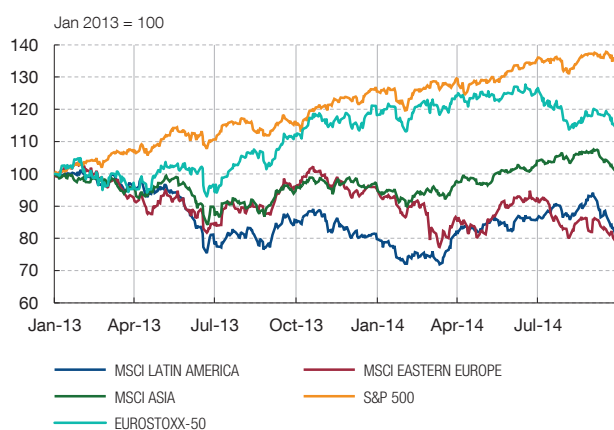
INTEREST RATES



INTEREST RATE SPREADS



WORLD STOCK MARKETS (a)



SOURCES: Datastream and JP Morgan.

a Stock market indices in dollars.

On the Latin American markets, the regional stock market index, proxied by the MSCI and measured in dollars, rose by 11.2% from April to early September (outperforming other emerging markets, albeit from lower levels), falling subsequently by 15% over the rest of September (see Chart 2). In local currency, the Brazilian stock exchange rose notably by 18.5% from mid-April to early September (38% from March), and Peru (15.6%) and Mexico (12.1%) were likewise prominent (see Chart 3). This contrasted with the slowdown in activity in the region, and with the change in cycle in credit ratings. In this respect, the expectations generated by structural reform progress in Mexico, high portfolio investment inflows into Peru and the expectations of a change in government in Brazil are among the local factors that help explain these rises, set against the earlier mentioned boom on financial markets globally. Two of the countries most closely linked to the commodities cycle, Chile and Colombia, performed significantly less favourably; this was compounded, in Chile, by the unveiling of a fiscal reform that heightens the tax pressure on corporations. The correction to Latin American stock markets in September was greater than that in other emerging markets since in addition to general risk aversion there have been other more specific factors such as uncertainty about the elections in Brazil (its stock market fell by almost 13% in September), the resignation of the governor of the central bank of

Argentina, or the fall in oil prices which has dragged down the Colombian stock market (-9.4%).

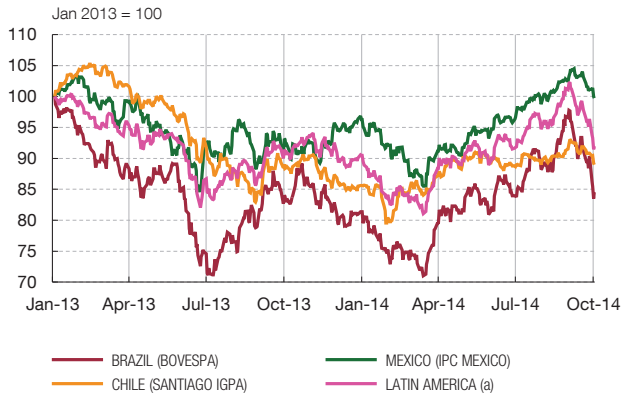
In the same vein, the sovereign spreads of Latin American countries have held on a downward path since mid-April which was interrupted briefly in August, although towards the end of the period examined they increased significantly (see Chart 3). The region performed worse than other emerging areas since this risk indicator climbed more than 50 bp over the last six months compared with the rise of approximately 20 bp for other emerging markets. This behaviour was determined by the sovereign spreads of two countries: that of Venezuela – which rose by more than 240 bp to above 1300 bp, as the maturity of the highest debt of the last two years drew nearer against a backdrop of scant liquid international reserves and the downgrading of the sovereign rating by Standard and Poor's to CCC+ – and that of Argentina, which increased from 48 bp to 740 bp, after the declaration of selective default (see Box 1). The other sovereign spreads decreased until the beginning of September, especially in Chile (-17 bp, 12%) and in Brazil (-13 bp, 6%, where the sovereign rating was put on negative outlook), however, they widened significantly in line with the other emerging countries throughout September to levels not reached since the beginning of the year. In Ecuador, the spread narrowed by almost 100 bp, after its sovereign rating was moved up a notch, and subsequently widened. Also, interest rates on long-term bonds denominated in local currency declined in most countries until early September, largely correcting the tension triggered by the Federal Reserve's announcement in May 2013 (see Chart 3), and rose from that date, especially in Brazil.

Similarly, credit risk premia listed in CDS declined across the region until early September and then increased slightly with the result that at the end of the period analysed they stood at the levels recorded in April. Argentina and Venezuela were the exceptions. At present, these premia would seemingly be more in line with the ratings given by the rating agencies (see Chart 3). By country, the markets have priced in upgrades of the sovereign ratings of Mexico and Colombia, and downgrades of between one and two notches for those of Peru and Chile.

Exchange rates were generally stable to September with some exceptions (see Chart 3). The Chilean and Argentinean peso posted the highest depreciations. In particular, the Chilean peso depreciated by more than 7.5% from April, against a backdrop of a fall of around 10% in copper prices from the beginning of the year, a reduction in interest rates and a non-intervention policy by the central bank. In Argentina, the official exchange rate of the peso depreciated sharply mid-August (by 1.3% in two days); the pressure on the exchange rate when markets opened was also reflected in the spread between official and parallel market rates which reached an all-time high. The Brazilian real, which had scarcely depreciated by 1.4% between April and the first week of September, fell by 10% subsequently, compelling the central bank to increase its degree of intervention in foreign exchange markets, by rolling over a higher percentage of exchange rate swaps. In Venezuela a third regulated exchange rate came into operation which, despite trading 88% lower than the official rate and 80% lower than the exchange rate in foreign exchange auctions, remains far removed from the parallel exchange rate.

Finally, direct investment inflows into the region moderated considerably in 2014 Q2 to \$140 billion (in annualised terms) from \$164 billion in 2013 (see Chart 4). This was mainly due to the lower inflows into Mexico in Q2 (\$5.1 billion less than in Q1), as well as those into countries more closely linked to the commodities cycle such as Chile (\$2.4 billion less). By contrast, Brazil recorded higher inflows close to the average levels observed

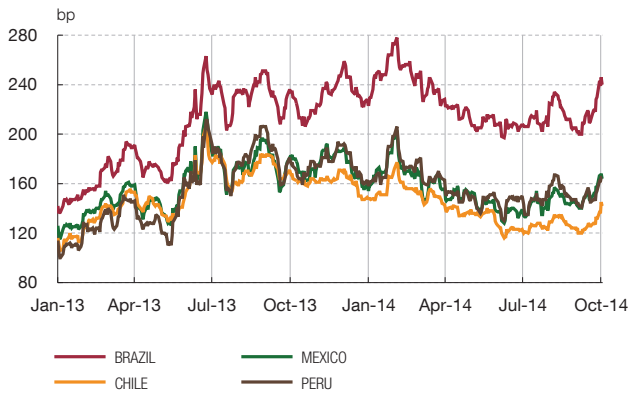
STOCK EXCHANGE INDICES



RATING AND IMPLIED RATING IN SOVEREIGN CDS



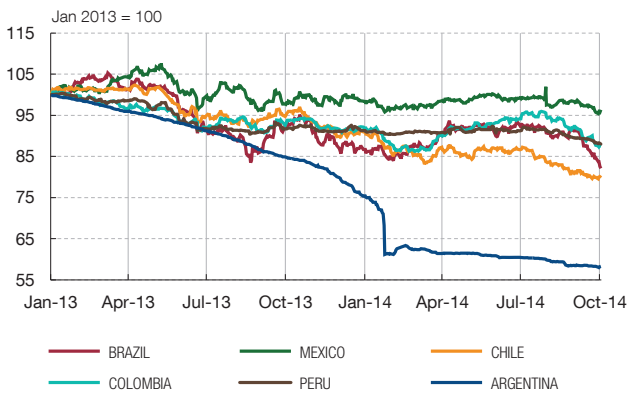
SOVEREIGN SPREADS



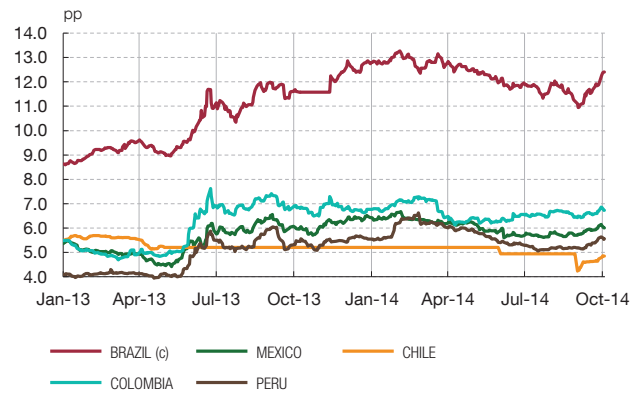
SOVEREIGN SPREADS



NOMINAL EXCHANGE RATE AGAINST THE DOLLAR



MEDIUM-TERM BOND INTEREST RATE IN LOCAL CURRENCY (b)



SOURCES: Datastream, JP Morgan, Bloomberg, Banco Central do Brasil and national statistics.

- a MSCI Latin America index in local currency.
- b 10-year government bonds in local currency.
- c 5-year interest rate swap.

since 2011. At regional level, foreign direct investment exceeded the current account deficit, albeit by a very narrow margin. Conversely, portfolio inflows rose in Q2 to more than \$84 billion in annualised terms, practically double the figure for 2013, as a result of investment in Mexico, particularly in the stock market which recorded the highest capital

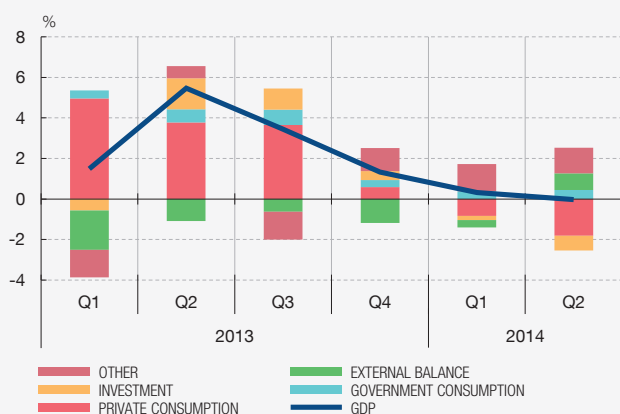
On 30 July 2014, Argentina failed to make a coupon payment on the 2005 and 2010 debt restructuring bonds, amounting to somewhat more than \$500 million. The Argentine government had ordered the funds to be transferred, but payment was blocked by a US court ruling (in the case *NML Capital v Argentina*).<sup>1</sup> The court considered that Argentina breached the *pari passu* clause,<sup>2</sup> by paying the creditors of the restructured debt while not paying the bondholders who did not participate in the 2005 and 2010 exchange (the holdouts). The ruling requires Argentina to pay the holdouts the principal and coupons that have accrued to date, a

total of \$1,330 million, and blocks the funds earmarked to pay the restructured debt. Argentina's sovereign rating was lowered by the main rating agencies to selective default level and default insurance was activated.

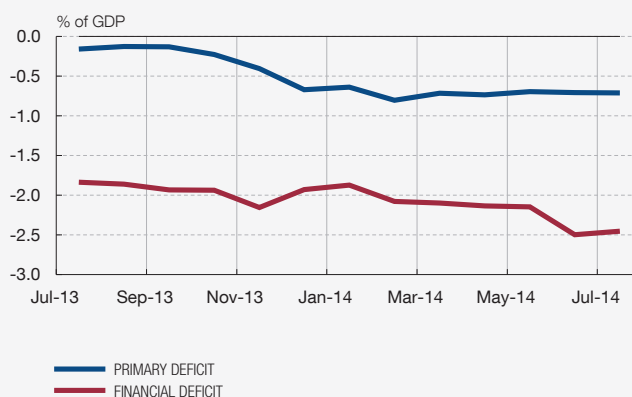
This is the second default by Argentina in the last 15 years, following the one in December 2001, when the government decreed a cessation of payments during a severe exchange rate and balance of payments crisis. The consequences of this default, and of the economic crisis that the country had been suffering since 1998, led to a fall in GDP of 10.9% in 2002 (and of almost 20% between 1998 and 2002), a deposits freeze, abandonment of the convertibility regime and the restructuring of sovereign debt, the implications of which have lasted until today. However, the nature of this latest default is exceptional, insofar as it has not been preceded by a serious balance of payments deficit, sovereign debt unsustainability or a severe economic crisis, but rather by judicial proceedings unrelated to the economy's solvency. As a result, the economic consequences will likely differ from those of the 2001 default. Moreover, this episode may have consequences for future sovereign restructurings, especially those relating to debt issued under New York law, which is usually chosen for issues made abroad.

- 1 In *NML Capital v Argentina*, a group of creditors, who purchased Argentine bonds under US law following the December 2001 default on the secondary market and who did not participate in the 2005 and 2010 exchanges, sued Argentina for the total amount of the principal and interest of the bonds in their possession. The judgment highlights the reluctance of Argentina to negotiate, a consequence of the "Lock Law" enacted in 2005, which to boost the acceptance of the exchange prohibits its reopening.
- 2 *Pari passu* clauses are common in debt contracts and establish that the debt cannot be subordinated to the debtor's other obligations. This subordination can be construed as meaning equality in the ranking, to avoid the issuance of new debt with priority over the existing debt, or equality in payment, which is the way it has been interpreted in this case.

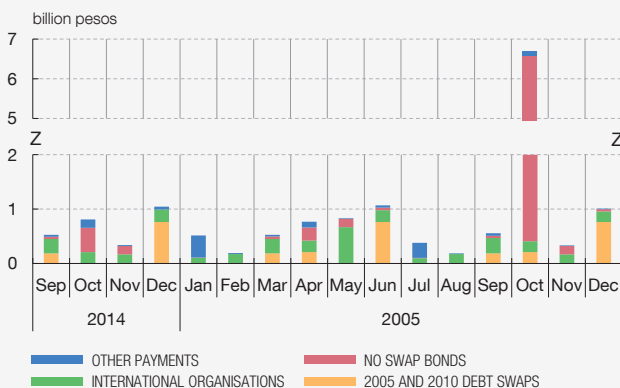
1 GDP BY COMPONENT



2 PRIMARY AND FINANCIAL DEFICITS



3 FOREIGN CURRENCY DEBT MATURITIES



4 EMBI



SOURCE: National sources.

The macroeconomic situation in Argentina today reflects significant weaknesses. The country entered a technical recession (two consecutive quarters of negative quarter-on-quarter growth) in 2014 Q1 and posted zero year-on-year growth in 2014 Q2 (see Panel 1). In addition, the economy has high inflation, an overvalued exchange rate and is in a cyclical recession, owing to the exhaustion of the growth model of the last decade and, more immediately, the scarcity of US dollars to pay for the imports of goods needed by the production chain. However, the ratio of Argentina's gross government debt to GDP, at 39.5%, is low by historical standards, while the budget deficit and, especially, the primary deficit are small, although on an upward trend (see Panel 2). The main concern is that the default will accelerate the deterioration in the balance of payments, leading to a crisis. Thus, the default could aggravate the economic situation, by closing access to the international financial markets.

This situation would exacerbate the economic policy dilemmas the country has been facing over the last two years. On one hand, further deterioration in the balance of payments would lead to a major outflow of reserves, which, although slow, on account of the financial isolation of Argentina in the last decade and the existence of capital controls, is worrying. In fact, reserves have fallen to almost \$28 billion, half their level at the beginning of 2011. The process of devaluation that has lowered the official exchange rate from 6 to 8.40 pesos to the US dollar in 2014 has not prevented a decline in exports, which limits foreign currency inflows, in an environment of falling prices for the country's main export, soy beans. In the short term, the commitments acquired in the negotiations with the Club of Paris and Repsol and the amount of external debt due to mature, which is estimated as more than \$11 billion by end-2015, are exerting further pressure on the reserves (see Panel 3). Moreover, the devaluation could push up inflation (between December 2013 and August 2014 prices rose by 18.2%). Further restrictions could be placed on imports to preserve a minimum level of international reserves, but this would have an even more negative impact on economic growth.

On the other hand, although the agreements with Repsol and the Club of Paris had succeeded in reducing the level of country risk, the failure of negotiations with the holdouts has partly reversed this process (see Panel 4), causing the interest rates on debt in US dollars to remain high for the private sector of the economy and

greater difficulty to attract foreign direct investment, especially to develop the Vaca Muerta oilfield. However, the increase in debt spreads has not been in line with the reaction expected before default,<sup>3</sup> and appears to correspond more to a situation of illiquidity than to a risk of restructuring or heavy losses for creditors.

In this situation, the Argentine government has chosen to attempt to sidestep the blocking of funds by changing the law governing bonds subject to foreign law to national law. An agreement to pay the holdouts seems to be unlikely before January 2015, when the Rights Upon Future Offers (RUFO) clause, which entitles bondholders of the restructured debt to benefit from any better treatment (voluntarily) agreed with another creditor, expires. A final solution to the default situation may be delayed until the end of 2015, when the mandate of President Fernández de Kirchner terminates.

The specific nature of the default and its potential consequences for the international legal framework have prompted a response from the international community. The IMF has warned of the increase in uncertainty in sovereign debt restructurings entailed by the Argentine episode, stemming from the improvement in the repayment prospects of holdout creditors and their ability to interrupt the flow of payments on restructured debt. During the hearing of the case, various countries, among them Brazil, Mexico and France, filed submissions in support of Argentina's position, highlighting the consequences for future debt restructurings. The case has had an impact on the debate opened by the IMF on the reform of debt restructuring tools. The current focus of discussion is improvement of the contractual framework, to add legal certainty. On one hand, the collective action clauses could include elements of bond aggregation in the votes necessary to change the terms of restructured bonds. This would make the holdouts' strategy more costly, as they would need to acquire a larger amount of bonds to achieve a majority sufficient to reject an agreement. On the other hand, *pari passu* clauses could be amended, to avoid the judicial interpretation that has led to the blocking of payments in the case of Argentina. Discussions remain open and, in any case, the debt currently in circulation would not be affected by such reforms.

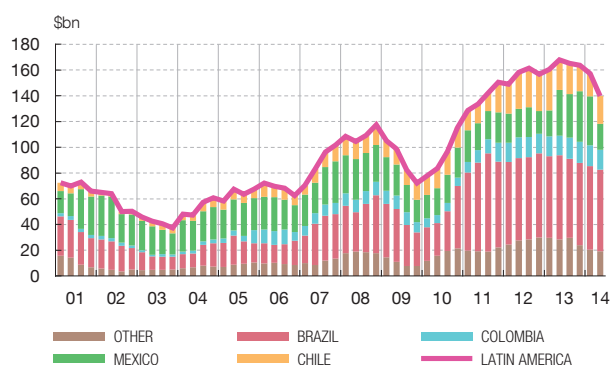
<sup>3</sup> Argentina's EMBI rose to 5,000 bp in December 2001, following the announcement of default, from 1,400 bp in September.

inflows in one quarter of the whole time series. As for Brazil, the increase in portfolio inflows centred on short-term fixed income securities.

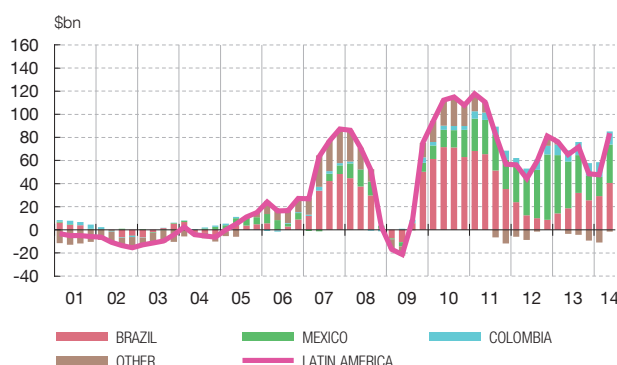
From April to September 2014, fixed-income issuance in the region reached \$61 billion, Brazil being the largest issuer both in terms of the public sector (two sovereign issues amounting to almost \$5 billion) and the banking and oil sectors (see Chart 4). Despite the proximity of a change in the monetary cycle in the United States and the worsening of the growth outlook for the region, the conditions of these issues have not varied substantially



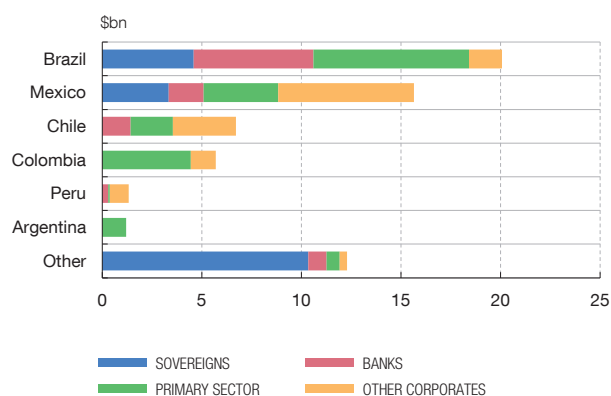
12-MONTH CUMULATED FDI FLOWS



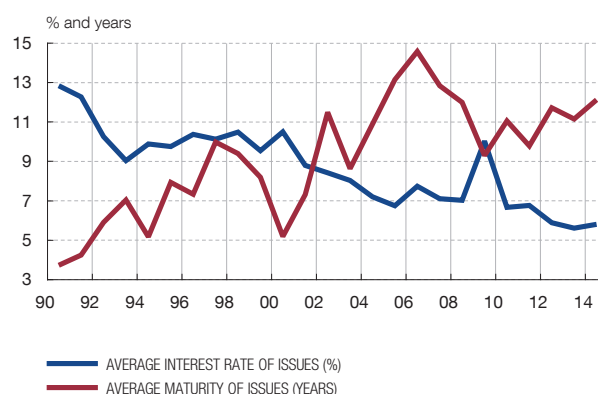
12-MONTH CUMULATED PORTFOLIO INVESTMENT FLOWS



INTERNATIONAL ISSUANCE IN LATIN AMERICA: FROM APRIL TO SEPTEMBER 2014



FIXED-INCOME ISSUANCE OF NON-FINANCIAL CORPORATE SECTOR



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

and there has been no significant increase in interest rates in the primary market and no shortening of maturities (see Chart 4).

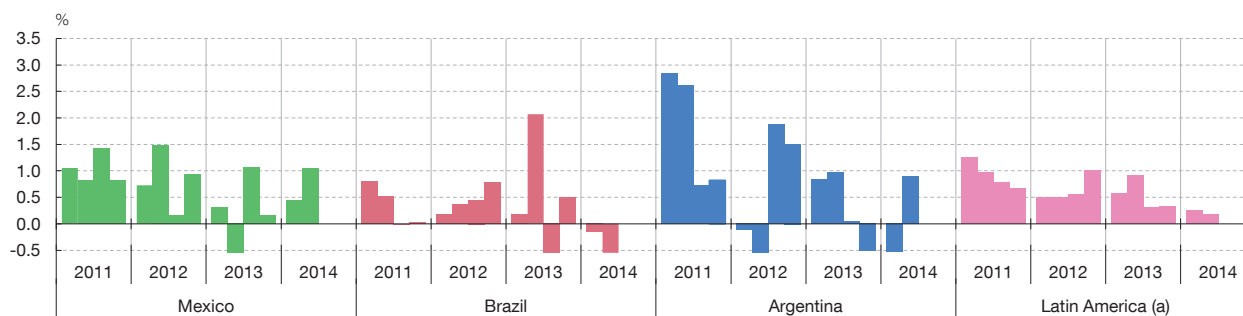
## Activity and demand

Economic activity slowed considerably in the first half of 2014, with quarterly growth rates for the region averaging 0.2% in the first two quarters of the year (see Chart 5); the year-on-year growth rate of the regional aggregate decreased from 2.3% in Q1 to 0.7% in Q2 (see Table 1). Admittedly, the significant weight in the regional aggregate of Brazil's economy – which went into recession in Q2 – accounts for most of this fall, but there was a very marked slowdown in Chile (1.9% year-on-year in Q2, down from 2.4% in Q1) and, especially, in Peru (1.7% year-on-year in Q2 and 5.1% in Q1). That comes in addition to the “technical” recession in Argentina in 2014 Q1, despite a slight recovery in Q2. Only Colombia, with growth of 6.5% year-on-year in Q1 and 4.3% in Q2, and Mexico, which posted stronger growth in Q2, showed greater buoyancy.

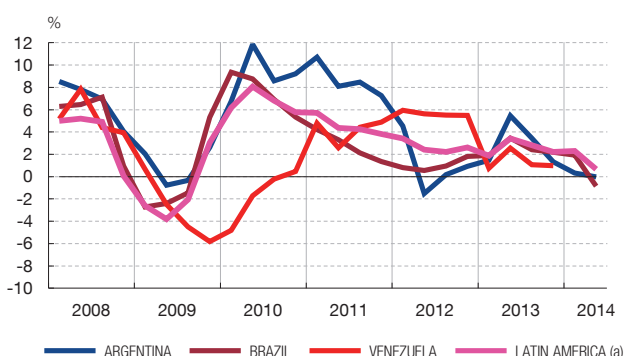
This easing of growth can be explained by both common reasons and the idiosyncratic situations of the countries. In Argentina and Venezuela<sup>2</sup> the recession has specific characteristics to the extent that the external constraint is, to a varying degree, limiting

<sup>2</sup> National accounts data are not available for Venezuela for Q1 or Q2 and, consequently, the conjecture that it is in a recession is based on partial indicators (see the section on economic developments by country).

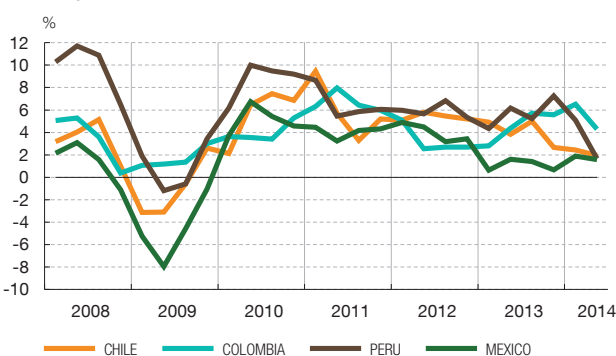
GROSS DOMESTIC PRODUCT  
Quarter-on-quarter rate



GROSS DOMESTIC PRODUCT  
Year-on-year rate



GROSS DOMESTIC PRODUCT  
Year-on-year rate



SOURCE: National statistics.

a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

growth, against a backdrop of an overvalued exchange rate, monetisation of fiscal imbalances and high inflation, and the failure to adjust relative prices. In the other countries, also to a varying degree, the high correlation of the cycle with that of their main trading partners illustrates the degree of external dependence of Latin America, directly through demand for exports and, to a greater extent, through the effect of the terms of trade in aggregate demand. Accordingly, just as the continuous rise in the terms of trade supported economic buoyancy during the last decade, its correction in recent years has triggered, symmetrically, the opposite effect. That contributes to explaining the moderation of growth in Chile, where the cumulative fall in the terms of trade exceeded 18% in the last three years – although it has tended to stabilise recently – and the economy has weakened more than expected. In Peru, the fall in the terms of trade occurred later and more swiftly, accumulating 11% in the last two years, while in Colombia these terms held at a high due to the weight of oil in its export basket and the economy has remained very buoyant. In Brazil, where the terms of trade have fallen moderately, it is the collapse of investment which explains why the country has entered into recession after three years of below potential growth. Mexico, being less reliant on commodities, performed better, with a recovery initially led by external demand which shows different behaviour to other economies in the region.

By component, average domestic demand for the region contributed 2 pp to year-on-year growth in Q1 and 0.2 pp in Q2 (see Chart 6). External demand continued to make a very

## LATIN AMERICA: MAIN ECONOMIC INDICATORS

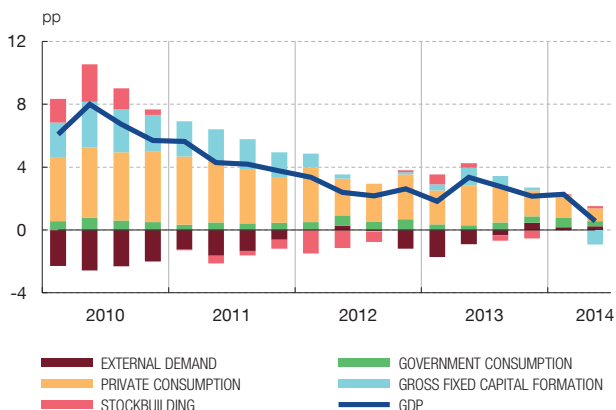
TABLE 1

	2012	2013	2012		2013				2014		2014
			Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	September
<b>GDP (year-on-year rate)</b>											
Latin America 6 (a)	2.8	2.5	2.2	2.6	1.8	3.4	2.8	2.2	2.3	0.7	
Latin America 5 (a)	2.9	2.5	2.5	2.9	1.9	3.1	2.7	2.3	2.6	0.8	
Argentina	0.9	2.9	0.2	0.9	1.5	5.5	3.4	1.3	0.3	0.0	
Brazil	1.0	2.5	0.9	1.8	1.9	3.5	2.4	2.2	1.9	-0.9	
Mexico	4.0	1.1	3.2	3.4	0.6	1.6	1.4	0.7	1.9	1.6	
Chile	5.4	4.1	5.5	5.2	4.9	3.8	5.0	2.7	2.4	1.9	
Colombia (b)	4.0	4.7	2.5	2.7	2.8	4.4	5.7	5.6	6.5	4.3	
Venezuela	5.6	1.3	5.5	5.5	0.7	2.6	1.1	1.0			
Peru	6.0	5.8	6.8	5.4	4.3	6.2	5.2	7.2	5.1	1.7	
<b>CPI (year-on-year rate)</b>											
Latin America 6 (a)	5.2	5.3	5.2	5.2	5.3	5.6	5.2	5.1	5.3	6.1	7.0
Latin America 5 (a)	4.5	4.5	4.6	4.5	4.5	4.9	4.4	4.3	4.6	4.8	5.2
Argentina (c)	10.0	10.6	10.0	10.6	10.8	10.4	10.5	10.7	10.0	15.0	19.8
Brazil	5.4	6.2	5.2	5.6	6.4	6.6	6.1	5.8	5.8	6.4	6.7
Mexico	4.1	3.8	4.6	4.1	3.7	4.5	3.4	3.7	4.2	3.6	4.2
Chile	3.0	2.1	2.6	2.2	1.7	1.9	2.3	2.5	3.2	4.5	4.9
Colombia	3.2	2.0	3.1	2.8	1.9	2.1	2.3	1.8	2.3	2.8	2.9
Venezuela	21.1	38.3	19.0	18.8	22.6	33.0	43.4	52.9	53.3	55.6	-
Peru	3.7	2.8	3.5	2.8	2.6	2.5	3.1	3.0	3.4	3.5	2.7
<b>Budget balance (% of GDP) (d)</b>											
Latin America 6 (a)	-2.0	-2.3	-2.0	-2.1	-2.1	-2.2	-2.5	-2.4	-2.6	-3.0	
Argentina	-2.0	-1.9	-1.5	-1.8	-1.9	-1.8	-1.8	-1.8	-2.1	-2.3	
Brazil	-2.5	-3.3	-2.8	-2.5	-2.8	-2.8	-3.3	-3.3	-3.2	-3.6	
Mexico	-2.6	-2.4	-2.2	-2.5	-2.0	-2.2	-2.8	-2.3	-2.8	-3.2	
Chile	0.6	-0.7	0.4	0.6	0.2	-0.7	-0.5	-0.7	-1.0	-0.8	
Colombia	-1.9	-1.9	-1.2	-1.9	-1.4	-2.5	-2.7	-2.2	-2.7	-3.7	
Venezuela	-4.8	-	-	-	-	-	-	-	-	-	
Peru	1.3	1.3	1.6	1.3	1.2	0.7	0.5	0.5	0.4	0.0	
<b>Public debt (% of GDP)</b>											
Latin America 6 (a)	39.8	39.8	41.0	41.2	41.4	40.1	40.2	38.6	-	-	
Argentina	32.7	31.9	31.9	33.0	32.1	31.7	32.5	33.2	-	-	
Brazil	58.8	56.7	58.9	58.8	59.4	59.0	58.2	56.7	57.5	58.6	
Mexico	28.5	31.1	28.5	27.5	29.3	29.7	30.3	29.9	31.9	32.0	
Chile	12.0	12.8	11.3	12.0	11.5	12.1	12.6	12.8	12.7	13.5	
Colombia	32.2	-	32.4	32.2	33.0	33.3	34.9	34.6	36.0	35.2	
Venezuela	-	-	-	-	-	-	-	-	-	-	
Peru	21.0	20.2	20.2	20.8	19.5	18.5	17.7	19.0	18.3	18.3	
<b>Current account balance (% of GDP) (d)</b>											
Latin America 6 (a)	-1.6	-	-1.7	-2.0	-2.4	-2.6	-2.8	-2.8	-2.8	-2.9	
Argentina	-0.2	-0.7	-0.3	-0.2	-0.3	-0.3	-0.6	-0.8	-1.0	-0.2	
Brazil	-2.4	-3.6	-2.2	-2.4	-3.0	-3.2	-3.6	-3.6	-3.7	-3.7	
Mexico	-1.3	-2.1	-1.0	-1.3	-1.6	-1.9	-2.1	-2.1	-1.8	-1.9	
Chile	-3.4	-3.4	-2.9	-3.4	-4.0	-4.1	-3.5	-3.4	-3.1	-2.4	
Colombia	-3.1	-3.3	-3.2	-3.1	-3.5	-3.2	-3.2	-3.3	-3.5	-3.9	
Venezuela	2.9	-	4.2	2.9	1.7	1.3	1.9	-	-	-	
Peru	-3.3	-4.5	-2.9	-3.3	-4.2	-4.4	-4.7	-4.5	-4.5	-5.0	
<b>External debt (% of GDP)</b>											
Latin America 6 (a)	19.7	20.3	19.6	19.8	20.0	19.6	19.8	20.4	21.0	-	
Argentina	23.5	21.8	24.4	23.5	23.0	21.7	22.9	21.8	23.6	-	
Brazil	13.9	13.8	13.5	13.9	14.6	14.1	13.7	13.8	14.6	15.2	
Mexico	19.2	20.6	19.1	19.2	19.1	18.7	19.3	20.6	20.9	22.0	
Chile	44.1	47.2	42.1	44.1	43.5	42.9	44.4	47.2	48.6	50.4	
Colombia	21.3	24.4	21.5	21.3	21.7	22.2	23.9	24.4	23.9	24.4	
Venezuela	31.1	-	31.8	31.1	31.2	32.0	32.8	-	-	-	
Peru	29.3	29.3	29.9	29.3	30.5	29.6	29.3	29.3	30.1	30.5	

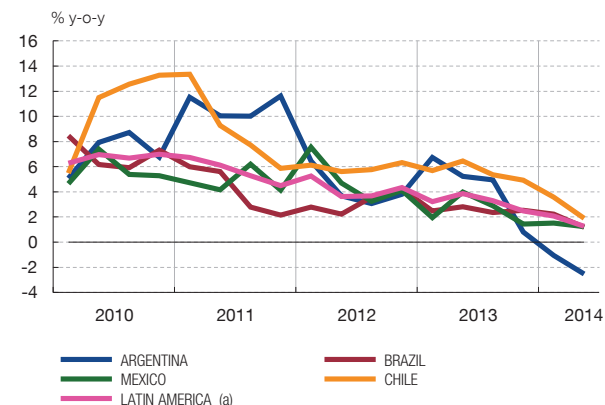
SOURCE: National statistics.

- a Latin America 6: all the countries represented, except Venezuela; Latin America 5: all the countries represented, except Argentina and Venezuela.  
b Seasonally adjusted.  
c 2014 inflation is calculated as the cumulative figure since December 2013.  
d Four-quarter moving average.

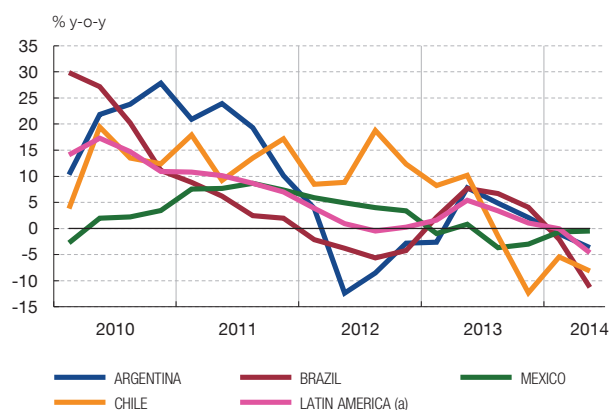
CONTRIBUTIONS TO YEAR-ON-YEAR GDP GROWTH (a)



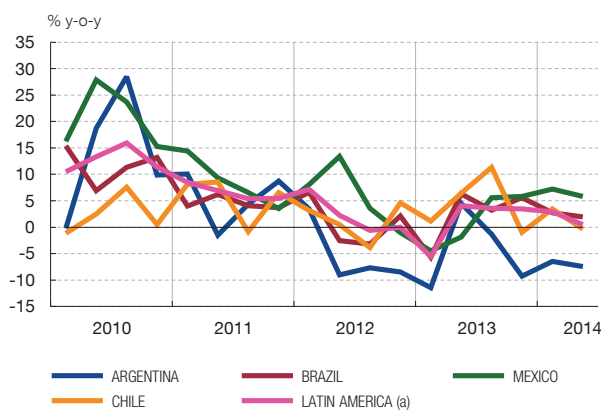
PRIVATE CONSUMPTION



GROSS FIXED CAPITAL FORMATION



EXPORTS



SOURCES: National statistics and IMF.

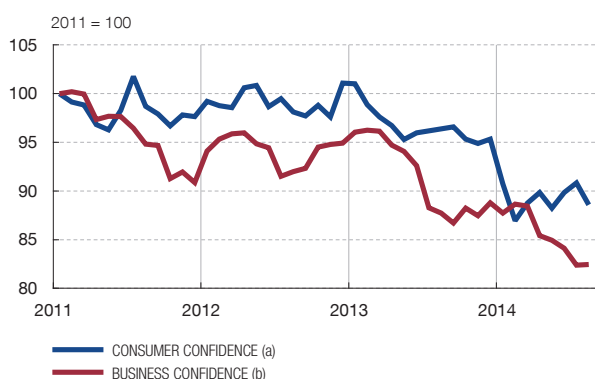
a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

small, albeit increasing, positive contribution (0.4 pp in Q2), since although exports grew only slightly, there was a considerable adjustment in imports (-1.2% in Q2).

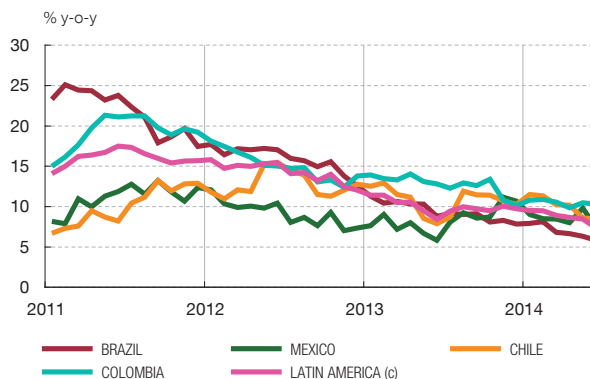
One shared feature of the weak economic performance in the first half of the year is the fall in investment (-4.6% year-on-year, the first negative figure following the crisis). Two types of factors seem to be affecting this performance to a different extent depending on the country. These are, on one hand, the maturation of the investment cycle associated with the downward movement in commodities prices and the increase in production costs and, on the other, the fall in business confidence due to a loss of credibility to some extent in economic policy management, perception of greater intervention and, on occasions, the absence of a clearer reform drive to increase medium-term potential growth. Consequently, the decline in investment seems to be having a greater effect on countries that are more reliant on the commodities cycle (such as Chile, -8.1%, and Peru, -4.5%), or those where business confidence has deteriorated more (Brazil, -11%). In Mexico, where recent reforms should improve the climate for investors, the rate of decline of gross capital formation eased but, nevertheless, slipped -0.5% year-on-year in Q2 (public investment fell -8.4%). Colombia

Year-on-year rate, indices, and three-month moving average of the year-on-year rate

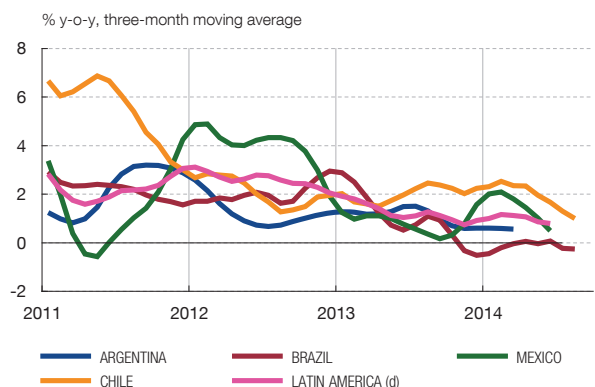
CONSUMER AND BUSINESS CONFIDENCE INDICES



REAL CHANGE IN CREDIT TO THE PRIVATE SECTOR



JOB CREATION



DEMAND AND ACTIVITY INDICATORS



SOURCES: National statistics and Datastream.

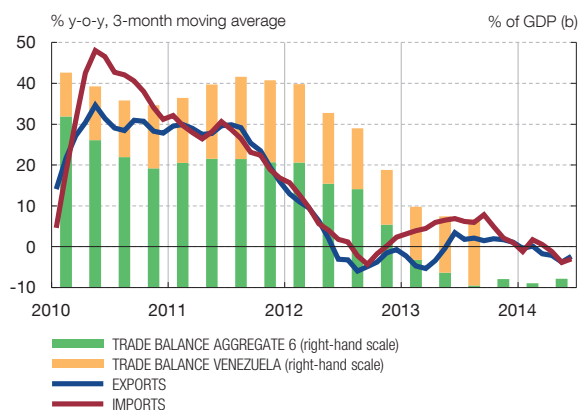
- a Aggregate of Argentina, Brazil, Chile, Mexico and Peru.
- b Aggregate of Brazil, Chile, Mexico and Peru.
- c Aggregate of Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
- d Aggregate of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
- e Aggregate of Brazil, Chile, Colombia and Mexico.
- f Aggregate of Brazil, Chile, Colombia, Mexico and Peru.

continues to buck the trend with gross capital formation growth of more than 10% year-on-year boosted by an infrastructure investment plan. Although the situation by sector seems very different, on average investment in machinery and equipment has contracted and construction growth has been weak.

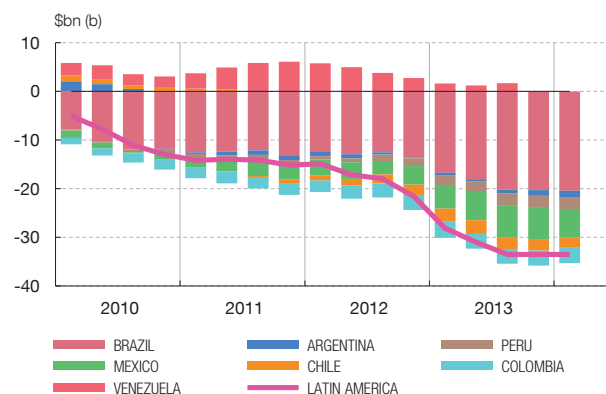
In this setting of slowing domestic demand, the growth rate of private consumption has tended to ease to 1.3% year-on-year in Q2 (2.1% in Q1). Despite the low levels of unemployment in most of the countries, labour markets are weakening in several of them. In fact, employment has decelerated to 1% (see Chart 7), as have real salaries (even falling for the second consecutive year in the most vulnerable countries). Growth of credit to the private sector continued to moderate across all the countries, except for Colombia.

Developments in external demand notably show the emergence of marked differences across countries. In contrast to growth of 0.5% in volume exports for the region as a whole in Q2, in line with a gradual recovery in the demand of the region's major trading partners and the stabilisation of China, in Mexico they grew 5.8% year-on-year in Q2. Conversely, in

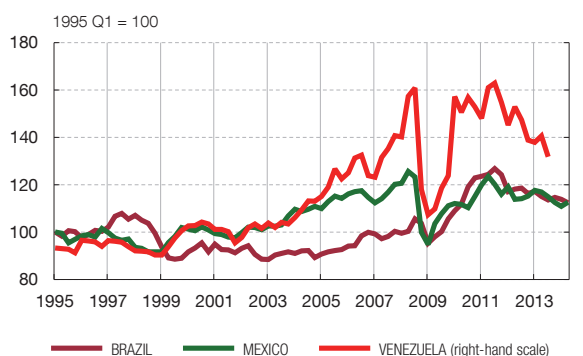
EXPORTS AND IMPORTS (a)



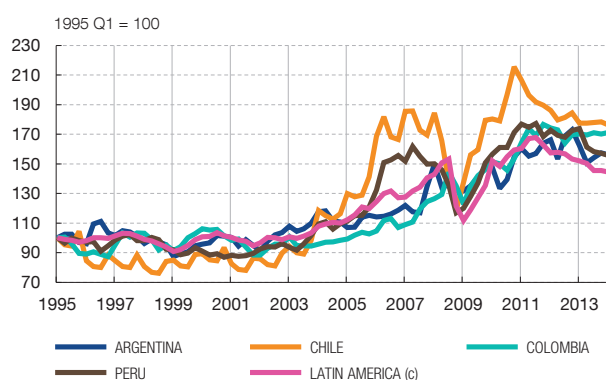
CURRENT ACCOUNT BALANCE



TERMS OF TRADE



TERMS OF TRADE



SOURCES: Datastream, national statistics and central banks.

- a Customs data in dollars, aggregate of the seven main economies except Venezuela. The trade balance of Venezuela is represented separately given that no data has been available since 2013 Q4.  
 b Four-quarter moving average.  
 c Aggregate of the seven main economies, as a GDP-weighted average for the region.

Argentina, Peru, Colombia and Chile they posted large declines. The downward adjustment in imports is partly linked to the fall in investment.

The surplus on the trade balance narrowed substantially (excluding the data for Venezuela which have not been published since end-2013) and practically reached equilibrium against a backdrop of ongoing declines in the prices of the main commodities (see Chart 8). However, as a result of the reduction of the income deficit linked to lower repatriation of profits by commodity exporters and the positive performance of tourism, the current account deficit ceased widening and stabilised around an average of 2.9% for the region. In Chile the depreciation of the exchange rate together with the fall in investment, prompted a sharper correction, whereas in Colombia and Peru the external imbalance continued to widen.

The higher frequency indicators published after Q2 seem to anticipate greater inter-regional differences. Industrial production recorded negative rates on average which have not been seen since the crisis, as a result of the performance of Brazil, Argentina, Chile

and Peru, whereas in Colombia and Mexico it increased. In those countries for which PMIs are published these indices have continued on a downward trend with the exception of Mexico, where it has risen considerably. Finally, the growth rates of retail sales have remained robust (with higher growth in Mexico, Chile and Colombia and lower growth in Brazil) but, in any event, they are considerably lower than those recorded before 2013. Overall, this information points to the continued weakness in the largest countries in South America and, by contrast, to stronger demand in Mexico.

## Prices and economic policies

In contrast with the slowing trend of activity and demand, consumer prices in the group of five countries with inflation targets moved on a slightly rising trend (see Chart 9). The inflation of this set of countries, which at end-2013 stood at slightly above 4% year-on-year, amounted to 5.2% in September 2014, mainly owing to the rise in inflation in Brazil, Chile and Mexico, reaching the upper limit of each central bank's target.

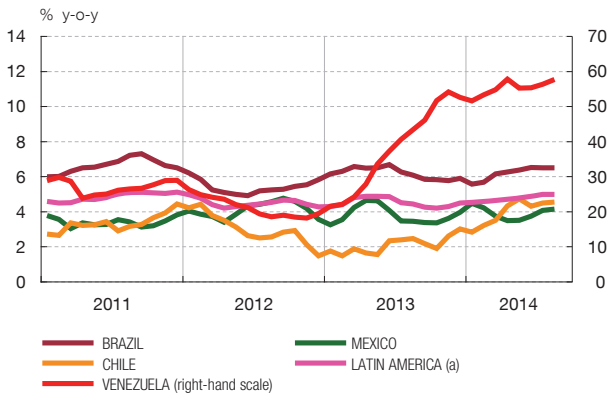
The factors underlying the rise in inflation differ in these three countries which explains the varying monetary policy responses. In Brazil inflation hovered persistently around the upper limit of the band and core inflation grew at an even higher rate than headline inflation, as a result of the sharp increase in services prices. This has meant that medium-term inflation expectations have not ultimately stabilised and have exceeded the upper limit of the target band (see Chart 10 and Table 2). In Chile, most of the rise is attributable to the effect of the depreciation of the exchange rate and the medium-term inflation expectations which have remained anchored at around 3%, despite the increase in core inflation. In Mexico, although inflation rose to 4.2% year-on-year in August, the central bank of Mexico has forcefully eased monetary policy as it considers that the rise is temporary. Medium-term expectations have tended to decrease, demonstrating Mexico's highly credible monetary policy. In Peru and Colombia inflation held at rates within the target bands, in the case of Colombia despite the buoyancy of domestic demand.

The Brazilian central bank ended the cycle of monetary tightening in April, following a cumulative rise of 375 bp in one year, and has held official interest rates at 11% since then. Tougher internal financial conditions, together with the gradual opening up of the output gap on account of slowing demand, should make it easier to steer medium-term inflation towards its target. However, the possibility of adjustments to administered prices following the elections and the recent depreciation of the real are upside risks which could make meeting the target difficult. The central bank has recently relaxed the reserve requirement to increase liquidity.

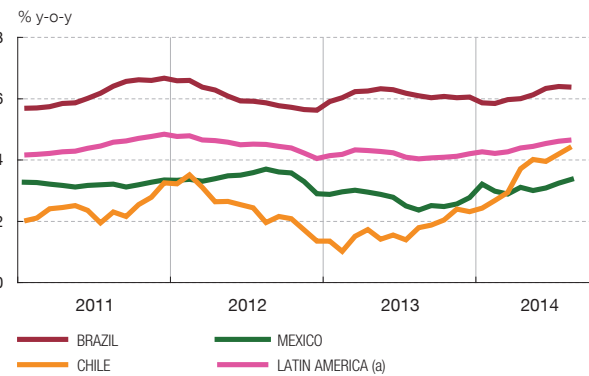
The central bank of Mexico lowered its official interest rate by 50 bp to 3% in June, in an unanticipated move (the cumulative cut over the last two years amounted to 150 bp), while the Chilean central bank cut its benchmark rate at each of its last three meetings by 25 bp to 3.25%. Finally, the central bank of Peru, which had taken action specifically by decreasing the reserve requirement in recent months, also decreased its official interest rate in September to 3.50%, down from 3.75% in July. Colombia was the only country to raise official interest rates (by 125 bp) against a backdrop of strong domestic demand, although the recent slowdown in output to around the potential growth rate may indicate the end of the upward cycle.

In Argentina, inflation, according to the new official index, stood at 19.8% in cumulative terms to September, a growth rate which once again seems to diverge from private estimates (ranging from 35% to 40% year-on-year). Monetary policy, which had tended to tighten in tandem with the exchange rate adjustment at the beginning of the year, eased

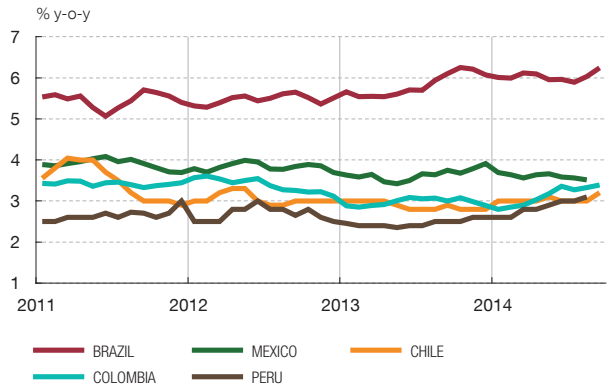
INFLATION RATE



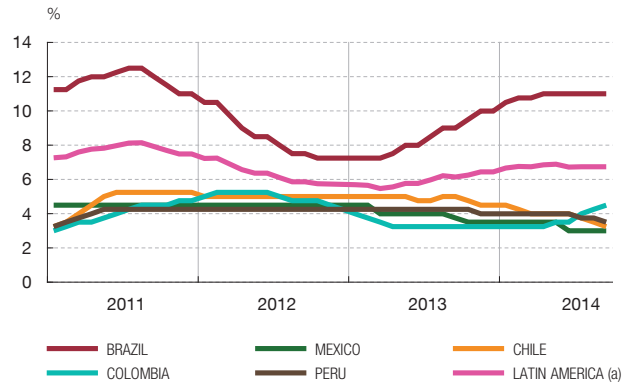
CORE INFLATION RATE



12-MONTH INFLATION EXPECTATIONS



OFFICIAL INTEREST RATES



SOURCES: Datastream and national statistics.

a Aggregate of Brazil, Chile, Colombia, Mexico and Peru, as a GDP-weighted average for the region.

over the summer with an interest rate cut against a backdrop of a worsening recession and the selective default, although this easing was subsequently reversed. Finally, in Venezuela, where the money supply is increasing at rates of above 100% to finance the government deficit, inflation soared to 59.7% year-on-year in August, a situation which is getting worse due to the shortage of consumer and producer goods arising from the fall in imports because of the tight restrictions on access to foreign currency.

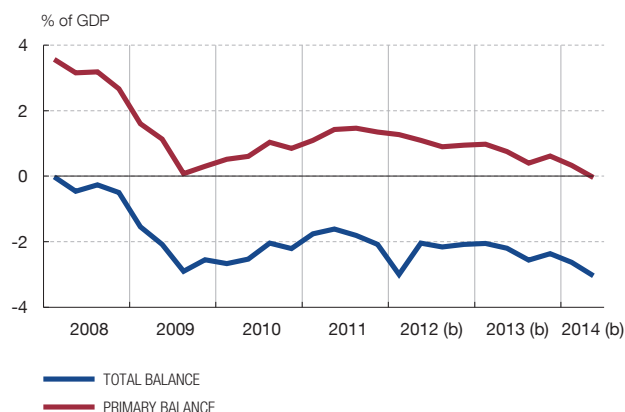
Fiscal policy has remained, on average, neutral or slightly expansionary according to the changes in the cyclically-adjusted primary fiscal balance, albeit with considerable differences across countries. Venezuela continues to pose the greatest risks in this connection, where, with the due caution warranted by the shortage of data, it is estimated that the already burgeoning deficit has continued to increase (actual primary expenditure according to the Treasury increased 18% in real terms in the first five months of the year, after having fallen 5% in 2013). Argentina is also fragile from a fiscal standpoint (see Box 1). In the other countries, there has been a tendency to postpone the expected fiscal consolidation, especially on account of the cyclical fall in revenue which has also been impacted by the decline in commodities prices. Additionally, certain stimuli have been extended (Brazil), expansionary fiscal packages have been announced (Chile) and the consolidation targets envisaged have been postponed (Mexico). On the whole, revenue



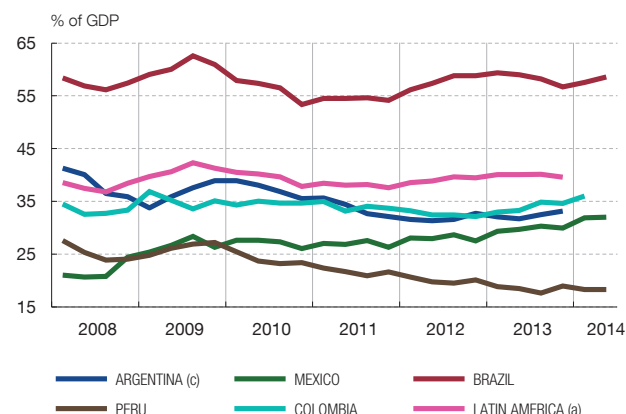
**MAIN PUBLIC SECTOR FIGURES**  
Percentage of GDP

CHART 10

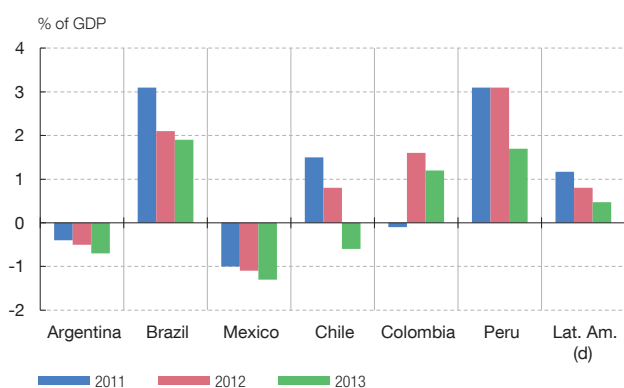
**BUDGET SURPLUS (+) OR DEFICIT (-) IN LATIN AMERICA (a)**



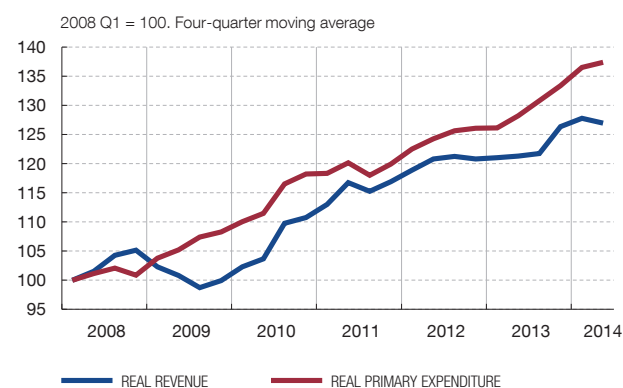
**GROSS PUBLIC DEBT**



**PRIMARY BALANCE**



**REAL PRIMARY REVENUE AND EXPENDITURE IN LATIN AMERICA (e)**



SOURCES: National statistics and Fiscal Monitor (IMF).

- a Aggregate of the seven main economies, as a GDP-weighted average of the region.
- b In Venezuela, 2012 quarterly data estimated from annual data. In 2013 and 2014 aggregate excluding Venezuela.
- c Excludes untendered debt in the debt swap offers of 2005 and 2010.
- d Aggregate of the six countries represented.
- e Aggregate excluding Argentina and Venezuela.

**INFLATION**  
Year-on-year rates of change

TABLE 2

Country	Target	2013		2014		2015
		December	Fulfilment	August	Expectations (a)	Expectations (a)
Brazil	4.5 ± 2	5.9	Yes	6.5	6.3	6.2
Mexico	3 ± 1	4.0	Yes	4.1	3.9	3.5
Chile	3 ± 1	3.0	Yes	4.5	4.2	2.9
Colombia	3 ± 1	1.9	Yes	3.0	3.3	3.2
Peru	2 ± 1	2.9	Yes	2.7	3.0	2.7

SOURCES: National statistics and Consensus Forecasts.

- a September 2014 Consensus Forecast for the end of the year.

has tended to moderate whereas expenditure continued to rise. The aggregate budget deficit has grown to close to 3% of the region's GDP and the aggregate primary surplus has disappeared (see Chart 10).

## Trade and reforms

At the Pacific Alliance summit in July it was announced that from Q4 the Mexican Stock Exchange will be included in the Latin American Integrated Market ("MILA" by its Spanish abbreviation) which currently comprises the stock exchanges of Colombia, Chile and Peru. This will create a stock market with a capitalisation of more than \$1.2 billion (representing 58% of the four countries' GDP) and around 1,000 firms. The possibility of closer ties with MERCOSUR was discussed, with a view to all or some of its members joining this bloc – a change which could be of some importance for the Alliance in the future – and certain free trade agreements were concluded which will give Panama and Costa Rica access to the bloc. The Alliance's focus on the Pacific was reflected by its members commencing and making progress with negotiations to reach free trade agreements with Asian countries (Peru with India and Russia, Chile with Indonesia and Colombia with Japan).

Relations between MERCOSUR members continue to encounter difficulties. As a result of the financial problems in Argentina and weaker activity, intra-bloc trade has decreased considerably: Brazil's exports to other members fell 11% year-on-year in the first seven months of the year, while Argentina's exports declined at rates of 12%. Consequently, Brazil's exports to the rest of the bloc have decreased from 14% of its total exports in 2009 to less than 10% at present, whereas the share of imports has slipped from 11% to 7.5%. Admittedly, closer ties with the Pacific Alliance were not discussed at the summit at end-July, but the intention was announced to include Bolivia as a full member and to set up a trade area with the member countries of ALBA (Bolivarian Alternative for the Americas) and Petrocaribe (two regional agreements promoted by Venezuela). The elections in Brazil and Uruguay could prompt changes in the relations with other members and in the negotiations with other trade blocs if there are changes in the current governments. At the same time, the offer by MERCOSUR to resume negotiation of the treaty with the European Union, which would cover 90% of trade, has been completed, while Brazil and Argentina extended their car trade agreement for another year, with slightly more favourable conditions for Argentina.

In the area of structural reforms, in Mexico the necessary legislation for the entry into force of the reforms approved in the previous six months was enacted, especially the energy reform which has turned out to be more ambitious than initially planned. For this programme of reforms to raise Mexico's potential growth rate, its effective implementation is essential (see Box 2). In Chile a fiscal reform was approved to raise tax collection to finance improvements in the education and health systems. Finally, several initiatives and laws were approved in Venezuela which further increase government intervention.

## Economic developments by country

*Brazil's* economy entered a technical recession in 2014 Q2 since the quarter-on-quarter rate of change in GDP fell by -0.6%, after declining -0.2% in the previous quarter (revised down from 0.2%), as a result of the widespread slowdown in domestic demand and, in particular, in investment which decreased by -5.3%. In year-on-year terms GDP contracted by -0.9% in Q2, following an increase of 1.9% in Q1 and three years of weak growth of around 2%. The rate of investment fell back to 16.5% of GDP, the lowest since 2006, and the higher frequency indicators point to continued weakness in the short term (see Chart 11). Private consumption, which had been the main support for growth in recent years, also eased significantly to a year-on-year rate of 1.2% in Q2. Factors explaining these developments include the inflation performance, a slight

After almost two decades without any progress in structural reforms, the Government elected following the July 2012 elections proposed an agenda of sweeping reforms – unprecedented since the late 1980s – aimed at boosting the country’s potential growth. Indeed, Mexico, which has sound fundamentals – macroprudential policy management, low external vulnerability, above-investment-grade credit ratings and a healthy financial system – nevertheless evidences low factor productivity and very low growth rates, down on those of previous decades (see Panel 1). This box briefly examines the main reforms approved in Mexico.

The most significant reform from the economic standpoint concerns the energy sector, which affects both the oil and the electricity generation and distribution industries. This reform – which required an amendment to the Constitution – seeks to raise the country’s crude oil output, which stood in mid-2014 at its lowest level since 1980 (see Panel 2), by improving the management and efficiency of PEMEX, and to reduce the high cost of electricity in Mexico (it is about 70% higher than in the United States).

The part of the reform referring to hydrocarbons opens the way for agreements with private corporations on exploration and extraction, as well as for granting refining, petrochemical, transport and storage permits, although the nation will retain

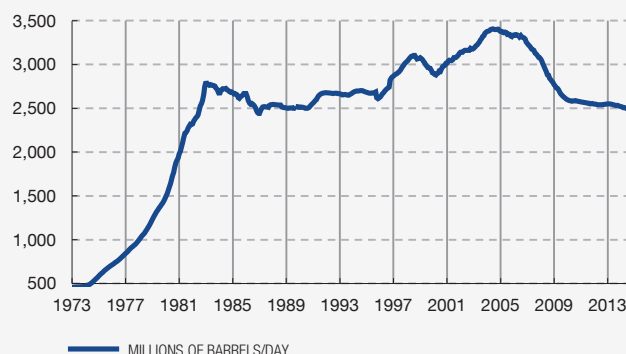
exclusivity over the ownership of sub-soil resources. The secondary legislation needed to set the reform in train was approved in mid-August. It establishes the so-called round zero – assignments by exploration area and production field that will be retained exclusively by PEMEX, and which will allow joint ventures –, it strengthens the budgetary autonomy of PEMEX – as the Treasury partly absorbs the company’s pension system and its equivalent in the electricity industry, the CFE (Federal Electricity Board)<sup>1</sup> –, and it liberalises retail distribution, opening the petrol station sector up to private companies in 2016, and eliminating in full fuel subsidies, which have been equivalent to 1% of GDP on average over the past five years, in 2018. Finally, private capital inflows into the oil sector, the Government proposes up to three exploitation models: payment of exploration fees, payment of royalties and wealth distribution arrangements. This flexibility in the format of agreements is the centrepiece of the new legislation, as it will enable each type of exploitation arrangement to be tailored to the most appropriate and profitable model both for PEMEX and for the private sector. Moreover, that part of the reform relating to the electricity sector introduces competition into the generation segment, allowing the participation

1 As a side-effect, the State’s medium- and long-term contingent liabilities would increase by around 5 pp of GDP.

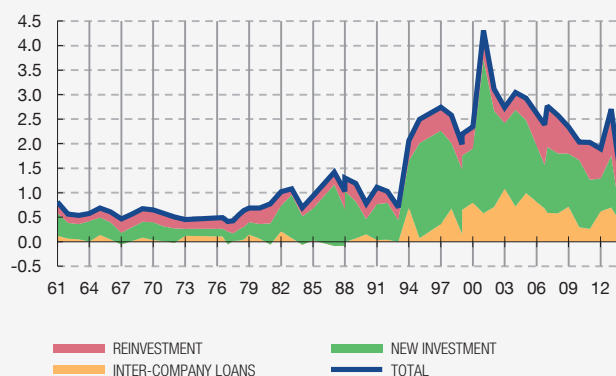
1 GDP GROWTH



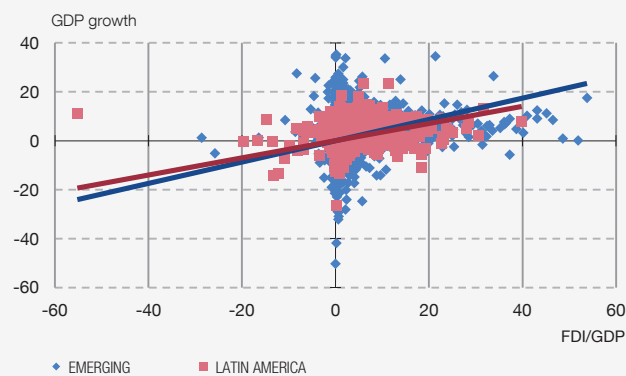
2 OIL PRODUCTION



3 FOREIGN DIRECT INVESTMENT RECEIVED (% GDP)



4 FOREIGN DIRECT INVESTMENT (% OF GDP) AND GROWTH (%)



SOURCES: INEGI and Banco de España.

of private firms and opening the way for industrial clients to choose their suppliers. Moreover, the creation of a wholesale electricity market is planned, under the control of the new National Centre for Energy Control, where the large corporations may sell the electricity they generate. The CFE will also maintain the distribution and sale of electricity to households. In both sectors – hydrocarbons and electricity – the powers of the regulatory agencies will be strengthened.

Another very significant reform, approved in June 2013 and implemented in July 2014, is that of the telecommunications sector. The aim is to reduce the cost of access to these services, which is twice that in the United States, and to raise the number of users. The new law eliminates the restrictions on foreign investment in mobile telephony, requires firms with a dominant position in the market to divest themselves of assets, and creates a new regulating body, the *Instituto Federal de Comunicaciones*, to oversee licence awards.<sup>2</sup>

The reform of the financial sector, approved in January 2014, seeks to introduce greater competition and efficiency, facilitating the transfer of collateral and salary payments from one institution to another, simplifying the regime for providing and realising collateral, cutting the commissions charged to businesses for the use of electronic means of payment and strengthening the agency responsible for processing user complaints. It should be recalled here that Mexico is not a highly banked economy. Bank lending in Mexico represents around 30% of GDP (20 pp below the average level in the region and far below the level corresponding to its per-capita income) and barely 20% of the population use formal financial services. In short, the financial reform aims to increase the protection of creditors' property rights, eliminating the legal loopholes that allow debtors to draw out the debt resolution process. On the regulation front, the Basel III rules have been afforded the status of a law and savers' rights in bank insolvencies, a key aspect of the protracted 1995 crisis, are clarified. The reform contains some points that would indicate greater public involvement in the sector, such as the strengthening of development banking (removing from its mandate the need to maintain a high level of capitalisation and boosting the financing of underbanked sectors) and the power of authorities to carry out periodic assessments of credit levels, to encourage greater supply.

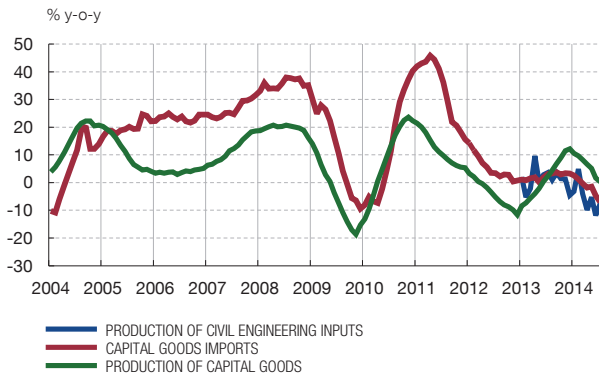
2 The main changes are: 1) elimination of preferential tariffs (whereby calls to phones using the same provider are cheaper); 2) elimination of domestic long-distance charges; 3) elimination of roaming charges, and 4) the requirement that companies supply unlocked mobile phones and allow customers to change provider in under 24 hours.

The fiscal reform, approved in October 2013, seeks to increase tax revenues by 2% of GDP in 2018 and to expand the social security network, establishing unemployment insurance, raising income tax and indirect taxes, reducing certain corporate income tax exemptions and harmonising VAT across sectors. The new law also adopts a structural fiscal rule, which limits the pro-cyclicality of fiscal policy, and sets up a sovereign wealth fund that will finance part of education and social security spending. Finally, the labour reform, approved under the previous government, seeks to reduce labour market entry and exit costs in order to limit informality.

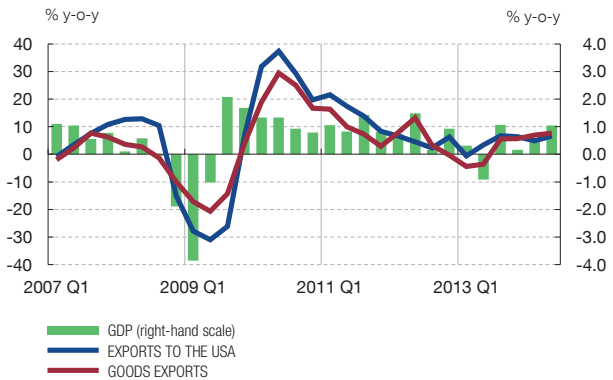
The approved package of reforms (mostly second generation ones, which not only eliminate obstacles to growth, but also actively promote it) will impact potential growth through numerous channels, in addition to the effect, common to all reforms, on agents' confidence. Without claiming to be exhaustive, the energy reform would act, among other factors, on foreign direct investment, attracting more capital to the oil industry. The fiscal reform would increase fiscal room for manoeuvre, reducing the pro-cyclicality of fiscal policy by establishing a new fiscal rule. The telecommunications and electricity industry reforms would liberalise services and increase competition further, reducing the pressure on consumer prices and thereby increasing monetary policy's room for manoeuvre. The labour reform would tend to increase productivity by reducing the degree of informality in the economy through the extension of social security benefits and the creation of unemployment insurance. Finally, the financial reform would make it easier for a larger part of the population to access banking services.

Estimates suggest that the energy reform could attract an extra \$5-30 billion of investment to the oil industry each year (the higher figure is the Government's forecast). Under the official scenario, foreign direct investment (FDI) inflows would amount to 1.5% of Mexican GDP, double their current levels, which have been very low since 2003 (see Panel 3), this being one of the factors explaining the low level of productivity in the Mexican economy. As seen for a broad panel of emerging countries in Panel 4, the correlation between FDI inflows and growth is positive; on the basis of this direct effect alone, Mexico could raise its long-term growth. Nevertheless, the entry into force of this broad set of structural reforms over a relatively short time period makes it difficult to estimate its overall impact. The range of estimates for the impact of the reform package on the potential growth rate is wide, extending from 0.5 to 2 pp. At the lower end, this would raise potential growth to 3.5%, and at the upper end to 5%. Reforms usually take a long time to bear fruit, but even the lower end of this range of estimates represents a very significant increase above Mexico's trend rate of growth over the last 30 years.

BRAZIL: INVESTMENT INDICATORS



MEXICO: GDP AND EXPORTS



SOURCE: National statistics.

downturn in the labour market, particularly in industry, wage moderation and lower growth of consumer credit. In particular, free-market lending decelerated to year-on-year rates of 5% in a climate of high household debt, although the rates for directed credit remained very high (27.3%).

The volume of exports grew moderately in Q2, by 1.9% year-on-year, as a result of the recovery in demand in the United States, Europe and Asia, excluding China. The contribution of the external sector to growth was positive chiefly due to the decrease in imports, of 2.4% year-on-year, which were pulled down by capital goods imports. In this setting and despite the slight deterioration in the terms of trade, the current account deficit decreased very gradually over the six months to 3.6% of GDP in August, thanks to a small improvement in the surplus on the trade balance which increased from 0.1% of GDP in January to 0.3% in August, which offset a fresh deterioration in the services balance from -2.1% of GDP to -2.2%.

The high frequency indicators do not indicate a favourable outlook in the short term: industry and construction confidence indexes stand below 50 or close to lows, as does the consumer confidence indicator. By contrast, industrial production in July recovered slightly, led by capital goods, a trend that was endorsed by the positive data of the monthly GDP indicator for July.

Despite weak domestic demand, inflation climbed from 5.6% in January to 6.5% in August, just on the limit of the target band on account of the strong rise in services prices. Core inflation rose from 6% in January to 6.7% in September. Against this backdrop, the central bank of Brazil has held its interest rate at 11% since April, following a cumulative increase of 375 bp. In the fiscal realm, the primary surplus fell to 1.3% of GDP in July, making it difficult to comply with the target of 1.9% for 2014, although it was announced recently that part of the funds from the sovereign wealth fund will be used to achieve the aforementioned primary surplus. The government deficit stood at 3.96%, its highest level since 2009, in a setting in which the slowdown in revenue growth (4.8% to July compared with 11.2% in 2013) outpaced that of expenditure (12.2% compared with 14.1% in the previous year). Nevertheless, it was attempted to maintain some fiscal impulse by extending industry exemptions and social contributions and action by BNDES to boost activity. Moody's changed the outlook on the sovereign credit rating to negative. The current president, Dilma Rousseff, won the first round of the presidential elections; a victory

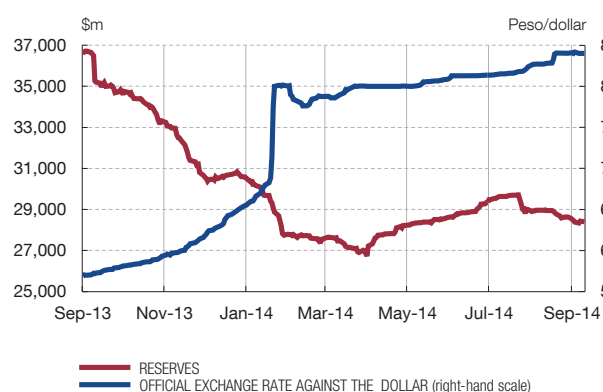
in the second round at the end of the month would point to a scenario of continuity in economic policies.

Following a lacklustre first quarter in which GDP grew 0.4% quarter-on-quarter, *Mexico's* economy experienced a more visible recovery from the second quarter (1% quarter-on-quarter) which, according to the most recent indicators, seems to be continuing in the second half of the year. The year-on-year rate of change of GDP in Q2 stood at 1.6%, compared with 1.9% in Q1, although it was pushed downwards by the effect of Easter (net of that effect year-on-year growth is estimated to have been 2.7%). The economic recovery is mainly led by the external sector (see Chart 11). Goods exports continued to perform well, increasing by 7.7% year-on-year in Q2 following a rise of 6.9% in Q1. Conversely, the fall in activity in the United States early in the year, a higher-than-expected impact on private consumption and investment from the rise in taxes, the slow recovery of construction and the drop in oil production had a negative effect on domestic demand. The high frequency indicators for Q3 (IMEF [Mexican Institute of Financial Executives] and producer confidence) suggest a strengthening of the cycle in the second half of the year, boosted by external demand and public spending, particularly on infrastructure. Also, it is estimated that other domestic demand components will begin to lend greater support. Thus, the unemployment rate decreased to 5.2% of the labour force in August (5.5% in July), employment in the formal sector increased by 3.2% in Q2, more than in previous quarters, and informal employment fell. Wages have been growing by 4% in real terms.

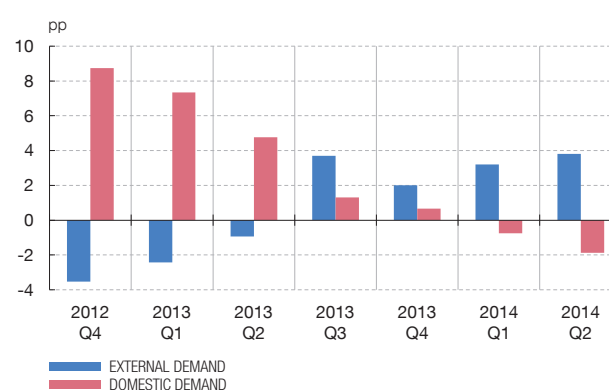
Inflation rose again towards rates of 4.2% year-on-year in September, slightly above the upper limit of the target band, although this was as a result of base effects which should peter out and permit rates to return to around 3% year-on-year from next year. Medium-term inflation expectations have not moved significantly from 3.5%. In this setting, the central bank cut the monetary policy rate by 50 bp in June to 3%. This decision was not unanimous for the first time in a long while. According to the minutes, the argument prevailed that inflation remains under control and no inflationary pressure was detected in the monetary policy horizon, along with the strategy of "efficient convergence" which means leading inflation towards the target with the lowest possible cost in terms of activity. At the beginning of August, the central bank chose to leave rates unchanged in a decision which shows confidence in the strength of the economy. The government deficit widened to 3.22% of GDP in Q2 and the primary balance deteriorated (-1.29% compared with -0.89% in Q1).

After 2014 Q1 when *Argentina* slipped into a technical recession, posting quarter-on-quarter growth of -0.5% (following -0.5% in 2013 Q4), in Q2 its economy grew 0.9%. The year-on-year growth rate stood at zero, down from 0.3% in Q1 (revised upwards). These developments are explained by the fall in domestic demand weighed down by the contraction of private consumption (-2.5% year-on-year) and gross capital formation (-3.7% year-on-year), which were only partially offset by government consumption (4% year-on-year). External demand made a positive contribution due to the significant decline of imports which was above 10% year-on-year. The economic situation is expected to worsen in the second half of the year. Exports and imports continued to fall at sustained rates of 10% year-on-year between January and August, as a result of the decline in soy bean prices and the restrictions arising from the shortage of foreign currency, and the 12-month cumulated deficit of the current account widened in Q2 to \$6.2 billion, slightly more than 1% of GDP, while the capital and financial accounts also ran a slight deficit due to the loan repayments by the central bank to international organisations. Reserves stood at levels of less than \$29 billion which prompted a devaluation of the peso early in the year

ARGENTINA: RESERVES AND EXCHANGE RATE



CHILE: CONTRIBUTIONS TO GDP GROWTH



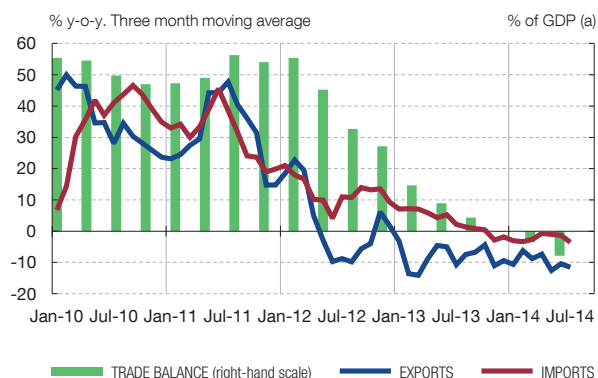
SOURCES: Banco Central de la República Argentina and Instituto Nacional de Estadísticas of Chile.

(see Chart 12). The judgment of the New York court in the trial against the holdouts, which blocked payment of the restructured debt, has led the country to a situation of selective default since 30 July, with implications for its economic performance (see Box 1).

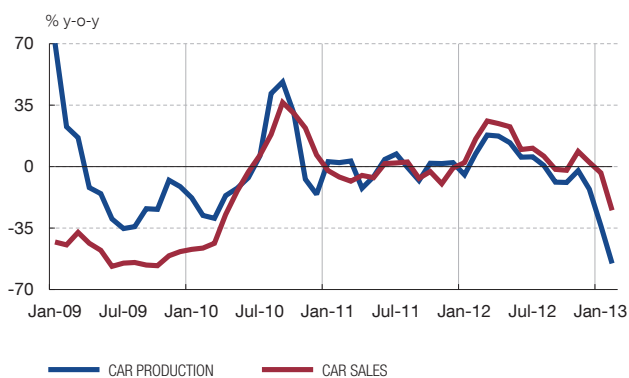
Inflation continued to rise and stood at 19.8% in cumulative terms to September, against a backdrop characterised by the ongoing monetisation of the government deficit and an increase in the pace of devaluation of the official exchange rate (8.44 pesos per dollar, compared with 8.1 in July). The gap between the official and unofficial exchange rate against the dollar widened to a high of more than 70%. In an attempt to ease exchange rate pressure, the central bank once again reduced the limit on dollar holdings of the banking system (to 20% of their asset position). The monetary base grew to August by slightly more than 19%, down from 24% at the end of last year and the lowest rate since 2010. This decline was explained by the absorption of liquidity by the central bank's auctions of securities, which was prompted by the rise in interest rates of almost 1000 bp since the beginning of the year. On the fiscal front, the public-sector primary deficit in the last 12 months stood at 0.7% of GDP, taking into account the central bank's transfers. Although public-sector revenue grew in nominal terms by around 39% year-on-year in the 12 months to July, as a result of high inflation, primary expenditure grew by 41%, due to the rise in current transfers to the private sector (subsidies).

During the first half of 2014, Chile's economy slowed more than expected. In quarter-on-quarter terms, GDP expanded 0.6% in Q1 and 0.2% in Q2, and in year-on-year terms it grew by 2.4% and 1.9% respectively, easing very significantly compared with average growth of 5% in the last three years. Domestic demand posted declines in two consecutive quarters and the year-on-year pace of contraction of investment stepped up to -8.1%. For a small open economy like Chile's, real effects of the commodities cycle have repercussions far beyond the realm of external and fiscal accounts. Consequently, in tandem with the decrease in copper prices and the depreciation of the exchange rate (by more than 13% against the dollar in the year to date) the composition of growth is rebalancing sharply and relatively quickly. This adjustment has led domestic demand to shave practically 2 pp off growth in Q2 and external demand to contribute 3.8 pp, as a result of the fall in investment and imports and of the, as yet, slow response of exports (-0.4% in Q2) (see Chart 12). Private consumption weakened considerably (1.9% year-on-year in Q2 compared with 5.2% in 2013) and only public consumption was more buoyant. In this setting, the unemployment rate followed a slightly upward trend.

PERU: TRADE BALANCE



VENEZUELA: PRODUCTION AND CONSUMPTION INDICATORS



SOURCE: Cavenez and Datastream.

a Four-quarter moving average.

The trade surplus to August was higher than that recorded during the same period a year earlier due to the strong fall in the value of imports (-9.1% year-on-year), since exports also decreased (-0.4% year-on-year). These developments, together with the lower repatriation of profits by commodity exporters, have been giving rise to a correction in the current account deficit which, at -2.4% in Q2, was more than 1.5 pp lower than a year earlier. Inflation climbed to 4.9% in September, above the upper limit of the central bank's target, reflecting the pass-through effect of the exchange rate. However, medium-term inflation expectations remain anchored at around 3%. Against this background, the central bank cut official interest rates by a further 75 bp from April to 3.25% in September. On the fiscal front, central government revenue decreased by -0.2% in the first half of the year with respect to the same period of the previous year, while expenditure increased 5.3%. In the first half of the year, a surplus of 0.1% of GDP was recorded, although for the year as a whole a deficit of around 2% of GDP is expected due to the foreseeable quickening of expenditure during the second half of the year; the structural deficit will stand slightly above 1% of GDP. The government presented a fiscal stimulus package amounting to \$500 million geared at stimulating public and private investment. Lastly, the fiscal reform was approved mid-September by the Chilean parliament with the aim of increasing tax collection by 3% of GDP to 2018. The funds obtained will be used for the education reform, health spending and greater fiscal balance.

Peru's economy also slowed more than expected during the first half of 2014. GDP posted zero quarter-on-quarter growth in Q2, following the quarter-on-quarter contraction of -0.2% in Q1. In year-on-year terms, the economy decelerated to 1.7% in Q2 from 5.1% in Q1. This performance is due both to the behaviour of domestic demand – which eased to 2.2% year-on-year in Q2 despite relatively firm private consumption owing to the sharp fall in investment (4% year-on-year) – and of external demand which shaved 0.7 pp off growth due to the decline in exports. The unemployment rate remained stable at below 6%. In the first half of the year the trade deficit widened; the pace of contraction of exports accelerated significantly mainly as a result of lower demand for commodities (see Chart 13). The current account deficit continued to widen to 5.1% of GDP. Inflation tended to moderate gradually to 2.7% year-on-year in September, within the central bank's target interval (2% +/- 1 pp). The central bank of Peru cut its benchmark interest rate in July and September by 25 bp to 3.5%. Similarly, in order to increase the funding of lending in local currency, it reduced the marginal reserve requirement for sol-denominated deposits six times (which



left it at 10.5%) and relaxed the reserve requirement for foreign trade. On the fiscal front, the central government recorded a primary surplus equivalent to 1% of GDP in the January-August period, which was lower than that of 1.8% posted in the same period of 2013.

In *Colombia*, activity began to slow in 2014 Q2 (-0.1% quarter-on-quarter and 4.3% year-on-year) following a very dynamic first quarter (2.5% quarter-on-quarter and 6.7% year-on-year). Nevertheless, it is the most buoyant country in the region. Growth in Q2 was supported by domestic demand which expanded 7.7% year-on-year, largely driven by investment (11% year-on-year) particularly in civil engineering works. By contrast, external demand explained the slowdown to a large degree, since it trimmed 4.4 pp from growth as a result of a sharp contraction of exports (8.6% year-on-year), due to base effects and supply constraints in the oil sector. The current account deficit continued to widen in the first half of the year and amounted to 4.4% of GDP in Q2. The leading indicators for Q3 show a slight easing, in a setting of a positive performance of the labour and credit markets. Inflation held within the central bank's target range (2%-4%), although it moved on a rising path reaching 2.9% in September in year-on-year terms as a result of higher food and house prices. Core inflation remained at below 3% almost throughout that period, favoured by the appreciation of the exchange rate. The central bank increased official interest rates by 25 bp at each of its last five meetings to August (when they stood at 4.5%) but left them unchanged at the meeting in September given the moderation of domestic activity and uncertainty in the international arena. Turning to fiscal matters, noteworthy is the government's proposal for a new fiscal reform in order to boost tax revenue and to enable it to meet the central government deficit target for 2014 and 2015 of 2.4% of GDP. In July Moody's raised Colombia's rating from Baa3 to Baa2 with a stable outlook, bringing it into line with S&P's and Fitch's ratings.

*Venezuela's* GDP data for the first half of 2014 and most of the high frequency indicators since September 2013 have still not been published. Partial indicators of the economy's position in the cycle such as output and car sales decreased very sharply in the first seven months of the year (see Chart 13), steel production fell by around -25%, and the use of oil rigs was down by -2%. By contrast, two of the variables underpinning private consumption – employment and credit – performed more favourably. Job creation stood at 3.1% year-on-year in the period of January-July 2014 and credit-card credit grew at rates of above 20% in real terms, although real wages continued to fall at very high rates. Inflation was 59.7% in August, owing to the shortage of imported goods (imports fell 20% in dollar terms in the first four months of 2014), growth of the money supply of more than 100% and the devaluation of the exchange rate prompted in practice by the entry into operation of SICAD II, the new foreign exchange market.

Reserves stood at \$21 billion at end-August (down by approximately \$8 billion on January 2013), \$6.5 billion of which are estimated to be liquid. The government has proposed the sale of PDVSA's subsidiary in the United States (Citgo) and has signed several loans with foreign oil companies in exchange for licences in the Orinoco belt, in order to preserve a minimum level of reserves, given the ongoing decline in exports (2% in the first four months of 2014). However, a large foreign debt will mature soon which has prompted a sharp increase in Venezuela's sovereign spread and a downgrading of its country rating to CCC+. At the end of September the government announced that part of PDVSA's revenue may be sold in SICAD II, thus easing budget restrictions, both of the government and of the state oil company in domestic currency, in addition to boosting the supply of foreign currency in that market which can be accessed by the private sector.

