

# Latin America Regional Overview

March 2010

- Strong fundamentals and counter-cyclical stimulus programs have set the stage for a robust economic recovery from the region's worst recession in 25 years
- Bank lending is returning to normal, domestic demand is growing and labor market conditions are improving
- In 2010 we expect the recovery to continue to accelerate and project regional GDP to increase 4.8 percent, or over twice as fast as that of the global economy
- A timely withdrawal of monetary and fiscal stimulus is essential to repair public balance sheets and preserve hard-won macroeconomic stability
- Long overdue structural reforms would further enhance economic growth prospects

## HELPING TO LEAD THE GLOBAL RECOVERY

The global slowdown, a collapse of commodity prices, reduced exports, and a sharp deterioration of confidence and labor market conditions resulted in a 2.3 percent contraction of Latin America's output in 2009 on an annual average basis (Table 1). However, fiscal and quasi-fiscal stimulus, a large monetary impulse, and a positive contribution from inventory accumulation helped put the region on a solid recovery path in the second half of the year. Capital flows recovered strongly after reaching near "sudden stop" conditions in the fourth quarter of 2008 and into early 2009, and international reserves increased to record levels. Flexible exchange rates and the strength of banking systems across the region provided further sources of resilience to the global shock. Led by **Brazil**, **Chile** and **Peru**, we project output in the region to increase by 4.8 percent in 2010 and 3.7 percent in 2011.

**Table 1**  
**Annual Real GDP Growth**  
*percent change, y/y*

	2007	2008	2009e	2010f	2011f
<b>Latin America</b>	<b>5.4</b>	<b>4.0</b>	<b>-2.3</b>	<b>4.8</b>	<b>3.7</b>
Argentina	8.7	7.0	-2.6	4.4	3.2
Brazil	5.7	5.1	0.0	5.8	4.0
Chile	4.7	3.2	-1.8	5.5	4.5
Colombia	7.5	2.5	-0.5	3.8	4.2
Ecuador	2.5	5.3	-0.8	2.6	2.2
Mexico	3.3	1.4	-6.5	4.4	3.5
Peru	8.9	9.8	1.0	5.6	5.0
Venezuela	8.4	4.8	-2.9	2.0	1.5

### Fred Jaspersen

1-202-857-3608  
fjaspersen@iif.com

### Nader Nazmi

1-202-857-3641  
nnazmi@iif.com

### Ramón Aracena

1-202-857-3630  
raracena@iif.com

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### Outlook

Researchers Jonathan Clark and Robin Koepke provided extensive support for this publication.

## Recent Economic Developments

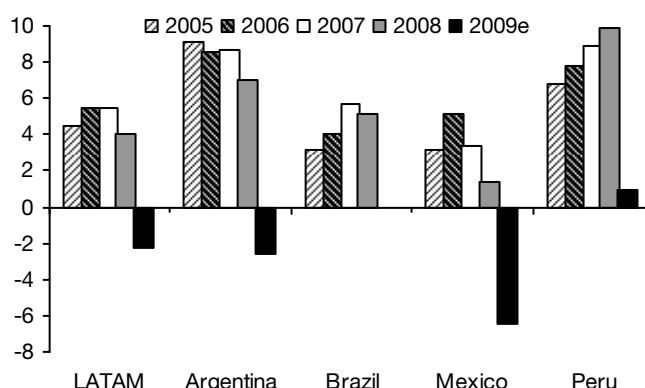
### WORST RECESSION IN 25 YEARS

- In 2009, the region experienced its worst recession since 1983. The combination of a deep global recession, a large negative terms-of-trade shock, and a substantial decline in capital inflows resulted in a 2.3 percent contraction of Latin America's output (Chart 1).
- The decline in GDP was most severe in **Mexico** (6.5 percent), reflecting the tight linkages between the U.S. and Mexican manufacturing sectors and a moderate counter-cyclical stimulus that was overwhelmed by the sharp decline in domestic demand. **Peru** was the only major Latin American country where the economy expanded in 2009, albeit by only 1.0 percent, thanks to countercyclical macroeconomic policies and a rapid recovery in global demand for its key exports (Chart 2).
- Substantial and broad-based policy support and a relatively closed economy allowed **Brazil** to rebound quickly from a recession brought on by the global downturn. Following a drop of 11.2 percent (saar) in the fourth quarter of 2008 and 3.5 percent in the first quarter of 2009, Brazil returned to positive economic growth at a brisk pace thanks to substantial policy stimulus and a recovery in external demand. Domestic demand and net exports have been the chief drivers of growth.
- Latin America's strengthening fundamentals in 2003-2008 provided room to maneuver for a more effective response to the global crisis, demonstrating that improved policy management enhances resilience in the face of adverse external shocks. Flexible foreign exchange regimes, transparent and responsive monetary policies, and countercyclical fiscal and quasi-fiscal stimulus helped the region weather the global storm.

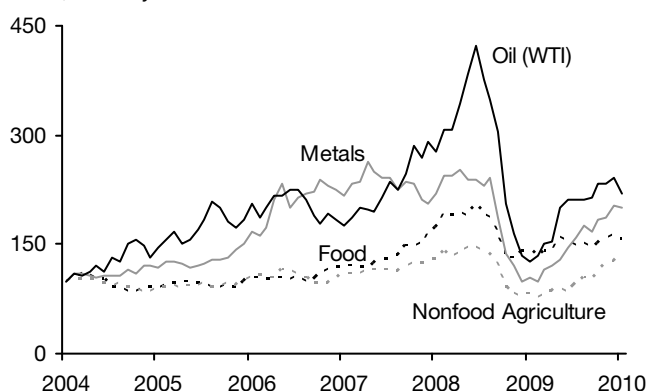
### STRONG RECOVERY BEGAN IN THE THIRD QUARTER

- Strengthening prices for the region's key commodity exports (Chart 2), increased net capital inflows, and a positive contribution from inventory accumulation helped put Latin America on a recovery path beginning in the second quarter of 2009 (Table 2).
- Following a contraction of 9.0 percent (saar) in the first

**Chart 1**  
**Real GDP Growth 2005-2009**  
percent change, y/y



**Chart 2**  
**Commodity Prices**  
index, January 2004 = 100



**Table 2**  
**Quarterly Real GDP Growth**  
percent change over previous period, saar

	2008				2009		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Latin America	5.3	3.3	2.4	-8.0	-9.0	1.4	5.3
Argentina	5.1	7.3	5.3	-2.0	0.2	0.5	0.2
Brazil	7.5	3.9	4.5	-11.2	-3.5	4.4	5.1
Chile	7.2	7.6	-5.1	-7.9	-2.9	-1.2	4.6
Colombia	-1.8	2.3	0.6	-5.0	0.3	3.3	0.9
Mexico	4.3	-1.4	0.2	-9.3	-23.4	-1.1	12.2
Peru	11.1	8.9	10.4	-3.9	-6.9	-1.6	9.7
Venezuela	-0.1	11.4	-0.1	2.3	-9.7	-1.8	-8.5

## Recent Economic Developments

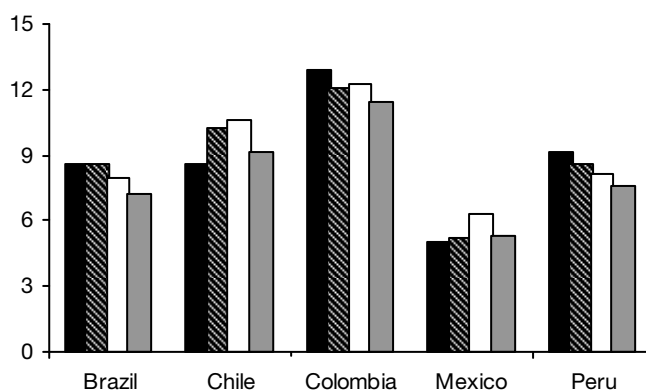
quarter, GDP recovered at a sluggish 1.4 percent pace in the second quarter before expanding by 5.3 percent in the third quarter. High frequency data suggest that this growth momentum continued in the fourth quarter of 2009 and the first two months of this year. Unemployment rates have declined and preliminary evidence suggests that labor market conditions are continuing to improve (Chart 3).

- The recovery in the second half of 2009 was especially strong in **Brazil** and **Mexico**, which together account for two-thirds of Latin America's output. In Brazil, domestic demand has recovered rapidly on the back of substantial macroeconomic policy stimulus, including a sharp increase in quasi-fiscal spending, and a surge in private investment. In Mexico, the initial stage of recovery has been driven primarily by improved performance in the manufacturing sector as a result of increased U.S. demand for the country's exports.

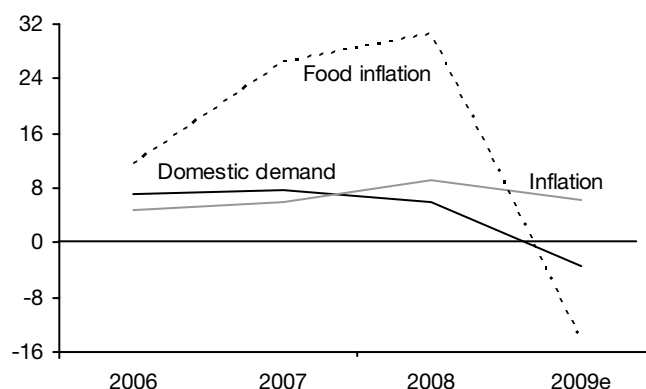
### INFLATION DECLINED IN 2009

- Declining domestic demand, a large negative output gap and softer international prices for foodstuffs and energy helped to bring inflation down across the region to a weighted average of 6.4 percent in 2009 from 9.3 percent in 2008 (Chart 4).
- The region's higher-than-expected 2009 inflation average is partially explained by outliers **Argentina** and **Venezuela**, where destabilizing macroeconomic policies pushed inflation to 17 percent (private estimates) and 25.1 percent, respectively (Chart 5). Despite the global slowdown, inflation readings in **Brazil** and **Mexico** were almost identical to their averages over 2005-2007. This is likely due to rigidity in labor and goods markets and stubborn inflation expectations.
- By contrast, other major countries in the region experienced a substantial decline in inflation (down to 2.0 percent in 2009 from 7.7 percent in 2008 in **Colombia**), near-zero inflation (0.2 percent in **Peru**, down from 6.7 percent the year before), or deflation (-1.2 percent in **Chile** compared to 7.1 percent in 2008).

**Chart 3**  
Unemployment Rate Q1 2009 - Q4 2009  
percent



**Chart 4**  
CPI, Food Prices and Domestic Demand  
percent change oya



**Chart 5**  
Consumer Price Inflation 2005 - 2009  
percent change oya



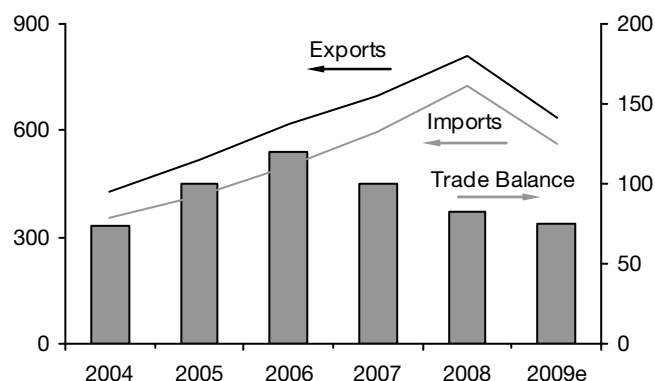
\*Private estimates 2008-2009.

## Recent Economic Developments

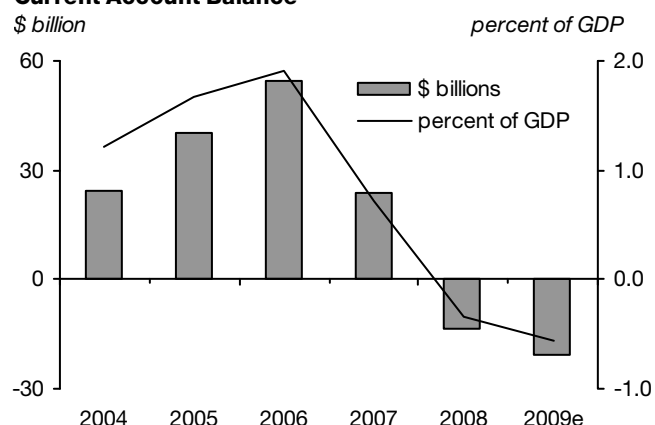
### EXTERNAL ACCOUNTS REMAIN HEALTHY

- Latin America's terms of trade deteriorated by 8.0 percent in 2009, reflecting a substantial decline early in the year in prices of the region's key commodity exports, including oil, metals and agricultural products. As a consequence of the regional and global recessions, import volume declined 18.9 percent in 2009 while export volume fell by 11.6 percent.
- In most countries, flexible exchange rates played a key role as shock absorbers. The weakening of domestic currencies, together with a contraction in domestic demand, resulted in a 22.6 percent decline in imports in 2009. This helped the region avoid a collapse of its merchandise trade surplus despite a large (22.0 percent) fall in exports (Chart 6).
- The trade surplus narrowed by only \$16 billion or 0.5 percent of GDP. This, together with a broadly unchanged deficit of \$96 billion in the services and income balance, resulted in only a moderate widening of the current account deficit from 0.3 percent of GDP in 2008 to 0.8 percent in 2009 (Chart 7).
- The trade-weighted, real effective exchange rate (REER) for the region as a whole depreciated 2.7 percent in 2009. This followed four consecutive years of REER appreciation which had resulted in a cumulative strengthening of 18.7 percent during 2004-2008. Exchange rate policies are discussed later in the report.
- Capital flows to the region recovered strongly in the second half of 2009 after reaching near "sudden stop" conditions in the latter part of 2008 and into early 2009. The recovery was sufficiently strong that it increased total capital inflows for the full year to \$158 billion, the second largest on record (Table 3).
- Foreign direct investment (FDI) declined by one-fifth in 2009, but was still sufficient to more than cover the region's current account deficit. With the important exception of Brazil, which ran a current account deficit of 1.6 percent of GDP, FDI flows to every country with a current account deficit were sufficient to cover these deficits.
- Banks and other private creditors reduced lending to the

**Chart 6**  
**Trade Balance**  
\$ billion



**Chart 7**  
**Current Account Balance**  
\$ billion



**Table 3**  
**External Financing**  
\$ billion\*

	2007	2008	2009e
Total inflows	233.7	144.6	157.5
Private inflows	227.4	130.6	135.7
Equity investment	132.7	89.2	113.4
Direct	88.2	92.1	66.9
Private creditors	94.7	41.4	22.2
Official inflows	6.3	14.0	21.8
IFIs	2.1	4.2	9.3
Bilateral credit	4.1	9.8	12.5
Resident investment abroad	-41.6	-33.7	-26.4
Resident lending/other	-88.2	-55.5	-77.8
Reserves ( - = increase)	-127.8	-42.2	-32.7

\*All figures net.

## Recent Economic Developments

region by \$20 billion in 2009, a 47 percent decline from 2008. The reduction in private sector lending was partially offset by inflows from the official sector. These increased by 50 percent in 2009 to over \$21 billion.

- Exceptional, one-off liquidity was also offered to the region in response to the global financial crisis. The IMF provided General and Special SDR allocations amounting to over \$17.6 billion and made Flexible Credit Lines available to Mexico and Colombia. Neither country has drawn on these lines. Similarly, the U.S. Federal Reserve extended \$30 billion emergency swap lines to Mexico and Brazil that remained open through 2009. Brazil did not activate the mechanism and in early 2010, Mexico repaid the \$3.2 billion it used. In a sign of the return to normalcy in financial markets, both lines were allowed to lapse in February 2010.
- Key external debt ratios in Latin America weakened as a consequence of contractions in exports and GDP as well as increased government borrowing. External debt rose by 11.5 percent in 2009 to \$930 billion or 126 percent of the region's exports, 30 percentage points higher than in 2008 (Table 4). The external debt-to-GDP ratio also rose in 2009, increasing three percentage points to 25.6 percent (Chart 8). While these ratios increased somewhat, they ended the year at levels that have proven to be manageable historically.
- A sharp contraction in domestic capital markets during the latter part of 2008 and the first half of 2009 prompted Latin American sovereigns to seek credit abroad, especially from multilateral institutions. This was done to ease the dollar funding shortage at home and to avoid crowding out private borrowers in the domestic market. Fifty percent of increased external indebtedness was the result of increased borrowing from official creditors.
- The region's international reserves increased for an eighth consecutive year to a record \$488 billion in 2009, equivalent to five months of imports (Chart 9). However, that increase was fully accounted for by **Brazil**.

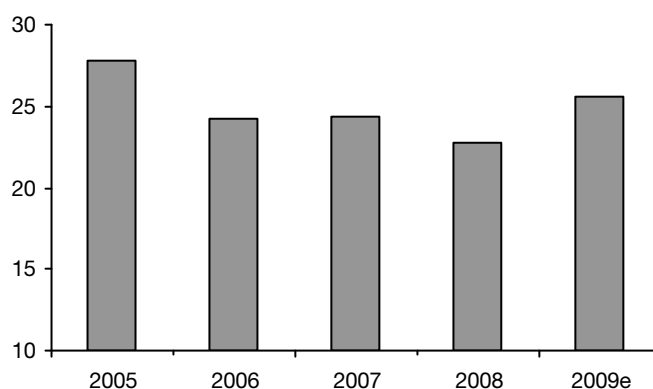
**Table 4**

**External Debt**  
\$ billion

	2007	2008	2009e
Total external debt	822.5	885.1	929.8
% of exports	101.0	94.5	125.9
IFIs	79.8	85.7	96.0
Bilateral creditors	74.3	84.1	95.9
Commercial banks	265.5	315.7	313.1
Other private creditors	402.8	399.6	424.8
Gross interest payments	49.1	49.2	47.0
% of exports	6.0	5.3	6.4
International reserves	393.5	435.7	488.5
Months of imports	5.7	5.3	7.3

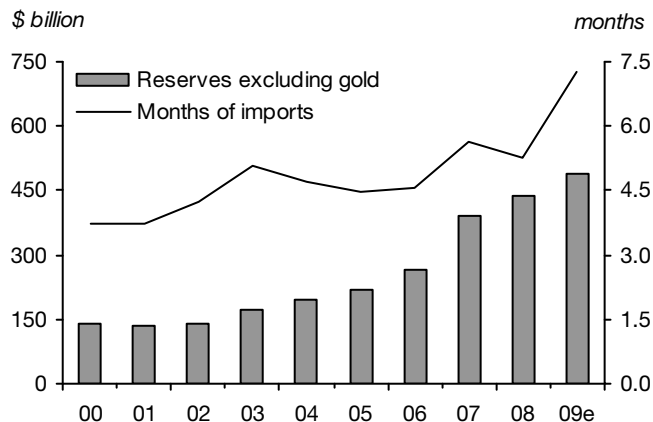
**Chart 8**

**External Debt**  
percent of GDP



**Chart 9**

**International Reserves**  
\$ billion



## Recent Economic Developments

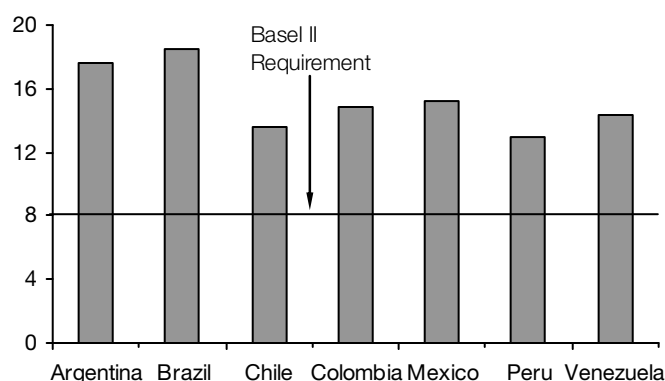
### BANKING SYSTEMS REMAINED STRONG

- The strength of the banking systems in major Latin countries provided an additional source of resilience to the global shock. They strengthened their banking supervisory systems and prudential regulatory frameworks in response to banking crises of the 1990s and early 2000s, well ahead of the global banking crisis of 2008-2009.
- According to the latest available data (mid-2009), the average capital adequacy ratio, defined as the ratio of capital to risk-weighted assets, was above 11.9 percent for every banking system in the region. This compares favorably to the 8 percent Basel II framework requirement (Chart 10).
- Nonperforming loans (NPLs) have increased only moderately across the region, with the average for the major Latin countries increasing to 3.2 percent in mid-2009 from 2.6 percent at end-2008. NPL ratios have remained relatively low by international standards and banks' provisions against potential losses associated with NPLs are high, ranging from 120 percent (Colombia) to 190 percent (Brazil).

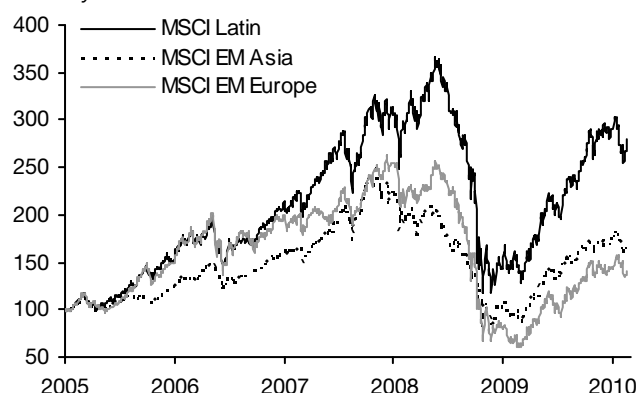
### FINANCIAL MARKETS RECOVERED STRONGLY

- The global financial crisis and deep recessions at home and in the U.S. resulted in a sell-off of Latin America's stocks and bonds beginning in mid-2008 and continuing into early 2009. Since then, stock markets have rebounded dramatically (Chart 11) and bond markets have also recovered. These asset market rebounds were driven by robust economic recovery in Latin America, increased appetite for risk and portfolio reprofiling by international investors in favor of emerging market assets.
- **Argentine** stocks, which had not participated in the rally of 2007 and lost half of their value in 2008, led the region with a 115 percent gain in 2009. What was seen by the market as improved prospects for the normalization of relations with international investors played a key role. With the exception of **Venezuela**, all other stock markets in the region also experienced impressive gains in 2009, ranging from 43.5 percent in **Mexico** to 82.7 percent in **Brazil** and 89.8 percent in **Peru** (Table 5).

**Chart 10**  
Bank Capital to Risk-Weighted Assets  
percent



**Chart 11**  
Emerging Market Stock Indices  
January 2005 = 100



**Table 5**  
Stock Markets  
percent change oya

	2007	2008	2009	2010 <sup>1</sup>
Argentina	2.9	-49.8	115.0	0.0
Brazil	43.7	-41.2	82.7	-1.9
Chile	13.8	-19.6	46.9	7.5
Colombia	-4.2	-29.3	53.5	-0.5
Mexico	11.7	-24.2	43.5	-0.7
Peru	36.4	-59.5	89.8	2.3
Venezuela	14.3	-17.3	14.6	-47.2

<sup>1</sup>Year to March 1.

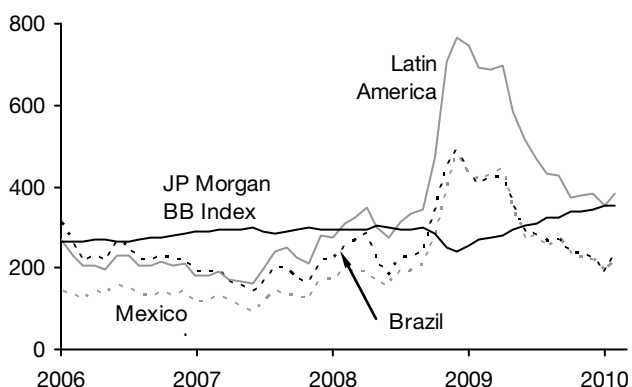
## Recent Economic Developments

- Latin America's bond spreads over U.S. Treasuries rose sharply in mid-to-late 2008 to well above noninvestment (BB) grade corporate credits. Part of this was due to a risk reassessment of poor credit countries **Argentina, Venezuela and Ecuador**. However, the spreads for investment grade Latin American sovereign debt (**Mexico and Brazil**) also rose to well above the BB credit spread in mid-2008 and stayed there until mid-2009.
- Since end-2008, sovereign bond and CDS spreads have declined substantially across the region (Table 6). Those for **Brazil and Mexico** have fallen well below BB corporates. In recent months, the Latin America spread has narrowed to levels that are in line with BB corporate credit spreads (Chart 12).
- Improved prospects for the economies of the region have spurred sizable private external capital flows into Latin American sovereign bonds. This has contributed to a substantial rise in risk-adjusted returns on Latin fixed income instruments (Chart 13).

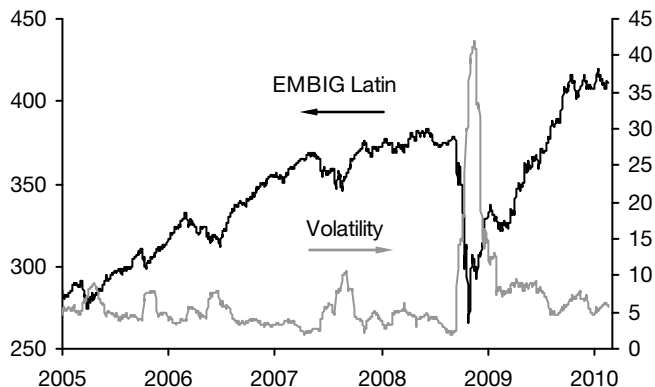
**Table 6**  
**Bond and CDS Spreads**  
*basis points*

	EMBIG Spreads			CDS Spreads		
	End-07	End-08	End-09	End-07	End-08	End-09
Latin America	275	746	355	195	1238	373
Argentina	410	1704	660	462	4041	914
Brazil	220	429	189	103	301	123
Chile	151	343	95	32	203	68
Colombia	195	498	198	130	309	143
Mexico	172	434	192	69	293	134
Peru	178	509	165	116	304	124
Venezuela	523	1864	1041	452	3218	1104

**Chart 12**  
**BB Corporate and Latin Sovereign Bond Spreads**  
*basis points over U.S. Treasuries*



**Chart 13**  
**Fixed Income Returns and Volatility**  
*basis points*



## Economic Policies

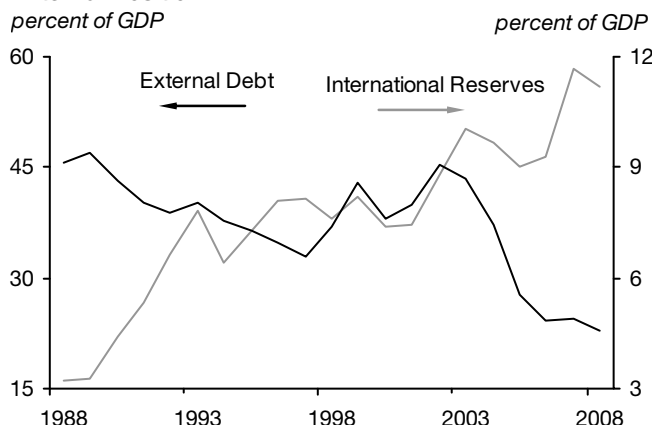
### ECONOMIC POLICY

- Stronger external and fiscal positions going into the recession made it possible for most Latin American countries to implement countercyclical policies in response to the global downturn without destabilizing their economies (Chart 14). Expansionary monetary, fiscal, and quasi-fiscal policies mitigated the output decline and set the stage for robust recoveries. Key factors contributing to the strong macroeconomic framework have been flexible foreign exchange regimes, high levels of international reserves, and improved public sector solvency ratios.

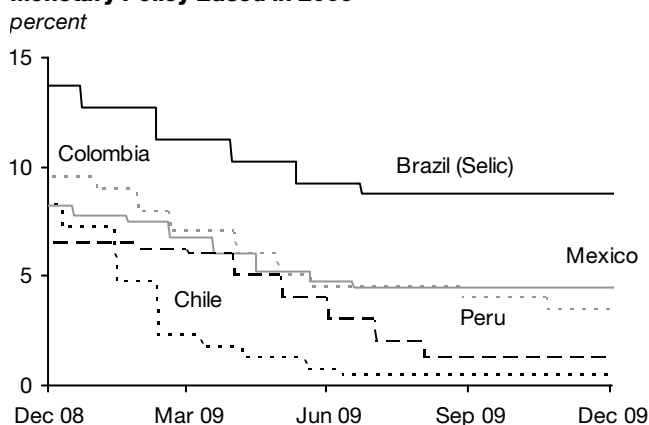
### MONETARY POLICY

- In 2009, monetary policy was directed at providing abundant liquidity to support economic activity. Policy rate cuts were complemented with reduction of bank reserve requirements (Chart 15). The lagged impact of monetary stimulus will boost private demand and growth throughout much of 2010. As the recovery is gaining momentum, inflation pressures are resurfacing across the region and setting the stage for a subsequent monetary tightening cycle.
- In **Brazil**, where the Selic policy rate was cut 500 bps during 2009 (Chart 16), exiting from conditions of exceptional liquidity has begun with an increase of reserve requirements on bank deposits. Effective March 9, 2010, marginal reserve requirements on time and demand deposits were raised to 8 percent, up from 5 and 4 percent, respectively. Effective April 9, the reserve requirement on time deposits will increase 1.5 percentage points to 15 percent. Reserves are to be held in interest bearing deposits only. The central bank estimates that this policy action will reduce liquidity by R\$71 billion (2.6 percent of 2009 GDP), thereby reversing a significant portion of the R\$100 billion injected into the system at the height of the global crisis in late 2008.
- Higher reserve requirements slow the rapid pace of growth of both bank credit and domestic demand, but enhance the central bank's policy scope to quickly boost liquidity in the event of an unforeseen, potentially disruptive, market-driven tightening of credit conditions. This ability proved decisive limiting financial contagion and stabilizing markets during the 2008-2009 global turmoil.

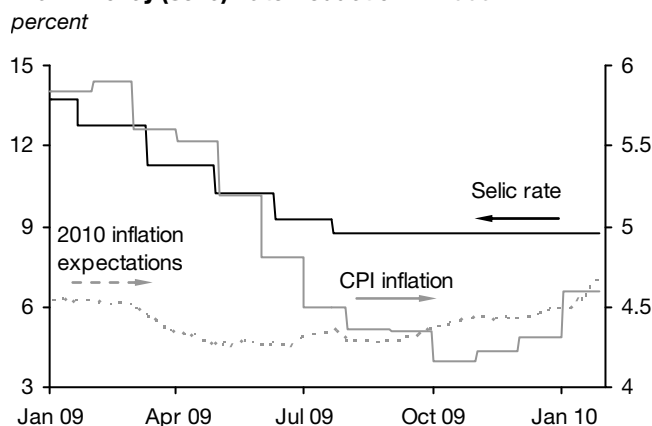
**Chart 14**  
**External Position**



**Chart 15**  
**Monetary Policy Eased in 2009**



**Chart 16**  
**Brazil: Policy (Selic) Rate Reduction in 2009**



## Economic Policies

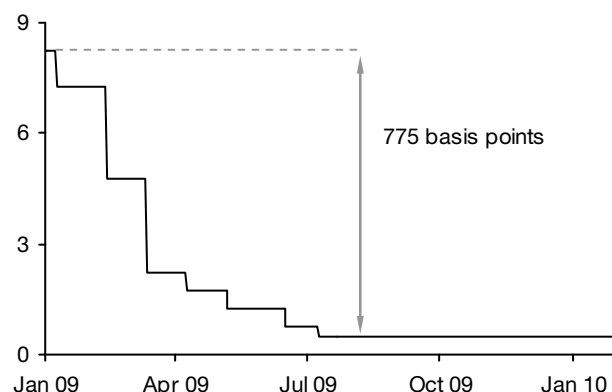
- In **Chile**, the policy rate was cut 775 bps to counter the global downturn, the most of any country in the region (Chart 17). Despite this, Chile has been relatively slow to recover largely due to its more open economy (exports are 40 percent of GDP) and the much greater impact of the global downturn on the domestic economy. The country's enhanced fiscal discipline would be expected to contribute to a more balanced exit from countercyclical policies. In normal circumstances this would reduce the magnitude of policy rate increases needed to achieve sustainable, non-inflationary growth. However, in the aftermath of the earthquake, macroeconomic variables, including inflation are likely to be severely impacted. Among other things, we expect monetary policy tightening to be delayed until later in the year in order to facilitate the recovery process. The rate hikes for 2010 are estimated not to exceed 100 bps, bringing the policy rate to 1.5 percent at the end of the year.

- With narrower policy scope given its substantial trade and financial links with the U.S., and relatively low level of international reserves compared to its investment grade peers, **Mexico** cut its policy rate only 375 bps in 2009 (Chart 18). With a still-large output gap, we expect Banxico to delay the beginning of the tightening cycle until the fourth quarter.

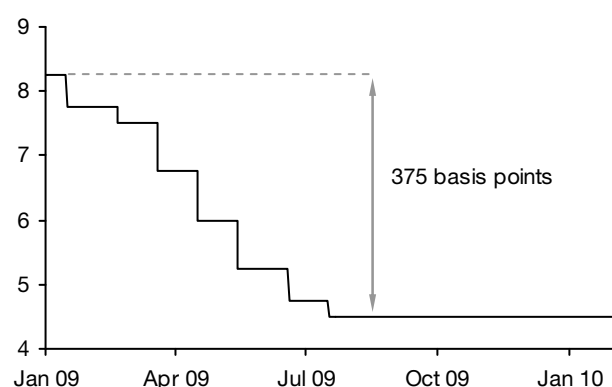
- In **Colombia**, despite a cumulative policy rate reduction of 600 bps in 2009, inflation expectations are well anchored to the 2.0-4.0 percent target range. This is likely to delay monetary tightening to the second half of 2010.

- In Argentina and Venezuela, monetary policy was expansionary in 2009 and is likely to continue to be so this year. In **Argentina**, loss of independence of the central bank is expected to result in an acceleration of inflation, while in **Venezuela**, the government will continue expanding money supply to boost economic activity ahead of key congressional elections in September (Chart 19).

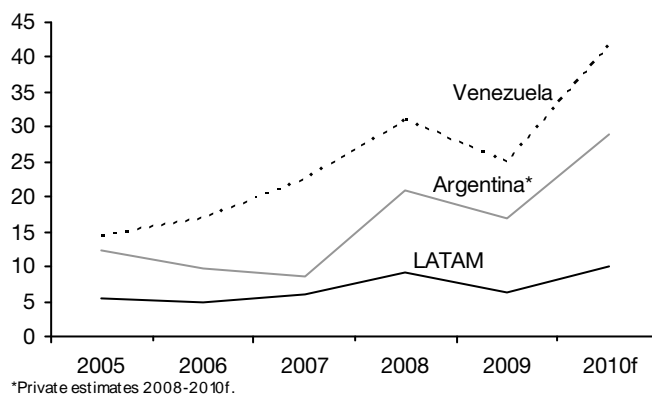
**Chart 17**  
**Chile: Policy Rate Reduction in 2009**  
percent



**Chart 18**  
**Mexico: Policy Rate Reduction in 2009**  
percent



**Chart 19**  
**Consumer Price Inflation**  
percent change y/y

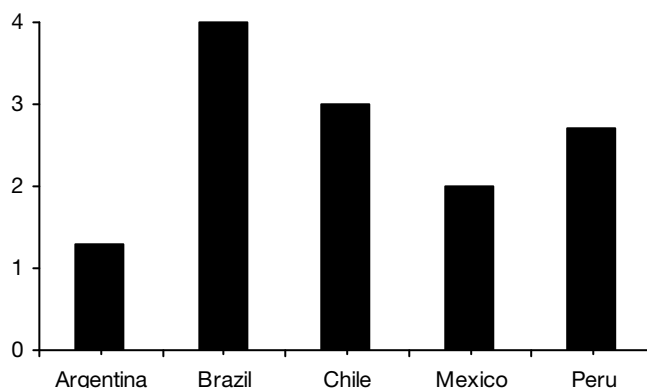


## Economic Policies

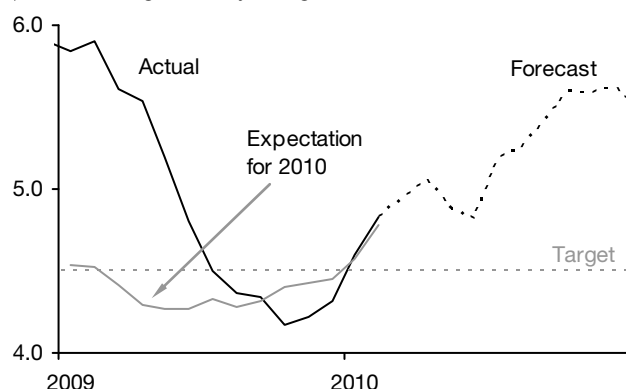
### FISCAL POLICY

- In **Brazil**, fiscal and quasi-fiscal stimulus totaled 4 percent of GDP as increased government spending and tax reductions were complemented by lending at below-market rates by state-owned banks (Chart 20). Quasi-fiscal stimulus by itself amounted to about 3 percent of GDP, twice that in Mexico, and was used to offset slow credit growth in the private sector. Politics are delaying the timely unwinding of fiscal and quasi-fiscal stimulus and that stimulus is beginning to overheat the economy and increase inflationary pressure. Inflation expectations for 2010 are rapidly approaching 5 percent, above the 4.5 percent inflation target (Chart 21). Despite the strong economic recovery under way, the government has continued injecting stimulus. The Treasury is to fund a further capital infusion to BNDES equivalent to R\$80 billion (2.4 percent of GDP) this year, making possible continued rapid credit growth by the bank.
- With an institutionally well-anchored countercyclical fiscal policy, **Chile** was able to support growth effectively while preserving the underlying strength of its public finances. The countercyclical fiscal stance (tax breaks, transfers to low-income households and employment subsidies) shifted the public sector balance to a deficit of 4.5 percent of GDP in 2009 from a surplus of 5.3 percent in 2008. This resulted in a “structural” deficit of 0.9 percent of GDP, below the target of a zero “structural” budget balance. The target is linked to the long-term price of copper and potential GDP growth. Countercyclical policy was financed with resources from the Economic and Social Stabilization Fund (ESF). As a result, the ESF balance declined to \$11.3 billion (7.3 percent of GDP) in 2009, down from \$20.2 billion at the end of 2008 (11.9 percent of GDP) (Chart 22).
- Given the economy’s high exposure to the recession in the U.S., the size of the fiscal impulse in **Mexico** was too small to offset the shocks from abroad. Relatively low international reserves, insufficient fiscal room, and the balanced budget requirement prevented the government from implementing larger stimulus measures. Quasi-fiscal support provided by national development banks amounted to 1.5 percent of GDP, about half the size of Brazil’s quasi-fiscal stimulus.
- In **Argentina**, fiscal policy has remained expansionary.

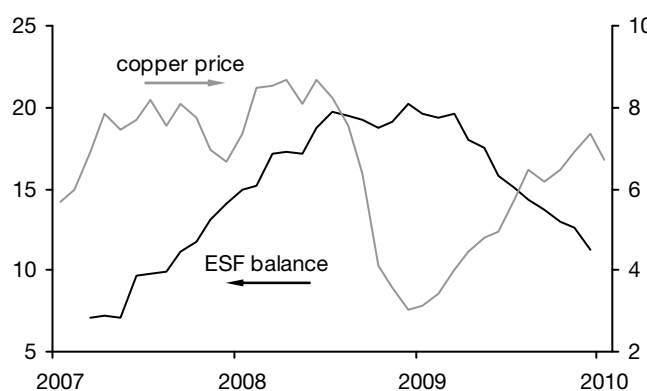
**Chart 20**  
**Fiscal and Quasi-fiscal Stimulus in 2009**  
*percent of GDP*



**Chart 21**  
**Brazil: CPI Inflation**  
*percent change over a year ago*



**Chart 22**  
**Chile: ESF Balance and Copper Price**  
*\$ billion*      *\$ '000 per metric ton*



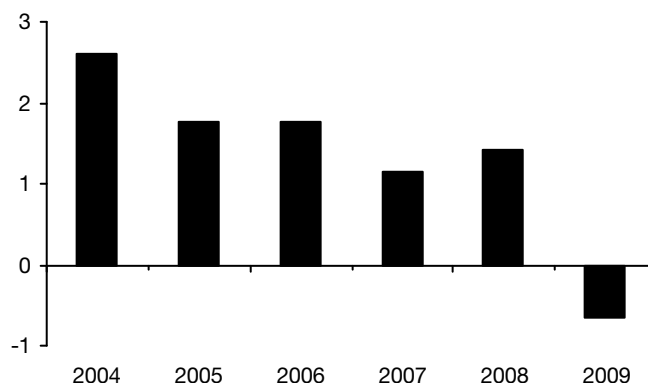
## Economic Policies

Although the size of the fiscal deficit, at 0.7 percent of GDP in 2009, is not large in comparison with that of other emerging market and mature economies, the fiscal situation is a source of concern because of the government's lack of access to global capital markets (Chart 23). This lack of access has prompted the government to rely on unorthodox sources of financing, including the nationalization of private pension funds, and borrowing from state-owned banks and the central bank. Most recently, conflict erupted over the government's attempt to seize \$6.3 billion of central bank international reserves. There is a risk that private banks may be forced to increase their holdings of government debt.

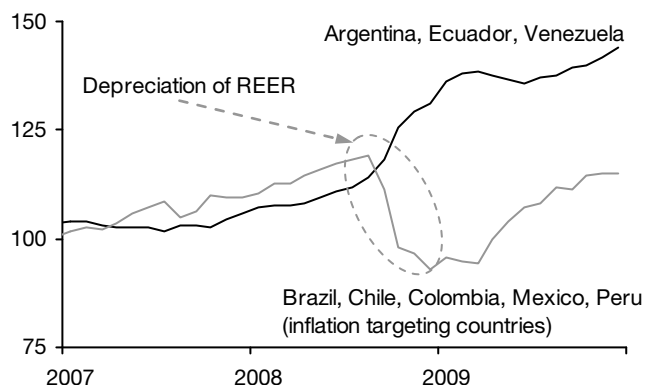
### EXCHANGE RATE POLICY

- For most major Latin American countries, flexible exchange rates have been an important element in the policy framework. Complemented with high levels of international reserves, floating exchange rates have proved a reliable buffer against adverse external shocks (Chart 24). While allowing different degrees of exchange rate flexibility, dependent on domestic economic and political constraints, floating exchange rate regimes have played an important role in underpinning the macroeconomic resilience of countries, including **Brazil, Chile, Colombia, Mexico and Peru**.
- The exception has been **Venezuela**, which for years has pursued a fixed exchange regime supported with strict foreign exchange controls. On January 8, 2010, President Hugo Chavez announced a devaluation of the *bolívar* against the dollar and replaced the single-rate fixed exchange system with a dual exchange regime (Chart 25). The two new officially fixed parities are:
  - A preferential exchange rate of 2.60 Bs.F/\$ for "essential" imports (food, medicine, public sector imports and others). This rate is equivalent to a 17.3 percent devaluation of the *bolívar* compared with its previous official value of 2.15 Bs.F/\$ set in 2005; and
  - An exchange rate of 4.3 Bs.F/\$ for other operations (most imports, exports and capital account transactions such as profits and dividends), a devaluation of 50 percent. This is the rate that the state oil company (PDVSA) will receive for oil exports.

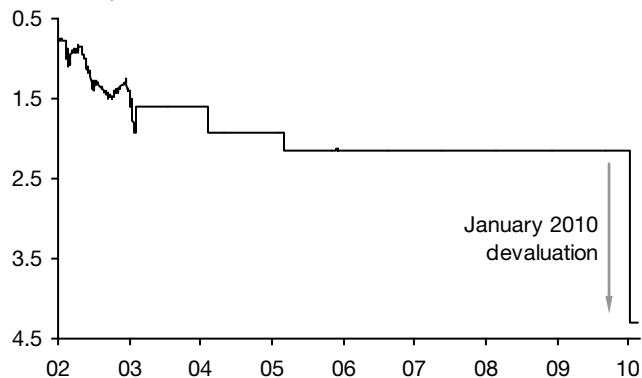
**Chart 23**  
**Argentina: Central Government Balance**  
percent of GDP



**Chart 24**  
**Real Effective Exchange Rates**  
index, 2006 = 100



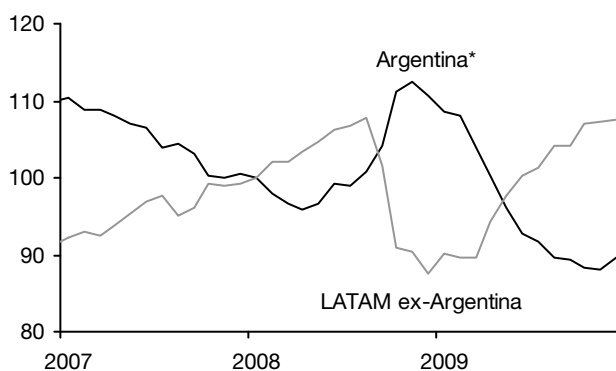
**Chart 25**  
**Venezuela: Exchange Rate**  
*bolívares per \$, inverted*



## Economic Policies

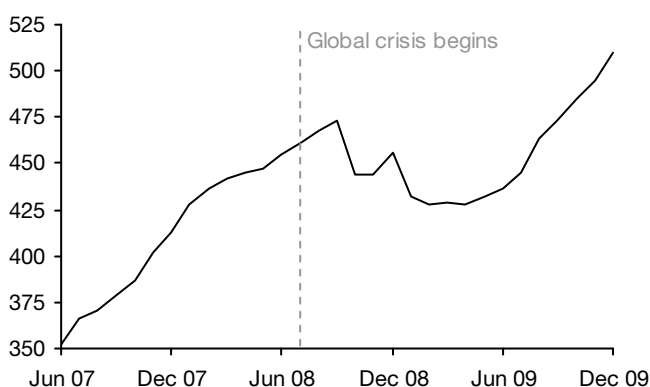
- In **Argentina**, the closely managed floating rate regime has remained focused on achieving a "stable yet competitive exchange rate" (Chart 26). This policy objective, however, is likely to become increasingly difficult to sustain. The risk of stepped-up flight to the dollar and drawdowns of bank deposits by residents will increasingly constrain the government's ability to aggressively devalue the *peso* to offset accelerating, double-digit inflation.
- Since the middle of last year, as international commodity prices continued to strengthen and it became clear that Latin America would be a front runner of the global recovery, the region experienced strong capital inflows and local currency appreciation. Concern among Latin American policymakers that capital inflows would result in excessive volatility in their foreign exchange markets and an undesirable appreciation of their currencies led a number of central banks in the region to resume their purchases of foreign exchange and accumulation of international reserves. As a result, the region's international reserves have now risen above pre-crisis levels (Chart 27).
- Brazil**, one of the countries most affected by capital inflows, experienced rapid and sustained local currency appreciation starting in March 2009. In October, the Brazilian government introduced a two percent tax known as the *Imposto sobre Operações Financeiras* (IOF) on fixed income and portfolio equity inflows. While Brazil has taxed debt inflows before, this was the first instance of portfolio equity inflows being included in the tax base. The tax does not differentiate short-term and long-term inflows, thereby discouraging both types. Although the tax's immediate impact was to discourage equity-related inflows, this is likely to weaken over time as the underlying driving force of capital inflows remains strong (Chart 28). Over the longer term, the tax will tend to constrain growth of the domestic capital market, distort resource allocation and put upward pressure on real interest rates. The orderly accommodation of capital inflows will ultimately require strengthening public finances, a pre-condition for reducing the real interest rate.

**Chart 26**  
**Real Effective Exchange Rates**  
*index, january 2008 = 100*

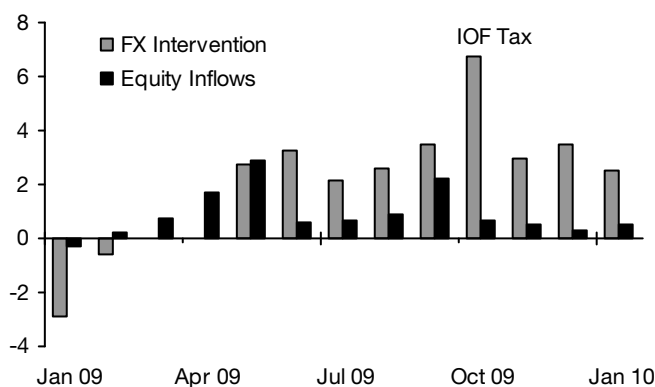


\*Based on official government statistics.

**Chart 27**  
**Total Reserves Latin America**  
*\$ billion, including gold*



**Chart 28**  
**Brazil: Equity inflows and Net FX Intervention**  
*\$ billion, monthly totals*



## Outlook

### OUTLOOK

- Strong fundamentals and countercyclical stimulus programs have set the basis for a robust economic recovery in 2010. The region is now on a steep recovery path. Bank lending is returning to normal, domestic demand is growing and labor markets are gaining momentum. We expect the recovery to continue to accelerate and project regional GDP to increase 4.8 percent this year, well above trend (Table 7).
- While the recovery is well under way, the pace and pattern varies widely among countries. In **Brazil** where the turnaround started early and has been especially strong, domestic demand is leading the recovery. Substantial policy stimulus contributed to strong growth in the second half of last year and that growth is continuing at a rapid pace. We expect GDP to increase by 6.5 and 5.5 percent (saar) in the first and second quarters, respectively (Table 8). We project domestic demand to grow by 7.5 percent this year and GDP to rise 5.8 percent (Table 9).
- **Mexico** is also on the road to recovery. The initial phase is being supported by robust export growth on the back of strengthening demand in the U.S. The three-month moving average of exports to the U.S. grew 6 percent in December over a year ago. The rebound in the second half of last year is set to continue as domestic demand strengthens, confidence improves, labor market conditions continue to recover and monetary policy remains accommodative. Following the 6.9 percent decline in domestic demand last year, we expect an increase of 5.0 percent this year. We project GDP to expand 4.4 percent.
- Favorable weather conditions, record grain harvests and expansionary macroeconomic policies are set to power a growth of the **Argentine** economy this year. We project output to increase by 4.4 percent based largely on substantial fiscal and monetary stimulus and on normalization of weather conditions. While official data suggest that GDP rose last year, we estimate it to have fallen 2.6 percent as a result of the global slowdown, commodity price declines and a severe drought that caused grain production to decline 30 percent.
- In **Chile**, the massive earthquake experienced in the south-

**Table 7**  
**Regional Outlook**  
*percent*

	2008	2009e	2010f	2011f
	<i>(percent change)</i>			
Real GDP	4.0	-2.3	4.8	3.7
Domestic demand	5.9	-3.5	5.7	4.1
Consumer prices	9.3	6.4	10.0	7.7
Terms of trade	7.3	-8.1	5.5	3.9
	<i>(percent of GDP)</i>			
Current account balance	-0.3	-0.8	-1.6	-1.4
	<i>(percent of exports)</i>			
Total external debt	94.5	125.9	117.8	111.9
Gross interest payments due	5.3	6.4	5.9	5.5

**Table 8**  
**Quarterly Real GDP Growth**  
*percent change over previous period, saar*

	2009		2010f			
	Q3	Q4e	Q1	Q2	Q3	Q4
Latin America	5.3	5.6	5.2	3.6	4.9	3.6
Argentina	0.2	4.8	9.8	4.2	3.2	1.8
Brazil	5.1	7.5	6.5	5.5	5.5	5.0
Chile	4.6	5.7	6.0	6.0	6.5	7.5
Colombia	0.9	-7.5	8.6	8.2	7.2	7.0
Mexico	12.2	8.4	4.2	1.8	1.2	0.4
Peru	9.7	15.0	4.5	4.0	4.0	4.5
Venezuela	-8.5	-5.0	-4.5	-5.0	14.0	4.0

**Table 9**  
**Brazil Outlook**  
*percent*

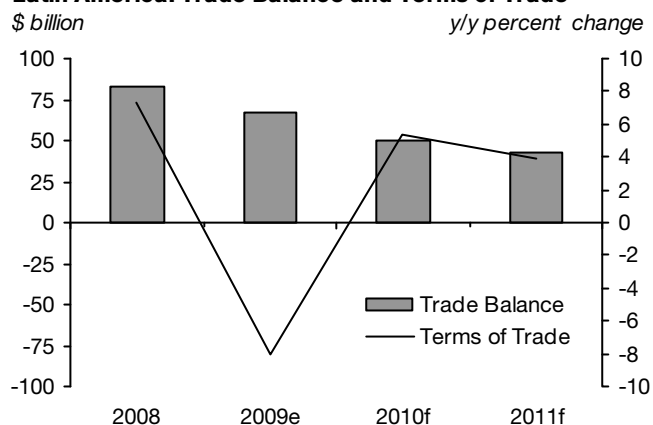
	2008	2009e	2010f	2011f
	<i>(percent change)</i>			
Real GDP	5.1	0.0	5.8	4.0
Domestic demand	7.8	-1.0	7.5	4.1
Consumer prices	5.9	4.3	5.5	4.8
Terms of trade	3.6	-4.9	1.9	-0.9
	<i>(percent of GDP)</i>			
Current account balance	-1.8	-1.6	-3.0	-2.5
	<i>(percent of exports)</i>			
Total external debt	127.4	170.6	165.8	158.0
Gross interest payments due	7.3	8.4	7.9	7.3

## Outlook

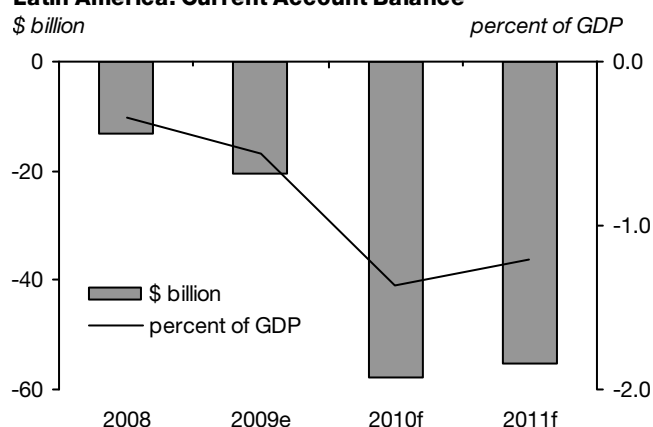
ern region of the country will take a toll on growth in the first half of 2010. However, we expect reconstruction efforts to boost activity in the second half and in 2011. We project real GDP growth of 5.5 percent this year, up from minus 1.8 percent in 2009, propelled by a surge in investment. The drivers of investment will be a substantial expansion of public investment spending to rebuild infrastructure, accommodative monetary policy and likely introduction of tax incentives for private investment.

- Because of increased earthquake-related public spending, the deficit of the central government is likely to remain relatively high by Chilean standards. We project it to be about 4 percent of GDP in 2010, broadly unchanged from 4.5 percent of GDP in 2009. Prior to the earthquake, we were expecting a fiscal surplus for this year. Monetary policy tightening is likely to be postponed to later in the year.
- While the region's terms of trade are expected to improve this year, the trade surplus is projected to decline to \$49.5 billion from \$66.6 billion in 2009 as import growth outpaces the recovery of exports (Chart 29). As a consequence, the current account deficit is projected to rise moderately to \$66.8 billion, the equivalent of 1.6 percent of GDP, a level that we expect to be easily financed (Chart 30).
- Net private capital inflows into Latin America are projected to increase from \$135.7 billion in 2009 to \$176.5 billion this year (Table 10). We expect multinational corporations to take advantage of the broad-based recovery to increase their investment in the region. From depressed levels last year, we project foreign direct investment to increase to a near-record \$85.0 billion this year from \$67 billion in 2009. We also expect an increase in net lending by banks as trade flows are restored.
- While Latin American issuance in international bond markets was interrupted recently as global risk aversion returned over concerns about debt sustainability in Greece, we expect the negative impact on the region to be relatively short-lived since most of the countries in Latin America emerged from the crisis with relatively strong fiscal positions. We project a rise in Latin American debt issuance to \$38.2 billion from \$24.1 billion last year as investors increasingly dif-

**Chart 29**  
**Latin America: Trade Balance and Terms of Trade**



**Chart 30**  
**Latin America: Current Account Balance**



**Table 10**  
**Latin America: External Financing**  
\$ billion\*

	2008	2009e	2010f	2011f
Total Inflows	144.6	157.5	191.3	188.2
Private inflows	130.6	135.7	176.5	170.9
Equity investment	89.2	113.4	122.4	128.0
Direct	92.1	66.9	85.0	98.1
Private creditors	41.4	22.2	54.2	42.9
Official inflows	14.0	21.8	14.8	17.3
IFIs	4.2	9.4	5.5	4.3
Bilateral credit	9.8	12.5	9.2	13.0
Resident investment abroad	-33.7	-26.4	-39.1	-43.6
Resident lending/other	-55.5	-77.8	-46.7	-68.9
Reserves (- = increase)	-42.2	-32.7	-47.4	-21.9

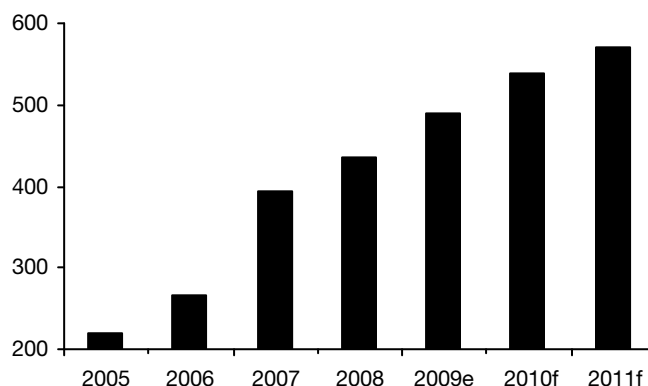
\*All figures net.

## Outlook

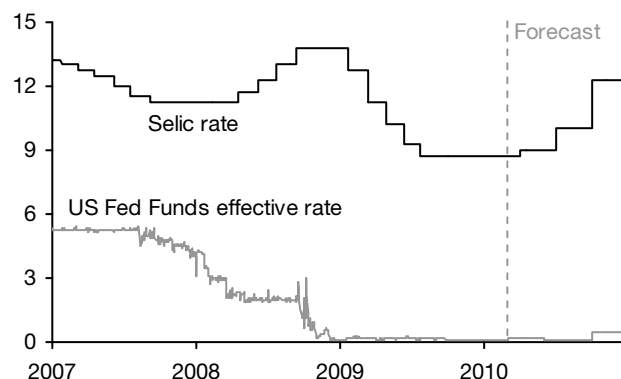
ferentiate among countries and are drawn to those with stronger fiscal and external positions and growth prospects.

- Official flows are projected to decline from the 2009 record high. Official emergency lending reached record levels last year as the Inter-American Development Bank, the World Bank, CAF and bilateral lenders stepped in to assist countries that lost access to international capital markets at the height of the global crisis.
- While official flows are set to decline this year, stronger private capital inflows will more than compensate for this for the moderate rise in the region's current account deficit. We project international reserves to increase by almost \$50 billion to a record \$539.5 billion (Chart 31).
- We expect Latin American currencies to appreciate as risk aversion fades and monetary tightening in Latin America resumes. **Brazil**, for example, is expected to raise its policy interest rate 350 bps to 12.25 percent by year-end. This compares to a projected increase of only 37.5 bps in the Federal Funds rate to 0.5 percent (Chart 32). We expect this pattern to be generalized throughout the region. As interest rate differentials widen relative to those in the mature economies and regional currencies appreciate, we expect portfolio flows to countries in the region to increase and for there to be a substantial decline in resident lending abroad.
- With the output gap closing in a number of countries later this year, we expect inflationary pressure to begin to build throughout much of the region (Chart 33). This is already beginning to take place in some countries where stimulus policies have been especially intense and recovery is already well advanced.
- Mexico** has also experienced increased headline inflation reflecting higher value-added taxes and administered prices. However, inflation has recently surprised on the downside and we expect there to be only a moderate rise in the price level this year, albeit above the official target range, given the large output gap that will not start to close until 2011.
- Several other countries will also experience moderate increases in consumer prices this year. In **Argentina** and

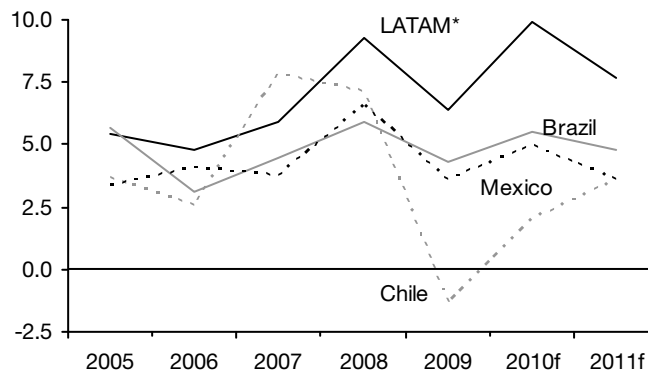
**Chart 31**  
**Latin America: International Reserves**  
\$ billion



**Chart 32**  
**Brazil: Policy (Selic) Rate Reduction in 2009**  
percent



**Chart 33**  
**Consumer Price Inflation**  
percent change y/y

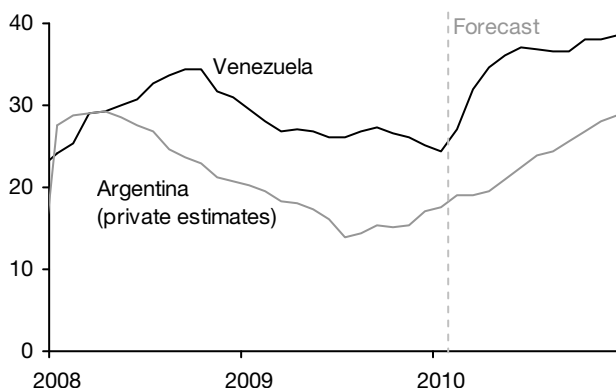


\*Private estimates for Argentina 2008-2011f.

**Venezuela**, where double-digit inflation is accelerating, there is little prospect that measures to stabilize prices will be introduced in the foreseeable future (Chart 34).

- The policy challenge ahead is the coordinated unwinding of these extraordinary stimulus measures. The optimal timing of exit strategies in each country will depend on the stage of the recovery cycle in that country and the nature and amount of stimulus deployed. A timely withdrawal of monetary and fiscal stimuli is essential to repair public balance sheets, prevent the resurgence of inflation, preserve hard-won macroeconomic stability, and enhance policy credibility. Upcoming elections in some key countries, however, appear likely to stand in the way of orderly and well-balanced exit strategies (Table 11).
- Policy interest rates are currently well below their neutral level throughout the region. In the five countries that have inflation-targeting regimes, **Brazil, Chile, Colombia, Mexico** and **Peru**, we expect policy rates to rise between 100-350 bps this year, starting with **Brazil** in April (Chart 35). The timing and intensity of tightening will be data determined depending on the pace of recovery, the degree and speed with which inflation accelerates and changes in inflation expectations.
- In the absence of a fiscal adjustment, we expect there to be a more rapid erosion of the output gap that will prompt central banks to tighten monetary policy sooner and more forcefully in order to keep inflation expectations well anchored to the inflation target. Such a policy mix—expansionary fiscal policy and tight money—will push real interest rates up more quickly and strengthen domestic currencies more than would otherwise occur, thereby reducing trend growth.
- The outlook for 2011 is for a less supportive external environment for Latin American countries as global growth slows after mature economies withdraw fiscal stimulus and raise interest rates. We project growth of regional output to decelerate to 3.7 percent as fiscal tightening and the lagged impact of tighter monetary policy reduces domestic demand (Chart 36, next page).

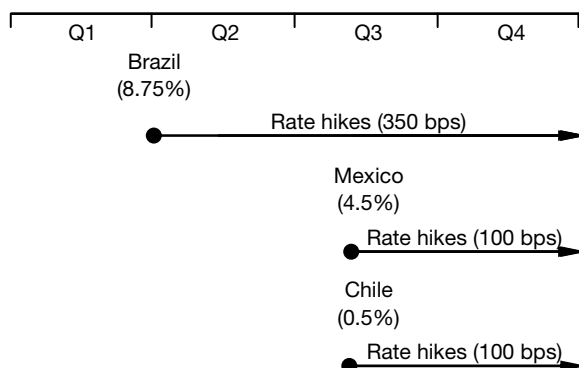
**Chart 34**  
**Consumer Price Inflation**  
*percent change oya*



**Table 11**  
**2010 Elections**

Country	Date	Type
Chile	Jan 2010	Presidential
Colombia	May 2010	Presidential
Venezuela	Sept 2010	Parliamentary
Brazil	Oct 2010	Presidential (1st Round)
Peru	Oct 2010 Apr 2011	Regional and Municipal Presidential and Parliamentary

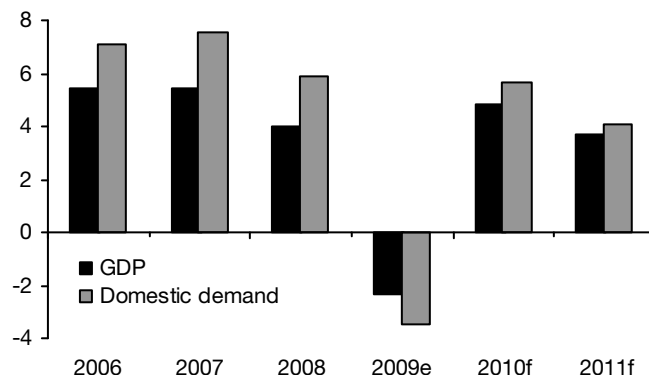
**Chart 35**  
**Tightening Cycle in 2010**  
*basis point increases*



## Outlook

- To prevent trend growth from declining, Latin American countries will need to strengthen their efforts to carry out productivity-enhancing reforms. Most countries in the region have made little progress restructuring and modernizing their energy sector. Some are experiencing power blackouts; many are losing energy self-sufficiency. Several are adopting policies that will accelerate the decline of oil production and slow development of new oil fields. Countries will have to modify their energy policies if they are to attract the capital and technology required to reverse this trend and accelerate growth.
- Other policy changes would further enhance the prospects for sustained and stronger economic expansion. Structural reform of public finances is still needed in a number of countries. For some, new sources of revenue are needed to widen their tax base and reduce the overdependence of fiscal revenue on a single export commodity, which would help these countries reduce their vulnerability to external price shocks. For many, reducing the fiscal burden of their public pension systems is long overdue. Institutional reforms aimed at strengthening the protection of property rights, legislation needed to increase labor market flexibility and establishing independent regulatory frameworks designed to increase competition and reduce costs will help attract additional investment and accelerate growth.

**Chart 36**  
**Real GDP and Domestic Demand**  
*percent change, y/y*



## Outlook

### Latin America

(millions of dollars, unless otherwise indicated)	2004	2005	2006	2007	2008	2009f	2010f	2011f
<b>Domestic economy and external trade</b>								
Real GDP % change	5.9	4.5	5.4	5.4	4.0	-2.3	4.8	3.7
Domestic demand % change	6.7	5.6	7.1	7.6	5.9	-3.5	5.7	4.1
Change in net foreign balance % GDP	-0.5	-1.0	-1.7	-2.4	-2.1	1.6	-1.0	-0.5
GDP deflator % change	9.8	7.3	7.4	6.1	8.7	6.4	8.1	6.6
Consumer prices % change end-period	6.6	5.5	4.8	5.9	8.2	5.6	8.3	6.7
Real deposit rate	1.8	3.3	3.5	2.6	1.3	0.4	...	...
Real effective exchange rate (2000=100)	88.2	94.4	97.5	100.9	104.7	101.9	110.3	114.4
Terms of trade % change	2.3	5.5	9.5	3.2	7.3	-8.1	5.5	3.9
Goods exports volume % change	13.7	7.7	4.0	3.0	-1.4	-11.6	5.1	4.5
Goods exports unit value % change	9.3	12.4	15.1	9.4	18.2	-11.6	11.9	9.4
Goods imports volume % change	15.5	11.0	13.4	13.2	10.5	-18.9	14.1	9.0
Goods imports unit value % change	6.8	6.6	5.1	5.9	10.2	-3.9	6.1	5.3
<b>Current account balance</b>								
Trade balance	73,658	100,117	120,455	99,502	82,687	66,599	49,535	42,306
Merchandise exports	428,104	519,108	619,818	697,446	809,464	628,895	727,274	820,001
Merchandise imports	-354,446	-418,991	-499,363	-597,944	-726,777	-562,296	-677,739	-777,695
Balance on services, income & transfers	-49,457	-59,635	-65,820	-75,458	-95,956	-95,918	-116,326	-107,692
Interest payments	-44,714	-44,770	-46,245	-49,148	-49,189	-46,965	-49,753	-51,501
Private transfers, net	25,480	30,375	35,714	38,351	39,784	36,440	38,133	41,167
Official transfers, net	3,416	4,642	6,606	6,157	3,894	2,925	3,252	3,405
Current account balance	24,201	40,483	54,635	24,045	-13,270	-29,319	-66,791	-65,386
(% GDP)	1.2	1.7	1.9	0.7	-0.3	-0.8	-1.6	-1.4
<b>External financing</b>								
Private flows, net	63,816	89,801	96,295	227,891	131,574	135,658	176,547	170,854
Private flows, net (old measure)	40,022	56,687	48,416	186,311	97,912	109,235	137,445	127,235
Equity investment, net, net	46,171	49,146	23,252	91,087	55,580	87,011	83,261	84,333
Direct equity investment, net, net	47,882	48,360	26,599	64,935	68,053	53,046	65,219	74,207
Outward, net	-13,467	-17,159	-35,033	-23,270	-24,090	-13,900	-19,750	-23,865
Portfolio equity investment, net, net	-1,711	785	-3,347	26,153	-12,473	33,964	18,042	10,126
Inward, net	8,616	16,740	9,498	44,462	-2,901	46,487	37,394	29,881
Outward, net	-10,326	-15,955	-12,845	-18,309	-9,572	-12,523	-19,352	-19,755
Commercial banks, net	-8,643	20,275	25,407	54,110	8,616	-1,925	16,030	19,716
Other private creditors, net	2,493	-12,734	-242	41,114	33,716	24,149	38,154	23,186
Official flows, net	-4,630	-28,708	-17,840	6,275	13,988	21,843	14,769	17,344
International financial institutions, net	-5,988	-28,916	-18,272	2,137	4,183	9,375	5,520	4,346
Official bilateral creditors, net	1,358	208	431	4,138	9,804	12,469	9,249	12,998
Resident lending abroad, net	-26,411	-44,641	-33,259	-69,870	-56,885	-63,719	-38,060	-47,754
Errors and omissions, net	-12,967	2,452	-5,820	-18,861	410	389	0	-2
Monetary gold (- = increase)	-61	-63	-140	-113	39	40	28	29
Reserves excluding gold (- = increase)	-20,154	-26,210	-45,993	-127,787	-42,194	-38,469	-47,391	-31,465
<b>External debt and debt service</b>								
Total external debt	743,330	678,318	694,883	822,450	885,135	929,849	993,077	1,055,864
% Exports goods, services & income	151.4	114.3	97.6	101.0	94.5	125.9	117.8	111.9
International financial institutions	127,431	92,949	75,765	79,833	85,707	96,012	100,352	105,067
Official bilateral creditors	70,912	68,110	69,164	74,336	84,097	95,907	103,501	115,927
Commercial banks	188,674	205,174	232,296	265,517	315,693	313,132	327,447	346,594
Of which Interest Arrears	20	0	0	0	0	0	0	0
Other private creditors	356,314	312,085	317,659	402,763	399,637	424,797	461,778	488,276
Gross interest payments due	44,714	44,770	46,245	49,148	49,189	46,965	49,753	51,501
% Exports goods, services & income	9.1	7.5	6.5	6.0	5.3	6.4	5.9	5.5
Reserves excluding gold	193,542	219,753	265,745	393,532	435,726	488,487	539,459	571,031
Months of imports of goods, services & interest	4.7	4.5	4.6	5.7	5.3	7.3	6.8	6.5

f = IIF forecast, ... = not available, e = estimate